

5-1938

Accounting and the Law

A. A. Berle Jr.

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

Recommended Citation

Berle, A. A. Jr. (1938) "Accounting and the Law," *Journal of Accountancy*. Vol. 65: Iss. 5, Article 2.
Available at: <https://egrove.olemiss.edu/jofa/vol65/iss5/2>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Accounting and the Law

BY A. A. BERLE, JR.

THE aim of this paper is to stimulate a more systematic method of evolving standard, but evolutionary, rules of accounting. The conclusion, if sound, follows from two premises. First, rules of accounting have become, in large measure, rules of law. Second, the present methods by which accounting theory is translated into the accounting rules—or, if you choose, into accounting practices—which thus enter the legal system, are not wholly satisfactory, especially in view of the results which now follow from that translation. By consequence, the task of developing a systematic yet flexible means of arriving at and recording the sound doctrine as it appears in the light of the knowledge of the day, takes the foreground as a major problem in the profession of accounting.

Emergence of Accounting into the Field of Law

John Bauer, writing eight years ago, accurately indicated that accounting development had paralleled, roughly, the enormous growth of business over the past half-century; and he concluded by insisting, also accurately, that the growing control of government over business furnished a powerful spur toward extending the best private practice to all business units in similar fields. He, of course, had in mind the control exercised in the field of railroads, utilities, insurance, and banking. Two years later, Frederick S. Fisher, Jr., of the New York bar, with some incidental assistance from the writer, took a somewhat wider base, and attempted to collect the common-law decisions in which guilt or innocence, liability or nonliability, had been predicated upon a pure rule of accounting: the result proving both formidable and a little surprising. In combination, administrative requirements and court decisions had built a not inconsiderable edifice upon the basis of "rules of sound accounting"; and even had the discussion stopped there, it was plain that this body of

NOTE.—This paper was presented before the American Accounting Association at Atlantic City, N. J., December 27, 1937. It is here reprinted from *The Accounting Review*, March, 1938, by special permission of the author and of the Association.

doctrine, unsystematized and indefinite, had assumed cardinal importance as—may the phrase be excused?—superjudicial legislation. But the problem became minor by comparison with the results created through the legislation of the next few years. The national securities act of 1933, under the guise of the simple phrases requiring disclosure of all material facts and elimination of any facts which might tend to mislead in registration statements and prospectuses, subtended very nearly the whole arc of accounting by the legal-rule line. The power given the commission to indulge its own views as to whether or not a set of accounts met the statutory requirements, very nearly made the newly formed commission a synthetic czar in the accounting field: access to capital rested on conformity to the rules sanctioned by it, while liabilities, civil and criminal, might follow noncompliance. The securities-exchange act of 1934 carried the process still further, as did certain strictly judicial determinations—as, for instance, the enlargement by decision of the effect of the Federal statute against use of the mails to defraud.

At all events, the accountant had suddenly come into his own, as a part of the mechanism of government control, though rather by the shot-gun route; and there he is likely to remain for some time to come. As a lawyer, I have to put my accounting books alongside my annotated statutes and my digests of case-law, and so must the judge before whom I argue, at which point the real argument here to be made must begin.

It will not, perhaps, be seriously argued that in 1933—or, for that matter, today—the phrase “sound accounting principles” did not describe a body of accepted doctrine comparable, let us say, to any branch of common law, as, for instance, the law of contracts or corporations. The profession was struggling nobly with the job of bringing the conception into reality. The Federal Reserve Board approved a standard audit program prepared by a committee of practising accountants, and another very capable special committee produced a preliminary report on accounting terminology, edited by A. P. Richardson, which had been the subject of heavy discussion for some years. The stock-list committee of the New York Stock Exchange, at which it is fashionable just now to take pot shots, but without which very little in this field would have been accomplished, had, at the insistence of Frank Altschul, engaged George O. May as accounting consult-

ant, and had begun to render a series of opinions in the field of corporate statements. Progress on many fronts was evident, but objectives were at once undefined and far away. Perhaps the preoccupation of accountants and businessmen with problems of taxation (which are usually too specialized to be of general use in ordinary business accounting) had diverted too much attention to that field to allow for the more general development connoted by the enormous impact of the legal rules which suddenly came into being. In result, the groups of accountants which assisted in drawing the forms and regulations for the Federal Trade Commission as the predecessor of the Securities and Exchange Commission in the fall of 1933, really found themselves faced with the job of codifying, unofficially, a huge field of accounting in a few weeks—and that in a profession which had only begun to agree on terminology. It is a tribute, both to the men and to the solid thinking done by writers and students of accountancy, that they were able to handle the assignment. One recalls the plight of a legislative committee in a southern state which was asked to enact a comprehensive statute covering the law of sales. It took the not unintelligent course of adopting, as its proposed law, the bulk of Professor Williston's treatise on sales, and calling it square. But the law of sales has a history and a body of authority covering several centuries; whereas accounting moved out of the function of a private convenience to businessmen into the legislative arena within a very few years. Perhaps it is as well that there was this forced evolution from the academic discussion to the legal fact; all discussions do, sometime, have to crystallize. But it leaves for consideration the problem of progress from this point on.

Now we might, to be sure, abandon the collective responsibility for further evolution to the government agencies having power in the field. The banking departments, the insurance commissioners, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Federal Reserve Board, the Securities and Exchange Commission, and the Courts will henceforth be issuing regulations, rulings, informal opinions, formal decisions, and so forth, which, aggregated, will form a growing body of authority; and the accountants' journals can criticize, arrange, and group this material. But I venture to question whether this will suffice, and to lay out some of the

dangers. Since the S.E.C. is probably the most effective force which today is thrusting accounting rules into the legal structure, let me take that mechanism as illustration.

Every administrative body has a specific job to do, and serves a special interest. That is why it is there. Its views on accounting, accordingly, are conditioned by its desire to reach that result, rather than by any interest in the healthy growth of accounting as a whole. No one who has read Professor Bonbright's classic treatise on judicial valuation can fail to have accepted his major conclusion, namely, that in the realm of valuation, the "sound" accounting rule varied entirely with the purpose for which the valuation was to be used. Consciously or otherwise, the result to be obtained reached backward. For the purpose of a stock issue, the basis of valuation was largely that of historical cost; for rate making, that of current appraisal, arrived at in any of several ways; for taxation, still another basis appears; for a reorganization plan, a new set of factors turns up. The illustration is no doubt extreme, because more divergence is possible in dealing with value or worth—largely because it is a matter of opinion, and subjective in quality—than in any other; but in greater or less degree, the same situation appears whenever accounting ceases to be a mere record of an historical transaction solely in cash. The theory of disclosure to an investor, under the registration provisions of the S.E.C. acts, in itself offers a specialized objective. Before the commission can ask what that investor ought to know, it must ask why he ought to know it—plainly, because he may be asked, or may wish, to buy or to sell a security. At once a theoretical student has to note a reservation.

For instance, it might be entirely in order, as a protection to prospective buyers of utility securities, to insist on a variety of adjustments tending to indicate lower plant values, higher charges to current maintenance, and so forth. This might, at the same time, be the worst disservice possible to existing security holders whose interest in income would lead them to build up the capital account as a basis for obtaining higher rates. It might be of real importance to portray a stock issue as risky to potential buyers at the very moment when another group of public interests was strenuously pressing for equity financing instead of bond—or debt—financing. Even within the investors' field alone there are ineluctable conflicts. Where no-par stock or nomi-

nal-par-value stock is concerned, the existing shareholders who may have paid real value for their holdings are interested in maintaining their contribution, while incoming shareholders are interested in coming in at the lowest price possible. Instances could be indefinitely multiplied: the point need not be labored. There is always danger, where accounting rules are made by specialized administrative tribunals, that the resulting body of doctrine may be lop-sided, if not positively dangerous, however conscientiously the rulings have been made from the point of view of the administrators making them.

Even more of a problem is the process by which these decisions—now become authoritative—are made.

In practice, accounting points are usually raised by the S.E.C. in the form of a "deficiency letter," which is sent to an applicant who desires to register securities for sale after his registration statement has been filed and gone over by the examining unit. At this point the registrant, or his counsel, decides either that they will comply with the suggestion implied in the deficiency letter, or that some one will go to Washington to argue the matter out with the subexaminers, carrying the discussion on (if there is failure to agree) with any senior officer of the commission he can get to listen to him. So far, so good; but the next phase is not so simple. If agreement is not reached by this informal process, the registrant has only one of three courses open. He may comply, irrespective of what he thinks about it; or he may withdraw his registration and abandon his financing; or he may stand his ground and go to a hearing under section 8-d of the act to determine whether a stop order should issue on the ground that he is trying to sell securities under a fraudulent set of representations.

One need be no fortuneteller to state in advance what the applicant will do. If he can, he will comply. If need be, he will abandon the business. Only if he is a merely irresponsible swindler will he, or can he afford to, try out an issue of accounting in the form of a hearing to determine whether or not he is about to commit a fraud. The result, naturally, is that most questions of accounting are settled by the star-chamber process, and chiefly by subexaminers. Businessmen who have any reputation do not put themselves in the position of putative swindlers merely to determine matters of accounting. The determinations so

taken are nonreviewable. Theoretically, of course, one could fight it out before the commission which, in practice, will support its technical staff as a matter of course, and then have the stop order which has already issued and destroyed the businessman's reputation, as well as the prospect of successful financing, reviewed by the District of Columbia courts. But no sane man would follow that program, for a victory would be as disastrous as a defeat.

Now this, it is submitted, is not a satisfactory state of affairs. Specifically,

- (1) Decisions so made are not recorded or available to others as a guide to conduct or a basis of informed criticism and comment;
- (2) They are by no means necessarily uniform, reasoned, systematic, or grounded on anything other than the feeling of the examining staff;
- (3) They are not reviewed by any competent authority, nor susceptible of being so; and
- (4) There is no procedure leading to the conclusion that such decisions are valid precedent rather than purely arbitrary determination, depending on the capability and integrity of the commission staff at any given moment.

Yet, at the present writing, there is the mechanism by which rules of accounting are determined and, for all practical purposes, written into the living law by the administrative agency having the greatest degree of control over the accounting profession save in a few specialized fields. Had the common law been developed in any such fashion, its major glory—the constant self-criticism which it engendered, and which has at all times been its safeguard, its forward light and its intellectual fertility—would never have come into existence. The criticism of process is fundamental. It matters not a whit that determinations may have been made (I think they have been made) with a high degree of integrity and competence. It is of little consequence that occasional formal decisions on accounting points have been publicly rendered by the commission in connection with some fly-by-night, who had nothing to lose anyhow and therefore elected the obviously futile course of fighting a stop order before the full commission, so that we have a few determinations, chiefly by way of obiter dicta in fraud cases, which

should have been stopped in any case. The plain fact remains that effective accounting rules are made in camera, without system, without effective submission to criticism, with little guaranty against arbitrary determination, and without the continuous and open self-examination which must go into rulings which attain to the sanction and dignity of law.

Method of Systematic Evolution of Accounting Principles

It is proper, here, to take temporary leave of the S.E.C., which in any case was selected only because it happened to be the broadest mark on an overfull horizon, and to attempt a more constructive attack. Since we are dealing with accounting rules or determinations which serve as a basis for legal action, disability or liability, a lawyer may be pardoned for importing the technique of his own profession, on the chance that it may prove useful to the newer, but sister profession which has thus suddenly converged. Yet a lawyer may as well keep his humility, for we are in an area where the common law itself is making heavy weather. Having come through a crisis of major difficulty in the Seventeenth Century, the theory of the rule of law (as contrasted with administrative processes, boiling down to government by men) is again under bitter criticism now in the middle of the Twentieth Century. So it will not do to be dogmatic in the now mixed economico-legal territory which goes by the name of accounting.

Where a government body has power to make an effective rule in any particular case, we have come to expect at least two and possibly three, safeguards which are also development mechanisms. These are, in order: (1) The opportunity for full argument, afforded both sides; (2) The requirement for a publicly announced, reasoned decision; (3) review upon appeal to a higher tribunal. It may be granted at once that a conscious attempt has been made, in recent years, by certain influences in the law to eliminate some, if not all, of these safeguards, and to deify the administrative process in and of itself. But this school of thought is so obviously an extreme as applied to American conditions that it cannot be taken as a permanent guide in building the intellectual framework of the newest branch of law,

which accounting really is. In any event, the classic model appears the more useful for our purposes.

There are, taken together, at least several dozen administrative agencies (exclusive of tax or revenue units) which today make law on accounting matters. Besides the S.E.C. in its registration work under the 1933 act, and under the 1934 act, there is the New York Stock Exchange, making determinations under its power to list or delist, and more incidental decisions under the little-known but highly useful institution of the miscellaneous calendar of the stock-list committee. There is the Interstate Commerce Commission with jurisdiction over railway accounting, the Federal Communications Commission with less defined but still material power over telephone and telegraph matters, the Federal Power Commission in respect of still other areas. The Federal Reserve Board has considerable latitude in accounting problems of banks and trust companies, and there are endless state commissions in other departments.

It should be within the realm of possibility to create a board of accounting appeals to which accounting questions could be referred, and which, by training, personnel, and equipment would be capable of rendering swift decision on such problems. The body might be either formal or informal, provided it were authoritative; for what is needed, here, is not so much a judicial proceeding as an authoritative statement of the best prevailing thought. It should be so set up that it could decide a specific problem—as, for example, the dispute referred to between an administrative examiner and a registrant who felt he was right but did not care to have the matter tried out by putting his honesty on trial. It should also be so placed that it could render advisory opinions in advance of a controversy or for general application. It ought not to follow the doctrine of *stare decisis* as do common-law courts; that is, precedent should not be binding. Rather, we ought to borrow from the experience of our European friends who practice the Roman law, and follow the system by which the writers, the scholars, the commentators are as persuasive authority as are the decisions of the group itself. Just as in older days in England, when a jury of merchants was occasionally convened to set out for the benefit of the law, which was then adopting the custom of merchants into its orbit, the actual fact of that custom, so today we could profitably have a continu-

ous mouthpiece for the best applied thought in accounting. To it any body dealing with accounting in the public interest might refer—and, perhaps, should be obliged to refer. We should then get a body of accounting authority which was properly argued, publicly announced, and responsible at the bar of the profession.

If this suggestion seems to take in too much area, we might work out a series of less ambitious, though less satisfactory, experiments. For instance, there is no real need for the S.E.C. to determine accounting questions only as incidents to a stop-order proceeding. In many cases neither the commission nor any party really believes that there is a question of intent to mislead, when in fact the issue is whether this or that item of income was or was not nonrecurrent, whether a specific expense cost should be capitalized, or whether a plainly historical entry of cost imparts a present-day appraisal. The dispute in any of these cases may be a difference of opinion. Indeed, in many situations there is a real problem whether the record deals with so-called "facts" at all; for there is no distinct line between fact and estimate or judgment in many of these matters. If, therefore, a central accounting board seems too visionary, we might make progress, so far as the S.E.C. is concerned, by having a special division to rule on problems of accounting and to issue published opinions after hearing argument—thereby at least creating a clear and growing body of available precedent—again, preferably without the constriction of any rule of *stare decisis* to inhibit further development as new light may appear. To such a division should be assigned the task of ruling on the accounting provisions of new regulations, of new forms, and of changes in old forms. Then, and not until then, will we begin to have something more satisfactory in the way of effective accounting opinion.

Implicit in either the more or the less ambitious plan is the hope that accountants will continue to be fertile in theoretical and professional discussion. Granted open, reasoned decision, and the professional comment, criticism, and review begin to operate. The only places where the United States Supreme Court can be overruled are the law schools and the law reviews. The only practicable method of checking a foolish or unwise administrative ruling on accounting is in the technical journals and the proceedings of the associations. In the law, we know that the long process of recorded study ultimately serves as a corrective upon

the most powerful courts; and the case for that correction is infinitely stronger in a relatively new field like that of accountancy. Wanting that continuous interplay of professional opinion and quasi-legal decision, your profession may well slip into a morass quite as deep as the valley from which it has climbed; having freed itself from the chains of servitude to businessmen, it may, all too easily, find itself merely the ciphering agency for virtually unreviewable bureaucrats. It took time to teach merchants that they could not give orders to accountants as to what their figures should show; and the profession must never drop to the point where its members are in demand primarily because their opinions will change whenever a subexaminer, for reasons not put on the record, wishes a different arrangement of figures.

From the strict legalistic point of view there is real reason for wishing this slow, steady, self-critical erection of accounting theory. For an accountant has both the power and the duty to look behind the strict legal line in drawing his conclusions—a power which lawyers can use only at hazard, and rarely with authority. For instance, a lawyer is taught that corporations are separate entities, irrespective of their stock ownership. If therefore X corporation sells its merchandise to Y corporation, which X happens to control as a subsidiary, the lawyer has to regard the transaction as a sale. From his point of view, title did pass from X to Y, and that settles it. The resulting liability is a debt from Y to X; and that settles that. But the accountant can go behind the returns. He does not, because of that fact, have to assume that the resulting debt is an account receivable; or, for that matter, that the sale is a commercial sale, classifiable with other transactions in the ordinary course of business. The lawyer may be right about the technicality of the title passing and debt creation, but the legal christening does not make the transaction a true conversion of inventory into collectible liability. Whereupon a good accountant will segregate the item and separately record or explain it. A banker may “pad” his position by accepting a year-end deposit, designed to be kept separate and returned to the depositor after New Year’s Day. A lawyer may advise that the relation of debtor and creditor—banker and depositor—is thereby created. An accountant, if he knows the facts, knows better, and declines to allow the padding. A lawyer, advising a dividend policy, must rely on the accountant to tell him whether

or not there is surplus justifying the dividend. An accountant can and must show him the way, or the limitation. It is not too much to say that in certain directions, the progress of the law is through accounting,—just as a century ago its progress lay through the custom of merchant-bankers, whence comes our entire jurisprudence of banking, negotiable instruments, and what is known as the law-merchant. No, we need the accountant quite as much for our own enlightenment and evolution as for his own peculiar contribution. But we need the cross-fertilization as a schematic, systematic body of doctrine; and that is to be had only by guarding the manner of its growth.