

ACCOUNTANTS' FINANCIAL STATEMENTS AND FACT-FINDING IN THE LAW OF CORPORATE REGULATION*

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THE accountant, traditionally portrayed as a modest clerk perched on a high stool before a ponderous ledger, has emerged in recent years as a man of professional stature with a unique importance in the business community. Three broad stages mark the accountant's evolution from scrivener to professional man. In the first stage, he appeared as the bookkeeper for a sole proprietor, recording such prosaic and incontrovertible facts as arrival and shipment of goods, receipts and disbursements of cash, and accounts receivable and payable. In the second stage, he was the servant of business management, digging out the vital statistics of the enterprise for its officers and directors and their commercial bankers. Today the accountant has reached a third stage in his development: he now deals with the financial statements of the large publicly-owned corporations which have assumed major importance in our economy.

The gigantic aggregations of capital which these corporations bring together have precipitated two problems of peculiar significance in the evolution of the accountant's work. First, this capital has been invested in land, buildings and heavy machinery, items enduring for many years — unlike the short-lived items of cash, receivables, and inventories with which the bookkeeper was once concerned. Such long-term assets require allocation of depreciation expense over their life expectancies and necessitate valuation at times when value may be far removed from cost. Second, these large aggregations of capital, collected from diverse classes of investors, present the problem of accounting for the contributions and of defining the respective rights of each class — a problem never faced by the bookkeeper of simpler business units. Thus, the accountant has been thrust into the role of arbiter: he must delineate the rights of the various groups interested in and affected by the corporate enterprise — common stockholders, preferred stockholders, bondholders or debentureholders, and, in the case of public utilities, consumers. Under state and federal security legislation, the accountant is, in effect, obligated to protect prospective investors against promoters, underwriters and existing investors, and to afford existing investors security against corporate insiders. These new burdens stem primarily from the fact that the application of many legal rules governing the inter-relationships between these

* Nothing herein should be construed as expressing the opinion of the Securities and Exchange Commission or of any member of its staff other than the writer.

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interests largely depends on classification of business facts in terms of accounting concepts.

Many such legal rules are found in the modern law of corporate distributions to security holders. Dividends, for example, may be paid only out of "net profits" or out of an "excess of assets over liabilities plus capital stock," both accounting concepts. Likewise, the classification of stock as par or no par, the use of a low stated value with a high paid-in surplus, the use of a high par value or a low par value combined with a large paid-in surplus—all these questions depend on legal or strategic considerations which arise out of the same accounting concepts.¹ Again, the payment of dividends on certain preferred stocks or the payment of interest on the corporate income bond is dependent on the accountant's determination of whether income has been earned. Similarly, the status of bonds as legal investments for savings banks and trust funds turns on whether the corporate income has afforded the necessary earnings coverages.² Finally, the "voluntary reorganization" frequently takes the form of a "quasi-reorganization," which, in effect, is nothing more than a manipulation of accounts. The extent to which such an accounting manipulation may legally occur, the extent to which it may have legal consequences, and the extent to which it must be accompanied by legal safeguards are some of the most rapidly developing problems of corporation law.³

Accounting concepts are no less significant when they appear as devices of control in the public regulation of business. Apparently, the Interstate Commerce Commission has made the right to issue securities under Section 20(a) of the Interstate Commerce Act dependent on rules of accounting.⁴ In order to protect investors, the Securities and Exchange Commission has promoted standardization and reform of accounting

1. See BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) bk. II, cc. II and III; SEC Accounting Release No. 9, Dec. 23, 1938; Healy, *The Next Step in Accounting* (1938) 13 ACCTG. REV. 1; Werntz, *Some Current Problems in Accounting* (1939) 14 ACCTG. REV. 117.

2. On the income bond, see Hansen, *Legal and Business Aspects of Income Bonds* (1937) 11 TEMP. L. Q. 330; Dewing, *The Position of Income Bonds as Illustrated by Those of the Central of Georgia Railroad* (1911) 25 Q. J. ECON. 396. For a similar problem with reference to stock, see *MacIntosh v. Flint & P. M. R. R.*, 34 Fed. 582 (C. C. E. D. Mich. 1888). On the earnings requirement for legal investments, see *Wabash Railway Income in 1930*, SEN. REP. No. 25, pt. 23, 76th Cong., 3d Sess. (1940).

3. See *Matter of Kinney*, 279 N. Y. 423, 18 N. E. (2d) 645 (1939); *Associated Gas & Elec. Corp.*, 6 S. E. C. 605 (1940); *New Mexico Gas Co.*, 6 S. E. C. 547 (1940); *The Philadelphia Co.*, 6 S. E. C. 752 (1940); SEC Accounting Releases Nos. 15 and 16, March 16, 1940; COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, *ACCOUNTING RESEARCH BULLETIN No. 3* (1939); PATON AND LITTLETON, *AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS* (1940) 112 *et seq.*; Note (1940) 49 YALE L. J. 1319; Werntz, *supra* note 1.

4. See LOCKLIN, *REGULATION OF SECURITY ISSUES BY THE INTERSTATE COMMERCE COMMISSION* (1925), particularly cc. IV, V and VII and pp. 85-87.

practice,⁵ not merely because accounting manipulation is characteristic of fraudulent stock-selling schemes,⁶ but also because accounting conventions underlie many of the business facts upon whose disclosure the federal system of investor protection is based. So complete is the permeation of accounting concepts into the business fabric that prescription of uniform systems of accounts is one of the most common regulatory devices in the public control of enterprise.

It will be the purpose of this Article to explore two questions which appear to be basic to the future cooperation of lawyers and accountants in corporation law generally and in the domain of public regulation in particular. The first is whether accounting principles which are used to interpret business facts have independent validity in themselves or are merely conventional techniques which should be adapted to the disclosure of legally operative facts. Prominent in this controversy is the question of whether financial statements should adhere to a cost basis, or should attempt to disclose value, a factor more important than cost in the solution of many legal problems. The second question to be explored is whether, assuming that the financial statements do show legally significant facts with respect to an enterprise, that enterprise and the persons with whom it deals, including public agencies, are bound by the facts thus disclosed or can successfully contend that the operative facts in issue differ materially from the facts disclosed by the accounts.

A. FINANCIAL STATEMENTS AND CONFLICTS BETWEEN LEGAL AND ACCOUNTING PRINCIPLES

The literature of legal-accounting problems is replete with discussion of the extent to which accountants need recognize legal rules in the preparation of financial statements. Reasoning purely *a priori*, the solution of this question seems to depend on the answer to the somewhat philosophical question of whether accounting is a science or an art. If it is a science in the sense that its principles have external validity, these

5. For cases under the Securities Act of 1933, see, *e.g.*, Metropolitan Personal Loan Corp., SEC Securities Act Release No. 2256, Aug. 23, 1940; The Republic Co., 6 S. E. C. 1062 (1940); *cf.* Potrero Sugar Co., 5 S. E. C. 982 (1939). For cases under the Securities Exchange Act of 1934, see, *e.g.*, A. Hollander & Son, Inc., SEC Securities Exchange Act Release No. 2777, Feb. 6, 1941; Alleghany Corp., 6 S. E. C. 960 (1940); Missouri Pac. R. R., 6 S. E. C. 268 (1939). See also Frank, *The Sin of Perfectionism* in EXPERIENCES WITH EXTENSIONS OF AUDITING PROCEDURE AND PAPERS ON OTHER ACCOUNTING SUBJECTS (1940); Sanders, *Accounting Aspects of the Securities Act* (1937) 4 LAW & CONTEMP. PROB. 191; Kaplan and Reaugh, *Accounting, Reports to Stockholders, and the SEC* (1939) 48 YALE L. J. 935; Henderson, *Practice under the Securities Act of 1933 and the Securities Exchange Act of 1934: From the Viewpoint of the Attorney* (1934) 58 J. OF ACCTY. 448; Werntz, *supra* note 1.

6. See SEC REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1940) pt. III, c. VI.

principles should not be distorted to meet the exigencies of man-made law. If, however, accounting is an art, a technique, it ought to be adapted to the structure of law which governs the enterprises for which the accountants account.

Leading accountants recognize that accounting is an art based on conventions — not immutable principles — which are justified by their utility proven in practice, not by their truth proven scientifically. Thus the Committee on Terminology, American Institute of Accountants, recently said:

“Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. . . . An accounting principle is not a principle in the sense that it admits of no variation, nor in the sense that it cannot conflict with other principles.”⁷

Most accountants acknowledge that accounting involves such substantial elements of judgment that two equally reputable and competent accountants may widely disagree as to the proper income statements and balance sheets of the same enterprise. Such matters of choice and discretion as the allocation of expenditures to capital account or to expense, the amortization or the writing off of debt discount and expense, the use of “last in-first out” or “last in-last out” as a basis for inventory valuation, and the selection of depreciation formulae, allow much latitude to corporate managements and their accountants in shaping financial statements.

Nonetheless, many accountants argue that this selective process need not be influenced by applicable legal considerations.⁸ Lawyers, conversely, are quite convinced that accountants must heed legal rules⁹ — and some

7. COMMITTEE ON ACCOUNTING RESEARCH, AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 7 (1940). See also Freeman, *Accounting Principles and the Law* (1934) 57 J. OF ACCTY. 467, 469; May, *The Influence of Accounting on the Development of an Economy* (1936) 61 J. OF ACCTY. 11, 13; May, *Uniformity in Accounting* (1938) 17 HARV. BUS. REV. 1. For an even more objective approach, see Hamilton, *Cost as a Standard for Price* (1937) 4 LAW & CONTEMP. PROB. 321.

8. Thornton, *Accounting Principles and Local Statutes* (1934) 57 J. OF ACCTY. 302; Thornton, *Law and Accounting* (1933) 56 J. OF ACCTY. 151; Paton, *Shortcomings of Present Day Financial Statements* (1934) 57 J. OF ACCTY. 108; Clader, *Principles Related to Earned Surplus*, in PAPERS ON ACCOUNTING PRINCIPLES AND PROCEDURE (1938) 36, 37. Compare PATON AND LITTLETON, *op. cit. supra* note 3, at 4, 106, with the doubts as to the position there taken expressed by a subcommittee of the American Institute of Accountants (1941) 71 J. OF ACCTY. 48, 57. See also the somewhat uncertain positions taken in Bowles, *Treasury Shares on the Balance Sheet* (1934) 58 J. OF ACCTY. 98; Wakefield, *When Lawyers and Accountants Disagree* (1934) 58 J. OF ACCTY. 117.

9. Hills, *Stated Capital and Treasury Shares* (1934) 57 J. OF ACCTY. 202, 472; Hills, *Accounting in Corporation Law* (1937) 12 WIS. L. REV. 494, 501; Hills, *Federal*

accountants side with the lawyers.¹⁰ This conflict can best be illustrated in terms of the example which is most discussed in the literature: the accounting treatment of the acquisition of a corporation's own shares. The most prevalent accounting treatment is, or at least was, to show the cost of the shares acquired as a deduction from the capital account, on the theory that reduction of capital is the practical and economic consequence of the purchase. But most modern writers now recognize that, without formal legal steps, the stated capital of the company is not reduced by the acquisition; the legal effect of the transaction is to reduce surplus, and any form of accounting which fails to present the legal realities is misleading, and may impose liability on the officers and directors¹¹ — and even the accountants.¹² Accordingly, accounting practice is moving toward a presentation of treasury stock as a deduction from surplus, or from the sum of stated capital and surplus.

Such an attitude apparently assumes that a primary responsibility of accounting is to state correctly the corporate legal obligations with respect to the capital and surplus accounts, and particularly, not to state earned surplus in an amount greater than is legally available for dividends.¹³ This aspect of accounting responsibility has not often been articulated because, ordinarily, this function of the accountant is automatically performed by a statement of income and surplus accounts according to established accounting conventions. But there is other evidence of its recognition in practice.¹⁴

Taxation vs. Corporation Law (1937) 12 WIS. L. REV. 280, 306; Katz, *Accounting Problems in Corporate Distributions* (1941) 89 U. OF PA. L. REV. 764; Lewis, *Some Legal and Accounting Questions Presented by the Michigan General Corporation Act* (1933) 8 ACCTG. REV. 145.

10. MARPLE, *CAPITAL SURPLUS AND CORPORATE NET WORTH* (1936) 45; Watson, *Principles Related to Treasury Stock*, in *PAPERS ON ACCOUNTING PRINCIPLES AND PROCEDURE* (1938) 31, 32; Freeman, *Accounting Principles and the Law* (1934) 57 J. OF ACCTY. 467; Herrick, *Law and Accounting* (1933) 56 J. OF ACCTY. 148; Marple, *Treasury Stock* (1934) 57 J. OF ACCTY. 257; Payne, *Net Worth under the Delaware and Michigan Corporation Laws* (1933) 8 ACCTG. REV. 1; Payne, *Accounting as Affected by the New Illinois and Pennsylvania Corporation Acts* (1933) 13 CERTIFIED PUBLIC ACCOUNTANT 669.

11. See Freeman, Herrick and Payne, *supra* note 10; Hills and Lewis, *supra* note 9; Marple, *Treasury Stock* (1934) 57 J. OF ACCTY. 257.

12. Lewis, *supra* note 9, at 151-59.

13. There may be some question whether accountants should be bound to disclose restrictions on dividends arising from contractual rather than statutory limitations on surplus. The text is stated in terms of a duty not to *overstate* surplus; accountants would recognize no obligation not to *understate* surplus available for dividends, *e.g.*, by failing to disclose a potential revaluation surplus.

14. See Foster, *The Application of Accounting Concepts to Legal Standards* (1938) 13 OHIO O. 62, 65-66. The duty of accountants to disclose the legal situation concerning dividends seems to have been an underlying postulate of many of the viewpoints on accounting disclosure expressed by the Securities and Exchange Commission and its staff; *e.g.*, their emphasis on balance sheet disclosure of the liquidating prefer-

While the legal situation should not, therefore, be ignored, accountants who insist that the law cannot justify departures from accounting principles in financial statements do have a plausible argument: the explication of economic facts in a financial statement is a function of the conventions on which that statement is based. Even though these conventions have not achieved complete uniformity, a certain degree of standardization already achieved has made for the ready analysis of financial statements. Consequently, if variations in law from state to state were permitted to destroy the existing uniformity of conventions, the present utility of financial statements would be gravely impaired. Any departure from standard conventions, whether or not justified under state law, even with the clearest explanation may be deceptive and render the financial statements useless as a basis for making comparisons with other enterprises.

Without attempting finally to decide whether accounting principles have such independent validity or utility that financial statements may be prepared in reliance upon them, legal concepts to the contrary notwithstanding, it seems probable that there is a compromise course which is preferable and practicable in almost every case. Where the law is such that financial statements prepared according to accounting principles do not reveal legally significant information, accounting techniques permit compromise by a presentation which discloses both the legal facts and the facts as they would be stated under currently recognized accounting principles. In practice, such techniques are evolving at many points. Thus, a short time after a quasi-reorganization has been legally accomplished, an enterprise may have an earned surplus legally available for dividends, although by ordinary accounting standards the results of operations over its life span may have left no surplus available. In such a case both the legal situation and the deviation from basic accounting standards may be revealed by dating the earned surplus account subsequent to the reorganization.¹⁵ Again, where preferred stock with a very small par value is issued at a price which creates a large capital surplus — the liquidating preference approximating the entire consideration received by the corporation — the accounting convention of carrying stock at par value in the balance sheet would not disclose a possible equitable restriction on the availability for dividends of the surplus which arises out of the disparity between the par value and the liquidating preference. Hence,

ence and issue price of preferred stock. These amounts may be so greatly in excess of par or stated value as to raise problems as to the legal availability of surplus for dividends. The Commission requires an opinion of counsel as to the availability of dividends. SEC Accounting Release No. 9, Dec. 23, 1938. See Werntz, Footnotes and Financial Statements (address May 3 and 9, 1939); Lewis, *supra* note 9.

15. See COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 3 (1939); SEC Accounting Release No. 15, March 16, 1940.

the better practice is to supplement the standard accounting presentation with a disclosure of the amount of the liquidating preference coupled with a legal opinion as to the availability of dividends.¹⁶ Again, in states where revaluation surplus is legally available for dividends, such a surplus can be displayed by a technique which reveals both the accountant's traditional cost-less-depreciation basis and the appraised value reflected on the corporation's books. Where dividends may be paid out of earnings for the current and next preceding years without regard to the existence of a deficit,¹⁷ surplus and deficit accounts may be presented so as to show clearly both the overall deficit and the earnings available for dividends for the current and preceding years. The solution in each case lies in the development of accounting techniques which disclose both the legal status of the capital and surplus accounts and their status according to accepted accounting principles. Both aspects of this disclosure are of fundamental importance to investors.¹⁸ Accountants who insist on presenting their own principles without regard to the legal considerations lose sight of the function of accounting as an art designed to tell people what they need to know.

B. FINANCIAL STATEMENTS BASED ON THE COST CONVENTION AND LEGAL PROBLEMS OF VALUATION

Extensive controversy has revolved around the contention that accountants are not revealing legally significant facts because they persist in adhering to their convention of carrying fixed assets on the balance sheet at cost. In view of the importance of the cost convention in the structure of the accountant's financial statements, this contention puts at issue the ultimate utility of accounting concepts in the solution of legal problems:

1. *Nature of Financial Statements Based on the Cost Convention.* It is commonly assumed that the accountant's balance sheet is an instantaneous photograph of the financial condition of a business at a given point of time, and that his income (or profit and loss) statement is a picture of the results of business operations between two such points of time. But such generalizations are descriptive, not analytic; they distinguish the accountant's statements from each other, but indicate nothing specific about their respective contents.

16. SEC Accounting Release No. 9, Dec. 23, 1938.

17. See DEL. REV. CODE (1935) c. 65, § 2066.

18. This solution may not be practicable in every instance. Some writers believe that dividend law has grown so complex that it is not possible to show a balance sheet figure for surplus which represents legally distributable surplus. SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 93; Henderson, *supra* note 5, at 448, 454; Littleton, *Dividends Presuppose Profits* (1934) 9 ACCTG. REV. 304; cf. PATON AND LITTLETON, *op. cit. supra* note 3, at 106.

For present purposes, the outstanding characteristic of the conventional balance sheet is the general use of cost as a basis for recording fixed assets, with appropriate deductions for depreciation. Broadly speaking, no appreciation or decline in asset value is recorded until realized by a sale. A reserve for depreciation is shown for depreciable items; the annual accretion to this reserve has its counterpart in an annual charge for depreciation expense in the income statement to record the *pro tanto* exhaustion of the utility of the assets during the year. The sum of the annual charges during the life of the asset will theoretically equal cost less salvage value. Thus, the successive income statements distribute the entire net cost as expense over the life of the asset, and the depreciation reserve is eventually sufficient to retire the asset from the balance sheet. It follows that the balance sheet at the end of any accounting period shows the portion of cost which has not yet been charged to operations, and does not purport to show value. Consequently, the characterization of a balance sheet as a "statement of condition" is misleading if that phrase is taken to mean a representation as to value.

Because the balance sheet based on the cost convention does not in fact show value, its advocates have been perennially criticized. Although the proponents of balance sheets based on value gained ground in the 'twenties,¹⁹ by the middle 'thirties their gains had been irretrievably lost, partly by reason of the gross errors and abuses which had occurred in write-ups and write-downs of value for income-puffing and security-selling purposes.²⁰ Consequently, the cost convention remains the fundamental concept of accounting.

The accountant is not necessarily wrong, however, in adhering to the cost principle, and he need not seek justification on the unconvincing grounds that cost is the best and only non-speculative evidence of value available,²¹ or that cost is "going concern value."²² A better justification is that value is not an accounting concept²³ and the accountant's job is

19. See table indicating the enormous number of write-ups and write-downs between 1925 and 1934 in 272 large industrial corporations studied, prepared from a study by Solomon Fabricant, in COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 5 (1940). See also Graham, *Valuation for Profit Determination* (1940) 15 ACCTG. REV. 145.

20. See PATON AND LITTLETON, *op cit. supra* note 3, 122 *et seq.*; SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 58-59, 63; Daniels, *Principles of Asset Valuation* (1934) 9 ACCTG. REV. 114; Paton, *Accounting Problems of the Depression* (1932) 7 ACCTG. REV. 258; May, *The Influence of Accounting on the Development of an Economy* (1936) 61 J. OF ACCTY. 11, 15-16; *A Tentative Statement of Accounting Principles Affecting Corporate Reports* (1936) 11 ACCTG. REV. 187.

21. Kelley, "Value" as an Accounting Concept (1935) 60 J. OF ACCTY. 50.

22. Daniels, *Principles of Asset Valuation* (1934) 9 ACCTG. REV. 114.

23. PATON AND LITTLETON, *op. cit. supra* note 3, at 10-12; Littleton, *Value and Price in Accounting* (1929) 4 ACCTG. REV. 147; May, *The Influence of Accounting on the Development of an Economy* (1936) 61 J. OF ACCTY. 11, 15; Peloubet, *Is Value an Accounting Concept?* (1935) 59 J. OF ACCTY. 201, 60 J. OF ACCTY. 53.

not one of valuation. His function is to account for the funds expended in the business. To him an asset used in production or distribution is merely a prepaid expense like insurance or rent; balance sheet assets (other than cash and its equivalents) are merely records of costs incurred and not yet charged to operations.²⁴

2. *The Utility in the Law of Balance Sheets Based on Cost.* But the question still remains as to whether the use of the cost convention rather than value in the balance sheet has not impaired the usefulness of the accountant's work for many legal purposes. Both law and accounting make use of certain important concepts—net worth, assets, capital, income, surplus, depreciation, and the like. Consequently, it is frequently assumed and asserted that the law follows accounting rules.²⁵ Yet the balance sheet often is not directly useful in the solution of legal problems, because the meaning of familiar terms in the balance sheet based on the cost convention is not the meaning which the law gives to them.²⁶

(a) *Dividends.* Weiner and Bonbright²⁷ have pointed out that legal rules concerning dividends have evolved in American statutes and cases in two major patterns. Under the "net profits rule," dividends may be paid only out of earned but undistributed profits. Under the "capital-impairment rule," dividends may be paid out of any excess of the value of assets over liabilities plus capital stock. Under the latter rule dividends may be paid only if capital will not thereby be impaired.²⁸ Thus, the

24. SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 58-59; Paton, *Economic Theory in Relation to Accounting Valuations* (1931) 6 ACCTG. REV. 89.

25. "The principles developed by accountants will be adopted by the law tomorrow." Fisher, *Legal Regulation of Accounting* (1933) 55 J. OF ACCTY. 9. See Berle, *Accounting and the Law* (1938) 65 J. OF ACCTY. 368; Berle and Fisher, *Elements of the Law of Business Accounting* (1932) 32 COL. L. REV. 573; Fisher, *The Integration of Legal and Accounting Concepts*, in PAPERS ON ACCOUNTING PRINCIPLES AND PROCEDURE (1938) 49; Hills, *Accounting in Corporation Law* (1937) 12 WIS. L. REV. 494.

26. An exception is the field of income taxation. Even though some accounting concepts are modified by the income tax laws, concepts based on the cost convention are extremely important in taxation: e.g., the concepts of realization of profit, cost as the starting point of "basis," and depreciation based on amortization of cost. See 2 BONBRIGHT, VALUATION OF PROPERTY (1937) c. XXVIII; Hills, *Federal Taxation vs. Corporation Law* (1937) 12 WIS. L. REV. 280.

27. Weiner, *Theory of Anglo-American Dividend Law: The English Cases* (1928) 28 COL. L. REV. 1046; *Theory of Anglo-American Dividend Law: American Statutes and Cases* (1929) 29 COL. L. REV. 461; Weiner and Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits* (1930) 30 COL. L. REV. 330, 954. Weiner, *The Amount Available for Dividends Where No-Par Shares Have Been Issued* (1929) 29 COL. L. REV. 906. These articles are summarized in 2 BONBRIGHT, VALUATION OF PROPERTY (1937) c. XXVII.

28. Recent writers have pointed out that the use of no par and low par value stock, and the accompanying development of paid-in surplus, have impaired the usefulness of

"net profits rule" places particular emphasis on events which the accountant records in his income statements — the net results of operations over the history of an enterprise. In contrast, the "capital-impairment rule" apparently emphasizes the value of an enterprise at a given point of time — the information supposed to be revealed by the accountant's balance sheet as traditionally understood. Applied literally, the "capital-impairment rule" would take account of unrealized appreciation; the "net profits rule" would not.

Although recognizing that the status of the law was uncertain, Weiner and Bonbright were of the opinion that the courts have not realized that their two verbalizations embody separate rules having different consequences. These writers contended that the courts have really assimilated these two rules into one, that of net profits.²⁹ This has been accomplished by adopting for dividend purposes the accountant's rule of "valuing" assets — a rule which refuses to value assets on any basis other than cost³⁰ — with the result that the surplus account contains only those realized earnings which are recognized by the accountant. To the extent that the courts in fact follow this standard, no matter how verbalized, the accountant's income statements, summarized in the earned surplus caption of the balance sheet, guide the lawyer in respect to the legality of dividend payments.

But, in a recent New York case,³¹ a statute framed in "capital-impairment" terms was held to require determination of value at the time of each dividend declaration rather than acceptance of the accountant's book figures. Other cases likewise suggest that value rather than the accountant's figures may be decisive in dividend litigation, particularly before judges unfamiliar with these mixed legal and accounting concepts.³²

the old tests. Suggestions are made for formulation of tests based on ratios of assets to liabilities. See Littleton, *Business Profits as a Legal Basis for Dividends* (1937) 16 HARV. BUS. REV. 51; Littleton, *A Substitute for Stated Capital* (1938) 17 HARV. BUS. REV. 75; Hills, *Model Corporation Act* (1935) 48 HARV. L. REV. 1334; cf. CAL. CIV. CODE (Deering, 1937) § 348(b); N. C. CODE ANN. (Michie, 1939) § 1179.

29. They cite *Bank of Morgan v. Reid*, 27 Ga. App. 123, 107 S. E. 555 (1921) and *American Steel & Wire Co. v. Eddy*, 130 Mich. 266, 89 N. W. 952 (1902) as examples of interchangeable use of the two rules.

30. See *So. Calif. Home Bldr's v. Young*, 45 Cal. App. 679, 188 Pac. 586 (1920); *Kingston v. Home L. Ins. Co. of America*, 11 Del. Ch. 258, 101 Atl. 898 (1917); *Sexton v. Percival Co.*, 189 Iowa 586, 177 N. W. 83 (1920); *Coleman v. Booth*, 268 Mo. 64, 186 S. W. 1021 (1916); *Wilson v. Barnett*, N. Y. L. J., Aug. 2, 1928, 1870 (Sup. Ct., 1st Dep't); *Hutchinson v. Curtiss*, 45 Misc. 484, 92 N. Y. Supp. 70 (1904); *Hill v. International Products Co.*, 129 Misc. 25, 220 N. Y. Supp. 711, 751 (1925), *aff'd without opinion*, 226 App. Div. 730, 233 N. Y. Supp. 784 (1929).

31. *Randall v. Bailey*, 23 N. Y. S. (2d) 173 (Sup. Ct., 1st Dep't 1940), (1940) 50 YALE L. J. 306.

32. *E.g.*, *Titus v. Piggly Wiggly Corp.*, 2 Tenn. App. 184 (1925), where it was held that although unrealized appreciation might not be used as a source of dividends, it

Under such decisions, the accountant's traditional balance sheet founded on the cost convention is of slight value in dividend law. And confusion of theories regarding the availability of dividends will persist unless lawyers and accountants are careful to recognize the differences in meaning which they respectively attribute to the same terms.

(b) *Value in Public Utility Regulation*. So long as *Smyth v. Ames*³³ is Scripture,³⁴ public utility rate regulation will purportedly be concerned with value, not with cost. Hence, financial statements founded on systems of accounts prescribed by regulatory bodies and based on cost, perforce, cannot control in such litigation. As a result, a public utility executive was able to say:

" . . . the most unfortunate feature of regulation in this country is that the book values of operating companies are totally unrelated to the legal values under which these companies operate, sell their electricity, and do their business. In other words, you have got a value on your books that has nothing to do with the income you can earn."³⁵

Cost is nonetheless one of the "elements" of value recognized in *Smyth v. Ames*, and state commissions tend to give it as much weight as they dare in rate base determinations.³⁶ But to the extent that the law is still based on value rather than cost, the accountant's financial statements will play a minor role in rate litigation.

The specific issue of the amount of depreciation, like the general problem of the rate base, is treated by the courts in terms of value rather than accounting language. For the accountant a reserve for depreciation, in harmony with his other book figures, shows the extent to which cost has been amortized by charges to earnings, not the extent to which value

might be used to absorb losses, thereby permitting dividends to be paid out of realized profit.

33. 169 U. S. 466 (1898).

34. Some persons believe that the changed composition of the Supreme Court and the following cases foreshadow the demise of *Smyth v. Ames*: *R. R. Comm. of California v. Pacific Gas and Elec. Co.*, 302 U. S. 388 (1937); *McCart v. Indianapolis Water Co.*, 302 U. S. 419 (1938); *Driscoll v. The Edison Light & Power Co.*, 307 U. S. 104, *rehearing denied*, 307 U. S. 650 (1939). Presumably the rule of *Smyth v. Ames* would be succeeded by the principle of returns on "prudent investment." See the dissent of Mr. Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Serv. Comm.*, 262 U. S. 276 (1923).

35. Floyd L. Carlisle, Chairman of Niagara Hudson Power Corp., quoted in testimony of Leland Olds in *Hearings before the Joint Committee on the Investigation of the Tennessee Valley Authority*, pt. 13, 75th Cong., 3d Sess. (1938) 5803.

36. Compare *R. R. Comm. of California v. Pacific Gas and Elec. Co.*, 302 U. S. 388 (1938) with *Los Angeles Gas Co. v. R. R. Comm. of California*, 289 U. S. 287 (1932). See *Northwestern Power Co.*, Fed. Power Comm. Opinion No. 56, Dec. 6, 1940, where the utility wanted to reaccount for cost on its books because of the increased importance of cost in rate regulation.

has diminished.³⁷ But it is obvious that a balance sheet in which the reserve for depreciation reflects amortization of cost will not be conclusive in matters involving depreciation in value.

It was to be expected, therefore, that in determining accrued depreciation for purposes of fixing the rate base the Supreme Court would reject formulae for amortizing cost³⁸ or the book accounts for depreciation reserve,³⁹ and would lean toward the "observational method", under which the appropriate depreciation reserve is determined by inspecting the property to compare its condition and value with that of a new plant.⁴⁰ Hence, so long as the rate base depends on value, the litigated cases will discuss depreciation in terms of value, not cost,⁴¹ and the accountant's balance sheet will be of little assistance.

(c) *Regulation of Security Issues under the Public Utility Holding Company Act.* In the light of the limited importance of the cost concept in the dividend and rate fixing situations, it might be expected that balance sheets would be given scant attention in determining the soundness of security issues, where safety lies in value, not in cost. But experience has proved the contrary to be true. Recent opinions of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 illustrate the persistence of value terminology in balance sheet analysis, with resulting semantic difficulties, even among persons who know that balance sheets record cost, not value. The Commission has consistently found it necessary to eliminate appraisal write-ups from property accounts, in order to reduce these accounts, and the balance sheet in general, to a cost basis.⁴² This policy reflects recognition of the principle that "the purpose of accounting is to account, not to present opinions of value."⁴³ Undoubtedly, the Commission realizes

37. See 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 185.

38. *Pacific Gas & Elec. Co. v. San Francisco*, 265 U. S. 403 (1924); *McCardle v. Indianapolis Water Co.*, 272 U. S. 400 (1926); cf. *United Railways and Elec. Co. v. West*, 280 U. S. 234 (1930). See Haun, *Inconsistencies in Public Utility Depreciation; Deduction of Depreciation for Rate Base Purposes* (1940) 38 MICH. L. REV. 479.

39. *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662 (1935). Compare *Board of Public Utility Comm'rs v. New York Tel. Co.*, 271 U. S. 23 (1926) with *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151 (1934).

40. The writer does not suggest that the "observational method," as ordinarily employed, is accurate even on a "value" theory. Observational methods will not disclose loss of service life, and hence, loss of value. See 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 204-05.

41. But see Mr. Justice Brandeis dissenting in *United Railways & Elec. Co. v. West*, 280 U. S. 234 (1930) to the effect that depreciation charges should be based on cost even when *Smyth v. Ames* controls the determination of value.

42. E.g., *Community Power & Light Co.*, 6 S. E. C. 182, 201 (1939); *Central Ill. Elec. and Gas Co.*, 5 S. E. C. 115 (1939); *Public Serv. Co. of Colorado*, 5 S. E. C. 788 (1939); *Middle West Corp.*, 7 S. E. C. 566 (1940); *Appalachian Elec. Power Co.*, SEC Holding Company Act Release No. 2430, Dec. 14, 1940.

43. Healy, *The Next Step in Accounting* (1938) 13 ACCTG. REV. 1, 6.

that a balance sheet stated at cost does not show the present values of properties. Nevertheless, in considering applications and declarations under Sections 6, 7 and 11 of the Act,⁴⁴ the Commission has used language which seems to assume that property accounts thus adjusted to cost indicate value for the purpose of determining the soundness of security issues.

A recent example is *Community Power and Light Company*,⁴⁵ a case involving not only the issuance of securities but the question of whether sufficient value existed to entitle common shareholders to participate in a reorganization. In its opinion, the Commission first pointed out that on the basis of *book* figures there was an equity for the common stock; then, by eliminating revaluation write-ups, it said that on the basis of *cost* figures, there was no equity for this stock. From this part of the Commission's opinion an uninformed reader might reasonably assume that book figures corrected to show cost were significant in determining the existence of an equity; otherwise, he might perceive no purpose in the elimination of the write-ups. But, in contrast to its own demonstration that there appeared to be no value by the test of cost, the Commission concluded that the existence of residual earnings for the common stock demonstrated that there was sufficient value. If, however, on the basis of earning power, there was an excess of value over cost, the existence of such an excess tended to support the company's revaluation — thus invalidating the Commission's assumption that these writeups had to be eliminated for valuation purposes.

*Newport Electric Corporation*⁴⁶ and *Public Service Company of Colorado*⁴⁷ similarly appear to have used book values as indicia of value, with the not surprising result that the conclusion based on book value was contradicted by more apposite evidence. The Commission said in the *Newport* case:

“ . . . the common stock equity in the net tangible property per books amounted to approximately \$575,000. . . . On these bases the proposed price of \$1,756,725 for the common stock appears high but in relation to the earnings record of the company . . . it appears not unreasonable.”⁴⁸

And in the *Public Service Company* case the Commission said:

“Declarant's record of earnings and dividends . . . indicates that the equity is more substantial than might appear by merely subtracting total inter-company appreciation from book figures and

44. For a general discussion of the Commission's regulatory functions under these sections, see Comment (1940) 49 YALE L. J. 492.

45. 6 S. E. C. 182, 201 (1939).

46. 4 S. E. C. 999 (1939).

47. 5 S. E. C. 788 (1939).

48. 4 S. E. C. 999, 1017 (1939).

comparing the difference with the face value of securities to be held by the public."⁴⁹

It is possible that the Commission, or some of its members, actually intend to hold that public utility property should be capitalized only to the amount of its book value after squeezing out write-ups. This would accord with a position taken by some state commissions.⁵⁰ It might be said in justification of such a position that if and when *Smyth v. Ames* is finally overruled, historical cost or some similar test may become the measure of the rate base. If so, rates will be fixed so as to earn a fair return on cost; consequently, cost will tend to approximate value.⁵¹ Finally, it may be argued that if any value above cost resulting from excess earning capacity is shown on the balance sheet, it is preferable that it be shown under some such caption as "goodwill", rather than concealed by purported revaluation of the physical assets themselves.

Up to the present time this question seems never to have been squarely presented to the Commission, partly because many of the revaluations recorded on utility company books in the 'twenties were arbitrary or based on intra-system transactions, and consequently are not now seriously defended as estimates of value. As yet the Commission has never refused to approve a utility issue because of insufficient asset coverage;⁵² so whether or not insufficient asset coverage on the basis of cost figures could be obviated by proof of higher enterprise value has not become an acute question. The present writer, however, hazards the guess that when the Securities and Exchange Commission is squarely presented with such a situation, it will not fail to recognize that a balance sheet based on cost is a record, not a statement of financial condition, and as such does not in itself show the value upon which the safety of a security issue depends. It is hoped that the Commission will soon abandon the language which treats cost as direct evidence of value, and state more precisely the real reason for its discussion of original cost in opinions dealing with security issuance—namely, that the influence of original cost on the rate base may affect value.

Once it is clearly recognized that book values do not purport to be representations of present values, much of the motive for recording

49. 5 S. E. C. 788, 820-21 (1939).

50. See *In re Pittsburgh Rys., C. C. H. Bankr. Serv.* ¶ 52821 (Penn. Pub. Serv. Comm., 1940); *Re California Water Service Co.*, P. U. R. 1928C 516 (Cal. Ry. Comm.); cf. Healy, *Financing the Utility Property Account*, an appendix to REPORT OF THE COMM. ON CORP. FIN. OF THE NAT'L ASS'N OF R. R. AND UTIL. COMM'RS (1940).

51. In fact, one member of the Commission has recognized the importance of cost in security regulation from this point of view. See the concurring opinion of former Chairman, now Circuit Judge, Frank in *Central Ill. Elec. and Gas Co.*, 5 S. E. C. 115, 134 (1939).

52. But cf. *Federal Water Service Corp.*, SEC Holding Company Act Release No. 2635, March 24, 1941.

appraisal values on corporate books will be eliminated. Thus, it will no longer be necessary to use appraisal write-ups "to balance security issues."⁵³ In one sense, the write-up has never been necessary to "balance" an issue sold for cash, for the issue is balanced by its proceeds, or the property in which the proceeds are invested. Of course, the "balancing" refers to past practice of writing up the property mortgaged as security for a bond issue to the point where it appeared to be adequate security, or to the practice of writing up the total assets to the point where there appeared to be an adequate margin of equity investment to safeguard an unsecured debt or preferred stock. But only so long as balance sheet figures are regarded as estimates of value is "balancing" necessary. When it is realized that they are based on cost, not value, the motive to distort the accounting records for valuation purposes will in large measure disappear.⁵⁴

3. *The Cost Convention in the Ascertainment of Enterprise Value.* What has been said thus far demonstrates that, inasmuch as the accountant's balance sheet is based on cost, it does not adequately answer legal questions concerned with value. But this does not mean that accountants are not justified in adhering to the cost convention. Paradoxically enough, financial statements are more useful in determining enterprise value when they reflect asset cost rather than when they reflect asset value.

It is apparent that a balance sheet in which the individual assets are stated on a cost basis rather than on a value basis affords no guide to enterprise value.⁵⁵ But this would be equally true of a balance sheet which purported to show the values of the assets separately. George O. May has well stated the reasoning:

"Turning now to the objection that if balance-sheets do not reflect values they ought to do so, because that is what the investor is interested in—a number of minor exceptions to the position thus asserted might be taken, but the answer to the objection is that . . . the figures would be of no real interest to the investor if they could be ascertained. . . .

". . . what the investor or speculator is interested in is the value of the business as a whole, and that is dependent mainly on

53. See the remarks of Commissioner Healy in *Central Ill. Elec. and Gas Co.*, 5 S. E. C. 115, 127-29 (1939), and in *Pub. Serv. Co. of Colorado*, 5 S. E. C. 788, 837, 850-51 (1939).

54. It is suggested in Fryxsell, *Should Appreciation be Brought into the Accounts?* (1930) 5 *ACCTG. REV.* 157, that the balance sheet be stated on a cost basis, with representations as to value in the prospectus. Other accountants assume that revaluations showing present value are necessary to support security issues. 2 *KESTER, ACCOUNTING THEORY AND PRACTICE* (3d rev. ed. 1933) 104.

55. ". . . but there is nothing in the statistical procedure of the accountant that implies either that these valuations are capital valuations or that the sum of them bears any simple relation to the capitalized value of a concern's earning power." Canning, *Some Divergences of Accounting Theory from Economic Theory* (1929) 4 *ACCTG. REV.* 1, 6.

what it will produce in the future and is not determinable by any purely accounting process. Not only so, but if the accountant were to assume the task of valuing the business as a whole, he would have met the assumed need, and it would be entirely supererogatory for him to attempt to allocate that value as between the different assets of the business."⁵⁶

May concludes that the greatest service which the accountant can render to a person desiring to know value is to shed light on earning capacity, and that this can best be done by ignoring fluctuations in the values of capital assets. This thesis has a sound economic basis: enterprise value is a summation of the present worth of future anticipated earnings.⁵⁷ As this fact gains recognition, the income statement becomes the account to which the investor attaches the greatest significance.⁵⁸ Emphasis in accounting, therefore, shifts from accuracy of balance sheet account totals to accuracy of income recording.

Accounting procedure will reflect income most accurately if it ignores fluctuations in the value of assets. A fixed asset, not for sale, but to be used in production, cannot produce income except as its use in production creates a flow of assets back to the enterprise. Therefore, no income results from appreciation in value of production goods, except in so far as that appreciation is reflected in the prices realized from finished goods sold.⁵⁹

It is sometimes argued that since the effective price determinants are current rather than historical costs, current costs should be shown on the books. It may be conceded that in a competitive market current replacement costs rather than historical costs of individual producers

56. May, *supra* note 7, at 18-20. See also *Consolidated Rock Products Co. v. Dubois*, 61 Sup. Ct. 675 (U. S. 1941).

57. See *Consolidated Rock Products Co. v. Dubois*, 61 Sup. Ct. 675 (U. S. 1941); 1 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 156-60, 237 *et seq.*; CANNING, *THE ECONOMICS OF ACCOUNTANCY* (1929) 197-98, 317-18; Littleton, *Value and Price in Accounting* (1929) 4 *ACCTG. REV.* 147.

58. May, *supra* note 7, at 20. Henderson, *supra* note 5, at 448, 455; Frank, *Accounting for Investors* (1939) 7 *THE COMPTROLLER* 380.

59. The Supreme Court recognized this point in *LaBelle Iron Works v. United States*, 256 U. S. 377, 393-94 (1921), where it said:

" . . . There is a logical incongruity in entering upon the books of a corporation as the capital value of property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost but to what probably might be realized by sale in the market. It is not merely that the market value has not been realized or tested by sale made, but that sale cannot be made without abandoning the very purpose for which the property is held, involving a withdrawal from business so far as that particular property is concerned . . ."

See also 2 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 954-55; May, *supra* note 7, at 18-20.

determine supply,⁶⁰ and that supply and demand determine price. Nevertheless, it does not follow that individual producers should revalue their assets at present replacement costs so that their books may reflect the effective price determinants. On the contrary, their books are kept to measure their own income,⁶¹ which is determined by excess of price over the costs which they have incurred, not the excess of price over costs which determine price.⁶² If a particular producer's plant cannot be replaced except for a price greatly in excess of its original cost, he is a low cost producer, and his margin of price over cost will be great. Conversely, if his costs are substantially higher than present replacement costs, he will have little or no margin of price over cost. His position as a high or low cost producer is reflected by his maintenance of gross profit margins above or below average margins in the industry over a period of years. For his own purposes and those of the investors in his business, the important facts are the costs he charges to the sale of his product, not the costs of the group of producers as a whole, or the costs of the marginal producer. Until the fixed assets are sold, any rise or decline in their value is important only in so far as it is reflected in the increase or decrease of income over the periods in which the cost of such assets is amortized. If, on the other hand, a producer revalues his assets in an attempt to show the effective price determinants, amortization of the amount recorded on the books will overstate his real costs and understate his true income,⁶³ or conversely, understate his real costs and overstate his true income.

Therefore, from the standpoint of accurate income reporting, the most useful income statements seem to be those which are based on cost, and which are supplemented by balance sheets showing costs not yet charged to operations. Of course, this conclusion does not mean that earnings statements based on cost provide a direct guide to the value of the enterprise once a capitalization rate is determined. Value is the

60. DANIELS, FINANCIAL STATEMENTS (1939) 178-81; Paton, *Economic Theory in Relation to Accounting Valuations* (1931) 6 ACCTG. REV. 89, 94; Littleton, *Value and Price in Accounting* (1929) 4 ACCTG. REV. 147; cf. Canning, *Cost of Production and Market Price* (1931) 6 ACCTG. REV. 161.

61. ". . . It is the purpose of accounting to record as nearly as possible actual costs for the individual enterprise . . ." DANIELS, FINANCIAL STATEMENTS (1939) 179.

62. "Naturally, the actual costs of different companies operating plants made up of parts purchased at different times and different prices will differ. But is it not the very function of accounting to show these variations?" Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCTG. REV. 302, 310.

63. Corporations which have thus confounded their books have struggled to devise compensating errors to correct their income accounts. See Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCTG. REV. 302; SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 31-32, 65; COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 5 (1940); Graham, *Valuation for Profit Determination* (1940) 15 ACCTG. REV. 145.

present worth of *future* anticipated earnings, and past earnings are significant to the investment analyst only in so far as they help predict future earnings.⁶⁴ But the accountant is not an analyst and cannot be expected to supply all the information on which the analyst bases his conclusions as to value. Just as the analyst must adjust past results in the light of forecasts of trends in demands, prices, competitive conditions, and the non-recurrence of certain items, so he must adjust past earnings as guides to future earnings in the light of probable changes in the costs of the particular enterprise. Among these changes may be the replacement of low-cost old plant with high-cost new plant which will require greater charges to operations. For that reason it may be that the accountant will want to supply information as to replacement values of present plant as footnotes or collateral notations on financial statements, or the management may want to supply information in its published reports outside the financial statements. Similarly, the management for its own purposes in determining pricing policies may want to have supplementary records showing replacement costs rather than actual costs. All such considerations, however, are incidental to the fundamental point that any estimate of the value of an enterprise must begin with the record of past earnings, which can be shown only if the financial statements reveal cost.

The ultimate conclusion is that accountants who persist in retaining the cost convention are not thereby ignoring the need of the lawyer for information as to value, but are in fact supplying the basic information from which value can be determined. But, of course, value determination must remain an inexact science so long as possibilities of conflicting results exist within the limits of accepted accounting principles.

C. THE CONCLUSIVENESS OF THE ACCOUNTS IN THE DETERMINATION OF LEGALLY OPERATIVE FACTS

Even though it is apparent that a financial statement should be drawn to show legally operative facts, the question of resolving conflicts which arise from the actual or potential existence of inconsistent financial statements for the same enterprise still remains.

The possibility of such inconsistency arises primarily because accountants do exercise judgment in selecting suitable conventions or in interpreting financial transactions. Not only may accountants at large

64. See *Consolidated Rock Products Co. v. Dubois*, 61 Sup. Ct. 675 (U. S. 1941); *Palmer v. Conn. Ry. & Lighting Co.*, 61 Sup. Ct. 379 (U. S. 1941); 1 BONDRIGHT, VALUATION OF PROPERTY (1937) 249 *et seq.* For examples of the practical problem of estimating future earnings from past earnings, see *Minnesota & Ontario Paper Co.*, 7 S. E. C. 456 (1940); *Flour Mills of America, Inc.*, 7 S. E. C. 1 (1940); *Griess-Pfleger Tanning Co.*, 5 S. E. C. 72 (1939); *La France Industries*, 5 S. E. C. 917 (1939).

differ in these matters but, from the same facts, a particular accountant may derive different conclusions shaped by the particular interest of the person for whom he is preparing the financial statement. For example, the commercial banker will be interested in the ability of an enterprise to liquidate assets quickly, the executive in matters of internal management, the investor in long term prospect: the accountant will wish to interpret the facts so as to direct the emphasis accordingly.⁶⁵

Possibilities of diversity also arise out of the fact that public regulatory agencies may prescribe different conventions for their several purposes. The courts recognize that the power to regulate accounting goes beyond mere prescription of the formal titles and break-down of the accounts, and extends to dictation of the appropriate interpretation of particular transactions. Thus, the Supreme Court has recognized the power of the Interstate Commerce Commission to require a railroad to charge to earnings the entire cost of a railroad line newly replaced and to capitalize the cost of replacement, instead of charging to capital the difference between the cost of the improvement and the cost of the line replaced.⁶⁶ Similarly, the Court has upheld an order of the Interstate Commerce Commission requiring a railroad to classify its coal mines as property not used for carrier purposes rather than as property used for carrier purposes.⁶⁷

Income taxation creates still a third opportunity for diversity. The concept of income embodied in the revenue acts is not always identical

65. Originally, accountants emphasized the interpretations which commercial bankers extending short-term credit placed on the financial condition of the enterprise, with resulting conservatism in balance sheets. Montgomery, *Accountants' Limitations* (1927) 44 J. OF ACCTY. 245, 259; Littleton, *Value and Price in Accounting* (1929) 4 ACCTG. REV. 147, 148. See Paton, *Aspects of Asset Valuation* (1934) 9 ACCTG. REV. 122, 124, deploring the effect which this emphasis has had on the development of accounting principles. The present tendency is to emphasize information for the investor, with particular emphasis on accurate income reporting. PATON AND LITTLETON, *op. cit. supra* note 3, at 1-3; Staub, *Uniformity in Accounting*, in PAPERS ON ACCOUNTING PRINCIPLES AND PROCEDURE (1938); Frank, *Accounting for Investors* (1939) 7 THE COMPTROLLER 380; *A Statement of the Objectives of the American Accounting Ass'n* (1936) 11 ACCTG. REV. 1; May, *Improvement in Financial Accounts* (1937) 63 J. OF ACCTY. 333, 340 *et seq.*; Paton, *Accounting Problems of the Depression* (1932) 7 ACCTG. REV. 258, 266. To eliminate the possibilities of ambiguity latent in efforts to make a single set of financial statements serve all needs, it has been suggested that the "all purpose" balance sheet be recognized as inadequate, and that different balance sheets be prepared for different purposes. 1 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 253; CANNING, *THE ECONOMICS OF ACCOUNTANCY* (1929) 86-88; Brink, *The Need for Single-Purpose Statements* (1940) 69 J. OF ACCTY. 284; Frank, *Accounting for Investors* (1939) 7 THE COMPTROLLER 380; May, *Eating Peas with Your Knife* (1937) 63 J. OF ACCTY. 15, 17; May, *Improvement in Financial Accounts* (1937) 63 J. OF ACCTY. 333, 337, 367; Montgomery, *Accountants' Limitations* (1927) 44 J. OF ACCTY. 245, 255, 259; but see *Single-Purpose Statements* (1940) 69 J. OF ACCTY. 186.

66. *Kansas City So. Ry. v. United States*, 231 U. S. 423 (1913).

67. *Norfolk & W. Ry. v. United States*, 287 U. S. 134 (1932).

with the economic,⁶⁸ or accounting,⁶⁹ or corporation law concept. Thus, the recent undistributed profits tax penalized the failure to distribute income, distribution of which might have been unlawful under state law.⁷⁰ Likewise, depreciation may be taken on one basis for tax purposes and on another for general purposes. Again, tax law may not recognize deductions of certain expenses which lawyers and accountants recognize as proper charges to income.⁷¹ As a consequence of these situations the taxpayer must frequently keep two or more sets of books.

Where financial statements potentially conflict, problems of adjustment are inevitable. Where there is no public control of accounting, the key to the question of the conclusiveness of statements appearing in a corporation's books is the evidentiary rule concerning admissions.⁷² But where a public regulatory agency has prescribed the accounts involved, the problem may become one of inter-agency conclusiveness. Much litigation seems to have settled one point at least: taxing authorities, operating under statutory schemes for determining taxable income, are not bound by the accounting prescribed by other agencies. Thus, the Commissioner of Internal Revenue need not base his computations of taxable net income on accounting permitted or prescribed by the Interstate Commerce Commission,⁷³ a state public service commission,⁷⁴ or a national bank examiner.⁷⁵ Likewise, a state is not required to base its system

68. *New Colonial Ice Co. v. Helvering*, 292 U. S. 435 (1934); *Weiss v. Wiener*, 279 U. S. 333 (1929).

69. *Surety Finance Co. v. Comm'r*, 77 F. (2d) 221 (C. C. A. 9th, 1935); *Lucas v. American Code Co., Inc.*, 280 U. S. 445 (1930); *Brown v. Helvering*, 291 U. S. 193, 203 (1934); *Securities Allied Corp v. Comm'r*, 95 F. (2d) 384 (C. C. A. 2d, 1938).

70. See *Helvering v. Northwest Steel Rolling Mills, Inc.*, 61 Sup. Ct. 109 (1940); PAUL, *SELECTED STUDIES IN FEDERAL TAXATION* (2d Series 1938) 19-20.

The subject of the divergence of the tax law of income and dividends and the corresponding field of corporation law is exhaustively explored in Hills, *Federal Taxation vs. Corporation Law* (1937) 12 Wis. L. Rev. 280.

71. The diversity of accounts has provoked much criticism. See Healy, *Before the Auditor Comes* (mimeographed address, May 15, 1939) 7; PAUL, *SELECTED STUDIES IN FEDERAL TAXATION* (2d series 1938) 19-20; *Citizens' National Bank of Orange v. Comm'r*, 74 F. (2d) 604 (C. C. A. 4th, 1935).

72. *Bessemer Investment Co. v. Comm'r*, 31 F. (2d) 248 (C. C. A. 2d, 1929); see cases collected in 1 Prentice-Hall 1941 Fed. Tax Serv. ¶ 6004; cf. *Northern Pac. Ry. v. Helvering*, 83 F. (2d) 508 (C. C. A. 8th, 1936).

73. *Old Colony R. R. v. Comm'r*, 284 U. S. 552 (1932); *Kansas City So. Ry. v. Comm'r*, 52 F. (2d) 372 (C. C. A. 8th, 1931), *cert. denied*, 284 U. S. 676 (1931); *Chesapeake and Ohio Ry. v. United States*, 5 F. Supp. 7 (E. D. Va. 1933); *Minneapolis, St. P. & S. S. M. Ry., 34 B. T. A. 177* (1936); *Union Pac. R. R., 26 B. T. A. 1126, 1142* (1932).

74. *Fall River Elec. Light Co., 23 B. T. A. 168* (1931).

75. *Second Nat. Bank of Philadelphia, 33 B. T. A. 750* (1935), refusing to follow *Citizens' Nat. Bank of Orange v. Comm'r*, 74 F. (2d) 604 (C. C. A. 4th, 1935) and *Lebanon Nat. Bank v. Comm'r*, 76 F. (2d) 792 (C. C. A. 3d, 1935).

of railroad taxation on income as determined by the Interstate Commerce Commission's classification of accounts.⁷⁶ And it seems reasonable to assume that this rule with respect to tax problems will apply to all other situations outside the field controlled by the particular agency which prescribes the accounting.⁷⁷

The problems of conclusiveness of accounts, prescribed by a regulatory agency with regard to matters within its own jurisdiction are more complex. On this point the Supreme Court cases appear confused. Recently, the Court seems to have indicated that the financial condition of a company as portrayed by the accounts is not necessarily conclusive in the determination of regulatory questions. This attitude is best illustrated in *Norfolk & Western Railway Company v. United States*,⁷⁸ where the Railway sought to enjoin enforcement of an Interstate Commerce Commission order requiring it to classify its coal mines as property not used for carrier purposes. The Court said:

"With great earnestness the appellant characterizes the order as in several aspects a denial of due process. . . . *But this is to ignore the fact that the order is one touching accounting merely; that before any rate base can be ascertained or any basis of recapture determined the carrier will be entitled to a full hearing as to what property shall be included; and not until the Commission excludes the assets in question from the calculation may the carrier assert the infliction of injury to its rights of property. . . .*

"We are not convinced by the assertion that the necessary effect of classifying the mines as non-carrier properties is to exclude them from consideration as capital in the issuance of securities . . . *the mere accounting classification can conclude neither the Commission nor the appellant upon the hearing of an application under § 20a(2). . . .*

"Appellant also characterizes the Commission's action as a denial of the legal right of the railway to adopt fair and reasonable methods of accounting. . . . *But there is no right to a particular form of accounting as such.*"⁷⁹

76. *Atlantic C. L. R. R. v. Daughton*, 262 U. S. 413 (1923).

77. The writer, however, knows of no cases other than tax cases which involve such situations.

78. 287 U. S. 134 (1932).

79. 287 U. S. 134, 141-43 (1932). Italics supplied. See also *Telephone and Railroad Depreciation Charges*, 177 I. C. C. 351, 381 (1931); *In re Classification of Accounts of Gas and Electric Companies*, P. U. R. 1921D 385, 386 (Mass. D. P. U., 1921); *Re New York & Richmond Gas Company*, 23 P. U. R. (n.s.) 463 (N. Y. Pub. Serv. Comm., 1938); *Re Uniform Classification of Accounts for Electric Utilities*, 14 P. U. R. (n.s.) 57 (N. H. Pub. Serv. Comm., 1936). Note that the conclusion of the *Norfolk & Western* case was reached although carriers are forbidden by statute [41 STAT. 493 (1920), 49 U. S. C. § 20(5) (1934)] to keep any accounts other than those prescribed by the Commission.

In *State Corporation Commission of Kansas v. Wichita Gas Company*,⁸⁰ the Commission prohibited gas distributing companies from recording on their books as expenses any payments made to an affiliated pipe line company in excess of thirty cents per thousand cubic feet. A three judge federal court enjoined enforcement of the order. The Supreme Court, reversing the lower court, held that, irrespective of the merits of the order, no injunction should have issued unless the company could prove irreparable injury. Since the findings and directions of the Commission were held to be merely legislative in character, designed only to secure information⁸¹ and thus not binding on the companies in subsequent rate proceedings, no present injury was found and the injunction was vacated. This case indicates clearly that accounting orders are not conclusive in subsequent rate litigation.

Neither the Supreme Court nor any other courts have recognized that these two cases apparently abandoned a position which the Court had earlier assumed in one of its leading cases on accounting, *Kansas City Southern Railway Company v. United States*.⁸² In that case the railway sued to enjoin enforcement of a regulation of the Interstate Commerce Commission which would have required it to charge to earnings the entire cost of a railroad line which had been recently replaced. The railway showed that it had been cheaper to build a new line than to improve the old line, and that, if the old line had been improved, the entire cost of that improvement could have been charged to capital, with no charge to operating expenses. Since, under the accounting procedure prescribed, the railway's books showed no operating income during the year in which the replacements were made, the railway could declare no dividends for that year on its preferred stock, which was non-cumulative. Moreover, this regulation prevented the railway from carrying the full cost of the improvements as an asset to balance the bond liability incurred to finance the improvements.

But the regulation was upheld against the contention that it impaired substantive rights. The Court did not question that substantive rights were involved; on the contrary, it definitely assumed that the prescribed accounting treatment was conclusive for all purposes, and precluded the payment of dividends. It said:

"The preferred stockholders as such are not before the court, and this is not a proper occasion for determining their rights. Supposing, however, that the enforcement of the accounting system does require them to forego their current dividends, we do not concede that this amounts to an unlawful taking of their property."⁸³

80. 290 U. S. 561 (1934).

81. On this point, see also *ICC v. Goodrich Transit Co.*, 224 U. S. 194 (1912).

82. 231 U. S. 423 (1913).

83. 231 U. S. 423, 453 (1913). The Court's attitude was not dependent solely on its expressed agreement with the principle of the regulation, for it went on to say:

The question whether the accounting methods prescribed by the Commission were conclusive for dividend purposes was not directly in issue in the *Kansas City Southern* case. But the case embodied a considered dictum which has been cited in other cases to demonstrate that accounting controls matters of substance. Thus, it was cited by the three judge district court in the *Norfolk & Western* case in support of the following language:

"Accounting under the order of the Commission is not merely a matter of form, but one of substance. *It sets forth the condition of public carriers for the information of their stock and bondholders and the investing public* as well as for that of the Commission. *It furnishes the basis for corporate financing* and many other matters affecting their very existence. . . ." ⁸⁴

Some lower federal courts, reflecting the confusion of the Supreme Court decisions in regard to the conclusiveness of regulatory accounting orders, have differed as to the proper jurisdictional theory for the judicial review of such orders. Two district court cases have assumed that jurisdiction exists because accounting orders relate to substance.⁸⁵ The Supreme Court itself has never spoken directly on the point. But the Court's conclusion in the *Wichita Gas* case that an accounting order was merely legislative in nature was buttressed by citing *United States v. Los Angeles & Salt Lake Railway Company*,⁸⁶ which had held that because the order was legislative in nature, an order of the Interstate

"But, did we agree with appellant that the abandonments ought to be charged to surplus or to profit and loss, rather than to operating expenses, we still should not deem this a sufficient ground to declare that the Commission had abused its power. So long as it acts fairly and reasonably within the grant of power constitutionally conferred by Congress, its orders are not open to judicial review." *Id.* at 456-7. The Court reasoned that the regulatory power of the Commission was over the corporate entity, and could not be defeated by agreements of the stockholders *inter sese* as to the disposition of profits. Such reasoning could not advance the Court very far, however, for precisely the same basic questions would have been presented if the corporation had had only one class of stockholders on whose behalf it complained that the regulation deprived it of the right to declare dividends.

84. Italics supplied. *Norfolk & W. Ry. v. United States*, 52 F. (2d) 967, 970 (W. D. Va. 1931). As has been pointed out, the Supreme Court decision in this case held that accounting orders deal with "accounting merely." See also *Chesapeake & Ohio Ry. v. United States*, 5 F. Supp. 7 (E. D. Va. 1933); *New York Edison Co. v. Maltbie*, 244 App. Div. 685, 281 N. Y. Supp. 223 (3d Dep't 1935), *questions certified*, 245 App. Div. 897, 282 N. Y. Supp. 550 (1935), *aff'd*, 271 N. Y. 103, 2 N. E. (2d) 277 (1936); *People ex rel. New York Rys. v. Public Serv. Comm.*, 223 N. Y. 373, 119 N. E. 848 (1918); *Passaic Consolidated Water Co. v. Board of Pub. Util. Comm'rs*, 5 N. J. Misc. 1078, 139 Atl. 324 (Sup. Ct. 1927), *aff'd without opinion by a court divided 6 to 5*, 104 N. J. Law 666, 141 Atl. 921 (1928).

85. *Norfolk & W. Ry. v. United States*, 52 F. (2d) 967 (W. D. Va. 1931); *Chesapeake & Ohio Ry. v. United States*, 5 F. Supp. 7 (E. D. Va. 1933).

86. 273 U. S. 299 (1927).

Commerce Commission determining a final valuation under Section 19(a) of the Interstate Commerce Act⁸⁷ was not reviewable even under a statute authorizing review of that Commission's orders.⁸⁸ If accounting orders are in fact merely legislative, the *Los Angeles* case would appear to preclude review. But the Supreme Court *has* reviewed accounting orders.⁸⁹ It has been suggested, however, that since violation of such orders is punishable,⁹⁰ they must be reviewable without regard to the issue of the conclusiveness of accounting orders in litigation of substantive matters.⁹¹

The rules of law that will emerge from the existing welter of decisions — which demonstrate only that the courts have not clearly analyzed the problem of conclusiveness—are, of course, not predictable with certainty. It is probable, however, that in matters relating to the interpretation of financial events, prescribed accounting will be conclusive for all purposes within the jurisdiction of the regulatory agency which prescribes it. Where the agency has direct regulatory power to deal with the particular problem involved, this is clear: no agency would stultify its regulatory powers by directing that financial events be interpreted on the books in a manner inconsistent with their treatment for other regulatory purposes. But in matters relating to "confiscation," prescribed accounting will not be conclusive, for the courts will make their own determinations as to value and expense.

Unlike agencies with comprehensive regulatory powers, the Securities and Exchange Commission under the two securities acts⁹² has no statutory purposes to achieve with respect to the financial statements of corporations beyond requiring full and truthful disclosure.⁹³ It is clear, nonetheless, that Congress intended the Commission to exercise such control over accounting as would insure accurate disclosure and make the accounts of different companies comparable.⁹⁴ To make this

87. 37 STAT. 701 (1913), 49 U. S. C. § 19a (1934).

88. Urgent Deficiencies Act, 38 STAT. 208 (1913), 28 U. S. C. § 41 (28) (1934).

89. *ICC v. Goodrich Transit Co.*, 224 U. S. 194 (1912); *Kansas City So. Ry. v. United States*, 231 U. S. 423 (1913); *Norfolk & W. R. R. v. United States*, 287 U. S. 134 (1932); *Am. Tel. and Tel. Co. v. United States*, 299 U. S. 232 (1936).

90. *Atlanta, B. & C. R. R. v. United States*, 28 F. (2d) 885, 887 (N. D. Ga. 1928).

91. As to penalties for disobedience of accounting orders of the Interstate Commerce Commission, see 34 STAT. 594 (1906), 35 STAT. 648 (1909), 49 U. S. C. § 20 (6) and (7) (1934). As to orders of the Federal Communications Commission, see 48 STAT. 1078 (1934), 47 U. S. C. § 220(d) (1934).

92. Securities Act of 1933, 48 STAT. 74 (1933), 15 U. S. C. § 77a *et seq.* (1934); Securities Exchange Act of 1934, 48 STAT. 881 (1934), 15 U. S. C. § 78 (1934).

93. The relevant provisions of the Securities Act are §§ 7 and 19(a) and schedule A, items 25 and 26. The relevant provisions of the Securities Exchange Act are §§ 3(b), 12(b), 13(b) and 23(a).

94. See *Hearings before Committee on Interstate and Foreign Commerce on H. R. 7852 and H. R. 8720*, 73d Cong., 2d Sess. (1934) 652-53; 15, 16 *Hearings on Stock Ex-*

uniformity possible, Congress deliberately refrained from requiring that the accounting prescribed by the Commission be consistent with accounting prescribed by state law.⁹⁵ This freedom of action has enabled the Commission to require adherence to accounting standards in financial statements filed with it even when state law permitted other treatment.⁹⁶ But, generally, the Commission has no control over the accounting of a registrant for purposes of internal management other than reports to the Commission.⁹⁷ Although no case has arisen on this point, it seems clear that a registrant will not be concluded by the accounts it files with the Commission, except where the evidentiary rule of admissions is applicable.

Two hypothetical examples will illustrate the problems which may consequently arise:

For instance, should a registrant accept the Commission's view that a particular item should be charged to earned surplus rather than capital surplus in reports filed with the Commission, no earned surplus might remain available for dividends.⁹⁸ Yet, if on its own books the registrant should charge the item to capital surplus and pay a dividend out of earned surplus, it seems evident that in a suit against the registrant's officers and directors for unlawful declaration of dividends, a report filed with the Commission showing no earned surplus should not be conclusive evidence of improper accounting treatment.⁹⁹

Again, if a financial statement filed under the Securities Exchange Act of 1934 shows fixed assets at cost less depreciation, although the assets be "worth" more than cost, the registrant should not be liable under Section 18(a)¹⁰⁰ for failing to disclose value to a stockholder

change Practices before Senate Committee on Banking and Currency, 73d Cong., 1st Sess. (1934) 6532-33, 6537, 6690-91, 6693, 6698-99, 7175, 7182, 7521.

95. See *Hearings on Stock Exchange Practices before Senate Committee on Banking and Currency*, 73d Cong., 1st Sess. (1934) 7599-7601; 78 CONG. REC. 8033, 8282, 8284, 8567 (1934).

96. See SEC Accounting Series Release No. 16, March 16, 1940.

97. This limitation, deducible from the language of both statutes, was expressly pointed out in the Senate Report on the Securities Exchange Act. SEN. REP. NO. 792, 73d Cong., 2d Sess. (1934) 10. See Kaplan and Reaugh, *Accounting, Reports to Stockholders, and the SEC* (1939) 48 YALE L. J. 935, for a study of the extent to which corporate reports to stockholders adhere to the requirements imposed by the Securities and Exchange Commission for reports filed with it.

98. This assumes that capital surplus is not available for dividends under applicable state law.

99. Doubtless, however, the report filed with the Commission should show the condition of the corporation's own books, in order not to conceal facts which affect the availability of dividends.

100. Section 18(a) of the Securities Exchange Act of 1934, 48 STAT. 881 (1934), 15 U. S. C. § 78r(a) (1934) provides that any person who files a report which is misleading as to a material fact shall be liable to any person who purchased or sold a security at a price which was affected by such statement for damages caused by the reliance.

who made a computation of the value of his stock from the report and sold it at a price determined accordingly. This result should follow even in states where the increased value could have been made the foundation for a write-up which would create a revaluation surplus available for dividends.

In summary, it appears probable that, except for the use of the accounting prescribed by a regulatory agency as evidence of facts in matters arising within the purview of that agency's regulatory powers, the financial statements of an enterprise will conclude neither the enterprise nor persons nor public agencies which deal with it. Such statements will be considered to be essentially purposive — rebuttable by challenging the applicability of the conventions or assumptions upon which they were based to the problem at hand.