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Dean Arden

Maxwell E. Aiken

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Dean Ardern
AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
and
Maxwell Aiken
RMIT UNIVERSITY

AN ACCOUNTING HISTORY OF CAPITAL MAINTENANCE: LEGAL PRECEDENTS FOR MANAGERIAL AUTONOMY IN THE UNITED KINGDOM

Abstract: The effectiveness of the capital maintenance concept that became enshrined in British companies legislation during the 19th century was almost immediately undermined when companies were permitted to pay dividends from 'circulating' capital surpluses, even though overall there were losses of total invested capital. It is generally accepted that the British courts were conscious not to limit management's capacity to innovate and operate their businesses in good faith, and to maximize the capacity of their entities to distribute dividends to shareholders now and in the future. Nevertheless, it is unclear why at the time some accounting methods were accepted as being satisfactory in certain situations but not in others. It is argued here that the British judges adhered to a number of complementary guiding principles when assessing the validity of particular accounting procedures. Central to these principles is the notion that individual firms have different planning horizons and associated particulars of risk assessment. These cannot be captured by the general use of surplus methods of profit determination using current market prices. Consequently, the courts resisted imposing uniform accounting and reporting requirements because traditionally they respected separation of ownership and control.

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INTRODUCTION

> " . . . the maintenance of corpus has been stretched beyond its natural usefulness" [Littleton, 1953, p. 89].

In Britain, the courts provided some of the earliest public arenas for the examination of accounting practices. Accounting practices were invariably ancillary to the main issues of cases, these being disagreements over matters of disclosure and financial measurement. Disputes classified as disclosure-based generally concerned the rights of members and directors of companies to inspect books of account. While these types of cases outnumbered measurement-related disputes brought before the courts, many of the key concerns were subsequently resolved through legislative intervention [Rahman, 1992, pp. 182-184, 191]. In contrast, disputes concerned with measurement issues, while relatively few, centered on the recurring debate over the amount of profits available for the purposes of dividend distribution [Reid, 1988, p. 2; Mills, 1993, p. 776]. To resolve such disputes, judges selectively turned to the notion of capital maintenance for guidance.

The doctrine of capital maintenance, the precept whereby the payment of dividends cannot be made out of capital, was inherited ostensibly from 18th century British charter corporations [Mills, 1993, p. 775]. In order to protect creditors a general consensus emerged. The capital of a company should be maintained so as to provide a fund that creditors could conceivably look to for the payment of their claims. This consensus ultimately became enshrined in law [Gibson, 1971, pp. 26-29; Benson, 1981, p. 22; Morris, 1986, p. 76].

Despite successive legislative requirements precluding the payment of dividends out of anything other than 'profits', it was not until the Companies Act, 1980 that a definition of distributable profits was incorporated into legislation.[1] This absence appears to have significantly constrained the British judiciary. While matters relating to the calculation and payment of dividends clearly fell within the courts' jurisdiction [Ford, 1993, p. 100], the lack of a substantive definition for the term 'profits' limited the judiciary's ability to make any significant determina-

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[1] Sections 39 and 40. Additional requirements in relation to investment companies are laid out in section 41, and in relation to insurance companies in section 42. See also Companies Act, 1985 (U.K.), section 263ff as amended in 1989.

tions on the issue [Dunn, 1975, pp. 16-17; Morley, 1979, p. 36; Corcoran, 1993, p. 100].

When applying legislation the courts are generally assumed to interpret public interest in terms of accepted notions of natural justice, statutory interpretation and precedent [Peirson and Ramsay, 1983, p. 292; Mills, 1993, p. 772]. Consequently, common law emphasizes justice between parties in a process that results from, and also tends to maintain, a society characterized by voluntary behavior and customs [Johnson, 1987, p. 67]. It would seem reasonable to assume, therefore, that the courts would take a negative view of companies contradicting the capital maintenance concept. However, in February 1889, Lindley, L.J. in the English Court of Appeal permitted the defendant in the case of *Lee v. Neuchatel Asphalte Company* (1889),[2] a quarrying company, to omit amortization for depletion of its mining lease when calculating profits available for dividend distribution [Morris, 1986, p. 71]. In turn, the *Lee* case provided the precedent for a succession of court cases that effectively marked the end of the capital maintenance concept as a means of directing profit and loss for dividend determination [Morris, 1984, p. 59].

French [1977] argues that a common aim amongst Lindley and the other reforming judges was to ensure effective creditor protection while at the same time providing significant freedoms for directors to allocate scarce resources to their best uses. The purpose of this paper is to demonstrate this emphasis. With reference to legal precedents established during the 19th century, our intention is to explain the general unwillingness of British courts at the time to mandate any particular accounting valuation policy which could inhibit the flexibility of management to grow and prosper benefits to the shareholders collectively in the longer term [Littleton, 1953, Ch. 1 & 5].

While French's work provides a useful framework for understanding the court's views on matters of dividend distribution, it does not provide a comprehensive explanation as to why, at the time of the *Lee* case, some accounting methods were accepted by the courts as being satisfactory in certain situations but not in others. Moreover, there appears to be no general consensus in the literature as to the significance or role of capital maintenance in British judicial reasoning during the 19th century. This would apply to accounting methods for the purposes of dividend determination, either before or after the *Lee* case [Reid, 1987a; 1987b].

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[2] 41. Ch. D. 1.

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It will be argued here that in both pre- and post-1889 periods, in addition to French's [1977] principle of 'freedom for action', the courts were also influenced by the authority for any proposed distribution and by the need for transparency of profit calculations. These had a variety of affects in terms of fairness and/or value for money to participants. Furthermore, unifying these two explanations into a common theme amounts to recognition of the *sui generis* nature of court decisions under precedent and the specific natures of the situations being encountered. Taken together, these guiding principles constituted a logical framework for judicial decision-making which ultimately conspired against the courts adopting the surplus approach of profit measurement under economic market valuation. Instead, they favored the profit and loss or double entry approach for profit determination and distributive purposes.

The remainder of this paper is divided into seven sections. The first section provides a brief description of the profit and dividend requirements contained in 19th century British companies legislation. The second section provides a summary of the main approaches available for determining capital maintenance. The third section reviews the literature regarding capital maintenance and the role of the *Lee* case in defining capital maintenance for judicial purposes. The fourth section details the main social, economic and institutional influences over British legislators during the 19th century. The fifth section provides a framework for understanding British judicial reasoning during the 19th century with regard to justifying accounting methods for the purposes of dividend determination. The sixth section provides a review of British court cases and judicial reasoning, both before and after the *Lee* case, within the context of the framework outlined in section five. The seventh section contains some concluding remarks about the links between present developments in cost and management accounting and the financial reporting function for organizations as a whole, and raises doubts about the use of microeconomic measures outside of perfect markets.

BRITISH COMPANIES LEGISLATION DURING THE 19TH CENTURY

Early British examples of the legislative rule relating company profits to dividends can be found in the Joint Stock Companies Registration and Regulation Act, 1844 and the Companies Clauses Consolidation Act, 1845. While the 1844 Act

provided that registered companies could declare dividends out of profits, the 1845 Act was more specifically formulated with a view of statutory companies' capital as the minimum value of the net assets which must be raised initially and then, so far as possible, retained in the business [Gower, 1979, p. 98]. Accordingly, the 1845 Act provided that the company shall not make any dividend whereby its capital stock will be in any degree reduced [clause 121].

Both the 1844 and 1845 Acts treated dividend policy as an aspect of capital maintenance generally, principally because the interests of shareholders and creditors were regarded as being in competition. Assets distributed to one group are not available for distribution to the other. Given that the power to determine dividends is delegated to directors by shareholders, then creditors were often in a relatively disadvantaged position [Ford, 1993, p. 92].

Following Parliamentary acceptance in 1855 of the principle of limited liability for joint stock companies (Limited Liability Act, 1855), British company law was consolidated in the Joint Stock Companies Act, 1856. Following almost 20 years of reform, the 1856 Act integrated the Joint Stock Companies Registration and Regulation Act, 1844 and the Limited Liability Act, 1855, as well as introducing other changes. Most evidently, the provisions relating to profits and dividends contained in the 1844 Act were not replicated in the 1856 Act itself but were inserted in the model Articles of Association [Ford et al., 1999, pp. 38-41]. While the Articles specified that dividends should only be paid out of profits and that a model 'full and fair' balance sheet should be drawn up so as to give a true and correct view of companies' financial affairs [Hein, 1978, pp. 171-172], the 1856 Act provided no guidance regarding the underlying accounting principles to be applied [Bryer, 1998, p. 57; Maltby, 1998, p. 11]. Moreover, being relegated to the model Articles meant that the disclosure requirements were optional.

Several consolidating acts followed the introduction of the 1856 Act, culminating in the Companies Act, 1862. Like the 1856 Act, the 1862 Act contained no compulsory accounting or auditing provisions dealing directly with the payment of dividends. As with the 1856 Act, all such provisions were contained in the model Articles of Association. For instance, Article 73 (Table A) provided that no dividend should be paid except out of the profits arising from the business of the company. Table A also suggested that before recommending any dividend, the directors could, but were not compelled to, set aside out of profits for the

company a reserve fund for repairing or maintaining the works connected with the business of the company.

Companies legislation introduced in Britain during the 19th century was customarily drafted with the purpose of protecting creditors by allowing a proportion of the nominal value of the share capital either to remain uncalled or to be retained within the company [Hadden, 1972, p. 70]. However, this purpose was eventually undermined when companies issued capital fully paid. Furthermore, as there were no legal requirements that the liabilities secured by companies were to bear any reasonable relationship to the company's assets, or that the original capital should be paid to the company in cash, a company could continue to trade despite having lost a substantial proportion of its capital courtesy of legitimate trading losses.[3]

ALTERNATIVE DEFINITIONS OF CAPITAL MAINTENANCE

Two broad approaches have been identified by the courts for determining profits for dividend determination. One of these models can be described as the 'surplus' approach, whereby the profit and loss statement plays a secondary role to the balance sheet by only verifying the accuracy of the underlying calculations. Profit is determined as the difference in net asset valuations adopted at the beginning and the end of the financial period [Kehl, 1976]. For instance, in *Binney v Ince Hall Coal and Cannel Company* (1866),[4] Kindersley, L.J. suggested that in determining net profits:

> The first step would be to make good the capital by taking stock and putting a value upon all the assets of the company, of whatever nature, and deducting therefrom all the liabilities (including amongst those liabilities the amount of contributed capital), and the surplus, if any, then remaining of the gross receipts would be net profit.[5]

Similarly, Fletcher Moulton, J. remarked in *re Spanish Prospecting Co Ltd* (1911)[6] that:

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[3] Section 13 of the Companies Act, 1855 provided that companies were to be wound up and dissolved when three quarters of their capital had been lost. However, this provision was not repeated in subsequent legislation [French, 1977, p. 315].

[4] 35 L.J. Ch. 363.

[5] See also *City of Glasgow Bank v Mackinnon* (1882) 9. Court Sess. Cases, 4th Series, 535 (Court of Session, Scotland).

[6] 1. Ch. 92; (1908-1910) All E.R. Rep. 573.

> 'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year.

When viewed as an accretion to the original investment, the existence of profits under the surplus approach implies that the removal of the surplus would leave a balance of assets equal in value to the original amount of the investment. Accordingly, profit determination under a surplus approach requires entities to incorporate changes in the value of all of their assets, including non-current and fixed assets, in the computation of profit [Kehl, 1976, pp. 3-13]. This approach also implies, by necessity, specifying the concepts of capital and capital to maintenance be adopted [Jones and Aiken, 1994, p. 201]. Therefore, profits under a surplus approach suggest that capital has been maintained for the owner under the proprietary theory of economics, which implies general application of market buying or selling prices current at period's end [Revsine, 1981].

The alternative to the surplus approach concentrates upon the profit and loss account as the primary evidence of the availability of profit. Described as the 'profit and loss account method', profit has been determined by the courts as the excess of total revenues received within a financial period, over that proportion of each production input's purchase price allocated in proportion to the contribution it makes to each period's revenues. In addition, a comparison might also be made of the opening and closing values of the inventory and other assets intended to be consumed or turned over within the business cycle. Any difference is then added or deducted from the difference between revenue receipts and expenditures [Ford and Austin, 1995, p. 663].

The profit and loss method places most importance on those financial transactions in which the specific reporting entity is directly involved, and little or no emphasis on the current market values of assets, particularly non-current or fixed assets. Nevertheless, the market prices of non-current or fixed assets may become relevant in certain circumstances, but only as proximate justifications of certain 'unexpired costs' by auditors. The profit and loss method, therefore, is driven primarily by the conventions of revenue recognition for a legal entity and by the matching principle of relevant costing under double entry [Littleton, 1953, Ch. 2 & 5]. Relevance is in relation to management's business strategies and the specific nature of the expenditures involved [p. 55].

The existence of profits under the profit and loss account method may or may not mean that capital has been maintained overall in terms of market prices in a proprietary sense of economic ownership. It ultimately depends upon whether or not market events have occurred, and the ways in which they have interacted during the financial period as a timing issue congruent with managerial strategies. For example, the unrealized loss on the value of a current asset could be completely offset by an unrealized gain on a non-current asset. Nevertheless, under traditional accounting procedures and for dividend determination purposes, any unrealized gain is unlikely to be accounted for whereas any unrealized loss will almost certainly be incorporated in the final profit figure. Historically, this is in accordance with the 'lower of cost or market' principle. However, it should be noted that professional accounting standards have increasingly permitted management to use the option of adopting management values, historic costs or current market prices for financial accounting and disclosure purposes. Under the separation of ownership and control it is management's perception of the unexpired cost of assets yet to be allocated, not the generality of market prices, which is relevant.

By incorporating changes in the values of all assets and limiting managements' discretion over the timing of revenue and expense recognition, the surplus approach could possibly provide a more theoretically rigorous measure of profit that is relatively less susceptible to managerial opportunism or conservatism [Chambers, 1966; Baxt, 1970]. It might also provide a means of measuring profit that is most closely aligned with the economic view under this concept of accountability and control [Edwards and Bell, 1961; Sterling, 1971]. However, this presupposes that assumptions and deductive logic can replace compliance with social codes for general acceptance of managements' responsibilities for strategic planning and operations. Accordingly, both the British judiciary and accounting profession rejected the surplus method in favor of the profit and loss account method for a variety of legal, ethical and commercial reasons [Weiner, 1928, pp. 1046-1050; Littleton, 1934, pp. 140-148; Yamey, 1962; Kehl, 1976; Jones and Aiken, 1994, p. 202]. Nevertheless, differences of opinion still exist amongst academics as to whether the *Lee* case represented a 'watershed' in terms of legal precedent with respect to the doctrine of capital maintenance. The matter can be somewhat clarified by Beaver and Demski's [1979] view that current market prices can be generally applied in perfect markets.

LITERATURE SURVEY

Published work on court cases dealing with disputes over the payment of dividends and capital maintenance tends to view the *Lee* case as a turning point in British judicial precedent. Interestingly though, there appears to be no general consensus as to the status of capital maintenance prior to 1889. Some authors have suggested that prior to this date the British courts refrained from imposing a capital maintenance view with regard to accounting matters, except to enforce private contracts or to redress fraud.[7] Therefore, the *Lee* decision was consistent with the judicial precedent laid down in previous cases. An alternative view is that prior to 1889 the courts attempted to protect creditors by advocating a 'capital maintenance view' and refused to permit the payment of dividends out of capital [Reid, 1987a, p. 10]. Consequently, the *Lee* decision marked a change in the law.[8]

Based on the findings from pre-*Lee* cases, Reid [1987a] claims that it was not uncommon for British judges to reject contractually-based accounting and dividend policies if they contravened the capital maintenance doctrine or other equitable considerations. Nevertheless, no consistent conceptual declarations of asset valuation and income determination were evident [Reid, 1987b, p. 247]. Furthermore, prior to 1889 the provision for depreciation received support although "not all decisions were in accord" and "no consistent concept of profit or depreciation emerged" [Reid, 1988, pp. 2-3].

Bryer [1998] suggests that prior to the *Lee* decision judicial views on asset valuation and income determination were consistent with Dicksee's [1903] concept of 'capital-revenue accounting' (CRA). However, following the *Lee* case, general agreement on CRA evaporated. Consequently, Bryer [1998, p. 57] argues that the *Lee* case signaled the end of the general acceptance of CRA. Bryer discusses Napier's [1997] suggestion that the *Lee* decision was 'anomalous' in the sense that it was consistent with the feudal law of settlement trusts, suggesting lingering feudal attitudes amongst the judiciary. However, he rejects Napier's thesis on the grounds that it is inconsistent with his own views

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[7] For instance, Dickinson [1904, p. 71], Hatfield [1916, p. 203], Weiner [1928, p. 1051], Edwards [1939, p. 179], May [1943, p. 52] and Johnston [1961, p. 545].

[8] For instance, Palmer [1898, p. 147], Strachan [1910, p. 233], Robson [1927, p. 266], Briggs [1934, p. 228], Cooke [1937, p. 440], Yamey [1941, p. 274], Gower [1954, p. 112], Edey and Panitpakdi [1956, p. 378] and French [1977, p. 307].

on the general socialization of capital. Furthermore, while the accounting allowed in *Lee* was feudal in form, it was not feudal in substance [Bryer, 1994], nor was the accounting in subsequent cases such as *Verner v General and Commercial Investment Trust* (1894)[9] [Cooper, 1894]. Nevertheless, Bryer's view that managers in the 19th century were functionaries of investor or establishment interests may require some modification given the nature of the legal and accounting decisions and practices emphasized here.

A.C. Littleton, arguably the pre-eminent American accounting scholar and historian of the first half of the 20th century, discussed the extent of general agreement with decisions by the courts [Littleton, 1933, p. 221]. This is interesting as Littleton had a marked affinity with and knowledge of the 'historical evolution' [1953, pp. 84-89] of accounting in both the UK and the USA during the previous one hundred years.

The central premise of Littleton's [1953] views on accounting was the overriding need for flexibility in measuring periodic performance of the *whole* organization, especially when long-term planning was involved. His belief was that managers have been given flexibility to the extent necessary to fulfill business activities and strategies in terms of community needs [1953, p. 55 & Ch. 5]. This appears to have grown out of his historical interpretation of the growth of regulation [1953, Ch. 1 & 6]. Given this focus, Littleton argued that the purpose of accounting is "(T)o make possible the periodic matching of costs (efforts) and revenues (accomplishments)" [1953, Ch. 2]. Furthermore, there must be a congruency between the measurement of costs for reporting purposes and managements' strategies and accomplishments (periodic revenues) for the organization as a *whole*. Managements' congruent costing at period's end (including unexpired costs of fixed assets) in terms of overall strategic plans coincided with Littleton's own edict of fairness amongst competing parties [1953, Ch. 1 & 2, pp. 84-95]. Consequently, in his view, capital maintenance is a policy option of management and not a fundamental objective for accounting itself [1953, p. 23]. Moreover, no current market price can have a general status of fairness applicable to all firms [1953, Ch. 12], particularly where long-term strategies for periodic assets exist [see also Bell et al., 1997].

Littleton knew from examining over four hundred years of history that managements' attempts to adopt their own

[9] 2. Ch. 239.

'exchange values' for fixed and current assets generally had been too hazardous in practical terms [1953, p. 84]. While possibly relevant and theoretically consistent in financial terms with managements' economic planning and financial strategies, management's valuation in exchange was impracticable for general use because of speculation and reporting abuses [1953, p. 85]. Thus, Littleton elected to revive and support the *general* application of historical cost. This move was expedient, not ideological, in that it brought together his logical and historical reasoning for congruent values in exchange and generalized conservatism. However, cost as the central focus for accounting units remained, as it remains today, with revenues as compensation and profit as reward [Littleton, 1953, p. 95].

The profit and loss method under Littleton's [1953, pp. 84-91] structure, whereby established professional justification procedures provide for *methodological* objectivity [Dewey, 1947] together with periodic costing relevant to management's existing strategies, represents the core of his structural theory. This process does not in itself justify the generalized expediency of mandatory historical cost. Strictly speaking within the framework, costs are specific to managerial strategies for the firm in its environment. Under more recent professional attempts at standardization these might often be justified through the use of historic and current market prices as surrogates for management values in exchange. Nevertheless, generalization cannot posit some kind of ideal for accounting practice. The environment for observation of a complex set of operations under longer-term planning has different conditions for observation and more variety in its natural setting than does observation for valuing a corner store in a perfect market at two points in time. Accountants had grown to understand this complexity of production issues as the emphasis for relevant periodic costing since the 17th century [Howard, 1932]. In fact, professionalism in accounting practice had moved, and continues to move, towards providing credibility for reduced reliance on non-proximate market prices as values.

Littleton's argument, which is accepted here as having been adopted by the courts, is that the gradual movement away from market valuation methods at discharge of venture responsibilities to periodic income determination as a product of the double entry system was scientific [1953, pp. 80-90]. It reflected evolutionary changes in various social, commercial and legislative conditions. Moreover, legislators never intended managers to be overwhelmed or thwarted by charge/discharge financial

reporting of valuations reflecting shorter-term perspectives, a problem evident in many securities markets today. The success and security of investment plans for the contribution of capital by shareholders collectively were agreed to be important. However, these issues had to be placed in perspective against the invention and growth of goods and services for the community as a whole. For instance, the Joint Stock Companies Registration and Regulation Act, 1844 was introduced to assist productive enterprises towards longer-term objectives for invention, innovation and growth. Consequently:

> The maintenance of capital is indeed important, but maintenance is an objective of management policy . . . The proper matching of costs and revenues carries the relation of capital and income further than does the relation of principal and interest. The action of matching treats capital as a means, income as an end [Littleton, 1953, p. 23].

Emphasis by the courts on freedom of contract over arbitrary and restrictive creditor and shareholder protection proposals and concepts appears to have mirrored the nature and general tenet of companies legislation introduced by the British Parliament during the 19th century.

INSTITUTIONAL AND PROFESSIONAL CONTEXTS

Dicey [1905; 1914] argues that after 1825, British legislative history comprised two relatively distinct periods of 'laissez-faire' individualism (1825 to 1868) and 'collectivism' (1868 to 1900). Company legislation introduced and adopted during the laissez-faire period generally aimed at avoiding any restrictions over freedom of contract [Dicey, 1914, p. 146]. In contrast, the collectivist era was characterized by company legislation designed to secure protections such as compulsory financial disclosure, particularly for those individuals who lacked influence over the directorate [Dicey, 1914, p. 264]. While convenient as a framework for examining the evolution of corporate legislation for disclosure in Britain during the 19th century [Jones and Aiken, 1995; 1999], Dicey's [1905; 1914] thesis has been subject to a number of criticisms [Brebner, 1948, p. 71; Roberts, 1961, pp. 78-83; Cosgrove, 1980, pp. 171-194; Perkin, 1981, pp. 57-60; Walker, 1996, pp. 306-312].

Questions about Dicey's [1905; 1914] framework highlight a number of issues, including characteristics of laissez-faire and collectivist elements in both pre- and post-1870 legislation

[MacDonagh, 1977, pp. 9-11; Wood, 1982, p. 126; Harris, 1992, p. 118]. Also, multiple political and public doctrines either compete against or encapsulate laissez-faire and collectivist ideologies [Parris, 1960, pp. 35-36; Parris, 1969, p. 273; Lubenow, 1971, p. 9; Henriques, 1979, p. 260; Robb, 1992, pp. 17-18, 148-158]. The malleability of definitional boundaries is also a problem [Taylor, 1972, p. 12; Holmes, 1976, pp. 683-685]. While important, the debate surrounding Dicey's division of public policy making in Britain into distinct periods is relevant here only to the extent that it highlights two significant themes: (1) the apparent coexistence of both laissez-faire/economic liberal and collectivist/interventionist ideologies in 19th century British companies legislation [MacDonagh, 1977, pp. 9-11; Wood, 1982, p. 126; Checkland, 1985, pp. 158-159]; and (2) the general ascendancy of economic liberal strategies in social and macroeconomic policy up until the early 20th century [Crouch, 1967, p. 199; McCord, 1970, pp. 126-128; Taylor, 1972, p. 39; Crouzet, 1982, pp. 108-109; Parker, 1990, pp. 54-59; Robb, 1992, p. 189].

Undoubtedly, any attempts to categorize history into discrete and coherent periods is likely to yield anomalies. For instance, while the 1840s and 1850s have been described as the high point of laissez-faire in Britain [Court, 1962; Hobsbawm, 1973, p. 190ff], there appeared to be implicit acceptance of state intervention to secure individual rights and to protect private property [Dicey, 1914, pp. 260-261; Taylor, 1972, pp. 53-64; Paul, 1979, pp. 47-48]. Furthermore, Maltby [1998, p. 14] argues that laissez-faire is not, in itself, an adequate explanation for the way in which companies were regulated during the 1850s and 1860s:

> Although politicians invoked laissez-faire, they were not prepared to pursue it rigorously, because of the impossibility of making a clear distinction between the preservation of individual and collective rights [Maltby, 1998, p. 12].[10]

Consequently, it appears that legislators were not trying to do away with company regulation, but merely seeking to identify a minimalist framework within which companies could operate [Maltby, 1998, p. 13].

Despite the important restrictive disclosure and auditing provisions contained in the 1844 and 1845 Acts, both were in substance more liberal than restrictive in character. Underlying

[10] See also Brebner [1948, p. 71], Perkin [1969, p. 325; 1981, pp. 57-68] and Seaman [1972, p. 170].

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the 1844 and 1845 Acts was the expectation by legislators that economic progress through capital centralization and the resultant economies of scale in production would contribute towards economic prosperity [Court, 1962; Hobsbawm, 1973]. Accordingly, one of the principal tasks of limited liability was to emancipate free enterprise by harnessing the increasing glut of domestic investment capital that had appeared because of the Industrial Revolution [Dicey, 1914, p. 202; Hunt, 1936, p. 118ff]. For example, during the 1790s, industry funding needed for merchandise and other inventories and fixed capital formation were on an equal footing. However, by 1835 the fixed capital needs of industry were three times that of merchandise and inventory requirements combined [Crouzet, 1972, pp. 32-33]. Accordingly, neither the 1844 or 1845 acts represented simply an attempt to increase investment opportunities for banks and other financial institutions.

As the demands for increasingly larger and more productive plant began to outstrip the ability of banks to accommodate effectively the ensuing requests for funds, the banks responded by gradually withdrawing from long-term industrial involvement [Littleton, 1953, Ch. 5]. As a consequence, the responsibility for long-term funding of industry and commerce increasingly fell to the mechanism of limited liability [Jefferys, 1938, p. 160; Goodhart, 1972, p. 135; Kennedy, 1976, p. 160]. The vast majority of private companies initially availed themselves of limited liability to reduce risks associated with soliciting investments from close associates [Lavington, 1921, p. 208; Jefferys, 1938, p. 119; Kennedy, 1976, p. 161] or 'inside' investors [Bryer, 1998; Maltby, 1998]. However:

> . . . when private or internal resources were insufficient and short term bank accommodation was too limited and risky, British firms and entrepreneurs after the 1880's were forced to turn to the second means of implementing limited liability, that of public quotations on a stock exchange [Kennedy, 1976, p. 162].

Both Jefferys [1938] and Bryer [1997] contend that the introduction of limited liability was in the interests of capitalists seeking suitably large investments. Likewise, Maltby [1998, p. 30] argues that:

> The interests of large investors, the 'merchant bankers and merchant princes' . . . predominated throughout. Limited liability favoured them, by offering the possibility for profitable but less risky investment.

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However, notwithstanding the benefits provided by limited liability to large investors, the legislation also benefited entrepreneurs with innovative ideas by providing them with more ready access to capital. This occurred despite their initial cautious behavior. For instance, the preponderance of high denomination company shares with large reserves of uncalled capital [Maltby, 1998, pp. 19-20] could be interpreted as typical of an immature market in which creditors were hesitant to relinquish old lending habits. Consequently, directors were compelled to act as if they were operating unlimited liability companies [Kennedy, 1976].

Most significant compulsory British companies legislation was passed during the 'collectivist' era.[11] Much of this legislation either introduced compulsory disclosure and auditing requirements, or else strengthened and modernized pre-existing auditing and accounting provisions. However, the move towards collectivism was not necessarily at the expense of freedom of contract. For instance, the 1862 Act provided that companies were required to adopt the set of articles provided in the Act unless shareholders and directors specifically negotiated a set [Jones and Aiken, 1995, p. 76].

The shift back to disclosure requirements evident in the Companies Act, 1900 can be tied directly to increasing absentee ownership, and the concomitant disappearance of financial intermediaries [Kennedy, 1976, p. 164]. Maltby [1998, pp. 27-28] argues that the general fall in nominal values of shares, combined with a declining use of uncalled capital, had a significant impact during the last third of the 19th century:

> Diversification by large investors, as well as increased participation by small ones, meant that the limited liability company was running into problems of the separation of ownership and control.

Nevertheless, it appears that the legislators were aware of the problems associated with the separation of ownership and control before the advent of the collectivist era.

While the disclosure and auditing provisions contained in the 1844 and 1845 Acts may have discriminated against small investors, their introduction was specifically directed at the

[11] For instance, the Regulation of Railways Act, 1868, the Life Assurance Companies Act, 1870, the Gaswork Clauses Act, 1871, the Metropolis Water Act, 1871, the Building and Friendly Societies Act, 1874, the Companies Act, 1879, the Electric Lighting Act, 1882, the Municipal Corporations Act, 1882 and the Companies Act, 1900 [Brown, 1905; Dicey, 1914; Edey and Panitpakdi, 1956].

prevention of willful acts of 'fraud and illegality'. Compulsory accounting disclosure was not necessarily invoked as a remedy for companies 'faulty in their nature' or 'fraudulent in their objects'. It was recommended as a means of warding off 'mismanagement' by making directors answerable increasingly to 'outside' shareholders [Maltby, 1998, p. 18]. Hence, restrictive accounting provisions were specifically linked by the legislators to the protection of private property and the maintenance of law in line with classical economic philosophies of regulation [Jones and Aiken, 1995, pp. 69-70].

Against this backdrop of legislative and economic change, the accounting profession was undergoing significant changes of its own. Based on the listings in the London Post Office Directory, the number of accountants increased dramatically between 1860 and 1880 from 264 to 700. Following on from this, in 1870 the Institute of Accountants was formed in London. It was subsequently merged with a number of other professional accounting associations in 1880 to form the Institute of Chartered Accountants in England and Wales [Edwards, 1989, p. 277].

Several authors have linked this growth in the accounting profession to changes in companies legislation and the market for company shares [Maltby, 1998; Bryer, 1998, p. 59]. Joint stock companies registered under the Companies Act, 1844 were required to comply with a series of provisions relating to the production and registration of audited balance sheets [Maltby, 1998, p. 11]. While these mandatory requirements were not carried over to the 1856 and 1862 Companies Acts, a number of specific industries were subsequently required to adopt compulsory disclosure and/or audit requirements. For instance, disclosure requirements were introduced for gas companies (Gaswork Clauses Act, 1871) and for electricity companies (Electric Lighting Act, 1882). Compulsory disclosure requirements and audit requirements were also introduced for railway companies (Regulation of Railways Act, 1868), water companies (Metropolis Water Act, 1871) and joint stock banks (Companies Act, 1879) [Morris, 1993; Jones and Aiken, 1995, p. 72].[12] Consequently:

[12] After 1868, auditing and accounting preparation provisions also appeared in a number of Acts relating to the governance of counties, municipalities and parishes, such as the Municipal Corporations Act, 1882 [Brown, 1905, pp. 319-320].

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> . . . as a more dispersed group of investors was beginning, albeit slowly, to demand accounting information, an accounting profession was emerging which could supply that information" [Maltby, 1998, p. 28].

While auditing and financial disclosure requirements were eventually granted compulsory status in the Companies Act, 1900 [Edey and Panitpakdi, 1956], audits could have been performed by arrangement for such companies and institutions as the Forth and Clyde Navigation Company (1786) using government loans in earlier times [Forrester, 1980]. In later times, trustee and government monies would have been audited in accordance with the provisions of the Exchequer and Audit Departments Act, 1866.[13] Nevertheless, it is unlikely that government inspectors would have accepted anything but financial statements drawn up by fully skilled financial professionals [Funnell, 2004].

Even though companies legislation provided managers with the freedom to act as innovators in reporting, accountants do not appear to have been passive participants, and many made formative moves to establish themselves as recognized authorities on accounting practice. As such, they would have been vocal about the need for flexibility of directors, as their clients, to achieve their longer-term plans [Lavington, 1921, p. 213; Jefferys, 1938, pp. 295-314; Kennedy, 1976, p. 168; Maltby, 1998, p. 28]. On the other hand, economic advisors to investors and creditors would have noted the increasing opportunities for supplying their services under the new arrangements for lending and the transfer of securities, as well as the need for safeguards in such an environment.

INTERPRETATIONS OF JUDICIAL REASONING

While the uncertainty evident with respect to legislative origins raises questions about whether court cases can reveal fundamental principles of accounting, or of law itself [Rahman, 1992, p. 185], it is possible that one can overemphasize these problems. Accordingly, it will be argued here that questions addressed by the law in considering the acceptability of particular accounting methods for the purposes of dividend determination have usually focused upon: (1) authority for the distribution; (2) transparency of its effects in terms of fairness and/or value for

[13] 29 & 30 Vict. Cap. 39.

money to participants; and (3) managerial freedoms to provide for the on-going capacity for distribution.[14]

With respect to the authority for the distribution, it appears that English judges during the 19th century entertained a hierarchy of priorities consistent with legislative priorities. This hierarchy of priorities began with evolving customs and legislative provisions. For instance, despite the courts generally embracing freedom of contract, there were occasions prior to the *Lee* case when they returned to older principles of equity [Atiyah, 1979, p. 404, in Mills, 1993]. Some of these more traditional principles of equity are evident in companies legislation, such as in the Joint Stock Companies Act, 1862. Once it was clear that legislative provisions were not being breached, the courts reasoned down to non-compliance with contracts and other specific constraints on persons and firms. Consequently, the capital maintenance requirement was only enforced when clear-cut violations of the law occurred [Johnston, 1961, p. 545; Keown and Mann, 1956, p. 163].

In their attempts to evaluate the transparency, fairness and/or value for money of profit calculations and dividend payments, the judiciary was compelled to pay particular attention to specific revenues and expenses. They were undoubtedly assisted towards this end by the increasing popularity of the double account system [Dicksee, 1895, pp. 117-120; Yamey, 1962; Edwards, 1985, p. 19]. While the double account system comprises a method of classifying the balance sheet, a detailed profit and loss account is a conventional feature of this system [Parker, 1990, p. 66; Jones and Aiken, 1994, pp. 202-204]. Moreover, the production of a profit and loss statement is integral to the objectives of the double account system, which are: (1) to demonstrate stewardship or accountability about how capital raised by companies is used or spent; and (2) to distinguish capital from revenue expenditure [Carter, 1937, pp. 1024-1026; Morris, 1993, p. 172].

With respect to managerial freedoms, the increasing distinction between shareholders and directors after 1856 led the courts to adopt the view that financial accounting was primarily determined by the priorities of management. These priorities then focused upon the financial capacities of business opera-

[14] It is interesting to note that normative economists of the 1960s who followed Canning [1929, p. 319] believed practicing accountants were not interested in distribution [Chambers, 1966, p. 99].

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tions to fund future operations as directors thought best, and to distribute periodic dividends which were fair to shareholders collectively [French, 1977, p. 322]. In doing so, the courts relegated capital maintenance to a policy option of management [Littleton, 1953, p. 23]. A common theme that links accounting principles is the recognition of the rights of stakeholders under the *specific* circumstances in question. With respect to the specific circumstances encountered, no two legal disputes were identical.

Prior to 1889, Master of the Rolls, Sir George Jessel, provided a number of interpretations of the capital maintenance notion that were seemingly consistent with the intentions of the legislature at the time.[15] The model balance sheet annexed to Table A clearly indicated, by its format, that the amount considered available for dividends was to be discovered by deducting from the value of total assets the sums owing to outsiders together with the amount credited as paid up on the share capital. Consequently, the view emerged that dividends: (1) could not be paid out of capital; and (2) could only be paid out of profits. Furthermore, the two restrictions were ostensibly treated as synonymous. Both were interpreted to mean that only the surplus of net assets over paid up capital could be divided.

After 1889, an alternative interpretation began to gain ascendancy. By substituting the legal notion of capital with concepts of 'fixed' and 'circulating' capital [Dicksee, 1916, p. 14; Yamey, 1941, p. 280], and by rejecting the idea that legal precedent did not permit companies to pay dividends if net assets were less than the paid up share capital, the reforming judges were able to provide important freedoms to businessmen with respect to dividend policy. Furthermore, they were able to maintain consistency with the broader legal precedent that dividends must not be paid out of 'capital' [French, 1977, p. 318]. However, in the process the courts significantly undermined the importance of the surplus method of accounting measurement in favor of the profit and loss account method. This followed an emphasis on production rather than on consumption, a focus which had existed since larger firms emerged in numbers during the 17th century [Howard, 1932].

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[15] For instance, *re Ebbw Vale Steel, Iron and Coal Company* (1877) 4. Ch.D. 327, *re Dronfield Silkstone Coal Company* (1877) 17. Ch.D. 76, *re National Funds Assurance Company* (1878) L.R. 10. Ch.D. 118, *Dent v. London Tramways Company* (1880) 16. Ch.D. 344 and *re Exchange Banking Company* (Flitcroft's Case) (1882) 21. Ch.D. 518.

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By suggesting that the two major legal limitations in fact had different meanings, the judiciary managed to maintain consistency with the precedent that dividends should only ever be paid out of profits. However, profits were no longer necessarily tied to the surplus of net assets over paid up share capital, as was evident from the findings in *Verner v General and Commercial Investment Trust* (1894).[16] While attempting to distinguish between circulating and fixed capital for the purposes of profit measurement, Lindley, L.J. concluded that:

> Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost and yet the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up as otherwise it would enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to the law.

Similar views were expressed by judges in other cases.[17]

The adoption of notions of fixed and circulating capital was also likely to have been aided by the increasing use of the double account system [Dicksee, 1895, pp. 117-120; Yamey, 1962; Edwards, 1985, p. 19], which actually presupposes a distinction between fixed and circulating capital [Cooper, 1888, p. 744]. However, because neither circulating nor fixed capital could be defined without reference to the specific accounting situations and strategies from which they had arisen, the courts relied increasingly upon management and company objectives to aid in establishing distributable profit for legislative purposes. Furthermore, where there was no suggestion of illegal activity or bad faith, the courts deferred to accepted accounting practice and therefore maximized management's opportunities to act and provide on-going distributions to shareholders [Yamey, 1962, pp. 430-431].

Critical to the acceptance and promulgation of these views was their compatibility with other forms of creditor protection, such as the solvency rule [French, 1977]. The solvency rule, whereby it was illegal for a company to pay a dividend if to do

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[16] 2. Ch. 239.

[17] *Binney v Ince Hall Coal and Cannel Company* (1866) 35. L.J. Ch. 363; *Lord Rokeby v Elliot* (1880) 41. L.T. 537, modifying (1878) 38. L.T. 846; and *Ammonia Soda Company Limited v Chamberlain* (1918) 1. Ch.D. 208.

so would make the company insolvent, was first introduced in the Companies Act, 1855 (section 9). Although the provision was carried over to the Companies Act, 1856 (section 14), it was subsequently omitted from the Companies Act, 1862. Nevertheless, the solvency rule clearly made an impression on the judiciary at the time, and appears to have had an on-going influence over judicial reasoning.[18]

French [1977, p. 320] suggests that the similarities between the solvency rule and other contemporary legal requirements, such as the fiduciary duties contained in trust law, encouraged the courts to adopt the solvency rule as a guide to creditor protection. Nevertheless, having real world references in the form of liquidity and leverage, the solvency rule was less likely to constitute an arbitrary constraint over management's ability to control and direct longer-term business activities, particularly the provision of on-going distributions to shareholders.[19] Consequently, the rule was able to provide a guide to minimum creditor protection without inhibiting legitimate trading activities.

EVOLUTION OF CAPITAL MAINTENANCE ISSUES

Authority for the Distribution: The authority and legitimacy of the dividend distribution appear to have been foremost amongst the concerns of the judiciary and on many occasions these priorities overrode the upholding of agency type contracts. For instance, in *MacDougall v. Jersey Imperial Hotel Co.* (1864),[20] Sir W. Page Wood held that the payment of dividends during a period when there were no revenues clearly amounted to a payment out of capital and, therefore, was illegal.[21] Subsequent

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[18] *Lee v. Neuchatel Asphalte Company* (1889) 41. Ch.D. 1; *Verner v. General and Commercial Investment Trust* (1894) 2. Ch. 239; *in re National Bank of Wales* (1900-1903) All E.R. Rep. 484; *Dovey and the Metropolitan Banks of England and Wales Limited v. John Cory* (1901) A.C. 477; and *Wilmer v. McNamara and Co. Ltd.* (1895) 2. Ch.D. 245.

[19] *Lubbock v. British Bank of South America* (1892) 2 Ch.D. 198; *Ammonia Soda Company Limited v. Chamberlain* (1918) 1. Ch.D. 208; and *Dimbula Valley (Ceylon) Tea Co. Limited v. Laurie* (1961) 1. All E.R. 769.

[20] 2 H.& M. 528.

[21] It should also be noted that in 1864 there were no statutory provisions requiring companies to pay dividends out of profit and that the rule was invoked on the basis of public policy [Ford et al., 1999, p. 40]. See also *re Ebbw Vale Steel, Iron and Coal Company* (1877) 4. Ch.D. 827, *re National Funds Assurance Company* (1878) L.R. 10. Ch.D. 118, *Guinness v. Land Corporation of Ireland* (1882) L.R. 22. Ch.D. 349, *re Alexandra Palace Company* (1882) 21. Ch.D. 149 and *Flitcroft's Case* (1882) 21. Ch.D. 519.

cases overwhelmingly confirmed the view that dividend payments could not be made to shareholders where there are no 'profits' reported, even where private contracts guaranteed such payments.[22]

If it was clear that individual stakeholder rights were not at risk, the courts most often appeared satisfied to enforce express agency-type agreements stipulating the use of particular accounting methods for profit and dividend determination. This is consistent with the view that the judiciary reasoned downwards from evolving customs and legislative provisions to non-compliance with agency contracts. For example, in *Davison v Gilles* (1879),[23] Jessel, M.R. concluded that in the company's articles, profits meant 'net' profits, principally " . . . because you do not get a reserve fund at all until you have paid your current expenses" [p.193n].[24]

Accounting principles and practices, or more precisely the numbers they generate, are often used to define competing property rights between contracting parties [Watts, 1977]. However, with respect to judicial priorities the need to uphold *specific* rights established under agency contracts overrode the expectation that companies should comply with *generally* accepted accounting principles and procedures. As long as neither the legislation nor creditors' protection had been violated, the requirements of the articles of association were respected. For instance, in *Dent v London Tramways Co.* (1880),[25] Jessel, M.R. sanctioned the payment of a preference dividend on the basis that, in accordance with the companies articles, there existed a profit for the year. Therefore, to have decided otherwise would have caused an obvious injustice [Yamey, 1962, p. 441]. Likewise, in *Lambert v Neuchatel Asphalte Company* (1882), Bacon, L.J. rejected the claim that the company should provide for depreciation of a long-lived mining lease on the grounds that the company's articles required no such reserves to be established. Bacon suggested that although Jessel's definition of 'net' profits

[22] See also *Salisbury v Metropolitan Railway* (1870)(2) 22. L.T. 839, *re Oxford Benefit Building and Investment Society* (1886) L.R. 35. Ch.D. 502, *Trevor v Whitworth* (1887) 21. App. Cas. 409, *Leeds Estate, Building and Investment Company v Shepherd* (1887) L.R. 36. Ch.D. 787 and *re Walters' Deed of Guarantee* (1933) 1. Ch. 321.

[23] 16. Ch.D. 347n.

[24] See also *Dent v London Tramways Co.* (1880) 16. Ch.D. 344 and *Kehoe v The Waterford & Limerick Railway Co.* (1888) L.R. 21, Ir. Ch.D. 221.

[25] 16. Ch.D. 344.

in *Davison v Gilles* (1879) was no doubt appropriate in the circumstances of that case, Neuchatel Asphalte's articles stated otherwise [pp. 884-885].[26] Similar reasoning to this was used subsequently in the *Lee* case.

In the lower court proceedings of the *Lee* case, Stirling, J. had refused to enjoin a dividend since the plaintiffs had failed to prove that the value of the company's assets had deteriorated [Kitchen, 1974, p. 124].[27] Stirling, J. indicated that his views on capital maintenance were closely aligned to those of Jessel's [Reid, 1987b, p. 251 and footnote 19].[28] However, he suggested that at some future time the company might have to set apart a substantial sum to represent depreciation in the value of the concession. This implies that at the time the charging of depreciation was regarded as indicative of the making of a good faith valuation of assets and that, provided there was nothing to suggest management had acted illegally, capital was being maintained [French, 1977, p. 309].[29] Nevertheless, the charging of depreciation was not compulsory, and *specific* rights established under agency contracts could in fact override the requirement that companies comply with *generally* accepted accounting principles.

Transparency of Distributional Effects: Another important influence over judicial reasoning with respect to dividend payments was the transparency of the profit calculations and the fairness of the resulting distribution. By adopting such a viewpoint, the courts were compelled to concentrate on specific revenues and expenses within the overriding considerations of the objectives of management and the company. For instance, in *Bale v Cleland* (1864),[30] Martin, J. agreed with the company's accounting treatment of preliminary expenses on the basis that allocating capitalized cost as an expense over future periods was consistent with the accounting practices adopted by railway

[26] Furthermore, Bacon, L.J. suggested that while " . . . the Court will interfere to redress any wrongs, . . . the Court never interferes to prescribe to companies what they shall do as to their own internal affairs" (p. 883).

[27] Not only had the terms and size of the concession recently been extended, but it was also being held on more favorable terms than had originally been the case.

[28] As suggested by Yamey [1941, p. 277], Stirling, J. " . . . merely reaffirmed the earlier series of decisions".

[29] For instance, *Binney v Ince Hall Coal and Cannel Company* (1866) 35 L.J. Ch. 363 and *Mills v Northern Railway of Buenos Ayres Company* (1870) L.R. 5. Ch.App. 621.

[30] 4. F. & F. 117.

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companies in similar circumstances at the time. However, the court rejected the company's treatment of expenditure incurred for research and development purposes as it had been applied in an arbitrary manner. Subsequent cases generally affirmed the courts' acceptance of companies capitalizing preliminary expenditures when applied in a systematic manner and when consistently confirmed by the company's auditor [Best, 1885, p. 573; Dicksee, 1895, p. 55].[31]

The courts focus on specific revenues and expenses as they applied to management's objectives was also evident in the *Lee* case, and a number of cases that followed *Lee*. By emphasizing the distinction between capital and revenue accounts, both Lopes, L.J. and Lindley, L.J. averted the possibility of including accretions or diminutions of capital in the determination of profits.[32] In doing so, the presiding judges effectively focused the legal fraternity's attention upon commercial and accounting issues, such as the significance of the accounting principle of revenue recognition [Littleton, 1953; Myers, 1959], rather than on a broad definition including principles of capital maintenance [Ford, 1993, p. 100].

Because most of the cases dealing with depreciation heard prior to *Lee* did not involve mining assets,[33] recognized opinion at the time suggested that the *Lee* decision may have applied only to companies working with wasting assets [Morris, 1986, p.72]. Nevertheless, *Lee* marked the beginning of a succession of court cases that further undermined the capital maintenance concept as a means of determining profit for the purposes of dividend distribution [Morris, 1984, p. 59].[34] It also highlighted the role of management and company objectives in determining the distinction between fixed and circulating assets. For instance, in *Verner v General and Commercial Investment Trust* (1894),[35] the court sanctioned a dividend from income received

[31] For instance, *Turquand v Marshall* (1869) 20. L.T. 766, *Rance's Case* (1870) L.R. 6. Ch. App. 104 and *re Oxford Benefit Building and Investment Society* (1886) L.R. 35. Ch.D. 502.

[32] See also *Glenville Pastoral Co. Pty. Ltd. v. FCT* (1963) 109. C.L.R. 199 and *BTR Nylex v. Churchill International Inc.* (1992) 9. A.C.S.R. 361.

[33] *Davison v. Gillies* (1879) 16. Ch.D. 347n; *Dent v. London Tramways Co.* (1880) 16. Ch.D. 334; and *Leeds Estate, Building and Investment Society Ltd. v. Shepherd* (1887) 36. Ch.D. 787.

[34] *Re Ebbw Vale Steel, Iron and Coal Company* (1877) 4. Ch.D. 827; *Re Dronfield Silkstone Coal Company* (1877) 17. Ch.D. 76; *Dent v. London Tramways Company* (1880) 16. Ch.D. 344; and *Lawrence v. West Somerset Mineral Railway Company* (1918) 2. Ch. 250.

[35] 2. Ch. 239.

from securities despite the trustees failing to make good the loss in the value of the securities. However, Stirling, J. did suggest that had the company been an ordinary trading company his decision would have been different.[36]

Cases subsequent to *Lee* further reinforced the courts' rights to consider each case presented on its own merits. For instance, in the case of *Bond v Barrow Haematite Steel Co.* (1902),[37] preference shareholders had urged that a dividend payment be made on the grounds that the losses arising from the flooding of mines and miners' cottages on a lease of mining rights could be ignored. However, in his judgment Farwell, J. declared that his opinion coincided with that of the experts, inasmuch as he thought that the money invested in these items (mines, etc.) was properly regarded in this company as circulating capital. Consequently, losses caused by the flooding had first to be made good before distributable profits were calculated [Ford and Austin, 1995, p. 666]. Following the precedent established in *Dovey v Cory* (1901),[38] Farwell, J. stated that:

> . . . the real question for determination, therefore, is whether there are profits available for distribution and *this is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses* (*emphasis added*).[39]

Underpinning the judicial decisions described above was the court's wish to avoid any ruling which could fetter the legitimate activities of the company under the particular conditions encountered [Littleton, 1953, Ch.11]. For instance, Lindley argued in the *Lee* case that it was not for the court to interfere in the activities of businessmen, particularly as there had been no suggestion of bad faith. Lindley also suggested that the appellant's argument that capital be maintained at all costs should be dismissed. By entertaining such ideas the court was being invited "to lay down certain principles, the adoption of which would paralyze the trade of the country".[40] Lindley had

[36] See also *Bolton v Natal Land and Colonisation Co.* (1892) 2. Ch. 124 and *re Kingston Cotton Mills Co., No.2* (1896) 1. Ch. 331.

[37] 1. Ch. 353.

[38] *Dovey and the Metropolitan Banks of England and Wales Limited v John Cory* (1901) A.C. 477.

[39] Interestingly, Farwell would have come to the same conclusion whether he had followed the House of Lords *in re National Bank of Wales* (1900-1903) All E.R. Rep. 484 at 365, or if he had followed the Court of Appeal's *Lee* ruling.

[40] 41. Ch.D. 1, at 24.

based his views on the fact that the legislation contained no direct reference to the payment of dividends [Yamey, 1941, pp. 277-278].

Managerial Freedom to Provide for the On-Going Capacity for Distribution: While the findings in the *Lee* case did not require depreciation to be charged on fixed assets in that particular case, nothing in the judges' findings forbid the practice outright. This appears to be borne out by the limited impact the *Lee* case had on the rate of adoption of depreciation accounting amongst British mining companies [Morris, 1986]. Of paramount concern to the judges was that funds should not be arbitrarily locked into business entities that may not have any immediate or longer-term prospects. Thus, the *Lee* decision was not so much a special situation only generally applicable to companies working wasting assets [Morris, 1986, p. 72], but a special situation which was only generally applicable to companies operating specific projects with limited lives.

In the *Lee* case, the directors did not intend that the company would carry on the business in perpetuity. Consequently, there was little point in providing for the continuity of the asset [Dicksee, 1895, pp. 128-129; Morris, 1986, p. 72]. However, in cases where the charging of depreciation was considered appropriate for the circumstances, the courts held that the businessman's view on depreciation should be accepted.[41] Consequently, the role of depreciation in company accounting was interpreted by the courts to facilitate continuity of the firm in its environment where continuity was an objective of management. Where it was not, real world outcomes from the reporting process itself, such as dividend restriction, were not supported by principles which were unfair in the context.

General acceptance of the profit and loss method by managers may well have guided the courts towards the view that funds should not be arbitrarily locked into business entities. For instance, it was conventional under the profit and loss system that fixed assets were neither valued nor depreciated [Jones and Aiken, 1994, p. 204]. Nevertheless, the profit and loss method still permitted managers to charge depreciation if the circumstance warranted. In contrast, profit determination under the surplus approach required entities to incorporate changes in the value of all their assets, including non-current and fixed assets,

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[41] For instance, *Rishton v Grissell* (1868) L.R. 5. Eq. 326 and *Kehoe v The Waterford & Limerick Railway Co.* (1888) L.R. 21, Ir. Ch.D. 221.

in the computation of profit [Kehl, 1976, pp. 3-13; Revsine, 1981; Jones and Aiken, 1994, p. 201].

While cases subsequent to *Lee* did little to clarify the main problems with capital maintenance issues, they did confirm the trend in the post-*Lee* decisions [Yamey, 1941, p. 282]. For instance, when the *National Bank of Wales* case reached the House of Lords as *Dovey v Cory* (1901),[42] the view was taken that rigid rules could be potentially disastrous to companies:

> People put their money into a trading company to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero and possibly involve its ruin.

Judicial hesitation over forcing trading entities to retain funds beyond an amount which was considered 'economically sensible' diminished any opportunities to make the capital maintenance concept explicit. However, as the continuity of a harmonious relationship between shareholders and management depends on the regular payment of dividends as well as management's control over strategy formation, the law's concession was of great value. It also provided a means by which the judges could ensure capital was not bound up in any particular investment profile. Nevertheless, if there had been any confusion surrounding the issue of paying dividends out of the excess of receipts over current expenses despite fixed capital being lost, the *National Bank of Wales* case was probably the best opportunity available to the judiciary to re-establish the position taken prior to 1889. However, the judiciary declined to take up this opportunity [French, 1977, pp. 314-316], the Lord Chancellor doubting whether dividend questions could ever be treated in the abstract at all [Yamey, 1962, p. 436]. Furthermore, the capital maintenance principle enunciated in the *Lee* case, that business matters are the province of business men, was reaffirmed by the highest tribunal [Yamey, 1962, p. 437].

The findings in subsequent cases, such as *Lawrence v West Somerset Mineral Ry.* (1918),[43] established conclusively that the judiciary had clearly rejected the doctrine of capital maintenance. While the payment of a dividend and the imminent termination of the lease on the firm's principal asset would have left inadequate assets to repay the bondholders in the event of

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[42] *Dovey and the Metropolitan Banks of England and Wales Limited v John Cory* (1901) A.C. 477.

[43] 2. Ch. 250.

dissolution, the court refused to intervene on behalf of the bondholders because the dividend was being paid out of divisible profits [Yamey, 1962, p. 437].

CONCLUSIONS

Principles, conventions and rules of science-based professions have respected, sustained and empowered the methodological precedents of their respective disciplines over time. This is especially so in the human and biological sciences [Dewey, 1939, 1947; Foucault, 1970, p. 363; Grene, 1985, p. 7]. In this sense decisions of the courts in the 19th century and the associated schema of Littleton [1953, Ch. 1, 5, 8 & 12] presume a continuing duty to avoid epistemological anomalies and unfair outcomes in practice. These might be associated with the use of microeconomic theories. That is, accounting choices imposed on management which give rise to values and other amounts which lack congruency with managerial strategies could distort accounting practices for the firm as a *whole* in its specific and continuing environment. These numbers potentially lack authenticity as traditional justifications, being a first step in knowledge towards the discovery and establishment of a new 'situation' for observation and analysis [Dewey, 1939, Ch. 6; Grene, 1985, pp. 7-8]. They might also lack the capacity to facilitate understanding of pre-conditions as analytical observations, thus necessitating change to methodological traditions [Hopwood, 1987].

On numerous occasions both before and after the *Lee* case British courts were asked to adjudicate on the appropriateness of particular measurement methods for the purposes of dividend determination. In general, the judges exhibited a consistency in their decision-making. Furthermore, no substantial evidence exists to suggest that the courts took the view that longer-term management strategies should be subsumed by annual disclosure of current 'value to the owner' calculations under the surplus method. Judicial attempts to understand accounting valuations as they related to distributional issues were predominantly concerned with management capacity to control and direct business activities and to determine on-going distributions to shareholders, particularly in the longer-term [Yamey, 1941; Littleton, 1953]. Consequently, it has been argued here that the British courts rejected the surplus method of profit determination for distributive purposes on the grounds that as a methodology it is insufficiently robust to envisage many of the

specific risk factors, estimates of cash flows and resultant dividend distributions incorporated into management's planning horizons [Bell et al., 1997].

Hopwood [1987] may have divined the element of traditional accounting practice as determined by the courts from his observations of the transformation of Josiah Wedgwood's accounting system (1772) for the firm as a *whole*. This was in its overall role of matching performance of the firm to its environment. The matching principle based on relevant costing has been established in Europe since the 17th century [Howard, 1932, p. 93]. Unless facing a perfect market [Beaver and Demski, 1979], this ethic for matching under double entry cannot be displaced by selection of historic or current market prices, although they may be used as proximate prices for justification of unexpired costs under the traditional production emphasis. Thus, when Wedgwood established his new system based on accounting practices relevant to both the strategies and the decision structure of the organization as a whole, then innovative qualities empowering origin and persistence of accounting practices could come into play:

> The fine details of the production process could now be related to the aims and performance of the organization as a whole. Policies created at the top of the organization could be related to specific aspects of organizational functioning" [Hopwood, 1987, p. 218].

In other words, Hopwood's basic measurement structure should ultimately be related downwards to Kaplan and Norton's [2001a; 2001b; 2004] 'balanced scorecard' for congruence with established and on-going management strategies and related profiles.

The basic ethic of accounting measurement captures the spirit of traditional macro evolutionary practice and legal precedents where periodic evaluation of prospects and strategies for the firm as a whole becomes aligned with management awareness under the profit and loss method favored by the courts. Accordingly, the judiciary did not prohibit the use of economic concepts such as depreciation. Rather it was a discretionary responsibility of managers who would be expected to *justify* the calculations and the resulting periodic financial outcomes [Dicksee, 1895, pp. 128-129; Morris, 1986, p. 72]. Littleton, although an economist, followed the tradition and suggested that " . . . depreciation measures the productive contribution of the asset in question" [1953, pp. 212-213]. However, without justification he chose to adopt the expedient solution of linking peri-

odic assessment of asset prices and depreciation to 'invested cost' in market places, being generalized historic cost. Despite protestations to the contrary [1953, Ch. 2, 5 & 8], this historical market price process turns his profit and loss structure into a quasi-surplus method having no status in periodic reporting. It mandates depreciation as an accounting principle, a process not endorsed by the British courts under the double entry reification of management responsibilities for control in financial terms. Traditionally, market prices of any kind are proximate prices and surrogates for 'objectivity' in practice. The do not imply the 'essence' of periodic accounting measurement [Hopwood, 1987, p. 211]. Under Littleton's [1953] macro-evolutionary approach, costs become outputs as benefits to the community as a whole; revenues are compensation to the entity; and profits are rewards [p. 95].

This ethic of justification would have been seen by the British courts as driving the double entry system for the firm as a whole entity in practice; not current market prices as increases of value to the owner being an economic reference to periodic capital maintenance. However, this only applies if business institutions have not given up long-term planning for production in favor of shorter-term asset revaluation to enrich speculation in the buying and selling of securities.

While microeconomic measures of market prices may be relevant in certain specific circumstances, they may not of themselves provide outside of perfect markets a picture of the firm's *whole* performance under managerial strategies [Bell et al., 1997]. For instance, a study of Lindley, L.J. in *re London and General Bank* (no.2) (1895)[44] shows that more than the discovery and 'adding up' of market prices is required for the independence and competence of auditors. In addition, the distinction between circulating and fixed capital has come to be generally regarded as arbitrary and, therefore, unworkable for the purposes of economic-based models of profit measurement [Cooper, 1894, p. 1041; Revsine, 1973; Prakash and Sunder, 1979; Samuelson, 1980]. Nevertheless, this has failed to this day to inhibit the general acceptance in practice of costing methods based broadly upon fixed and variable concepts. These are aids in determining congruence with management strategies unless constrained by the 'lower of cost and market' rule [Aiken and Ardern, 2003].

[44] 2 Ch.673; 64 L.J. Ch. 866.

In more recent times, accounting standard setters in Britain and Commonwealth countries such as Australia have adopted a different approach to that of the British judiciary. In an attempt to restrict the role of managerial judgment, policy makers have increasingly sought to limit the permissible number of classification, measurement and transformation procedures [Bromwich, 1985, p. 1; Taylor and Turley, 1986, p. 1; Langfield-Smith, 1990, p. 6]. Policy makers have also recommended that economic values be allowed under professional accounting standards and that companies produce abridged financial reports. Many of these changes appear to be reactions to events such as corporate collapses that reveal systematic abuses of accounting procedures. However, some appear to be reactions against historical cost as a general rule. The first step toward avoidance of disclosure type losses is, however, enforcement of managerial valuation obligations.

The British courts in the 19th century clearly assumed that the legislators had not intended to force companies to disclose periodic changes only in the market prices of fixed assets where management's strategies were longer-term. Moreover, they appreciated that these reporting behaviors could diminish on-going economic opportunities and social responsibilities, and thus potentially restrain management's capacity to plan and to adapt to new challenges for the firm. Instead, the courts focused on the periodic matching of costs ('efforts') and revenues ('accomplishments'), and whether there existed a congruency between the measurement of costs (both expired and unexpired) and management's long-term strategies.

If something different to a periodic overall macro portrayal of the whole firm under management's strategies in its specific evolving environment for continuity is required in the modern era, then governments, economists, stock market analysts, liquidators and potential investors may need to be prepared to sponsor individual specialized reports. This is how markets for micro information should work in a free-enterprise society [Beaver, 1981]. As for capital maintenance, environmental factors relating to a diversity of planning horizons and risks have varied, but not necessarily or generally corrupted, choice of accounting measures under standardization [Aiken and Ardern, 2003]. Historically, a need for objectivity and economic measurement for the community did not cloud the focus of the British courts on management's mission as the longer-term criterion of financial success. This may provide relevance for accounting assessments

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of unexpired costs as congruent residuals of periodic activity [Littleton, 1953, p. 98].

The courts in 19th century Britain would have been aware that the emergence of large-scale private organizations facing imperfect markets since the end of the 17th century had given emphasis to accounting for relevant costs with a focus on production, not consumption [Canning, 1929, p. 319; Howard, 1932, p. 93]. Relevant costing for 'unexpired costs' [Littleton, 1953, Ch. 5] is not the expediency of generalized historical costs. It must be congruent with management strategies for the organization as a whole under the double entry based profit and loss approach [Hopwood, 1987, p. 218; Bell et al., 1997]. Away from complete and competitive markets [Nickel, 1995], macro-evolutionary accounting reports of this nature cannot be reduced generally to scientific laws and principles of microeconomics as a theoretical and legal ideal under capital maintenance hypotheses or related efficiency criteria [Shwayder, 1967; Beaver and Demski, 1979; Ayala, 1985].

Financial accounting and auditing has often focused on the application of historic and later current market prices, for businesses operating in complete and competitive markets. However, the avoidance of too heavy reliance on such prices, and emphasis on relevant cost control by management congruent with overall strategies (Kaplan and Norton, 2004), not simply upon the collection of more revenues in the shorter-term, is pertinent. Such cost control is pivotal to the extent of innovation and future profit sharing in imperfect markets.

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