ACCOUNTANTS AND THE LAW

By Ralph Wienshienk

The Securities and Exchange Commission has recommended to Congress that unregistered corporations with assets of three million dollars and a minimum of three hundred security holders be required to file financial statements with the Commission. Support of this move was based in part on the conclusion that, "... the financial statements [of unregistered corporations] were generally grossly inadequate, not withstanding that 85% of them had been subject to the expert review of a certified accountant. ... it [is] clear that certification of itself does not assure adequate information to the investing public." 2

The Journal of Accountancy objects to the report because it "... launches at the accounting profession inferential criticism." 3 The editorial goes on to comment, "It is not always true that accounting procedure on which the SEC would issue a deficiency necessarily violates generally accepted accounting principles." 4 A leading spokesman of the accounting profession took an even stronger position by asserting:

"... [accounting] procedures should first win the approval of those whose authority rests on professional skill, experience, and judgment and, ... the function of those whose authority rests upon law should normally be exercised to encourage the adoption of and in due course to assist in the enforcement of principles and procedures which have secured that approval. In this manner it should be possible to arrive at accounting principles and accounting procedures that will be generally accepted and will be authoritative in every sense." 5


2. SEC REPORT, supra note 1, Pt. III, p. 16. This finding was the result of a study based on annual statements of 70 unregistered companies. Detailed explanation of the selection process and discussion of typical deficiencies together with supporting exhibits may be found in SEC REPORT, supra at App. C, p. 39.


4. Id. at 95.

These current opposing claims recast the issues of a continuing conflict that has centered in main about the following problems. Should legal rules conform to accounting concepts or must accounting procedures reflect legal reasoning? 6 Is accounting an exact science or a practiced art? 7 Are general purpose financial statements feasible or single purpose statements necessary? 8 Should regulatory agencies adhere to accounting conventions? 9 Who is an independent accountant and what is the legal effect of his audit report? 10 Is tax consultation the province of lawyer or accountant? 11

Effort to answer these questions has elicited comment from both the accounting and legal professions on myriads of detail. Developments of the past decade, which require no recital here, have accelerated the inquiry. Despite occasional divergence the literature of both professions reveals an increasing awareness of rapprochement. 12 Justice Douglas in criticizing legal education ten years ago rose above professional tribalism to state, “The upshot of what I have been saying is . . . that any considered treatment of this subject [corporation

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6. Consult Berle and Fisher, Elements of the Law of Business Accounting, 32 Col. L. Rev. 573 (1932); Kripke, Accountants' Financial Statements and Fact-Finding in the Law of Corporate Regulation, 50 Yale L. J. 1180 (1941); Hills, Accounting in Corporation Law, 12 Wis. L. Rev. 494 (1937); Wernitz, Progress in Accounting, 72 J. Accountancy 315 (1941); Montgomery, Is the Profession Going Legalistic?, 74 id. at 523 (1942); Wixon, Legal Requirements and Accounting Standards, 20 Accounting Rev. 139 (1945).


8. See Kaplan and Reaugh, Accounting, Reports to Stockholders and the SEC, 48 Yale L. J. 935, 979, 980 (1939); 1 Bonbright, Valuation of Property 253-54 (1st ed. 1937).


11. See Maxwell and Charles, National Conference of Lawyers and Certified Public Accountants, 81 J. Accountancy 120, 124 (1946); Byerly, Relationship between the Practice of Law and of Accounting, 66 id. at 154 (1938).

12. “The interweaving process seems to have gone so far that in some measure rules of accounting and rules of law are almost indistinguishable.” Berle and Fisher, supra note 6, at 573 n. “The complex interrelationship between law and accounting reveals itself in many forms. . . .” Graham, Law and Accounting, 17 N. C. L. Rev. 19 (1938). See also Hills, supra note 6, at 511; Paton, Recent and Prospective Developments in Accounting Theory in Dickinson Lectures in Accounting 87 (1943); Levy, Accountants' Relationship with Lawyers, 72 J. Accountancy 26 (1941). But consider: “Time and time again the Bureau, the Board of Tax Appeals, the Tax Court, and Circuit Courts have rendered opinions and decisions that have violated sound accounting theory.” Edelmann, Is Income Tax Accounting “Good” Accounting Practice?, 24 Tax Mag. 112, 116 (1946).
finance] would entail a subtle fusion of the so-called legal and business aspects since in final analysis they are one."

Throughout the literature on the subject of inter-relationship between law and accounting there is seeming accord on two fundamental hypotheses.

I. Generally accepted accounting principles constitute a useful external standard. They provide an impartial medium for communicating business phenomena to participants and other interested parties.

II. Independence of the Certified Public Accountant is measurable and desirable. The objectivity thus attained is the best assurance that financial statements will accommodate the needs of conflicting interests.

It is proposed to test the validity of these hypotheses since they so frequently form the inarticulate premise from which conclusions on specific points easily follow. "Unanalyzed habits of thought are the most stubborn of facts" and a bar to progress whenever they insulate underlying problems from exposure and examination.

I. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The demand for codifying accounting procedures in a defined set of "generally accepted accounting principles" stems from the desire of the individual accountant for the assurance that common agreement provides. Equal incentive for codification comes from the desire of non-accountants for standards by which to judge the work of the accountant. A quest for certitude is not peculiar to this problem. The search for external standards to gauge men's conduct is a continuing one. The utility of embracing "generally accepted accounting principles" as one such external standard is questionable. The danger of accepting a vague phrase as the key to resolving complex problems has been alluded to in other contexts. Leon Green, formerly Dean of Northwestern University Law School, in discussing the analysis of negligence actions warned, "... it is disastrous to clear thinking and the law's development to crowd too many concepts into an expansible catchword." "General acceptance" is an elastic criterion for determining the propriety of varied accounting procedures.

15. Support for this proposition can be had by reference to "Standards" in the index to Holmes, The Common Law 421 (1881); Frank, Law and the Modern Mind (1936) passim.
A. Significance to Accountants

Reference to "generally accepted accounting principles" is widespread among practicing accountants. Reports of Independent Certified Public Accountants accompanying financial statements uniformly contain the following paragraph or its equivalent:

"In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at [date of report], and the results of its operation for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." 17

The origin of this certification is found in an exchange of letters between the American Institute of Accountants and the New York Stock Exchange beginning September 22, 1932.18 Later publications of the American Institute adopted the above paragraph as the recommended form for audit reports.19

The belief that accounting techniques can be organized into a body of principles has significance for accountants as marking the final stage of evolution from occupation to profession. This transformation is divisible roughly into three stages: recording, advising management, and protecting equities.20 Citation to "accounting principles" was a convenient device for persuading a recalcitrant client that the method favored by his accountant was the correct one.21 Deference by management to this type of reasoning gradually resulted in limiting the control exercised over the accountant's decision and eventual recognition of his professional stature.

B. Significance to Lawyers

Increase in the size and complexity of business organization, separation of ownership from management, and emphasis on fluid
investment markets multiply instances today when the court is petitioned as arbiter of conflicting interests. One consequence of this broad social and economic change is the juxtaposition of law and accounting. To the legal profession "generally accepted accounting principles" are a refuge from the rigors of analysis. Accounting terminology appears in statutes as exact and definitive mandates. The wide discretion permitted directors averts judicial analysis of accounting conclusions. The grant to regulatory commissions of authority to prescribe accounting methods has been successfully invoked as an argument against judicial review in two recent cases before the Supreme Court.

In *Northwestern Electric Company v. Federal Power Commission* the Supreme Court speaking through Mr. Justice Roberts said, "The case presents only a question of proper accounting . . . It is not for us to determine what is the better practice so long as the Commission has not plainly adopted an obviously arbitrary plan." In *United States v. New York Telephone Company* Mr. Justice Rutledge concluded the opinion of the Court by stating, "We repeat that for a court to upset an accounting order it must be 'so entirely at odds with fundamental principles of correct accounting' . . . as to be the expression of a whim rather than an exercise of judgment."

The accounting order in the *Northwestern Electric Company* case denied dividends to common stockholders until a $3,500,000 property write-up could be eliminated by annual charges to net income after payment of dividends on preferred stock. The accounting question in the *New York Telephone Company* case involved an order of the Federal Communications Commission requiring a $4,166,000 reduction in asset balances and surplus. Whether the result reached in these
cases was equitable or whether the administrative orders involved were properly outside the scope of judicial review is not the concern of this paper. But the classification of regulatory rulings affecting substantive rights as accounting orders is an unsophisticated solution to the very real problem of eliciting meaningful criteria for marking the bounds of judicial review. Whether the court will substitute its judgment for that of regulatory bodies should not depend on tenuous definitions of what constitutes an accounting question.

The accounting profession has vigorously protested against this practice, but for other reasons. The amicus curiae brief filed by the American Institute of Accountants in the Northwestern Electric Company case included the statement, "Members of the Institute are concerned . . . with the possibility that a procedure which they believe is not consistent with sound accounting principles may be so described in a decision and thus be given a legal sanction." The Institute is clear on the point that "generally accepted accounting principles" means to accountants, acceptance by them.

C. Attempts at Definition

The task of reducing "generally accepted accounting principles" to writing is an absorbing mental exercise among accountants. Each "re-statement" evokes concurrence and dissent. The American Institute of Accountants maintains a permanent Committee on Accounting Procedure to study new problems as they arise. Pronouncements of this committee are contained in Accounting Research Bulletins. To date twenty-nine such Bulletins have been published.

It is not intended to compare these various "re-statements" in order to emphasize differences within the profession nor to note the

30. For a stimulating approach to this problem see Gellhorn, Administrative Law c. 11 (1940); note particularly discussion on p. 893, n. 3.


32. The following citations are only representative and do not purport to provide a complete bibliography on "accounting principles": Sanders, Hatfield and Moore, op. cit. supra note 23; Am. Accounting Ass'n., A Tentative Statement of Accounting Principles, 11 Accounting Rev. 187 (1936); Paton and Littleton, An Introduction to Corporate Accounting Standards, Am. Accounting Ass'n. Monograph No. 3 (1940); Greer, To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?, 65 J. Accountancy 213 (1938); Fiske, Dohr and Barr, Comments on "Statement of Accounting Principles," id. at 308; Paton, Comments on "A Statement of Accounting Principles," id. at 196; American Inst. of Accountants, Reports on "An Introduction to Corporate Accounting Standards" and "A Statement of Accounting Principles," 71 id. at 48 (1941); Stempf, Critique of Accounting Principles Underlying Corporate Financial Statements, 72 id. at 105; Boyd, A Comparison of Principles and Procedures, 74 id. at 46 (1942); Kester, Sources of Accounting Principles, id. at 531; Sanders, Accounting Principles—American and British, 79 id. at 112 (1945); Research Dept. of American Inst. of Accountants, Corporate Accounting Principles, 80 id. at 259 (1945).
areas of agreement.\textsuperscript{33} Even complete unanimity would not ameliorate the fallacy common to all such “re-statements.” The fallacy is one of assuming that the needs of management, investors, creditors, and the government can be accommodated by financial statements based on identical techniques of recording and interpreting the dynamic process of commerce. Problems of dividends, partnership dissolution, bankruptcy relief, merger, price control, patent infringement, director’s liability, adequate information for credit granting and investing, regulation of rates, assessment of taxes and a host of other problems cannot be kept in focus within a single set of “generally accepted accounting principles.” The assumption that interpretation of business activity can adduce universal standards ignores that accounting must have reference to dissimilarity in the purposes for which an accounting is sought.

The use of alternative methods of accounting affect the interests of all members in the corporate family. It is at least doubtful whether the choice of alternatives should reside with accountants unless it is acknowledged that the accountant should be the arbiter of substantive rights between competing equities. To reason that the accountant’s choice of methods in each case is inexorably impelled by “generally accepted accounting principles” may veneer the problems of a sensitively integrated economy but contributes little to solution. Professional vocabularies may be persuasive to the uninitiated but Mr. Justice Cardozo dispelled the sanctity of jargon when he wrote: “. . . the excuse that the language of craftsmen is unintelligible to those untutored in the craft . . . may cover with a semblance of respectability an otherwise ignominious retreat. It will hardly serve to still the pricks of curiosity and conscience.” \textsuperscript{34}

The folly of relying on a set of universal standards to serve dissimilar purposes can be better understood by analyzing the complex nature of some problems to which these standards must be applied.

D. Usefulness as a Standard

1. COST OR VALUE IN THE BALANCE SHEET? The question of whether financial statements should reflect the amount paid for property or its current value cannot be dealt with adequately on the level of “accounting principles.” Analysis of this question must relate to the intended function of the answer.

When the purpose of the accounting is to aid in arriving at a rate base the propriety of stating assets at cost or value loses its character

\textsuperscript{33} Simultaneous comparison and criticism of five “restatements” was the subject of an interesting doctorate thesis. See \textsc{Buchan}, A Critical Analysis of Recent Formulations of Accounting Principles (unpublished thesis in Yale University Library, 1943).

\textsuperscript{34} \textsc{Cardozo}, The Nature of the Judicial Process 9 (1921).
as an argument on accounting theory. The issue becomes part of the underlying conflict between investors seeking greater return and consumers interested in lower rates. "Accounting principles" must yield to a multitude of more compelling criteria in resolving the issue of a "fair rate." The Supreme Court recently discussed the problem at length in *Federal Power Commission v. Hope Natural Gas Company.*

In gauging the benchmark of legal capital designed for creditor protection, stating assets at cost when current value is higher increases the margin of protection. Conversely, when asset value falls below cost, emphasis on creditor protection would stress value in property accounting. The issue here is only superficially a conflict on accounting procedure. The basic problem is how much protection shall be given creditors to balance the limited liability provided investors by incorporation.

Reduction of assets from cost to a lower figure representing value will result in smaller annual charges for depreciation computed on the new base. This procedure may permit distributions to common stockholders because of the resulting increase in net income but it will weaken the security of preferred stockholders, particularly when the senior stock carries a preference on liquidation. The conflict cannot be resolved equitably by confining discussion to accounting theory.

The retention of assets at cost may aid investors by avoiding fluctuations in depreciation charges and consequently rendering the income statement more useful as an indicator of earning capacity. However, the credit grantor may contend that, "... appreciation by the accountant of the problems confronting the credit grantor places ... responsibility upon the accountant ... to prepare financial statements in a manner which ... values the actual worth of the individual items composing the assets of the client—not the book figures but the actual value." 

No answer to the question of cost or value in the balance sheet has meaning in a concrete situation without defining the elements of cost and spelling out criteria for value. The answer to this *accounting* question will vary not only with the function of the answer but with the reasons for disparity between cost and value and the direction and extent of divergence. It is apparent the subject cannot be pursued far without passing from the special competency of accountants.

35. 320 U. S. 591 (1944) [testing validity of FPC rate determination under Natural Gas Act of 1938, 52 Stat. 821 (1938), 15 U. S. C. § 717 (1940)]. Note particularly the statement by Mr. Justice Jackson in his dissenting opinion: "To make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates." 320 U. S. at 643.


37. See May, *op. cit. supra* note 18, cc. 5 and 6.
2. DEPRECIATION. The use of different methods to compute depreciation charges produce significant differences in the Income Statement. Montgomery in Auditing Theory and Practice, discusses eight methods of accounting for depreciation. A table at page 489 of the book demonstrates the arithmetical variations produced by the application of several methods to an identical fact situation. Another factor materially affecting the amount of annual depreciation is the estimate of the property's useful service life, involving considerations of technological obsolescence as well as physical wear and tear. The procedure most frequently applied in practice is the "straight-line method," providing for equal charges each year of the estimated useful life of the asset. Mr. Montgomery rationalizes the popularity of this method by explaining: "It is the feeling of a majority of executives and independent public accountants that, when a problem is difficult and an estimate must be made, the best way to make it is the simplest way possible." 38

The purpose of this discussion of depreciation is to emphasize the range of discretion present within "generally accepted accounting principles" in order to dispel the notion of certitude which arithmetic imparts to accounting. The amount of depreciation charges in a particular year may determine whether non-cumulative preferred stockholders will irretrievably lose their right to a dividend. Assurance that whatever method is adopted by a company will be applied consistently from year to year stops far short of functional accounting and provides an inadequate substitute for criteria by which the selected method may be tested.

3. GOODWILL AS AN ASSET. The treatment of goodwill represents another area in which accounting principles supply no functional tests for decision. Three principal issues arise in considering alternative methods of handling goodwill. (1) When should it enter the accounts and what determines the dollar amount of the entry? (2) Should goodwill be amortized or remain as a permanent asset? (3) Must the Income Statement reflect amortization or may the annual charges be made directly to earned surplus and/or capital surplus?

Frequently goodwill makes its appearance when assets are acquired by payment in stock of the purchasing company. When the value of the physical assets is less than the par or stated value of the securities exchanged for them, the label attached to the difference is significant. If it represents payment for goodwill, vendors of the property and directors of the corporation may be protected in creditor suits predicated on illegal issuance of watered stock. If the alleged

goodwill is interpreted as stock discount creditors may prevail. The choice of accounting methods again becomes a decision on the rights of antagonistic interests. The plan adopted for amortization is equally important to creditors and holders of different classes of stock. Retention of goodwill as a permanent asset increases the possibility of dividends and reduces the margin of creditor protection. Write-off against capital surplus may prejudice the position of preferred stockholders and bondholders by permitting dividends to junior securities without first recouping the amount of the write-off from current revenues.

The Internal Revenue Bureau does not permit amortization of goodwill as a deduction from taxable income.\textsuperscript{39} The Federal Power Commission makes amortization obligatory.\textsuperscript{40} The Securities and Exchange Commission has taken no definite stand on this point but is inclined to view with suspicion indefinite retention of goodwill as an asset.\textsuperscript{41}

But the problems outlined above illustrate that taxation, rate-determination, and investor protection are not the only purposes of accounting by which the handling of goodwill must be tested. The prevailing view among accountants permits wide management discretion in the recognition of goodwill as an asset and selection of a method for amortization.\textsuperscript{42}

4. MATCHING COSTS AND REVENUES. Financial accounting is the process of matching costs and revenues with the fiscal period as reference point. When this arbitrary index fails to supply a decisive answer, the allocation conventions of accountants become umpires again of the rights of parties. "Generally accepted accounting principles" purport to separate the continuing processes of business into calendar segments and to measure the result in definite quantitative terms. The Cost Accountant, in seeking to aid management with problems of internal control, has frequently abandoned the calendar year for more functional allocation bases.

For purposes of setting selling prices, determining which item in a multiple-product industry is most profitable, judging the efficiency of

\textsuperscript{39} "No deduction for depreciation, including obsolescence, is allowable in respect of good will." 26 Code Fed. Regs. § 3.23 (1)-3 (1938). Clarke v. Haberle Crystal Springs Brewing Co., 280 U. S. 384 (1930); Dodge Bros., Inc. v. United States, 33 F. Supp. 312 (D. C. D. Md. 1940).


\textsuperscript{41} See Wernitz and Rickard, Requirements of the Securities and Exchange Commission in Contemporary Accounting c. 38, p. 5 (Leland ed. 1945).

those responsible for production, and valuing inventories, costs and revenues are often related to the units of product or service which the company has been organized to market. As a device for measuring performance, costs are apportioned to whatever operation or function management desires to study. Cost per mile traveled by salesmen, cost per meal served in an employee cafeteria, and cost per cubic yard of concrete poured are only representative of the innumerable allocation bases which the nature of the business and the needs of management can extend indefinitely.

Reporting for creditors and investors has not received similar attention from the accounting profession. The possibility of enlisting the techniques of cost accounting for purposes outside its managerial function was discussed by Kaplan and Reaugh in their article "Accounting, Reports to Stockholders, and the SEC." 43

5. RECOGNITION OF REVENUE. Accounting principles make sales the touchstone of revenue. Llewellyn has ably demonstrated that the word "sale" has no significance without reference to the context in which it is applied. 44 But insistence on sale, however defined, as a requisite of revenue recognition may not be acceptable for all purposes of accounting. The New York courts permitted appreciation of unsold assets to be included in measuring the source from which dividends were payable, 45 and in testing the legality of reacquisition by an issuing company of its own stock. 46

Realization that sale does not assure collection, that distribution costs regularly are incurred after the date of sale, and that accounts receivable do not provide immediate funds for the payment of debts might argue for abandonment of sale and adoption of cash receipt as the determinant of revenue when the focus of accounting is reporting to creditors.

Appreciation in the value of fixed assets and inventory does not occur at the instant of sale but accrues over a period of time from a multiple of factors. If ownership of business remained static this point would have less practical significance. However, dating realization of business revenue at the time of sale may be unfair to the stockholder who held his security during the period of gradual increment and transferred it just prior to the sale of the corporation asset or inventory.

6. LOSSES DURING EARLY LIFE OF A COMPANY. Costs are likely to exceed revenues during the developmental years of

43. 48 Yale L. J. 935, 951 (1939).
44. Llewellyn, Across Sales on Horseback, 52 Harv. L. Rev. 725 (1939).
a new business. This excess of costs might be interpreted as an investment benefiting future periods and consequently be carried forward as a deferred charge among the assets, to be apportioned against subsequent income. The same excess of cost could be viewed as an operating loss of the period in which it arose and be treated as a deficit or reduction of the capital invested in the business.

The fact that alternative accounting procedure may increase assets or result in a deficit has more than theoretical interest for stockholders and creditors. Realization that debts cannot be paid with capitalized expenses would reason against the handling of developmental costs as an asset when reporting to creditors. On the other hand, treatment as an asset favors stockholders by removing an obstacle to early dividend payments. Conversely, treatment as a deficit emphasizes creditor protection by postponing distributions to stockholders until the deficit is recouped from later operations. Non-cumulative preferred stockholders would be particularly affected by a postponement in dividends. It is evident that discussion must revolve about the nature of the transactions that resulted in an excess of costs and analysis of which interests should bear the risks of early development.

7. NON-RECURRING LOSSES AND PROFIT. Stockholder's use of earning power as a basis for valuing securities and bondholder's concern over the probability of uninterrupted interest payments have placed current emphasis on the importance of the Income Statement. "Generally accepted accounting principles" reserve considerable discretion to management in determining the content of the Income Statement. One test of inclusion and exclusion relies on distinctions between items of cost and revenue that are "recurring," "non-recurring," "normal," and "extraordinary." Ratios drawn from the Income Statement to evaluate earning power are materially affected by these distinctions. Accounting principles postulated on loose phrases are inadequate to marshal business phenomena for all purposes.

The probability that an item of expense will recur must be computed in terms of the decision it will influence. The probability should be weighted differently when accounting to secured creditors, unsecured creditors, preferred stockholders, and junior equities. To the extent that certification by an accountant indicates agreement with management's opinion of "normalcy," accounting principles provide no assurance that the Income Statement appropriately tests earning power for credit grantors and investors.

8. FLUCTUATION IN THE VALUE OF MONEY. Changes in the value of the dollar may become a serious problem of
the post-war economy. Accounting employs the dollar as a common denominator in reducing business activity to quantitative measurement. To the extent that stability of the monetary unit is fictional, accounting techniques for matching costs and revenues conceal the fiction. Dollars of one year may have more or less value than dollars of succeeding years and their commingling in financial statements is an arithmetic of apples and oranges:

Base-stock and last-in, first-out methods of inventory accounting represent attempts to remove price level fluctuations from the computation of income. For the most part, however, "generally accepted accounting principles" ignore changes in the purchasing power of the dollar. The error becomes more significant during periods of substantial change and when accounting for business transactions that affect a succession of fiscal periods. A typical example of such transaction is the apportionment of the cost of depreciable assets (recorded in dollar value at date of acquisition) to revenues of later periods (recorded in different dollar value).

It is outside the scope of this paper to establish how great a fluctuation must occur before the accounting postulate of a stable money unit is serious error. The significant point here is whether the answer should be sought from the accounting profession. To do so ignores the economic, political and legal implications of the issue.

9. CORRECTING ENTRIES. Correcting entries provide an accounting technique for adjusting errors of judgment which subsequently come to light. In a fluid business structure of shifting stockholders and creditors the accounting postulate of continuity requires more study.

How long accounts will be considered open for adjustment and which interests or individuals should bear the loss or reap the gain of earlier judgment errors demands analysis of the type found in legal discussions of the Statute of Limitations. The failure to provide adequately for depreciation, uncollectible receivables, or contingent liabilities in prior years may have permitted dividend distribution to individuals owning securities during those years. Correcting entries in the current year may deny distribution to present stockholders. The legal theory of estoppel might argue against permitting certain accounting adjustments when credit has been granted on the basis of prior representations. Correcting entries would provide an artful device for tax avoidance if the Internal Revenue Bureau allowed adjustment of depreciation estimates from year to year. Conversely, adjustments

47. See Paton, Essentials of Accounting 484 (1938); American Inst. of Accountants, The Last-in, First-out Inventory Basis, 73 J. Accountancy 146 (1942).
in plant accounts to reflect the cost of the property when it was first
devoted to public use is a requirement of the Federal Power Commis-
sion. Thus the propriety of a particular correcting entry involves
problems not resolved by "generally accepted accounting principles."

This selection of examples is fortuitous and far from exhaustive.
Three factors make them apposite here.

(1) They demonstrate the element of surmisal in "generally ac-
tained accounting principles" and the extent to which substantive rights
are shaped by the opinions, estimates, and approximations of ac-
countants.

(2) They emphasize the choice reserved to management among
the broad alternatives encompassed by accounting conventions. When
management conclusions are supported by glib assurance that they
comply with "generally accepted accounting principles," the circle of
reasoning is completed.

(3) Finally, they illustrate the futility of reducing to a single set
of general purpose financial statements, the myriad relationships of
business activity.

Recognition of these factors leads to the rejection of "generally
accepted accounting principles" as a useful external standard and
reveals compliance with those "principles" to be an illusory assurance
of proper analysis.

E. Departures from the Standard

Whenever some segment of the total business phenomena is singled
out for direct examination the ineffectiveness of "generally accepted
accounting principles" as an external standard becomes apparent.

Determining "income" as the basis for equitably distributing the
costs of government is perhaps the most familiar example. Price
policy determination is another instance. The Office of Price Admin-
istration adopted a concept of "out-of-pocket" costs in computing a
"product standard" as one measure of the fairness of maximum prices
in multiple-product industries. The then Deputy Administrator for Ac-
counting of that agency admitted: "The term is one difficult to measure
by accounting since it represents a concept rather than an unvarying
dollar-and-cents figure that accountants can pick up." The extent
to which the OPA did rely on accounting conventions was perhaps

48. See Blough, Federal Income Tax Reporting in Corporate Financial State-
ments 117 (Kester and Inghram ed. 1940). Contra: Edelmann, supra note 12.
49. Green, Price Administration in Contemporary Accounting, c. 35, p. 4
(Leland ed. 1945).
more a concession to emergency than a tribute to analysis. This observation finds support in Professor Hamilton's article, "Cost as a Standard for Price," containing the most provocative discussion of accounting that has appeared to date.

The use of accounting as an aid in utility regulation has necessitated conforming accounting conventions to the social need they serve. Illuminating discussion of this problem appears in Kripke, "A Case Study in the Relationship of Law and Accounting," and Kohler, "Development of Accounting for Regulatory Purposes by the Federal Power Commission."

The Securities and Exchange Commission has retreated from the notion that investor protection can rest on the "professional skill, experience and judgment" of the accounting profession. In a series of sixty-two Accounting Releases beginning in 1937 the Commission has indicated its conception of accounting for investor information. Continued lip-service has been rendered "generally accepted accounting principles." But the current discussion between the accounting profession and the SEC over the treatment of "tax savings" in Statements of Income indicates that the Commission reserves the right to determine acceptability.

"Generally accepted accounting principles" are thus revealed as the residual of inherited conventions which have not been subjected to functional analysis from the focus of the varying purposes they purport to serve. Allegations that the test of accounting principles is their "social usefulness" does not assuage the burden of demonstrating that the accounting profession has special competency to evaluate social usefulness. Such allegations seem to conflict with remonstrations against regulatory agencies for adapting accounting techniques to the specific social need for which the agency was created. Illustrative of this point are the vigorous arguments of the accounting profession against the Federal Power Commission's "original cost" concept and the Securities and Exchange Commission's treatment of "tax savings" both referred to earlier in this paper.

50. 4 LAW & CONTEMPO. PROB. 321 (1937).
51. 57 HARV. L. REV. 433 (1944).
52. 14 GEo. WASH. L. REV. 152 (1945).
53. See note 5 supra.
54. For the view that the SEC has published insufficient information on accounting policy see Note, Accounting Principles and Auditing Responsibilities Established under the Securities Acts, 33 ILL. L. REV. 820, 841, 842 (1939).
56. SANDERS, Progress in Development of Basic Concepts in Contemporary Accounting, c. 1, p. 3 (Leland ed. 1945); AMERICAN INST. OF ACCOUNTANTS RESEARCH BULLETIN No. 1 (Sept., 1939).
57. See notes 9 and 55 supra.
II. THE INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

The evolution of accountancy as a profession and emergence of the Independent Certified Public Accountant have been exhaustively traced elsewhere. In the light of that history the word independent has special significance. It is largely the history of a struggle to escape management domination by enlarging the role of the accountant from hired recorder to professional analyst. The extent to which this separation has been accomplished is a tribute to the pioneers in the profession.

A. Shaping the Concept

The term Independent Certified Public Accountant was given added sanction as an index of objectivity by the Securities Act of 1933. Schedule A of that act specifically requires that financial statements accompanying a registration statement be “certified by an independent public or certified accountant.” State laws governing admission to practice accounting and ethical codes of national and local professional societies represent attempts to give force to the concept of independence.

Discussion of the varied fact situations which destroy independence and a review of recent SEC opinions involving this point appear in a recent article co-authored by Mr. William W. Werntz, formerly Chief Accountant for the SEC, and one of his associates, Mr. Edmund B. Rickard. The prevailing view of independence as the touchstone of objectivity is found in a statement by Mr. Werntz that, “The goal of such a principle is obvious—the accountant’s opinion, if it is to be valuable to the reader of financial statements, must be arrived at objectively and expressed impartially.”

B. Distortion of the Concept

When independence of the accountant meant freedom from subservience to the desires of his immediate client it represented a commendable aim. As an argument that the judgment of the accounting profession should be free from control by administrative agencies it is a specious distortion. Belief that independence from management is a

58. Cf. LITTLETON, ACCOUNTING EVOLUTION TO 1900 (1933); BROWN, A HISTORY OF ACCOUNTING AND ACCOUNTANTS (1905); ANYON, RECOLLECTIONS OF THE EARLY DAYS OF AMERICAN ACCOUNTING (1925); Research Dep’t. of American Inst. of Accountants, Accountant’s Reports—or Certificates, 71 J. ACCOUNTANCY 436 (1941); Hurdman, Independence of Auditors, 73 id. at 54 (1942); see note 20 supra; BOYD, A STUDY OF C.P.A. LEGISLATION IN THE UNITED STATES—1896-1940 (unpublished thesis in Yale University Library, 1941).


60. WERNTZ AND RICKARD, op. cit. supra note 41, at 19; see also SEC ACCOUNTING SERIES RELEASES No. 2 (May 6, 1937); No. 22 (Mar. 14, 1941); No. 47 (Jan. 25, 1944).

61. WERNTZ AND RICKARD, op. cit supra note 41, at 19.
guarantor of objectivity ascribes to accountants a capacity for complete detachment. It further assumes that such detachment will aid in equitably reconciling the conflicting interests with which financial statements perforce deal.

The virtue of this type of objectivity cannot be assumed so easily. Despite the source of his fee the public accountant should be held to a fiduciary standard in relation to the specific persons or interest for whom each single-purpose financial statement is consciously prepared. The auditor’s report should state clearly whether the particular audit was designed to provide information for creditors, stockholders, potential investors, management, taxing authorities, regulatory agencies, or some other interest. The report should further contain reasoned conclusions based on a review of the accounting records as a representative of the identified user of the information. Functional analysis of accounts designed to fit each need they serve impels a representative fiduciary capacity. Independence from management is only the first step in that direction. Such a view of accounting does not relegate it to a subordinate role. It does not deprive it of professional stature. It does not deny integrity nor the capacity of the accountant to serve different interests at different times. It does deny the ability of any individual to serve different interests at the same time. Analysis of the lawyer’s position in corporate reorganizations furnishes ample proof for “. . . the simple and obvious principle that no man can well serve, directly or indirectly, two or more masters.”

III. AVENUES FOR PROGRESS

“Generally accepted accounting principles” and the “independence” of the Certified Public Accountant are deeply rooted concepts. For that reason the greater part of this article is devoted to clearing the air for what follows. When it is recognized that public accounting and law face the common task of balancing competing equities—firm ground for cooperation appears. The disciplines and techniques of accounting and those of law may then converge. To argue that one profession will lead and the other follow is pedantry. To see that both are inseparable is common sense.

Positive steps in alliance could pursue these paths:

I. Practicing and academic members of both professions should seek together delineations of the rights, duties, privileges, powers, liabilities, and immunities of parties to business ac-

When the contours are shaped the best technique for tracing and communicating them will yield to analysis.

II. The educational programs of both professions should provide better mediums for mutual understanding. This requisite to cooperation cannot be over emphasized.

III. The final step must be concerted effort in influencing legislative acceptance of joint solutions. Whether Congress or the State Legislature is the proper forum remains a choice for the future.

63. Current emphasis on cooperation stresses settlement of jurisdictional disputes between accountants and lawyers in tax practice rather than joint analysis of the type suggested here. See Maxwell and Charles, National Conference of Lawyers and Certified Public Accountants, 81 J. ACCOUNTANCY 120 (1946). For an example of more comprehensive cooperation on state level consult Studer, The Lawyer and the Accountant, 77 id. at 368 (1944).

64. Accounting courses in law schools and preparation for the legal section of state C.P.A. examinations constitute a beginning in this direction. Books such as GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE (2d ed. 1938) and DOHR, LECTURE NOTES ON THE LAW OF ACCOUNTING (1942) represent integrated treatment of law and accounting. For a discussion of the need for further integration see DOUGLAS, Education for the Law in DEMOCRACY AND FINANCE 278 (1940).