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Legal Regulation of Accounting

By Frederick S. Fisher, Jr.

At the present moment there is a definite, articulate, movement to control and regulate, either by statute or otherwise, the present methods of auditing corporate statements. This much is clear. But any such movement must, of course, be coördinated with certain legal rules already worked out by the courts of this country. The question is thus at once presented: "Do there now exist any legal rules governing accountancy?" If the law, as developed by the decided cases and other authorities, now presents a complete and adequate system of control, there is no need for a required or uniform technique of accountancy. But if this is not the case, one must then attempt to analyze precisely where the control by the law is incomplete and precisely where it is necessary to develop further principles and standards.

I

To understand fully the significance of any judicial case or authority, as well as its bearing upon the subject of accountancy, it is necessary in the first instance to consider the characteristics and general technique of the two sciences. Only by grasping this background, historical if you will, may one fully appreciate the significance of the presently decided cases. It is only by comprehending legal technique that one may intelligently consider the assertion later to be made that there is in essence a presently developed law of accounting.

The common law of England, which has been adopted in great measure by the courts of this country, had its origin in the eleventh or twelfth century. Since that time the number of judges and the number of reported cases, the principles and rules of law developed, and the complex interweaving of various social and economic factors have resulted in a tremendous and overwhelming body of law which, because of its very size, is slow and ponderous in its movement and in its ability to reflect the contemporary and almost daily changes of the society in which it acts.

The profession of accountancy, on the contrary, is of a more recent origin. Perhaps the first accounts were the statements of the Roman grain merchants and Greek bankers; perhaps the first

development of clean accounting principles came into existence with the Lombard loans floated by the Medici dynasty. In any real sense of the word, however, it would seem that the accounting, voyage by voyage, of the British East India Company is a more accurate point at which to say that accountancy in the modern sense originated. At all events, the science of accounting, as well as the art, became an important and significant profession not much more than a hundred or so years ago. Within the last hundred years however, and especially within the last fifty years in the United States, the profession of accounting has grown enormously. The complexities of business, the rapid development of our large industries and the tremendous expansion of commercial activity throughout the world have made it obligatory to develop a more or less uniform method whereby business conditions might with some degree of intelligence be reported.

When one considers these divergent developments of law and accounting it is not surprising to see that the art of accountancy has progressed much more rapidly and has been much more sensitive to the needs and requirements of a particular generation than has the law. One may say with some degree of accuracy that the law is slower moving than is accounting. The principles today developed by accountants will be adopted by the law tomorrow. However, during the past twenty or thirty years, there has been decided a surprisingly large number of cases, which, for the most part, take the more fundamental rules of accountancy and crystallize them into rules of law. What formerly was a matter of professional ethics now has become a matter of legal obligation. In many large sections of accountancy there is no longer room for debate between accountants as to proper methods of procedure. Such debate has become academic and of theoretical interest only. The law has adopted what has seemed to it the sounder rule and has terminated the matter. When the files have been closed by a decided case it then behooves the accountant to put aside the debate, the alternative practices advocated by various members of his profession, and to adhere solely to the rule of law laid down by the courts.

When once the law has set forth its recognition of a particular rule of accounting practice, a new process then comes into practice. The lawyer will take the decided case, study it, analyze it and develop certain secondary rules from it which he feels will also be adopted by courts using the same technique, the same logic,

the same assumptions which were used in the case first decided.

It would seem, therefore, that we have a curve in spiral form, a curve which never closes but always expands. The accounting profession views the needs of the day, the ethics that are practised by the community, the ethics that should be practised by the community, and, from a consideration of all the factors available to it, decides that a certain procedure is proper. Certain of its members, however, decide that in logic and good conscience the rule should be otherwise. Sooner or later, depending upon the magnitude of the point, on its importance to some property interest, a case is brought into the courts of law and argued. Accounting experts are brought in to testify as expert witnesses; reason and logic are brought to bear on the problem; social and economic requirements as well have their sway. After all these considerations (depending on the astuteness and zeal of counsel) have been discussed, the court then lays down its rule. The dissenters among the accountants are then to a greater or lesser degree silenced on this precise point. Perhaps the secondary rules developed may or may not accord with sound accounting practices; whether or not they do is often dependent on the ability of counsel to present a proper and persuasive argument based on considerations of public policy and business necessity. At all events a "basing-point" has been developed, a line begun, and, for better or for worse, the system of precedent-making and case-matching has been inaugurated anew.

II

Now, having considered what is meant by the phrase "The law frequently adopts rules of accountancy and crystallizes them into rules of law," it is necessary to analyze yet another factor—does the law consider problems of accountancy from the point of view that accountants employ? That this problem is not one of theoretical interest only should be quite clear. An illustration may, however, be in point.

In accord with modern business practice we may expect to see and, in fact, do see, the stockholder and his interest playing the most spectacular rôle. If the stockholder has been given erroneous or misleading information, such conduct is at once written up in the daily press with great furor. There are, however, various other interests which are equally significant if not more vital to the commercial well-being of the community. In addition

to the stockholder there are the banker, the trustee of an estate, the various governmental agencies, such as insurance commissioners, the lender of short-term credit (perhaps to be distinguished from the lender of long-term credit) and many other interests, either actually or potentially in conflict. The importance of this consideration should be clear. One particular report, even though "accurate," may not begin to satisfy the inquiries of two different interests. The lender of short-term credit has no interest in the manner by which a company has accumulated its surplus—so long as there are sufficient assets capable of being levied upon he is well pleased. The purchaser of a long-term debt is, on the other hand, vitally interested in whether his company's surplus has been "manufactured" by a reduction of stock or has in fact been earned. Again, the bank examiner may have a strong need to know whether or not there are outstanding any contingent liabilities, while the trustee of an estate invested in the stock of such a bank might have only a minor interest in such fact. Examples may be multiplied to show that accounts adequate for the protection of one interest may be wofully lacking as soon as another interest becomes involved.

While up to the present there seems to have been no accurate discussion of this precise point, it seems safe to say that the accountant considers the interests of his client in the first instance, limited perhaps by certain outstanding principles of public representation, and then considers his job well done. It seems equally safe to state that the law has been primarily interested in the point of view of those persons who advance credit to the accounting concern. The majority of cases that have been found to consider points of accountancy have contemplated them from the point of view of the money-lender. Has he lent money on the faith of an erroneous certificate or other statement?

The rules of accounting laid down by the courts are, therefore, for the most part biased or prejudiced rules. It seems fit to consider what cognizance both lawyers and accountants should take of this problem. While it may be the case that no "true" picture can be presented of a contemporary enterprise, it may not be fallacious to assert that two pictures, from two angles, will give a more accurate and uncolored presentation than either alone. Certain it must be that this problem can no longer be ignored by either profession, when it is common knowledge that one set of financial statements will reach the investor about to sell stock, the

bondholder about to foreclose his mortgage and the banker about to consider his loan. The question of legal liability, if the foregoing analysis be correct, is only a short step forward. At least one method of attack is, of course, immediately suggested, namely, that of liability for a misrepresentation of fact made with knowledge and relied on to the plaintiff's detriment.

In view of the foregoing discussion, two propositions are submitted as being derived from the principles stated:

(1) All existing legal cases that consider problems of accounting should be carefully analyzed and, where necessary, discounted if it appear clear that too much stress has been laid on the position and point of view of the creditor.

(2) The accounting profession should consider that the same document will in all probability be used for comparatively opposite purposes and that these documents should therefore be constructed with that contingency in mind. Where it is impracticable to furnish several sets of accounts, careful and legible notations should be made of any facts which may unduly color the statement if read from one angle rather than another.

It is appropriate to consider next the rules of law applicable to accountants and the rules of law applicable to accountancy. The considerations to be watched for have been indicated, viz: the slowness of the law and the probability that both professions overemphasize particular interests.

III

In the law of accounting as elsewhere one should start with basic principles of honorable conduct. For the sake of clarity an attempt has been made to reduce these principles to stated theorems which will serve to center attention at the proper places.

1. *The duty of an auditor is to convey information, not to arouse inquiry.*

This principle was laid down in 1895 by Lord Justice Lindley when he delivered his opinion in the case of *London and General Bank* (reported in [1895] 2 ch. 673). In speaking of the ways by which an accountant could audit a statement with apparent honesty and yet succeed in concealing unfavorable probabilities and financial conditions from his readers, his lordship observed that

> "A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much

> information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. . . . The duty of an auditor is to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement."

The sophisticated observer of the recent business practices might be at a loss to reconcile them with this clear and forthright statement of professional standards. At all events, the statement quoted above seems axiomatic and in need of no further elaboration. The circumstances to which it might with facility be applied are, on the other hand, so numerous that any attempt to illustrate must be beyond the limits of this discussion.

2. *An account which states only facts may nevertheless be erroneous, and therefore the basis for legal action, if it combines those facts in a misleading way.*

The leading case on this subject is so recent that a mere mention of its name should serve to recall its facts. In the case of *Rex* v. *Kylsant* (decided by the court of criminal appeal in 1931) it was held erroneous to state that a company had earned an average income over a period of years when in fact the company had earned tremendous profits during the boom years of the war and had earned little if any profits thereafter. The court there stated with convincing candor that "a document might be false not only by reason of the facts actually stated in it, but also by the implication which a reader would draw from it." To be sure, the basis of the decision was the authority of an old English statute; this fact, however, only strengthens the conclusion that an English court will be eager to seize upon such laxity and such indifference and equally eager justly to punish it whenever it may arise again. A very interesting critique of this case was published in THE JOURNAL OF ACCOUNTANCY in January, 1932. It is interesting to note that the learned author of that comment considered that "the very fact of resort to average is a red flag to the cautious." It is safe to say that only the most sophisticated would have so considered it in the halcyon days before 1929. Furthermore the statement quoted assumes, without too much justification, that financial statements are only for the intelligently cautious.

3. *An accountant may not certify as a fact true to his own knowledge that a financial statement is in accord with the books of account where such a declaration is false.*

As Chief Judge Cardozo pointed out in *Ultramares* v. *Touche* (255 N. Y. 170) an accountant is not allowed to be guilty of reckless misstatement or of an insincere profession of an opinion. While he may be relieved from any liability if he has been guilty of an "honest blunder," he is not necessarily "bound to be a detective or to approach his work with suspicion or with a foregone conclusion that there is something wrong." To quote the words of Lopes, L. J., in the *Kingston Cotton Mill* case, decided in 1896, ([1896] 2 Ch. 279), "he is a watch dog but not a bloodhound." In short, an accountant's work is more than that of a mere bookkeeper.

While there are other ramifications of these principles, it is submitted that a compliance with the spirit as well as with the letter of the foregoing three principles would be sufficient to keep an accountant free from any liability which might otherwise arise from his acts. Perhaps it might be advisable to state one further caution to the effect that a true observance of the second principle above listed may be had only when the accountant bears in mind the various points of view which may be brought to bear upon his statements. What may be a clear and careful presentation of the facts from one point of view may not necessarily be so from another.

From these fundamental and basic principles governing the acts of accountants, it is a short step to a consideration of the rules of law laid down for the accounts themselves.

IV

The principles governing the actual setting forth of the financial statements, at least so far as the law has considered them, are in reality no more than a detailed development of the foregoing. While one may glibly state that the accountant should strive to set forth a true picture of the condition of the enterprise for which he is accounting, that does not add to the discussion.

In the first place, one meets again the problem of the point of view from which the statements will be considered. An example may serve to clarify. It is uniformly stated that a bank is not entitled to include as cash on hand money which it holds temporarily on bailment or on trust, purely for the purpose of making a good showing as to current assets. As was pointed out in *U. S.* v. *Peters* (87 Fed. 984), one can not have "cash on hand" if there be an agreement to return the money at a later date.

Suppose, however, the transaction were such that a court would leave the parties in the position in which it found them. Would the fact that a suit could not lie be sufficient to allow an accountant to include such funds as cash on hand? In a case as clear as this the commercial probability that the accounting enterprise will refuse to return the borrowed funds is practically zero. Therefore one may say that the accountant can not rely on the legal relations between the parties, and in fact the law itself recognizes the part played by this factor of commercial probability.

It is a task beyond the endeavor of this article to consider all, or even a large proportion of the decided cases on accounting. An attempt has been made merely to indicate a few salient cases or lines of authority which illustrate the several propositions submitted; for a more thorough collection of cases, the reader is referred elsewhere. [An article by Messrs. Berle and Fisher in *Columbia Law Review*, 1932, page 576, presents many legal cases which support the theorems here advanced.—Editor, J. A.]

1. *Financial Statements must clearly indicate the quality of the items included.*

Perhaps the most striking examples of quality occur in contingent items and capitalized expenses. As to the first, a bank examiner may be vitally interested in the amount of notes on which an accounting bank is guarantor; the lender of funds for thirty days to an industrial organization may have comparatively little interest in any contingent liability of his debtor. It is true that the law conventionally recognizes as contingent all claims that depend upon the occurrence of a future event other than the mere (inevitable) passage of time. Yet from a commercial point of view one may separate contingent liabilities in accord with three characteristics. They may be classified according to the probability that they will mature; according to the time when, if ever, they mature; or according to the characteristics they will have when they have matured into claims which the enterprise may or may not have to satisfy. It is submitted that the matter is largely one of degree—the more complete the financial statement, the more will remote and possible claims be included. So, while an account for the benefit of a stockholder might adequately portray the quality of the company's liabilities if there were included the "actuarial value" of the company's liability as guarantor, nevertheless, if the same account were for the benefit of a bank comptroller, definitely interested in all possible liability of

a bank, it is safe to say (and there is legal authority which asserts) that the account would be inadequate. Thus it may be concluded that the degree of commercial probability plus the interests viewing the account must both be considered in deciding whether or not the quality of any particular item warrants inclusion in a financial statement.

As to the second item considered under this heading of "quality," viz. capitalized expenses, it is frequently said that any enterprise may show a profit by charging off its mistakes to capital and its profits to income. The cases so far indicate a mixed test depending on reasonableness and hindsight for its effect. If a particular expense in fact proved advantageous then it was proper to capitalize it, provided the amount was a reasonable one. One may find some assistance in approaching the problem if one considers a comparison here to the question of contingent liabilities. Just as the problem of determining what liabilities, whether contingent or not, should be included rests primarily on judgment as to where to draw lines between a capitalized hope and a capitalized legal obligation, just so does a consideration of capitalized expenses rest on where to draw the line between capitalized hopes and capitalized commercial (or economic) fact. One may indeed say that the problem is one of deciding where, in the period of gestation of a transaction from thought to profit (or loss) in the bank, to draw the line. So it has been held unnecessary from the point of view of a creditor to include an unliquidated contract claim against the accounting company as one of its debts. The basis of this rule is that the contract was not yet performed and was, therefore, contingent. This liability seems, however, more imminent than that of a guarantor of a note—which was required to be listed in *Cochran* v. *U. S.* (157 U. S. 285). Yet a promise to pay out a portion of future profits, if any, has been held to be an outstanding obligation. Here the interests of a prospective purchaser were involved, and so, a shift of emphasis was natural. This latter case (*William* v. *Beltz*, 30 Del. 360) is one of the few that recognizes the importance of the point of view in considering the adequacy of a financial statement. Thus it appears that the law, while recognizing that the enterprise of today must incur large expense preliminary to beginning operation, refuses to allow the hopes and expectations of the accounting party to control the accounting—the quality requisite is one of commercial fact, not introspective, wishful thinking.

In summary, then, of the first theorem it may be rephrased as follows: Where the quality of any fact or negotiation is such that it materially affects the commercial standing of the accounting enterprise, from whatever point of view, the law will require such fact or condition to be shown. And it is implicit in this statement that sound commercial experience shall govern any line of probability which it may be necessary to draw.

2. *All items on a financial statement should state the degree of interest held in them (whether ownership or otherwise) by the accounting enterprise; or, in the alternative, all items deviating from a clearly recognized and known standard should be clearly indicated as deviations.*

This point considers primarily the creditor. Can he in fact seek satisfaction from those items which are listed on a balance-sheet as assets? The law has proceeded quite far along these lines. For example, it has been held bad accounting to list as a current asset items in which the accounting company had only a lessee's interest—the theory being that a creditor could not in fact avail himself of such merchandise and would, therefore, be misled to his injury. And again the problem of interest, coupled of course with that of quality, appears in consolidated accounts. Thus suppose that a holding company controlling three subsidiaries received income from one subsidiary while the remaining subsidiaries were operating at a loss. This at once raises the problem whether the holding company may or may not pay dividends to its stockholders. If the attributes of interest and quality are considered the solution is brought nearer.

3. *Items listed on a financial statement must be valued in accord with some well-recognized scheme of valuation, and, if extraneous facts warrant it, there should be included alternative bases of valuation.*

It is currently maintained that accountants are not concerned with valuation as such. True it may be that accurate valuation is an ideal, perhaps unattainable. Yet to the extent that the accountant, by professional standards or by force of law, considers, for example, depreciation or reserves for uncollectible notes and accounts, to that extent he must and does consider valuation, and to that extent the law has entered the field.

In considering this problem of valuation there are several points of interest. In the first place it is usually stated by the courts that the accountant should generally observe a conservative valuation

—namely a valuation at cost or market, whichever is lower. The cases laying down this principle are, however, cases which for the most part consider the interests of the banker or other lender of credit and, as is natural, the courts tend to adopt what they consider a more conservative view. In point of fact, however, this view, while perhaps more conservative, is, nevertheless, still a most liberal one. For example, if a debt is not paid when due, the creditor seeking to enforce his claim against the assets of the concern must rely on the proceeds obtainable from a forced sale of those assets. It is common knowledge that a sale on liquidation will net less than the merchandise is in fact worth in a "hand-picked" or trade market.

It appears from this simple illustration that there are at least four tests of valuation. The valuation may be confined to cost or to market, to the lower of these two, or to a more conservative test, namely, the proceeds of a forced liquidation. It is quite obvious that any one or even any two of these bases used in conjunction may present a comparatively misleading and false impression. For example, if the valuation is based on the test, cost or market, whichever is lower, and there is a rapidly climbing market which because of its inertia (if for no other reason) is practically certain to continue rising until liquidation of the merchandise in the ordinary course of business, it may be extremely misleading to carry the inventory at cost although quite within the legal rules so far laid down. And this leads us at once to the question of whether or not a cause of action based on a misrepresentation will arise when the accountant uses too conservative a test of value, as well as when he employs too optimistic a test.

Another point of interest in valuation is that the cases, still considering the interests of the creditor, require that any reserve for depreciation or other loss in value should be clearly identified with the particular assets so adjusted.

From this discussion of the principles of valuation it is found that it is obligatory, to present a true picture of the facts, to consider the commercial probability of receiving precisely what particular items are said to be worth. In guarding against a misrepresentation of value one must consider not only the point of view but also the effect on value of various probable occurrences such as a forced liquidation, a continued business depression, or a probable advance in prices due to recent climatic or industrial changes. It may be as misleading to carry goods at cost if the

market has permanently risen (due perhaps to a crop decimated by hurricanes) as it would be to carry them at cost when "the bottom has dropped out of" the market, due perhaps to a financial panic. Note that similar problems arise in considering fixed assets.

4. *The standards of the accounting profession should wherever possible be followed by the practising accountant.*

Little by little the adjudicated cases are citing accounting authority as a basis for their decisions. So long as there exists an independent and impartial body of accountants it seems only just and expedient that their impersonal ruling should be followed as far as is possible. Such a rule of law makes at once for flexibility and for progress.

5. *Wherever financial statements are presented covering more than one period, the basis of accounting should be identical for all periods, unless any deviation in practice or any variation in accounting method is plainly disclosed.*

This subject as yet has not been dealt with by the law. It is, however, presently a matter of serious discussion by accountants. And in fact the New York stock exchange in its statement on investment trusts (April, 1931) strongly urges that such trusts in their reports call attention to any change of method or to the use of more than one method during an accounting period. Its justice seems obvious—so long as there are periodic accounts for periods less than the life of the enterprise, the instinct of everyone interested in ascertaining the condition of the business is to compare a series of such accounts. One hopes thereby to have discovered not merely the present condition of the enterprise, but the trend of its development. Obviously a change in apparent development can be manufactured by simply changing the method of accounting. If, for example, the rate of depreciation is changed from 10 per cent. in 1930 to 5 per cent. in 1931 a company may well earn more profits in the latter year, although in point of fact its operating income had seriously declined. These considerations raise a pretty question of law. If one accept the idea that the allocation of income and expenses to one or another account lies largely in the discretion of the management, there is no legal basis for saying that any account is inaccurate. However, the fact remains (compare *Rex* v. *Kylsant*) that such a change in accounting method will result in a wholly misleading impression to be derived from the combined or comparative statements. It is strongly

urged at this point that there is an implied representation that in the absence of a notation to the contrary the method of accounting remains unchanged. Certainly, in view of the fact that the commercial and economic world as a body inevitably compares the successive series of accounts issued by the large corporations, it must be accurate to say that accountants are aware of the use to which their statements will in part be put. This certainly seems to suggest that people who render accounts hold out that their successive accounts are on a comparable basis unless otherwise specifically stated. The argument is stronger where, in the first instance, a series of accounts are asked for, as when a bank requests a set of statements for the past four years as a basis for making a loan. From these facts alone there may be spelled out an understanding that for these periods at least the accounts were kept upon a comparable system and were, therefore, capable of being used to determine with some degree of accuracy the trend of the business.

A sixth point, not yet sufficiently thought through to be made a theorem, but of sufficient importance to mention here, is briefly this: if the customary business cycle is recurrent every third year, and the accounts are rendered yearly, to what extent should this factor be indicated? If a layman, unfamiliar with this cycle, were to be shown three income statements he might suppose that the company had embarked upon an unprecedented wave of prosperity, when in point of fact, it was more or less in the commercial "doldrums." If statistics are adjusted for seasonal changes, why should not accounts be? They can at least indicate that fact.

By way of a summation of the first half of this article several points may be outlined:

1. The accountant, by virtue of his recurrent and ever-increasing activity, is in touch with the daily needs of the community. Because of this and other factors he is able to reflect, almost day by day, the changed philosophy of accounting as well as the changed requirements and needs of the community in which he acts.

2. The law, because of its longer life and its greater size, is slower to move. It reflects tomorrow what the business community needs and attains today; case by case it builds up a body of law to answer the needs of the community.

3. The law does, however, accept and adopt the rules and precepts of the accounting profession as they are presented to it

for decision. This process is comparatively slow because of several factors:

(a) All problems of accounting are not presented to the courts as soon as they arise;
(b) Only a selected few of the many problems that may or do involve the law of accounting ever arrive before a court.
(c) When the cases that eventually arrive in the courts are finally presented for adjudication it is often a matter of years before a decision will be handed down.

4. Yet even at the present moment it may be said with some degree of safety that the law has adopted a comparatively large number of accounting rules and accounting conventions, and, in some instances, has considered and rejected other accounting principles, and that there is, therefore, a body of case-law from which we may elicit a set of theorems in a very real sense equivalent to "principles of the law of accounting."

5. To a surprising extent these theorems are in accord with sound accounting standards. When they deviate from accounting standards it is difficult to say which, in point of pure reason, is the more correct.

6. The law and the practice of accounting are at present not complete for several reasons:

(a) They often overemphasize one or another point of view, leaving unconsidered other and equally important interests.
(b) There are various gaps in accounting authority as well as in judicial authority, which must, if accurate accounting be desired, be both filled and regulated.

7. The tool most easily adopted by the law for reviewing accounting standards is the action for a misrepresentation of fact. This must be considered from at least three angles:

(a) What interest is raising the question (and was his interest within the consideration of the accountant when he prepared the statements);
(b) Are the legal facts accurately stated;
(c) Have the commercial facts and the commercial probabilities been accurately and thoroughly stated?

. . . . .

V

Examination of the first half of the problem shows that while there is a body of cases concerned with the law of accounting, it is

by no means a complete one. It therefore becomes necessary to consider the arguments for and against a statutory system designed to supersede or to incorporate or otherwise to aid the present law of accounting. By way of setting aside unnecessary objections, several points are first briefly discussed.

The accounting profession by itself can not effectively legislate a system of accounting; nor is there any reason why it should attempt so thankless a task. Its relations to the community, as well as its differences of opinion, are excellent reasons against such an act.

In the second place, whether desired or not, there is present in point of fact a commercial system which has compulsory auditing as a constituent part. Whether the audit be made by a private bookkeeper employed by the management, by an independent auditor and expert, or by some person of rather indefinite hue, the fact remains that business methods and the demands of the community insist on some form of periodic accounting. The treasury department, the New York stock exchange, the bankers, the interstate commerce commission—all recognize the financial and economic necessity of compulsory accounts. Factually and theoretically we are practically over the dam. Nor can one expect this well-reasoned and well-supported movement for compulsory accounting to die at one puff of opposition. It is present, it is worthy, and should be aided with all available means.

At the outset it is clear that there are two lines of control open. The law may adopt a set of standards, couched in comprehensive language, and aiming to inform the accountant of general principles whereby he may guide his actions. It may, on the other hand, attempt a complete enumeration of all the precise acts which he should and should not do, so that by a mere reading of the prescription, the accountant may govern his actions with perfect safety. To enumerate the choice is in effect to chose. Only an omniscient economist could attempt to prescribe detailed rules of conduct.

VI

In considering this problem a further fact becomes apparent. The accountant, as a legal personage, has been slowly evolving from the laity. He has become recognized as an expert somewhat similar to the lawyer or the doctor. However, unlike these two professions, the accountant and his acts are not to be considered primarily from the point of view of the person who hired him.

The lawyer or the doctor expects to be paid by his client or patient; he expects, in the vast majority of situations, that his good or bad advice will be restricted in its effect to the person who in the first instance employed him. It is not so with the accountant. True it is that he may be employed and paid by one man or one interest, such as the management of a large corporation. Nevertheless, the effect of his statements and of his accounts go far beyond the person with whom he originally contracted. To be sure, the New York court of appeals in the *Ultramares* case, its most recent decision on the subject, decided that there would be no liability for negligence on the part of an accountant toward a third person, one with whom the accountant had no contractual relations. The court there pointed out that liability for negligence, if established against the accountant, would extend to many callings other than an auditor's. While at first sight this case might seem to dispose of the problem under discussion it is submitted that, in view of the previous discussion, the calling of an auditor differs so markedly from the callings of other professional men that the case may well be limited in its application. It seems clear, if one ask for thirty or so copies of a statement, that it will be difficult to infer an intention to broadcast that statement to the world. On the other hand, should one go to an accountant and say, "Will you please audit my accounts so that I may publish a statement of my financial condition in the *Journal of Commerce* and the *Wall Street Journal*" it would be difficult to assert that the accountant so employed would be at liberty to draw up a set of reports as favorable as could be to the interest of the management and, let us say, at the same time actively unfavorable, misleading and inaccurate if considered by a stockholder—liability would seem a necessary consequence of such conduct. Yet, because of ambiguous judicial rulings, a need for more legislation on this and other problems in accountancy becomes apparent and imminent.

VII

Moreover, in many states there already exist statutes requiring, and to some extent regulating, corporate accounting. At this point a brief consideration of these statutes may aid in the development of the discussion.

Accountants' reports may themselves ground a cause of action or they may be a mere adjunct to the successful prosecution or

defense of a suit. The statutory law of Great Britain, as well as of the United States, has enacted many provisions for safeguarding the various interests that may rely on corporate financial statements. These safeguards, both civil and criminal, are intended to protect at least two large groups of persons who might have cause to deal on a financial basis with a corporation—first, the stockholder, actual or prospective, and, second, the banker, or other person who advances credit on the faith of the statements exhibited to him. In order adequately to cover these interests the law has imposed restrictions on two other groups—directors or other officers of the corporation, and accountants or auditors employed by the corporation. Perhaps the English larceny act of 1861 is the first important attempt to control the dissemination of misleading corporate statements. This statute, and its successor, section 274 of the companies act of 1929, fix the duty to keep proper books and to present proper periodic statements.

These statutes have been followed by various enactments in this country. Thus directors of national banks are under a similar duty not to make false entries. And in New York section 665 of the penal law applies to directors or officers of any corporation and defines the offense in terms similar to the English statute. Another section of the penal law (section 952) provides a penalty for misstatements concerning securities. While this section has not as yet been invoked to attack a balance-sheet, it seems to afford a convenient and useful mode of procedure.

Although many of the states have enacted statutes purporting to regulate the financial statements of corporations, the paucity of litigation under these statutes and their failure to provide detailed, uniform and scientific accounting methods would tend to indicate that in most instances the statutory requirements may be met by a most meager and superficial report and that only the most flagrant falsified statement would justify the easier procedure under the statute—easier in that damages are more certain and more easily proven. The best-known of these statutes is that enacted by Massachusetts. But here again appears an overemphasis of one point of view—the liability imposed by this statute is in the nature of a private remedy for a wrongful act arising from a breach of duty owed to corporate creditors, and it is created for their benefit alone.

In the legislative enactments of other jurisdictions there is little similarity in the requirements imposed upon directors, even

though about half of the states provide for some form of liability. The statutes differ in what they consider misconduct and in what they consider a proper penalty for such misconduct. The general tendency is to provide for so minimal a certificate or report that a plea of lack of knowledge, or of intent to defraud, or of reliance upon an accountant, will be sufficient to prove compliance with the statutory requirements.

It is, of course, well-known that there exist at least two or three extra-legislative requirements for keeping accounts. Thus the interstate commerce commission and the various public service commissions of the several states in their rulings and under legislative authority stipulate the manner in which the several enterprises coming under their jurisdiction shall keep accounts. By these means there is prescribed to some extent a uniform system of accounting. Another and still more unofficial source of regulation is to be found in the provisions of the New York stock exchange. The present exchange rules provide that all listed corporations shall, before being granted the privilege of listing, agree to furnish their stockholders with periodic statements. As yet, however, there are few requirements as to the form or contents of these statements—so long as they have the outward and visible attributes of accuracy the agreement has been honored. It may perhaps be, if the arguments advanced throughout this article be accepted, that an action for deceit will lie against a director or an auditor for falsely representing to the exchange certain particulars concerning the financial condition of the corporation in question.

As a prelude to further discussion of the problem of compulsory accounting, then, several propositions may be stated:

(a) There is, in point of fact and of theory, a presently developed obligation on the part of industry to prepare and to furnish accounts.

(b) There has been some legal and some extra-legal experience of compulsory accounting.

(c) This experience has shown that present-day requirements are too indefinite and of too little strength (by way of enforcement) to rest alone.

(d) The accountant must now be recognized as a professional man in the nature of a public servant.

(e) The advantages, both to the profession and to the public, of *uniform* accounting are too well-known and too obvious to require further analysis.

VIII

The problem now divides itself into three branches: Can any rules of accounting be laid down by legislative enactment? Assuming that this is possible, will it lead to any degree of uniformity? Assuming that it is not possible, is there any other way of accomplishing the purpose?

One thing at least is definite: it is suicidal to crystallize accounting technique at this point. Accounting knowledge is not sufficiently adequate, nor sufficiently stereotyped, to undertake the manifold risks which such an action would obviously entail. This is not, however, the conclusion of the matter.

There are, as has been pointed out above, certain standards of professional conduct and of accounting technique which are, or which clearly ought to be, recognized as fundamentals of accountancy. This at once suggests an analogy to the methods used by the common law—the facts of each particular case are decided in accord with fundamental principles, tempered by the special circumstances of each case and the changing needs and philosophy of the community.

Adopting this technique, it appears that it is not too hopeless nor too dangerous a task to enact statutes which will lay down broad standards of action in accountancy. While it is beyond the scope of this article to phrase such a statute, it seems highly probable that with a certain amount of expert thought, coupled with an understanding both of law and of accountancy, a workable comprehensive statute could be drafted. The advantages of such a statute seem obvious: item by item, each individual case would be decided on its merits without too great a handicap in a pre-determined adherence to specific rules; there would be a liberty of administrative action coupled with a publicity of administrative findings. Perhaps a most important advantage to be had by such a method as this is that the administrative officers would be able to, and would have to, use the knowledge and advice of an accredited body of accountants—the work in all probability could not be done without the assistance of such a group of technical experts.

The statute could in fact go further than merely advocating principles. It could with a degree of safety lay down certain minimal requirements such as were discussed in the first part of this article. The specific requirements so laid down would have

to consider questions of quality, value, interest, point of view and various others, such as uniform comparative accounts. In fact the entire group of items customarily included on the several financial statements should each have certain fixed and definite tests required by statute. At the present writing it seems that the statute should go further and provide that any accountant who feels that the circumstances of a particular case are sufficient to warrant the application of other and different tests should be allowed to use such other tests provided he gives a full disclosure of the general rule, of the special circumstances taking the case out of such rule, and of the precise test or rule applied in lieu of the statutory requirements.

As was pointed out by Frederick B. Andrews in his recent article, published in THE JOURNAL OF ACCOUNTANCY for November of this year, this device at once raises a pretty question: Does the notation of important information by means of a small and practically illegible footnote fully comply with the conception of full disclosure? The point made by Mr. Andrews is unanswerable; one may add only the thought, so well expressed by Lord Justice Lindley, that an accountant should dispense information, not arouse inquiry. Furthermore it may be observed that it is unavailing to state how one arrives at a result if the result arrived at is meaningless.

IX

One final point should be briefly considered. Should such a statute as the one here outlined be enacted by the federal government or by the several states? I submit that the only effective way to acquire a uniform system of accountancy is via a federal statute. To recommend state action would be to recommend forty-eight probable variations in requirements—there can never be a guaranty that even a so-called "uniform law" will be adopted without change. Furthermore, the pressure of local politics and jealousies, of state rivalries and competition render state action extremely uncertain and untrustworthy.

If, then, the federal statute be considered the safer vehicle, there appear only a few objections.

The first of these would seem to be the prohibitive cost of establishing yet another governmental bureau. In considering this cost it seems apposite to observe that the ancient proverb, "in knowledge there is power," is still in full force and effect.

It is not necessary for a supertrust to fail in order to bring misery and suffering to many an honest, intelligent and unsuspecting investor. The set-up of modern business is such that its financial statements are the mirror of reality—the door of the cave beyond which we can not venture. And if the mirror be clouded, we remain helpless. May it, therefore, be said in honesty that the cost of assuring uniform, trustworthy, and accurate pictures of business condition and progress is so great that the savings of our citizens should be gambled against it? Even now there is money, and security, to be lost by relying upon mis-information. In fact the present conception of many financial statements is that "he who reads should run."

The second objection concerns itself with the constitutionality of such a proposed statute. While it is beyond the province of this article to consider a question of such magnitude in detail, a few observations should serve to clarify the problem. It is of course clear that much can be accomplished if the proposed statue be drafted in terms of a regulation of interstate commerce. It might well be, however, that a more thorough control would be obtained if uniform reports were required as an aid to a speedy and efficient ascertainment of taxable capital and income.

. . . . .

The aim of this article has been to present the case for a further step in the attainment of a uniform compulsory system of accountancy. That in fact there is compulsory accounting today can not be seriously questioned. That uniform accounting has many advantages, both for the profession and for the laity, seems equally clear. It is therefore submitted, in view of the present stage of development of the law of accounting, that the several principles set forth should be supported and added to by appropriate legislation, preferably federal. The wishes of the individual person must be subordinated to the needs of the community. The standards of the profession should receive the sanction of the legislature. The rules of the existing law should be recognized and furthered. And finally the interests of all who may have occasion to make use of corporate accounts should be thoroughly considered and protected.