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Accounting Standards in the United States and the United Kingdom: Their Nature, Causes and Consequences

George J. Benston*

The purpose of this article is to account for the existence of differing accounting standards in the United States and the United Kingdom despite a common language, common practice and a fundamentally common political and economic base in the two countries. What factors explain the fact that, while accounting standards in the United States are codified and explicit, they remain on the whole uncoded and implicit in Great Britain? From which system does the investor more likely benefit? The first section of this paper begins with descriptions of auditing and reporting standards in each country. The factors which influence the establishment of accounting standards are examined in the following section. Within this second section, the inherent limitations of accounting measurements are discussed, from which some hypotheses are developed explaining the function of accounting standards and speaking to the question of why the standards are stated explicitly or implicitly. The answers to these questions are then contrasted with four environmental differences between the United States and the United Kingdom: (1) the professional environment, (2) the economic environment, (3) the regulatory environment and (4) the legal environment. Finally, the last section presents a cost-benefit analysis of explicit and implicit accounting standards for investors.

I. ACCOUNTING STANDARDS IN THE UNITED STATES AND THE UNITED KINGDOM

The term "accounting standards," as used herein, denotes the implicit or explicit rules or conventions which define (1) the allowable data transformations used in the preparation of the financial statements, (2) the formats of the statements, and (3) the *ex post facto* tests of the statements used by independent accountants (auditors)¹ in arriving at an opinion. Accounting standards are separated

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1. The designations "accountant" or "auditor" are used interchangeably in this paper

into financial reporting standards, which include the first two categories, and auditing standards, which include the third category. Though accounting standards may refer to the numbers presented in any financial statement, they generally are assumed to refer primarily to the published statements of publicly owned corporations.

On the whole, the similarities between the accounting standards of the United States and the United Kingdom outnumber their differences. Because of this similarity, an accountant from either country could relocate in the other without feeling too much out of place and without needing special glossaries to interpret line descriptions in financial statements. Accounting professors often hold visiting appointments during which, with little additional preparation, they can teach both the theoretical and applied aspects of auditing and accounting (other than income taxation). The bond between countries is further evidenced by the fact that accounting periodicals are read and contributed to by practitioners and professors on both sides of the Atlantic.

The principal difference lies in the way accounting standards are stated and the extent to which they mandate the presentation of financial data. These differences are due, I believe, to differences in the professional, economical, regulatory, and legal structures of the two countries. As a consequence, the data made available to the public differ somewhat and the cost of producing and distributing the data differs somewhat more. But before the factors which influence the setting of accounting standards are described and analyzed, the principal differences in the standards themselves should be outlined.

A. *Auditing Standards in the United States*

Both auditing standards and rules for reporting financial data are far more formally stated in the United States than in the United Kingdom. With respect to auditing, the American Institute of Certified Public Accountants (AICPA) has drafted and adopted general and specific auditing standards. These are published as "Codification of Auditing Standards and Procedures."² Three main categories of auditing standards are delineated in the "Code": (1) general standards, (2) standards of field work and (3) standards of reporting.

and stand for the independent certified (U.S.) or chartered (U.K.) public accountant who certifies or reports on the financial statements primarily of publicly-owned corporations.

2. 1 CCH A.I.C.P.A. PROF. STANDS. §§ 110.01-561.10 (1974). For a brief description of the development of auditing standards see M. Moonitz, *Obtaining Agreement on Standards in Accounting Profession*, STUDIES IN ACCOUNTING RESEARCH 4, 4-8 (American Accounting Association, 1974).

The first category describes the general qualifications of the auditor and his need for independence. The second states the necessity for planning and supervising an audit, the requirement that the client's internal control system be evaluated, and the requirement that competent evidentiary matter (including physical verification) and confirmations be obtained to support the auditor's opinion. The third category requires assurance that the statements on which an opinion is given are prepared in accordance with generally accepted accounting principles applied consistently, and describes the conditions under which an auditor may and may not give a "clean" or a "qualified" opinion. In addition, the AICPA has adopted a series of suggested audit procedures (Industry Study Guides) for specific industries.

The Securities and Exchange Commission (SEC) has, in general, allowed the AICPA to develop and codify auditing standards. As Louis Rappaport observes, "With a few exceptions [reports of security dealers, investment companies, and the like] the SEC does not prescribe the procedures to be followed by the independent public accountant in his examination for the purpose of certifying financial statements to be filed with the Commission."³ The SEC has used its power, however, to enforce the application of generally accepted auditing standards and procedures.⁴ The Commission also has actively supported the AICPA's adoption of observation of inventory counts and confirmation of significant receivables as mandatory audit requirements. The most active intervention of the SEC, though, is in enforcing its definition of independence,⁵ a definition that was adopted by the AICPA in 1963.⁶ This definition requires CPAs to be scrupulously independent in appearance as well as in fact: neither they, their families, nor any member of their firms may have any financial interest in their clients; nor may they give opinions on statements prepared from records on which they worked or supervised the original work.

B. Auditing Standards in the United Kingdom

In contrast, British auditors do not work under a code of formally stated auditing standards. Neither the Companies Acts nor the Institute of Chartered Accountants in England and Wales (ICAEW) dictates specific procedures to be followed in an audit. Rather, as Bruce Picking states, "While the Companies Acts lay

3. L. RAPPAPORT, *SEC ACCOUNTING PRACTICE AND PROCEDURE* 5-1 (3d ed. 1972).

4. *Id.* at ch. 5.

5. 17 C.F.R. § 210.2-01 (1974).

6. 2 CCH A.I.C.P.A. PROF. STANDS. § 101.01 (1974).

down requirements with which the auditor must comply, the English Institute [ICAEW] has preferred to rely on persuasion rather than compulsion in most instances."⁷ In this regard, the ICAEW has published a statement, "General Principles of Auditing," which suggests general standards of auditing and field work procedures that are similar to those followed in the United States.

The Companies Acts, however, do require limited liability companies to be audited. The Acts specify the auditor's rights and qualifications. In particular, the auditor must be appointed by and report to the shareholders at the general meeting, rather than to the board of directors or management as is often the case in the United States. In addition, the auditor has the right to inspect the company's books and records and be present and be heard at shareholders' meetings.

An auditor in the United Kingdom must be a member of a recognized body of accountants and must be independent. Generally, independence is defined as it is in the United States, with one notable exception: the British auditor is not precluded from having a financial interest in the company audited. The ICAEW (and the other British Institutes) requires only that an auditor be independent in fact, not necessarily in appearance as in the United States. The Institute, moreover, does not have a detailed written code of conduct as does the AICPA.

C. Reporting Standards in the United States

Agreement on reporting standards or accounting principles in the United States has been neither as extensive nor as easily achieved as the codification of auditing standards.⁸ The AICPA established a series of committees that issued opinions seeking to define the "correct" accounting for specific transactions and situations. The most long-lived of these was the Committee on Accounting Procedures (CAP). From 1939 through 1959 it issued 51 Accounting Research Bulletins (ARBs) which recommended rather

7. Picking, *Auditing Standards*, ACCOUNTING & BUSINESS RESEARCH, 13, 60-70 (winter 1973).

8. For an excellent history and analysis of the role of the AICPA and ICAEW in the development of accounting principles see S. ZEFF, FORGING ACCOUNTING PRINCIPLES IN FIVE COUNTRIES: A HISTORY AND ANALYSIS OF TRENDS 1-90, 110-236 (1972) [hereinafter cited as ZEFF]. A good review of the role of the AICPA in the codification of accounting standards is found in AICPA Study on Establishment of Accounting Principles, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS (1972) [hereinafter cited as AICPA Study], which also recommended creation of the Financial Accounting Standards Board (FASB). The problems experienced by the AICPA in obtaining agreement on reporting standards are contrasted with their success in developing and adopting auditing standards.

than demanded that particular practices be followed. Consequently, a number of alternative accounting methods came to be considered "acceptable." This situation led to criticism of the accounting profession for allowing companies to report what seemed essentially similar events in different ways. As a result, the press, analysts and other critics charged that financial statements lacked comparability and that investors might be misled.⁹ The AICPA responded to this criticism in 1959 by replacing the CAP with the Accounting Principles Board (APB). Unlike its predecessor, the APB commissioned research projects that were intended to lead to authoritative pronouncements. Less than half the pronouncements issued, however, were preceded by research studies. After its first few years, the APB concentrated on specific, pressing problems which it "solved" by narrowing the number of permissible procedures.

In spite of these efforts, pressure on the accounting profession continued to build. An increasing number of lawsuits—with accompanying news coverage—were filed against CPAs.¹⁰ The accounting practices of conglomerates, other firms that grew by mergers and acquisitions, and land development and real estate companies were criticized severely. The APB was castigated, as was its predecessor, for allowing a wide variety of accounting practices to be called "generally acceptable." The 1972 study commissioned by the AICPA recommended creation of a new organization, the Financial Accounting Standards Board (FASB), independent of the AICPA and sufficiently well funded to employ well paid full-time directors and staff who would conduct research and promulgate opinions.¹¹ These recommendations were accepted, and in 1973 the APB was scrapped in favor of the FASB. The opinions published thus far by the FASB continue the trend towards narrowing alternative acceptable accounting practices.

The move towards uniformity in accounting reporting practices was furthered by the AICPA's adoption in 1972 of Rule 203 of the restated Code of Professional Ethics.¹² The rule requires that "[a] member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by the Council to

9. See, e.g., L. RAPPAPORT, *supra* note 3, at 3-1 to 3-9. See generally A. BRILOFF, UNACCOUNTABLE ACCOUNTING (1972).

10. See Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 BUS. LAW. 1205, 1223 (1974); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113 & n.2 (1971).

11. See AICPA Study, *supra* note 8, at 70 (creation of FASB recommended).

12. 2 CCH A.I.C.P.A. PROF. STANDS. § 201.01 (1974).

establish such principles which has a material effect on the statements taken as a whole"¹³ An exception is allowed if the member believes that the statements would otherwise be misleading, in which event the departure and its effects must be disclosed,¹⁴ but the onus is on the accountant to justify a deviation from the "principles" if it has a material impact on the financial statements.

Perhaps the most important force in moving United States accounting standards toward greater uniformity is the SEC. Sections 19(a) of the Securities Act of 1933¹⁵ and 13(b) of the Securities Exchange Act of 1934¹⁶ give the SEC the power to prescribe

. . . the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts. . . .¹⁷

Rather than use this power, the Commission has chosen to accept the practices deemed generally acceptable by the accounting profession. The realization that the SEC could prescribe accounting procedures, however, has spurred the AICPA towards formalization of "generally accepted accounting principles."¹⁸

That the SEC has neither used its power to reshape accounting into whatever image it thought best nor even conducted, or sponsored much research on the question does not mean that it has been passive. The SEC's Regulation S-X¹⁹ prescribes the specific items which must be disclosed in the financial statements filed with the Commission. The list of accounts is long in comparison to the standards of reporting in the United States before enactment of the Securities Act and in comparison with reporting in other countries.²⁰ For the balance sheet, Regulation S-X calls for more than sixty-five specific items compared to thirty-nine required in the United Kingdom by the Companies Act and The Stock Exchange.^{20.1} For the

13. *Id.*

14. *Id.*

15. 15 U.S.C. § 77s(a) (1970).

16. 15 U.S.C. § 78m(b) (1970).

17. Securities Exchange Act of 1934 § 13(b), 15 U.S.C. § 78m(b) (1970). The wording of the 1933 Act is substantially similar. 15 U.S.C. § 77s(a) (1970).

18. The SEC's role in establishing accounting principles is described in RAPPAPORT, *supra* note 3, at ch. 2-4.

19. 17 C.F.R. § 210 (1974).

20. See Benston, *Corporate Financial Disclosure in the U.K. and the U.S.: A Comparison and Analysis*, INSTT. OF CHARTERED ACC'TANTS IN ENGLAND AND WALES ch. 3 (1975).

20.1. These counts are very inexact since the separate listing of required items was

income statement, the SEC requires about fifty-three items compared to thirty-seven required in Great Britain. Regulation S-X and the instructions to the forms also specify rules for consolidating statements of a company and its subsidiaries, disclosing contingent liabilities, and, among other practices, reporting extraordinary income and expense. In addition, the SEC requires that registered companies prepare a statement of changes in financial condition (source and application of funds), quarterly statements and monthly reports.²¹

The Commission also has been a powerful force in maintaining the traditional conservative bias in accounting data. The historical basis of recording assets is the only method allowed, with very few exceptions. In particular, the SEC has neither permitted assets to be revalued to their replacement or market values nor permitted general price level adjusted statements. Even before APB Opinion No. 17 was issued in 1970,²² requiring companies to write off goodwill and other intangibles over the lesser of the period benefited or forty years, the SEC generally insisted on relatively rapid write-off of intangibles.²³ Until recently, prospectuses could not include "soft" information, such as appraisals of assets and forecasts of sales or earnings. Nevertheless, pursuant to a statement of policy in a yet unadopted 1972 Release,²⁴ the SEC has allowed the use of soft information under certain limited circumstances.

It might seem that the SEC's influence on the contents of financial statements is limited to the forms filed with it. The Commission's proxy regulations,²⁵ however, require that companies send financial ("information") statements to shareholders with respect to meetings, whether or not proxies are solicited. Rule 14a-3,²⁶ adopted in 1967, requires a company to note and explain any material differences between the statements presented to shareholders and those filed with the SEC. Thus, though the SEC does not specify the form or contents of the financial reports made by management to their shareholders, Rule 14a-3 effectively makes Regulation S-X and the SEC's other pronouncements the determinants of published finan-

made for purposes of reference rather than for the present purpose. The count of the number of items listed in Regulation S-X also considerably understates the complexity of the Regulations.

21. See 17 C.F.R. §§ 240.13a-1, .13a-11, .13a-13, 249.310, .312 (1974).

22. A.P.B. Opinion No. 17, Intangible Assets (Aug. 1970).

23. See L. RAPPAPORT, *supra* note 3, at 3.34-37.

24. Securities Act Release No. 5362, [1973 Transfer Binder] CCH FED. SEC. L. REP. § 79,211 (Feb. 2, 1973).

25. 17 C.F.R. § 240.14a (1965); 17 C.F.R. § 240.14c (1966).

26. 17 C.F.R. § 240.14a-3 (1967).

cial statements for all registered corporations (generally, intrastate owned corporations and those with one million dollars or less assets and 500 or fewer holders of a class of equity securities).

D. Reporting Standards in the United Kingdom

As is the case with auditing standards, British reporting standards, as governed by the Companies Acts of 1948²⁷ and 1967²⁸ are not nearly as formalized as they are in the United States. All limited liability companies, whether widely held or not, must prepare and present annual, audited balance sheets and income statements to security holders and to the Department of Trade and Industry (DTI).²⁹ In 1971, 527,643 companies not in liquidation were registered with the DTI. Of these only 15,452 were public companies³⁰ and only about a third of these were listed on The Stock Exchange. There is no over-the-counter market, as we know it, in the United Kingdom. The contents of prospectuses are prescribed by the Companies Act of 1948, Fourth Schedule.³¹ As in the United States, a prospectus is required when securities are offered to the public, but this almost always occurs in conjunction with obtaining a Stock Exchange listing. Prospectuses need not be prepared for rights and secondary offerings, as is required in the United States since a prospectus is not required for securities that are substantially the same as securities of the same company that already are listed. Furthermore, the Companies Acts' definition of a security is much less expansive than is the SEC's definition.³² Hence, though many more

27. Companies Act 1948, 11 & 12 Geo. 6, c. 38 (1972).

28. Companies Act 1967, 2, c. 81 (1972).

29. Companies Act 1948, 11 & 12 Geo. 6, c. 38, § 124-29 (1972).

30. 1971 Department of Trade and Industry Annual Report. A private company is one that limits its members to 50 and prohibits any invitation to the public to subscribe for any shares or debentures in the company. Companies Act 1948, 11 & 12 Geo. 6, c. 38, §§ 124-29 (1972).

31. Companies Act 1948, 11 & 12 Geo. 6, c. 38, sched. 4 (1972).

32. The Companies Act 1948, Part II, "Share Capital and Debentures" does not explicitly define "share capital" or "debentures." Section 455 defines "debenture" to include "debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of a company or not," and "share" to mean "share in the share capital of a company, and includes stock except where a distinction between stock and shares is expressed or implied." The Securities Act of 1933, § 2(1) defines a security as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

In addition, rulings and case law have extended the definition considerably.

United Kingdom than United States companies are subject to annual reporting requirements, many fewer are required to prepare prospectuses.

Administration of the Acts is the responsibility of the DTI. It has the power to initiate investigations, appoint inspectors, bring proceedings in the name and on behalf of shareholders and require corporate officers to produce books, documents and themselves as requested by the inspectors. The Acts also give the DTI (and the Director of Public Prosecutions and Lord Advocate) the power to make summary judgments on all matters punishable by fines.

Although the DTI has the power to "alter or add to the requirements of this Act as to matters to be stated in a company's balance sheet, profit and loss account and group accounts"³³ and to adapt requirements to the circumstances of individual companies, the quoted section continues: "No regulation shall be made under subsection (1) of the section so as to render more onerous the requirements therein referred to. . . ."³⁴ Thus the DTI cannot and does not promulgate regulations and rules as does the SEC. Nor does it either examine the reports filed with it or even verify that all limited companies have filed reports as required by law. Rather, as the Jenkins Committee reported with approval: ". . . except where fraud or misfeasance is in question and damage has been caused, they do not ordinarily proceed to prosecution unless requests to the company to comply with the Act have been made and failed."³⁵ Essentially, then, the DTI is much more a repository for documents than a regulatory agency.

The Companies Acts require companies to report specific items, such as particulars about share capital, reserves, the distinction between fixed and current assets, the amount of investments by type, goodwill, outstanding loans, sales, depreciation, interest, charitable and political contributions, directors' emoluments, and salaries of principal officers. The accounting requirements of the Acts are not limited, however, to the specifically mentioned items. Rather, the Companies Acts require that companies keep ". . . such books as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions."³⁶

Since almost all publicly held companies are listed on The Stock Exchange, the Exchange's reporting requirements supplement those given by the Companies Acts. In general, The Stock

33. Companies Act 1948, 11 & 12 Geo. 6, c.38, § 454(1), at 696 (1972).

34. *Id.* § 454(3), at 696.

35. Report of the Company Law Committee, CMD. No. 1749, § 505 (1962).

36. Companies Act 1948, 11 & 12 Geo. 6, c.38, § 147(2), at 523 (1972).

Exchange's rules exceed those of the Acts by requiring semi-annual statements, more detail with respect to prospectuses, and approval of the prospectuses by the Quotations Department before securities are marketed. In this regard, the Quotations Department operates much as does the SEC. The Stock Exchange defers completely to the ICAEW and the other Institutes of Chartered Accountants with respect to accounting "principles." In June, 1972, The Stock Exchange adopted the following provision: "The Council support the accountancy bodies in the formulation of their Accounting Standards, and expect reports to be prepared in conformity with those standards. Any significant departure therefrom must be disclosed and explained."³⁷ While this statement is similar to the SEC's Accounting Series Releases 4 and 150, The Stock Exchange does not promulgate detailed regulations such as Regulation S-X or issue opinions on accounting standards such as the Accounting Series Releases.

Thus, given the specific reporting requirements of the Companies Acts and The Stock Exchange's listing agreement, the Institutes of Chartered Accountants (England and Wales, Scotland and Ireland) are completely responsible for the promulgation of accounting standards. Since all public accountants must be members of one of the recognized accounting bodies to practice their profession, the bodies are, in principle, very powerful. Nevertheless, the United Kingdom Institutes have not been nearly as active in rule making as have their counterparts in the United States. Before the Taxation and Financial Research Committee of the ICAEW was founded in 1942, pronouncements on accounting and auditing concepts and procedures were not made.³⁸ Between 1942 and 1953 the Council of the ICAEW approved fifteen "Recommendations on Accounting Principles." These Recommendations, which were not binding on the members of the Institute, dealt with such subjects as income tax charges, disclosure of reserves, consolidated accounts, the content of balance sheets and income and expense statements, depreciation, valuation of stock-in-trade, accounting for changing price levels and accounting reports for prospectuses. From 1953 through 1969, fourteen additional Recommendations were issued, four of which replaced earlier Recommendations. Topics covered included two on which the Council of the English Institute disagreed with the position taken by the Research and Publications Committee of the Institute of Chartered Accountants of Scotland—accounting for invest-

37. The Stock Exchange Rules, c.3, ¶ 6, at 49 (1974).

38. ZEFF, *supra* note 8, contains an extended discussion of the development of accounting principles and standards in the U.K.

ment grants and the treatment of unrealized capital gains by investment trusts.

The "Recommendations" were, as their title indicates, recommendations rather than obligatory rules. As the usual introductory paragraph to the Recommendations states:

Whilst it is recognized that the form in which accounts are submitted to shareholders is [subject to compliance with the Companies Act] a matter within the discretion of directors, it is hoped that the Recommendations will be helpful to members in advising, in appropriate cases, as to what is regarded as the best practice.³⁹

The ICAEW's approach to pronouncements on accounting practices changed in 1969. Partly because of several highly publicized events that led financial journalists to "wonder" how different accountants could report different profit amounts for what appeared to be the same transaction, and partly because it was already moving in that direction, in 1970, the ICAEW in association with the other accountancy bodies formed an Accounting Standards Steering Committee (ASSC).

In contrast to the introduction to the Recommendations, the "explanatory foreword" to the Statements of Standard Accounting Practice prepared by the ASSC and issued by the ICAEW states:

The Council expects members of the Institute who assume responsibilities in respect of financial accounts to observe accounting standards.

Where this responsibility is evidenced by the association of their names with such accounts in the capacity of directors or other officers the onus will be on them to ensure that the existence and purpose of standards are fully understood by non-member directors and other officers, and to use their best endeavours to ensure that standards are observed or, if they are not observed, that significant departures from them are disclosed and explained in the accounts and their effect, if material, disclosed.

Where members act as auditors or reporting accountants the onus will be on them not only to ensure disclosure of significant departures but also, to the extent that their concurrence is stated or implied, to justify them.

The Council, through its Professional Standards Committee, may inquire into apparent failure by members of the Institute to observe accounting standards or to disclose departures therefrom.⁴⁰

The next three paragraphs begin, however, by stating: "Accounting standards are not intended to be a comprehensive code of rigid rules,"⁴¹ and conclude with the general principle: "In judging exceptional or borderline cases it will be important to have regard to the spirit of accounting standards as well as to their precise

39. Recommendations on Accounting Principles, Council of the ICAEW.

40. ICAEW, STATEMENTS OF STANDARD ACCOUNTING PRACTICE ¶¶ 3-6, at 1 (rev. 1973).

41. *Id.* ¶ 8, at 2.

terms, and to bear in mind the overriding requirement to give a true and fair view."⁴²

Through November 1974 the ICAEW has issued thirteen Exposure Drafts which cover such topics as accounting for mergers and acquisitions, extraordinary items, stocks and work in progress, value added tax, deferred taxation, and inflation, and the contents of a required funds statement. Two discussion papers—inflation and accounts, and corporation tax under the imputation system—were released. Three of the thirteen Exposure Drafts were converted into Statements of Standard Accounting Practice: "Accounting for the Results of Associated Companies," "Disclosure of Accounting Policies," and "Earnings per Share," the last statement issued in February, 1972. In May 1974, three additional Statements of Standard Accounting Practice were recommended by the ASSC for approval by the Councils of the accounting bodies: "The Accounting Treatment of Government Grants," "Accounting for VAT," and "Extraordinary Items and Prior Year Adjustments."⁴³

Thus it would seem that British accountants are moving closer to their American counterparts in specifying accounting standards which all companies must follow. British rules essentially maintain, however, that each accountant should rely on his professional judgment and integrity to determine whether a company's accounts present a "true and fair view" and are prepared in conformity with the Companies Acts.

II. FACTORS WHICH INFLUENCE THE ESTABLISHMENT OF ACCOUNTING STANDARDS

A. *The Function of Accounting Standards—Some Hypotheses*

Were it possible for the accounting numbers reported in financial statements to be unambiguous measures of wealth (balance sheets) and changes in wealth (income statements), a major function of reporting standards would be obviated. Unfortunately, such measurements require knowledge of the present values of future cash flows or current market values of assets and liabilities. This information rarely is objectively known. Future cash flows are difficult to estimate with a satisfactory degree of certainty, nor can anyone be sure of the rate at which these flows should be discounted to determine present values. Current market values do not exist for very many assets and liabilities, nor is there much certainty that the

42. *Id.* ¶ 10.

43. ICAEW, STATEMENTS OF STANDARD ACCOUNTING PRACTICE (rev. 1974).

values estimated will prevail should exchanges actually be made. Consequently the economic value of an enterprise and of its individual assets and liabilities can be determined only by subjective estimates of cash flows, discount rates and market values.

The accounting numbers that are reported, then, are the result of imperfect measurements of economic transactions. These transactions are stated in monetary units which are aggregated into classes. This process necessarily involves the application of expertise and judgment. Auditing expertise is required to determine that the monetary units recorded on a company's records reflect physical units (such as inventory, claims to assets—e.g., receivables, fixed assets) owned, debts owed, and changes therein over time. Judgment is required to determine how much of an asset is depreciated during a given time period, what monetary value should be assigned to an asset received in an asset exchange in which neither asset has an objectively determined market value, and what amount should be assigned as the cost of goods sold when the inventory was purchased at different prices.

In spite of these imperfections, were the readers of financial statements intimately familiar with the economic events that impinge on a company and fully cognizant of the limitations of accounting measurements thereof, there would be little need for accounting standards. These readers could determine how well the financial statements reported the entity's wealth and its changes. They could adjust the reported numbers for the biases and limitations of the accounting numbers or disregard the numbers if they gave misleading or meaningless signals. Unfortunately, many readers of financial statements do not have the required knowledge to determine how well financial statements report economic events. Nor can they obtain the information they want from other sources. Therefore, they must rely, partially, on the expertise and judgment of others, including analysts. A company's managers, who are intimately familiar with the company and its environment, are well equipped to prepare the financial statements. Since an important function of financial statements is to report on the manner in which the managers have used the resources entrusted to them, however, it obviously would be unwise for shareholders and creditors simply to accept the managers' report. While the managers' judgments might be as accurate as can be expected, the accounting reporting process is inherently subject to manipulation by those managers so inclined.

Consequently, for many centuries non-management owners

have engaged independent, expert accountants to audit the records of the managers and give their opinions about the financial statement prepared by the stewards. The owners then can rely on the judgment and ability of the independent accountants to verify that the managers' reports were not deliberately manipulated to hide major defalcations or inept use of resources. When ownership of enterprises became so widespread that the owners could not personally judge the honesty and ability of independent accountants, it became desirable to certify these experts as meeting some minimum level of integrity and ability. Thus the states (in the United States) or professional societies (in the United Kingdom) established the designation, certified or chartered public accountant, to identify these experts to the public. It obviously harms members of this designated group of experts when one of their number fails to meet the level of independence and expertise expected by the public. The establishment and maintenance of a minimum standard of performance has value to the group, therefore, beyond the service such a standard may provide for limiting entry into and competition within the profession. This rationale explains, I believe, the existence of auditing and independence standards, whether explicit or not.

Reporting standards are designed also to protect the profession, particularly against the charge that an individual is not independent or expert when, in the light of later events, the financial reports appear to be inaccurate or misleading. As is discussed above, accounting numbers are inherently imperfect measures of economic events. What may have been a perfectly reasonable reporting decision subsequently may appear suspiciously fraudulent. An example would be the treatment of an exchange of property for a long term note receivable as a sale where ultimately the note cannot be collected. Therefore, the profession may seek to protect the reputations of its members by establishing standards that govern the reporting of events.

Accountants are not the only group who find accounting standards desirable. As is discussed above, owners also may find auditing standards an efficient means of assuring that the auditors followed the minimum professionally established procedures. This assurance is particularly desirable when auditors are engaged by management. An honest and competent management also might want to assure owners that the reports prepared have, indeed, been independently and competently verified. Finally, government regulators may find accounting standards very useful. When these officials are charged with overseeing the disclosure of financial data, they are

perhaps more concerned than are accountants that the data appear "correct" or, at least, not misleading or fraudulent. Unlike accountants, regulators do not work with (and are not compensated by) clients who want to communicate the economic "facts" of their enterprise to shareholders and prospective investors. Rather the regulators must absorb the cost of public and industry criticism and risk loss of legislative support if they permit publication of financial statements that disgruntled investors charge are misleading or fraudulent as a consequence of errors of judgment or inadequate audits by accountants. Regulators, therefore, are interested in having accounting standards against which to evaluate the financial statements presented to the public.

B. The Standards—Explicit or Implicit?

The following discussion examines the factors that appear to determine whether auditing and reporting standards are explicit or implicit, rigid or flexible. Differences in the professional, economic, regulatory and legal environments in the United States and the United Kingdom provide a means for testing hypotheses on the strength and effect of the factors mentioned. In general, I believe public accountants would prefer that accounting standards were implicit rather than explicit. The more explicit the standards, the less freedom accountants have to exercise their professional skills and judgment, and hence their esteem and the economic value of their services are commensurately diminished. Given this underlying preference, one may hypothesize that accounting standards would be more explicit with less effective peer pressure within the professional environment, wider ownership of shares by individuals, greater governmental regulation and greater legal liability of accountants.

1. The Professional Environment in the U.S. and the U.K.

The United States and the United Kingdom differ with respect to the professional organization of accountants in several important respects. First, American certified public accountants are licensed by the states. Each state determines the educational experience and personal qualifications required of candidates. While the required examination is generally the same in each state and is graded centrally, the states individually determine when candidates may sit for all or part of the examination, and the state authorities may assign final passing or failing grades to marginal papers. Each state also determines the conditions under which a CPA licensed in an-

other state may move his practice. Perhaps most important with respect to peer pressure, only the states may revoke a CPA's license or otherwise discipline him for inept practices, lack of integrity, breach of fiduciary responsibility, or other conduct that tends to bring dishonor on the profession to the detriment of other CPAs. CPAs need not join the AICPA and as a result about a third are not members. Hence, the non-members are not subject to the AICPA's Code of Professional Ethics, nor are CPAs subject to the SEC's disciplinary authority if they do not audit the records of a client who is subject to the Securities Acts.

Chartered accountants in the United Kingdom must be admitted to membership in one of the six recognized accountancy bodies (the largest being the ICAEW). In addition, members are subject to the rules of the bodies even if they are not engaged in the practice of public accounting, so long as they wish to be known as chartered accountants. Thus, when the ICAEW states that "The Council expects members of the Institute who assume responsibilities in respect of financial accounts to observe accounting standards,"⁴⁴ it is exercising its authority over company directors and comptrollers as well as independent auditors. Because the power of the accountancy bodies over chartered accountants is so great, presumably they must exercise care and restraint in promulgating explicit accounting and auditing standards. In effect, their Statements of Standard Accounting Practice are the law for the accounts of all limited liability companies.⁴⁵

In addition, the accounting profession itself is more compact in the United Kingdom than in the United States. The relatively small size and the concentrated geographical distribution of the major British accounting bodies' membership (England and Wales, Scotland, and Ireland) tend to bring a chartered accountant who is incompetent or who lacks integrity to the attention of his colleagues. In the United States, the AICPA has a nationwide membership and the state societies have little power over individual CPAs who may only hold membership in the AICPA (if that). As a consequence, peer pressure is a more potent force in the United Kingdom than in the United States.

Finally, the British issuing houses follow a practice with respect to prospectuses that assures the existence of minimum accounting standards for the statements of publicly owned companies. If a small or medium sized firm of chartered accountants has audited

44. See note 40, *supra*, and accompanying text.

45. See text accompanying note 66 *infra*.

the books of a company that applies for listing on The Stock Exchange, the issuing house or broker who handles the issue usually insists that a well-known firm of chartered accountants be appointed additionally as reporting accountants. Reporting accountants also may be appointed even when a large firm is the company's auditor. This practice thus provides a potential peer review by the "better" firms of the auditing and reporting practices of accountants who audit the records of companies going public.

In summary, the professional environment in the United Kingdom leads to considerably greater peer control over auditing and reporting practices than is the case in the United States. Hence, the need for explicit accounting standards is greater in the United States than in the United Kingdom. As the descriptive material presented in section I indicates, the British chartered accountants have no explicitly stated auditing standards and few explicitly stated reporting standards.

2. The Economic Environment in the United States and the United Kingdom

The nature of the demand by persons for information about individual corporations is the principal relevant difference in the economic environment between the two countries. In general, American corporations are owned by more individual investors who directly trade their securities than are British corporations. Further, American investors appear more interested in using or at least in reviewing financial statements for investment decisions than are investors in the United Kingdom. This demand by numerous individuals for financial information determines, in part, the way information is supplied by corporations.

Though reliable data on the number of persons who own shares is not available, in part because shares often are reported in a broker's street name, it seems clear that both in absolute and relative terms the number of individuals owning and trading corporate shares is greater in the United States than in the United Kingdom. With respect to stockholders, at year end 1969 some 68.4 percent of American corporate stock outstanding was held by individuals⁴⁶ (and some minor institutional investors) compared to 47.4 percent held by individuals, executors and trustees in the United Kingdom.⁴⁷ Since American corporations, in general, are larger than

46. 38 SEC ANN. REP. 151 (1972).

47. J. MOYLE, *THE PATTERN OF ORDINARY SHARE OWNERSHIP, 1957-1970*, at 11 (1971). (latest available data is for 1969.)

their British counterparts, they obviously have more owners. In addition, the corporations listed on The London Stock Exchange tend to be more closely held than American listed corporations. The New York Stock Exchange requires that corporations have at least 2000 shareholders who hold no less than 100 shares each.⁴⁸ The American Stock Exchange requires listed corporations to have at least 1200 shareholders holding 100 shares or more.⁴⁹ In contrast The (London) Stock Exchange requires only that at least thirty-five percent of a class of equity shares be in the hands of the public.⁵⁰ Trading of securities also is much more widespread in the United States than in the United Kingdom. In addition to the over-the-counter market, there are thirteen American stock exchanges while the United Kingdom has no over-the-counter market and only one stock exchange. In the United States, securities salesmen and brokers actively solicit investments by individuals, while in the United Kingdom this practice is not permitted. Investors in the United Kingdom tend to purchase securities through their banks or from brokers and issuing houses with whom they have relatively long standing relationships.

These differences in the economic environment suggest that American investors and analysts would demand more financial data than would be demanded in the United Kingdom. In the United Kingdom, the banks and brokers with whom persons deal often have either direct knowledge about the affairs of corporations or direct access to this information. Both American corporations and the holders of their securities are too numerous and geographically widespread to permit the type of informal transmission of reliable information, by informed intermediaries, as exists in the United Kingdom. Consequently, formal communication of information—primarily including information about audits—via financial statements is demanded more in the United States than in the United Kingdom. Furthermore, as is argued above, explicitly stated auditing and reporting standards are desired by investors and analysts in situations where they are not in direct contact with the enterprise upon which the reports are made.

American investors also appear more concerned than British investors with earnings as an indication of investment value. Earnings per share have been commonly reported in the United States for a long time, but only recently were calculated as a matter of

48. New York Stock Exchange Company Manual, at B-3 (as amended Sept. 30, 1971) in 2 CCH FED. SEC. L. REP. ¶ 23,086, at 17,705.

49. American Stock Exchange Guide, § 10, 001, July 1972, in 2 CCH FED. SEC. L. REP. ¶ 23,025.081, at 17,058.

50. The Stock Exchange Rules, c.1, ¶ 16(h), at 6 (1974).

course in the United Kingdom. The British attitude toward the purpose of financial statements is well expressed in the ICAEW's Counsel's memorandum in the *Hedley Byrne*⁵¹ decision: ". . . the object of annual accounts is to assist shareholders in exercising their control of the company by enabling them to judge how its affairs have been conducted. . . . The purpose for which annual accounts are normally prepared is not to enable individual shareholders to make investment decisions."⁵² The American attitude is expressed by the SEC, which asserts that the disclosure of financial accounting data is required so that "investors may make a realistic appraisal of the merits of securities and thus exercise an informed judgment in determining whether to purchase them."⁵³

This demand for corporate financial information has implications for the way information is produced. In the United States, corporate management generally must provide financial statements to a large number of shareholders and other interested parties if the corporation wants widespread trading in its shares. These people range widely in the degree of experience, financial expertise, and technical ability with which they read the statements. The more sophisticated readers might know that the statements can convey little, if any, information that is sufficiently timely or meaningful for them to use for portfolio investment decisions. Other readers, however, might demand that management answer their many and varied queries about the meaning of the numbers reported. Hence, the company's resources might be husbanded by management were they able to claim, to the satisfaction of shareholders, that the statements were prepared in accordance with generally recognized accounting principles, as promulgated by professional independent public accountants.

This hypothesis is consistent with the data. In the 1920's, ownership and trading of shares by persons was much more widespread in the United States than in the United Kingdom, possibly even more so than it is in the United Kingdom today.⁵⁴ Perhaps as a consequence, movement toward promulgation of explicit accounting standards began much earlier here than in the United Kingdom. The AICPA (then the American Institute of Accountants) endorsed an influential memorandum, "Approved Methods for the Prepara-

51. *Hedley Byrne & Co. v. Heller & Partners, Ltd.*, [1963] 2 All E. R. 575 (H.L.).

52. ICAEW, *Accountants Liability to Third Parties—The Hedley Byrne Decision*, at 2 (Aug. 1965).

53. SEC, *THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION*, 1 (1967).

54. Reliable data on individual share ownership is not available; these statements are based on the unanimous opinions of brokers in both countries whom I interviewed.

55. AICPA, *Approved Methods for Preparation of Balance Sheet Statements* (1917).

tion of Balance Sheet Statements," in 1917.⁵⁶ A revised statement was formally adopted in 1929. In the late 1920's, the Institute engaged in discussions and an exchange of letters with the New York Stock Exchange that led to the formal adoption of six "rules or principles" in 1934.⁵⁶ The United States, of course, enacted much more demanding securities legislation in the 1930's than exists today in the United Kingdom.

The degree of disclosure of financial data also reflects the demand for data by investors and the economies of supply by corporations. In 1926, all of the New York Stock Exchange listed corporations published balance sheets and net income, fifty-five percent disclosed sales, forty-five percent disclosed cost of goods sold, seventy-one percent disclosed depreciation and eighty-two percent were audited by CPAs.⁵⁷ By the year prior to the requirement of disclosure by the Securities and Exchange Act of 1934, the percentage of corporations disclosing sales had risen to sixty-two, fifty-four percent had disclosed cost of goods sold, and ninety-three percent had disclosed depreciation. Ninety-four percent of the listed corporations were audited by CPAs. Similar data are not available for the United Kingdom during this period. In the year before the Companies Act of 1967 required the disclosure of sales, however, as much as thirty percent of U.K. listed companies did not report this information.⁵⁸

Thus the data are consistent with the hypothesis that greater demand for financial information by widely dispersed individuals results in corporations supplying financial statements prepared in accordance with explicit accounting standards in order that corporations can increase public confidence in their management and thus increase the demand for their securities. As the United Kingdom has moved closer to the United States in more widespread interest in shares by persons, their accounting standards also have become more explicit.

3. The Regulatory Environment in the United States and the United Kingdom

Differences in the regulatory environments in the United States and the United Kingdom were considered earlier. In short, the SEC is an active, rule-making agency that enforces its decrees while the

56. For a full discussion see ZEFF, *supra* note 8, at 110-268.

57. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACC'TING REV. 515, 519 (1969).

58. See Benston, *supra* note 20, at 4-39.

DTI is primarily a repository for financial statements filed in compliance with the Companies Acts.

As the analysis previously presented indicates, an active regulatory agency has an incentive for insisting on conservative, explicit, even rigid accounting standards. Such standards reduce the risk to the agency that it will be criticized for "accepting" statements that, when viewed with the benefit of hindsight, appear misleading or fraudulent. Explicit standards and detailed rules also allow the agency to process efficiently the statements filed with it. Therefore, it is not surprising that the SEC tends to want uniform, conservative reporting by corporations. The Commission's staff must handle a large number of prospectuses and periodic reports. Although it is specifically not charged with approving or disapproving the statements filed with it, it cannot and does not simply accept a statement without examination. Instead, the SEC requires registrants to disclose more data, eliminate disclosure of non-verifiable data, and change the basis and form of accounts. Should the staff allow a prospectus to become effective that later proves to be misleading, the Commission may be severely criticized. One of the most notable examples of this possibility is the *Kaiser-Frazer* case,⁵⁹ where an underwriter refused to perform on its contract because it claimed the registration statements, which became effective, were materially misleading.⁶⁰ The courts upheld the underwriter in a suit by *Kaiser-Frazer*, and a subsequent Congressional Committee issued an investigation report that was sharply critical of the SEC. The recently revealed instances of allegedly fraudulent periodic financial statements filed by National Student Marketing,⁶¹ Equity Funding,⁶² and Home Stake Production⁶³ may lead to additional, though probably unwarranted, criticism of the Commission.⁶⁴

What, then, can the SEC do to protect itself from these criticisms and from critics who charge that the staff gives inconsistent

59. *Kaiser-Frazer Corp. v. Otis and Co.*, 195 F.2d 838 (2d Cir.), *cert. denied* 344 U.S. 856 (1952).

60. *Id.* at 840. See RAPPAPORT, *supra* note 3, at 13, 9-14 for a more complete description.

61. *SEC v. Nat'l Student Marketing Corp.*, D.D.C. Civil Action No. 72-225; Feb. 3, 1972. Full Text of Complaint in [1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360.

62. *SEC v. Equity Funding Corp. of America* [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,917 (Complaint by SEC and permanent injunction set forth in full). See also *United States v. Goldblum*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,200 (C.D. Cal. 1973) (Summary of 105-count indictment against 20 former employees of Equity Funding and 2 of the firm's auditors).

63. *Anderson v. Home-Stake Production Co.* Complaint filed May 22, 1974, 1974 BNA SEC. REG. & L. REP. No. 263, at A-13 (N.D. Okla.).

64. See, e.g., Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553 (1974).

rulings to different registrants? An obvious solution is to insist that registrants report verifiable, traditional, voluminous, uniform accounting data. Requirements are imposed on all corporations even though the "problem" they were designed to "solve" applied only to a few corporations. For example, apparently as a consequence of the Penn Central failure, all corporations are required to report their compensating balance arrangements and other details related to short term borrowing. Since this information may have been useful to investors in this well publicized case, all corporations must incur the expense of additional calculations and reporting.⁶⁵

The SEC also has not permitted appraisals of assets, particularly mineral and oil deposits. It would be very difficult for the staff to determine whether the appraisals were competent or dishonest. It is both safer and administratively more efficient simply to forbid appraisals, even when accompanied by explanations about the appraisers and methods of appraisal and warnings about the probability of error. These considerations also appear to have been important determinants of the SEC's policy of not allowing other departures from the historical basis of recording assets.

In the United Kingdom, appraisals of assets are permitted, as are forecasts. The DTI, which is not responsible, *de jure* or *de facto*, for accounting standards, does not promulgate rules and regulations. Consequently, the specific items required to be disclosed are limited to those explicitly listed in the Companies Acts enacted by Parliament.⁶⁶ The reader also should recall that the Companies Acts apply almost equally to all limited liability companies—of which there are over 500,000. It probably is clear to the legislators and government officials in the United Kingdom that imposition of detailed reporting requirements on so many companies where the owners are the managers, and hence, are directly aware of the economic status of their enterprises, would impose costs that exceed the expected benefits. Thus differences in the regulatory environment in the United States and the United Kingdom also "explain" differences in the explicitness of accounting standards. The more regulation, the more explicit are accounting standards.

4. *The Legal Environment in the United States and United Kingdom*

*Common Law Differences.*⁶⁷ In both the United States and

65. SEC Accounting Series Release No. 148, CCH FED. SEC. L. REP. ¶ 72, 170 (Nov. 13, 1973).

66. The requirements appear in scattered sections of the 1948 and 1967 Acts.

67. Actions for breach of contract and actual or constructive fraud are not discussed because accountants in both countries are similarly liable.

Great Britain some ten years ago, the primary benefit rule expressed in *Ultramares*⁶⁸ governed the liability of accountants to third parties for negligence.⁶⁹ The court held that investors and other third parties could not hold accountants liable for a negligent audit if the report “. . . was primarily for the benefit of the [client] . . . for use in the development of the business, and incidentally or collaterally for the use of those to whom [the client] and his associates might exhibit it thereafter.”⁷⁰ This rule was applied very narrowly, so as to make the efforts of third-party plaintiffs generally unsuccessful in providing that they were primary beneficiaries of a negligent audit.

The first important change in the application of the primary benefit rule occurred in the United Kingdom, as a consequence of the *Hedley Byrne* decision.⁷¹ Though the House of Lords did not discuss liability for annual accounts (the case involved an accommodation credit report by a bank upon which a third party relied to his damage), the decision makes it clear that an accountant who makes a negligent, though honest, misrepresentation, may be liable for financial damages caused to a person with whom no contract exists.⁷² The Counsel to the ICAEW interprets the application of the decision as follows:

In Counsel's view third parties entitled to recover damages under the *Hedley Byrne* principle will be limited to those who by reason of accountants' negligence in preparing reports, accounts or financial statements on which the third parties place reliance suffer financial loss in circumstances where the accountants knew or ought to have known that the reports, accounts or financial statements in question were being prepared for the specific purpose or transaction which gave rise to the loss and that they would be shown to and relied on by third parties in that particular connection. There is no general principle that accountants may be liable for damages if a report or statement which proves to have been prepared negligently by them is shown casually or in the course of business to third parties who suffer loss through reliance on the report or statement.⁷³

With respect to the accountant's liability to shareholders, they state:

. . . a decision by the shareholders collectively taken on the basis of negligently prepared accounts and resulting in improper payments by or financial

68. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

69. *Id.* See Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 BUS. LAW. 1205 (1974); Hill, *The Liabilities of International Practice in NEGLIGENCE AND THE PUBLIC ACCOUNTANT* 3 (1972).

70. *Ultramares Corp. v. Touche*, 255 N.Y. at 183, 174 N.E. at 446 (1931).

71. *Hedley Byrne & Co. v. Heller & Partners, Ltd.*, [1963] All E.R. 575 (H.L.).

72. *Id.*

73. *Accountants Liability to Third Parties—The Hedley Byrne Decision*, *supra* note 52, at 2.

loss to the company could result in liability. No claim by an individual shareholder, however, would succeed in respect of loss suffered through his own investment decisions made on the strength of misleading company accounts supported by an auditors' report containing negligent misrepresentations⁷⁴

This interpretation, however, is not unanimous in the United Kingdom. In particular, Mary Arden argues:

. . . it would be extremely difficult for an auditor to argue that he undertook no duty of care to shareholders in respect of loss suffered as a result of individual investment decisions taken on the basis of negligently prepared accounts. It is true that he had no particular shareholder, or transaction by a shareholder, in mind when reporting on the accounts. But he undertook a duty of care to the shareholders as a body and must have known that the accounts could be used by shareholders for their personal purposes. In other words it is very possible, although the matter is not free from doubt, that an auditor owes a duty of care to individual shareholders under *Hedley Byrne* when reporting on the annual accounts.⁷⁵

The accountant's liability with respect to prospectuses, however, does not appear in doubt. The Institute's Counsel states:

But if the audited accounts comprised in effect part of a document of offer, and the auditors knew or ought to have known that the accounts were intended to be so used, they could be liable to third parties for financial loss suffered through reliance on a negligent auditor's report in connection with the offer.⁷⁶

American law is also being extended to include liability of accountants to third parties. From his survey, R. James Gormley concludes that "[t]he trend suggests the likelihood either that the primary benefit rule is broadening to coincide with the foreseen person concept of the Second Restatement [American Law Institute, Second Restatement of the Law of Torts, 1965], or that the foreseen person concept is absorbing and superceding the primary benefit rule."⁷⁷

Thus, American and British common law now is interpreted as possibly, perhaps probably, supporting damage suits against negligent accountants by shareholders, investors, and other third parties who use published financial statements for investment decisions. There seems little doubt that accountants who certify financial statements for inclusion into prospectuses used to sell shares are liable for negligence to investors. Before considering the effect of these potential liabilities on the contents of financial statements,

74. *Id.*

75. Arden, *A Legal View of Current U.K. Practice*, in *NEGLIGENCE AND THE PUBLIC ACCOUNTANT* 24, 26 (1972).

76. *Accountants Liability to Third Parties—The Hedley Byrne Decision*, *supra* note 52, at 2.

77. See Gormley, *supra* note 70, at 1211 (discussing *RESTATEMENT (SECOND) OF TORTS* § 531 (Tent. Draft No. 10, 1964)).

accountants' liability under the securities laws of the two countries is outlined.

Securities Law Differences. Unlike the common-law similarities, considerable differences exist between the statutory treatment of accountants' liability in the two countries. The British statutes add very little to the common law. The 1948 Companies Act prohibits companies only from indemnifying their auditors from liability as a consequence of any negligence, default, breach of duty or breach of trust.⁷⁸

In the United States the Securities Act of 1933 and the Securities Exchange Act of 1934 made significant alterations in the common law. As interpreted in the *BarChris* case,⁷⁹ Section 11 of the '33 Act⁸⁰ does away with the requirement of privity of contract between the auditor and the investor as a condition of recovery by the investor. The auditor who has examined and reported upon the financial statements contained in a securities registration (and has consented to their use therein) is also deprived of his most important common-law protection in suits by third parties. All an investor need do to maintain a suit against the auditor is prove that the statements contained a material omission or misstatement. In his defense, the auditor must prove "due diligence"—that is, that after reasonable investigation he had reasonable grounds to believe, and did believe at the time the registration statement became effective, that the financial statements were true.⁸¹ It should be emphasized that the auditor's responsibility continues to the time the statements become effective (accepted by the SEC) even though this is after completion of the audit and preparation of the report.

Section 11 of the '33 Act applies only to purchases of securities in offerings. Section 10(b) of the '34 Act⁸² and SEC Rule 10b-5⁸³ extend to periodic statements the auditor's liability for making any untrue statement or omission of a material fact. Though the rule was adopted originally to prohibit "any manipulative or deceptive device or contrivance . . . in connection with the purchase or sale of any security"⁸⁴ it has been interpreted by the court to apply to auditors. As Gormley concludes:

[A]uditors whose opinions are used in connection with a sale or purchase of securities are exposed to potential liability in private suits under rule 10b-5

78. Companies Act 1948, 11 & 12 Geo. 6, c.38, § 205 (1972).

79. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

80. 15 U.S.C. § 77k (1970).

81. 283 F. Supp. at 697.

82. 15 U.S.C. § 78j (1970).

83. 17 C.F.R. § 240.10b-5 (1974).

84. 15 U.S.C. § 78j (1970).

even though they did none of the purchasing or selling and realized no profit in any securities transaction.⁸⁵

He also observes:

Since 1968 [Texas Gulf Sulphur] the term "in connection with" has been construed broadly enough so that audit opinions and audited or unaudited financial statements with which auditors became associated may, along with other corporate statements and information, be statements "in connection with" purchase and sales of the corporation's securities by investors, even though . . . not in a prospectus or in a purchase or sale of the corporation's securities.⁸⁶

He concludes, however, that

it is reasonable to require a plaintiff in a rule 10b-5 suit against independent accountants to prove more than ordinary negligence in connection with . . . financial statements, audited or unaudited.⁸⁷

Thus the American accountant is somewhat more vulnerable to suits claiming misrepresentation and negligence in the preparation of periodic statements than is his British counterpart, and he is considerably more vulnerable than a British accountant with respect to financial statements included in prospectuses registered with the regulatory agency. The most important difference in the two countries' legal environments, however, is the likelihood that aggrieved third parties will sue accountants.

Differences in the Ability and Propensity of Third Parties to Sue Accountants. It is much easier and more profitable for investors and other third parties to sue accountants for damages in the United States than in the United Kingdom. In the United States a derivative action suit may be filed by aggrieved minority shareholders against the officers and directors. Should the shareholders win, the amounts recovered are paid by the defendants to the corporation, and the plaintiffs and their attorney may be awarded legal costs and attorney's fees (the latter being an important motivation for such suits). In the United Kingdom a similar action can be taken under the "fraud on a minority" exception to the rule in *Foss v. Harbottle*,⁸⁸ but this exception has been applied very restrictively. Hence the Jenkins Committee in 1962 recommended that the Companies Act should give the court express power "to authorize proceedings to be brought against a third party in the name of the company by such a person or persons and on such terms as the Court

85. Gormley, *supra* note 70, at 1220.

86. *Id.* at 1221.

87. *Id.* at 1222.

88. *Foss v. Harbottle*, 2 Hare 461, 67 Eng. Rep. 189 (V. Ch. 1843). For a fuller discussion, see Boyle, *The Derivative Action in Company Law*, 1969 J. Bus. L. 120.

may direct."⁸⁹ This change, however, has not yet been enacted. In addition, the Companies Act of 1948 does not support a suit against an issuer of securities for a false prospectus as does the Securities Act of 1933.⁹⁰ Furthermore, while there is reason to believe that the United Kingdom Prevention of Fraud (Investments) Act of 1958⁹¹ would support a suit similar to the Rule 10b-5 actions in the United States, there have been very few such suits.

In the United States, the shareholder's ability to succeed in a derivative suit is limited by a number of technical requirements, including a subtle—and some claim an often almost unworkable—requirement of proof that the injury be to the corporate entity itself rather than to the individual shareholders in their individual capacities.⁹² If the latter is found to have been the case, a derivative action will not be allowed. Although this inability to demonstrate the validity of a derivative action suit is not unusual, American investors still have tremendous procedural advantages over their British counterparts by virtue of the class action suit under Rule 23 of the Federal Rules of Civil Procedure.⁹³ Even though the scope of these suits has been reduced and the costs of maintaining them increased by some recent Supreme Court decisions,⁹⁴ they can still be a potent weapon.

Though the shareholders' derivative suit and the class action have a number of technical and often strategically important differences between them, the similarities are much more significant. In each case the purpose of the procedure is to allow a large number of persons with possibly small injuries to be compensated in one action. Without the availability of these procedures, no single injury might promise sufficient recovery to warrant bringing the suit. By aggregating a large number of similarly situated parties in one action, however, the total amount recovered is often quite substantial. Even so, the pro rata recovery to any member of the group may often be very small, and the problem remains of motivating someone to initiate such action. Here one of the most striking differences be-

89. See Report, *supra* note 35, ¶ 206, at 76.

90. Compare Companies Act 1948, 11 & 12 Geo. 6, c.38 (1972), with Securities Act of 1933, 15 U.S.C. § 77(l)(2) (1970).

91. Prevention of Fraud (Investments) Act of 1958, 6 & 7 Eliz. 2, c.45 (1972).

92. See, e.g., 13 Fletcher Cyc. Corp. (Perm. Ed.) ¶ 5947 (1969).

93. Fed. R. Civ. P. 23.

94. See *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974) (holding plaintiff must bear the cost of providing individual notice to identifiable class members and notice requirements may not be waived or tailored to plaintiff's financial condition, even when an extremely large class would be included in the action); *Zahn v. International Paper Co.*, 414 U.S. 291 (1973) (holding even unnamed plaintiffs in diversity class actions must meet the jurisdictional amount requirement).

tween American and British legal practices prevails. In the United States shareholders' derivative action, if the shareholders are successful, the court will award a substantial legal fee to the successful attorney, and in the class actions, the initiating member of the class may arrange, with the approval of the court, for the attorney to recover a contingent fee.

Even if a class action is allowed in the United Kingdom, the practice of "taxing" unsuccessful litigants for costs and not allowing contingent legal fees is a powerful disincentive to law suits. Thus, while it is very common in the United States, it is rare for British shareholders to sue corporate directors, officers and accountants. In fact, since the courts have held that violations of most federal securities laws are admissible as bases for private civil actions, a significant part of the total enforcement of these laws results from private actions rather than from those initiated by the SEC. The Commission has on occasion specifically mentioned the use of private actions as the preferable mode of enforcement.

Administrative Legal Action. The Department of Trade and Industry, which administers the United Kingdom Companies Acts, is not at all the English equivalent of the SEC. Unlike the SEC, the DTI does not actually administer the securities laws; nor does it review the financial statements filed with them, investigate "suspicious" situations in the absence of a formal complaint, chastise, suspend or otherwise discipline auditors and others who practice before it. As evidence of the DTI's hesitance to undertake legal actions, it should be noted that in 1971 inspectors were appointed for twenty-four companies (ten of whom were previously appointed), and that charges were filed in 517 cases for failure to forward annual returns, fifteen cases of failure to keep proper books and thirteen cases of fraudulent trading.⁹⁵ The SEC, on the other hand, actively administers the federal securities laws and its principal impact is on the contents of and standards underlying financial reports. The SEC enforcement procedure utilizes such administrative actions as threats of investigation, publicity, stop-orders, injunctions, and suspensions from practice before it, as well as recommendations to the Justice Department for criminal prosecutions. In 1972, for example, twenty-seven administrative proceedings related to disclosure cases were instituted, 145 injunctions were ordered with 654 defendants enjoined and forty-nine cases were referred to the Justice Department for a variety of causes.⁹⁶

95. 1971 Department of Trade and Industry Annual Report.

96. 39 SEC ANN. REP. 170 (1973).

For auditors, however, the SEC's greatest power lies in the unfavorable publicity it can bring to bear on a CPA it feels has "misbehaved." One of the CPA's most valuable assets is the public's belief in his integrity, honesty and expertise. By suspending a CPA from practice, even for a few days or a week, the SEC can seriously damage his reputation. The mere public announcement of the investigation of a CPA can be a substantial punishment. Another modified weapon relied upon by the SEC is a time consuming review of registration statements filed by a CPA's clients. Further escalation might include a review of a CPA firm's audit procedures, as was agreed to recently by two large firms,⁹⁷ and civil and criminal charges against individual CPA's. While the latter procedures are rare, the cost to accountants should they even be threatened would be considerable.

Consequence of Differences in the Legal Environment. Although the two systems are very similar with respect to the common-law liability of accountants for fraud and negligence, the provisions of the United States Securities Acts and the ability and incentives of third parties to sue accountants are in sharp contrast to the lack of similar statutory provisions and third party incentives in the United Kingdom. Since the legal and quasi-legal actions that can be brought by the SEC are peculiar to the United States, American accountants are more likely to have to defend their audits and opinions before a court or regulator than are their British counterparts. While careful documentation of audits and a healthy skepticism about a client's enthusiasm are generally approved defenses, they may not be sufficient. What may seem to be an adequate audit procedure or a reasonable reporting decision, beforehand, may seem inept or deliberately misleading after the fact. What may be understood as competent professional performance and judgment for a given set of circumstances to a fellow professional may not be so understood by a jury, judge or even a regulator who must explain his action to legislators, the press or the general public. Therefore, accountants understandably attempt to rely on explicitly stated generally accepted auditing and reporting practice as a necessary means of defense against lawsuits and punitive regulatory actions. Explicitly stated standards allow CPA's to document that their actions were taken in accordance with recognized professional prescriptions.⁹⁸

97. See *In re Touche Ross & Co.*, SEC Securities Act Release No. 33-5459, Admin. Prac. File No. 3-4437 (Feb. 25, 1974).

98. *But see* *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 379 U.S. 1006 (1970). The Court ruled that fulfillment of recognized professional standards is not a

CPA's who fear lawsuits also can protect themselves by insisting that clients follow conservative accounting practices that tend to understate rather than overstate net income and equity. Two particular reasons in support of this practice deserve mention. First, the more stringent '33 Act provisions (Section 11) apply only to offerings of securities. While pre-offering (current) shareholders may lose if shares are sold for less than they would have brought had favorable financial statement data not been understated, relief generally is limited to purchasers.⁹⁹ Therefore conservatively stated reports in prospectuses are preferable to "correctly" stated reports. Secondly, investors are more likely to sue should prices decrease more than expected than if prices increase more than expected.¹⁰⁰ In an attempt to recover their losses from accountants, disgruntled investors may seize upon an *ex post* appearance of overstated earnings or equity as a basis for suit.

Accountants also can protect themselves from lawsuits by refusing to be associated with estimates that can later be shown to be incorrect. This tactic is frequently used with estimates where a future event will reveal the actual figure. For example, an accountant might estimate the market value of land, taking into account the range of possible sales prices and the probabilities that each might occur, from which an expected value is calculated. While this is the "best" procedure from which an estimate can be constructed before the fact, nevertheless it may turn out to be wrong. Either some other sales amount than the one with the greatest probability or expected value may be received or else conditions may change to invalidate the original estimate. Given that the estimate was demonstrably incorrect, it may be difficult to prove that it was honestly and competently made. Here, accountants can protect themselves by insisting that assets be recorded at historical cost, which is an objectively determined, verifiable datum, and by explicitly disassociating themselves from forecasts.

complete defense in a criminal case. While this reduces the value of more explicit standards, the Court indicated that a standard specifically aimed at the situation at issue in a case will have added evidentiary weight. *Id.* at 806. This pushes in the direction of more explicit and detailed standards.

99. The court's ruling in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), that fulfillment of recognized professional standards may not be a complete defense in a criminal case, somewhat reduces the value of explicit standards. The Court did indicate, however, that a standard specifically aimed at the situation at issue will have added evidentiary weight.

100. *See, e.g.*, Securities Act of 1933, § 12(1), 15 U.S.C. § 77l (1970).

4. *Summary of Environmental Differences*

As the prior discussion indicates, United States and United Kingdom accounting practices are what one would predict from the professional, economic, regulatory and legal environments of these countries. The professional environment in the United Kingdom permits a greater degree of peer pressure on accountants than can be achieved in the United States and consequently the need for codified, explicit accounting standards to maintain the public image of accountants is greater in the United States. The economic differences between the two systems center around the greater ownership and trading of shares by American investors which makes it efficient for American corporations to compile financial statements prepared in accordance with auditing and reporting standards that even unsophisticated individuals can recognize or accept. The existence of the SEC is another distinguishing feature between the United States and the United Kingdom. Since regulators find that codified, explicit standards allow more efficient administration of the statutes and a protection against adverse criticism should a corporation whose statements they "accept" "go wrong," it is not surprising that the SEC has been a force towards more explicit United States accounting standards. In the legal arena, American accountants are more vulnerable to lawsuits than are their British counterparts and are naturally more desirous of codified standards that can be used both as guidelines and also as justifications for actions that in retrospect may seem deliberately misleading.

III. CONSEQUENCES OF EXPLICIT VS. IMPLICIT ACCOUNTING STANDARDS FOR INVESTORS

Having explored the positive question, "why are accounting standards stated explicitly or implicitly?", I now address the normative question, "which practice is better for the investor?" "The investor" refers to present and potential shareholders as a group, where an individual has an equal probability of being an owner, seller, or purchaser of shares. "Better" refers to the expected money value of the investor's wealth, net of expected costs (reductions in wealth), given a specified degree of risk. Thus, if the adoption of formal accounting standards tends to increase the wealth embodied in corporate shares, this practice is considered better for investors.

A first observation is that the more explicit the *auditing* standards the less auditors will use their individual professional judgment to determine the scope of audits. Additionally, users of financial statements will have more reason to believe that specific

audit procedures were followed even when they do not know and cannot question the auditors. Thus, the cost of using financial statements should be lower. The cost to corporations of audits, however, would tend to be higher, since auditors must follow the stated minimum standards even in situations where they believe them unnecessary. For example, in the United States inventories *must* be physically verified and receivables *must* be confirmed where either of these assets represents a significant proportion of the current assets or the total assets of a company. British auditors need not follow these procedures (though they generally do) if they believe them unnecessary for the statements to be "true and fair." Thus there is a trade-off: somewhat greater reliability and lower cost of using financial statements versus somewhat higher audit fees.

A second observation is that more explicit *reporting* standards result in more objectively determined but at the same time less potentially meaningful financial information. If the scope for managements' and accountants' judgments about interpretations of the economic status, past and future, of a company is narrowed sufficiently by explicit standards, some potentially useful subjective estimates cannot be communicated. For example, although the amount and market value of mineral deposits may only be appraised imperfectly, the estimate can be more useful to investors than knowledge of the original cost of the resource. Similarly, while forecasts of sales may prove wrong, investors may still find management's forecast very useful. However, if the appraisal and forecast were intended to mislead investors, they would have been in a better position had publication of these estimates been prohibited.

A related observation is that more explicit *reporting* standards allow less scope for both managements' and accountants' judgments. Explicit reporting standards may permit management to choose among a few generally accepted procedures that reflect most situations accurately. However, management still may deliberately choose a method that, in a particular circumstance, misleadingly reports events. Accountants, then, may find it difficult to object to managements' choice of a "generally accepted accounting procedure." Should only a single procedure be deemed acceptable, it may inadvertently lead to misleading reporting where it is inappropriate.¹⁰¹ Where accountants are charged only with giving an opinion as to whether the financial statements present a "true and fair view" of the company's economic situation, they need only answer

101. A number of empirical studies, however, reject the assumption that reported accounting data affect share prices. For a review of the evidence, see Benston, *supra* note 20, ch. 4, § 4.2.6.

whether, in their judgment, a particular procedure meets this criterion. In this situation, however, users of financial statements must rely on the accountants' judgment and integrity. Lack of flexibility, then, reduces opportunities for deliberate manipulation but also increases the likelihood of inadvertent misstatements. Which alternative is "better" for shareholders depends on one's estimate of the ability and integrity of accountants.

Finally, explicit accounting standards require a formal means of establishing, changing and policing the standards. An FASB in the United States or ASSC in the United Kingdom is required to do research in support of proposed standards. The standards adopted must then be promulgated and enforced,¹⁰² which is a more expensive process than the informal acceptance of implicitly understood professional standards. The process of stating standards explicitly, however, may also bring increased knowledge and understanding that improves the usefulness of the data reported to investors.

In summary, the existence of benefits to investors of more or less explicit accounting standards depends on answers to the following questions:

1. Are the additional costs of auditing less than the expected additional value of the reliability of the data presented in financial statements?
2. Is the reduced potential for manipulation greater or less when there is more than one acceptable accounting standard for a given situation or when accountants are charged simply with certifying that the statements are "not misleading" or present a "true and fair view?"
3. Where the choice of alternative accounting procedures is severely limited, does the value of reducing the potential for manipulation exceed the cost of misinforming in situations where the prescribed procedure is inappropriate?
4. Does the prohibition of subjective and potentially inaccurate estimates reduce the expected loss to investors of deliberate misrepresentation more than it reduces the expected value to them of obtaining the estimates?
5. Is the cost of establishing and policing explicit standards less than the benefits to shareholders?

The experience of the United States and the United Kingdom provides some insight but no definitive answers to these questions.

102. See generally Moonitz, *supra* note 2.

The United States has experienced a number of serious frauds and business failures that were directly traceable to misleading financial statements and accountants have been charged with everything from negligence and neglect of duty to criminal fraud. Financial writers and academics have accused the profession of perpetrating frauds upon the public by allowing and even counselling clients to use generally accepted, though misleading, accounting procedures. In contrast, the United Kingdom has experienced no criminal trials, few civil suits and very few charges of unprofessional acts against accountants. One should not necessarily conclude from this experience, however, that explicit standards are less useful to investors than are implicit standards or that formal disciplinary procedures are less effective than informal peer pressure. As previously discussed, the many differences between the two systems preclude such broad generalizations.

Some conclusions, however, can be drawn. It seems clear that the gross costs to investors are greater for maintaining a system of explicit accounting standards than for maintaining a system of implicit standards. Among such costs are higher audit fees, FASB funding, SEC expenses, lawyers' fees and numerous other costs. What then are the benefits from the additional auditing and disclosure required? The available evidence on the relationship between published corporate financial statements and stock prices indicates that, when published, accounting data have either little information content or that the information they convey was learned from other sources before the statements were published.¹⁰³ Considering the conceptual problems inherent in measuring economic events, it is questionable whether financial statements can convey much information other than that the company's records were audited by independent, certified accountants who found no gross improprieties.¹⁰⁴ In this event, it would seem that explicit reporting standards may result in costs that exceed benefits to investors. Explicit auditing standards, however, may well be worth their cost where peer pressure and lack of knowledge about the qualifications of accountants make this a more efficient means of ensuring a standard of performance.

103. See Benston, *supra* note 20, ch. 4, § 4.2.6.

104. See Benston, *The Extent of Financial Reporting by Publicly Owned Companies: A Professional Behavior Hypothesis*, FINAN. EXEC. (Dec. 1975).