Journal of Accountancy

Volume 40 | Issue 1 Article 3

7-1925

Accountant's Duty to Uncover Questions of Law

Harold Dudley Greeley

The Accountant's Duty to Uncover Questions of Law*

By Harold Dudley Greeley

It is related of the ancient Greek, Simonides, that when his imperial master required him to formulate his ideas concerning the Deity, he requested one day in which to prepare them for statement. At the end of that day he confessed that he was not ready and requested an extension of two more days. When that time had expired he again admitted that he was not satisfied and asked then for four additional days. The narrative goes no further, but it is safe to assume that his unpreparedness increased in the same geometrical progression as his time allowance. It is in much the same spirit that one approaches the subject of this paper because it has for its basis the true relationship between the eminent profession of the law and the rapidly becoming eminent profession of accountancy. Concerning that relationship no one can speak with authority, but what each of us says may serve a useful purpose in stimulating further inquiry. In such inquiry we need both theory and practice. Neither alone will suffice, for theory without practice is futile and practice without theory is anarchy.

Before we discuss concrete instances of the accountant's duty to uncover questions of law, we may profitably devote some attention to certain preliminary matters. It would seem that the accountant should realize that law is a science, that he should have a general notion of how the lawyer thinks, of the law's terminology, and of what may be called the practical organization of the law. The accountant should realize the limitations, both quantitative and qualitative, necessarily imposed on his own knowledge of law, and he should develop a theory as to the correlation in practice between law and accountancy. Each of these points will be considered.

The accountant should understand that law is not a collection of unrelated rules subject to change daily at the caprice of the authorities. For all practical purposes it is a science, a special branch of knowledge, in which the data are methodically digested and arranged so as to be available for use. It is a body of

* An address delivered at a joint meeting of the Ohio Society of Certified Public Accountants and the Ohio State University, college of commerce and journalism, Columbus, Ohio, June 6, 1925.

principles and deductions to explain the nature of the rules of conduct for human beings based on social needs. It is an applied science in that it shows facts, events or phenomena as explained, accounted for or produced by powers or causes. It is not a pure science such as psychology or sociology and it does not go back to first principles. It merely arranges and classifies the interrelated facts of human conduct by referring them to the general truths and principles on which they are based. It is not and it never has been an exact science—from the days of the attempt to petrify justice in the twelve tables of Rome down to our present five-to-four decisions in the United States supreme court.

Law must be distinguished from litigation. The latter is resolvable into a syllogism, the major premise being the proposition of law and the minor premise the statement that a particular case comes under that proposition of law. The proving of the minor premise or what is called the practice of the law is an art, a principle put into practice and applied. Art, differing from science, is an operation or dexterity by which man pursues an end which he knows beforehand, together with all the rules prescribing the effective exercise of such dexterity. In art, truth is but a means to the end; whereas in science it is the end itself. Art involves the use of knowledge furnished by science and hence perfect art must be based on perfect science. The practice of the law is a useful rather than a fine art because it satisfies a positive, practical need.

Parenthetically, is accountancy a science or an art? It has been called both, sometimes in the same sentence. Double-entry bookkeeping certainly is a science. It presents all our present knowledge of the workings of known rules, coordinated and systematically arranged, and from its fundamental concepts we can, by reasoning, deduce rules for the novel situations which continually arise in the highly complex conduct of business. But accountancy, whether recording, presenting or verifying, is essentially practical. It cares nothing about the general body of truth and it conducts no investigation for the sake of general knowledge. It is of course based upon the science of double-entry bookkeeping, called the theory of accounts, and of course it has its rules for effective conduct which insure discipline in the use of the knowledge furnished by its basic science. But accountancy itself is something apart from the science on which it is based and the rules which it lays down. It would seem that accountancy is an art.

Certainly accountancy can not be taught with the ease with which the facts and laws of a science such as double-entry bookkeeping can be given over from one mind to another. Proficiency in accountancy must be acquired through practice. The art of accountancy is constantly developing, acquiring a theory as it grows, but a theory which is wholly dependent upon the practice, inseparable from it, and useful only in its guidance. Law, on the other hand, exists independently of its practice and can live without practitioners. Law is a science.

What do we mean by "legal mind"? How does it differ from the scientific mind—the mind of the theologian—of the doctor? We must admit that lawyers sometimes use "legal mind" by way of implying that they alone possess a peculiar type of powerful mental vision. We must admit also that losing litigants and others who have "felt the halter draw" frequently use the term as one decidedly of derision. In aggravated cases they seek emphasis by calling it legalistic. What is there in the legal mind which sets it off from the common man's common sense? The *Justice of the Peace* (London) thinks that the legal mind is merely "the fine edge put by practice upon the well-tempered steel of a first-class intellect." Such an intellect is the basic tool for technical achievement in any profession, but the law requires the development and exercise of certain faculties not equally called into play by other fields of activity. With a full realization of the dangers of generalization, I venture the opinion that the accountancy mind bears much the same relation to the legal mind that arithmetic bears to algebra, to borrow a figure used by Oliver Wendell Holmes in appraising Emerson's poetry. The accountant's chief concern may be symbolized by $2+2=4$, whereas that of the lawyer is more fairly represented by $a+b=c$. The accountant cares primarily for fixed, quantitative things; the lawyer is more vitally interested in symbols for undetermined amounts, in abstractions and infinite series, in seeking the universal in the particular. The accountant is quite as likely to think clearly, but the lawyer is more likely to reason well. Craft, "the power that deals with a few facts close at hand," may be highly developed almost in the absence of reason, "the power that deals with many facts, remote, recalcitrant, which require the mind to hold many pictured combinations at once or in quick succession." The imagery of reasoning is the means whereby facts seemingly unconnected can be woven into an entire fabric.

The lawyer's terminology need not bring confusion to the accountant if he will supply himself with a standard legal dictionary and form the habit of ascertaining the meaning of each new word as he hears it. From the regular exercise of such a habit he will soon acquire a vocabulary of technical words which will tremendously facilitate his work with attorneys—and, incidentally, he will learn a lot of law.

What is meant by the practical organization of the law is its system of legislatures with their statutes, of courts with their decisions, of administrative bodies with their regulations, and its methods of recording its principles so that they can be ascertained with reasonable effort. With all of these matters the accountant should have a working familiarity in order that he may uncover fraudulent or innocent deviations from prescribed standards of conduct.

In the accountant's knowledge of law a quantitative limitation must of course be recognized. Among the law's practitioners, the most profound student can not possibly be familiar with all fields of legal lore. How much more narrow then should be the learning of one not a lawyer at all. The accountant's work has been defined as the recording, presenting and verifying of transactions concerning the production, acquisition, conservation and transfer of values. Let his knowledge of law be confined to those branches of it which are directly related to his functions with regard to such transactions. The subjects of law usually taught in the university schools of commerce and in other institutions of the same general standard should be increased, however, to include a thorough course in evidence. The accountant needs this when he works with an attorney, especially if he expects to testify. He needs it whenever he advises the destruction of books, vouchers or other records or when he has to prepare evidence for submission in any litigation or other court proceeding. When he appears for a taxpayer before the United States board of tax appeals he finds a knowledge of evidence absolutely indispensable. The reported decisions show many instances in which an appeal was lost because of the taxpayer's failure to prove his case in accordance with established rules of evidence. For example, the appeal of William A. Daly (1 B. T. A. 993) was denied solely for lack of competent evidence. He tried to prove a March 1, 1913, value by offering in evidence a 1913 tax assessment, which the board excluded on the authority of a court decision.

The accountant's knowledge of law must have also a qualitative limitation; it can not be technically complete but must necessarily be confined to general principles. Therefore, in any actual, concrete case, the accountant will be wise if he refrains from giving a definite opinion as to precisely what the law is in the premises. The point would have to be an exceedingly simple one not to be influenced by decisions and dicta of the courts in analogous cases, and no one is competent to discover these influences who has not had both training and experience in legal research. Logic, common sense and a passion for justice are by no means sufficient to enable one to ascertain the view which a particular court would take of the law applicable to a particular set of circumstances.

In understanding his duty to uncover questions of law, the accountant should have a rather clearly defined theory as to the correlation or relationship between accountancy and law. The following outline is suggested as a basis for consideration:

Law makes four contributions to accountancy. It furnishes a field of labor; it guides that labor by laying down rules for its performance; it assists in performing the labor; and it regulates accountancy's practitioners. Formerly, law furnished a field of labor directly by making the auditor an officer of the court, as in the ancient action of account, thus including a certain portion of the accountancy field within its own limits. Today the field is furnished indirectly by the law's demand for theories and facts which can be established only by accountancy.

In the guidance of accountancy concerning matters which might be supposed to lie wholly within its province, law affects accountancy more extensively than is generally recognized. In many instances today accountancy is told what is income and what is expense, what are assets and what are liabilities, and thus ceases to exercise its own function, even to the point of going counter to its own principles in obeying the dictates of law. In certain types of industries such as municipalities, railroads, banks and insurance companies, accountancy finds specific directions not only as to the form of the statements it must prepare but even concerning the daily bookkeeping of the industry. In the field of corporation accounting and that of the administration of decedents' estates and trusts, law controls almost entirely the distribution of principal and income.

Since law has prescribed these rules and since rules of law can safely be read only by lawyers, it follows that accountancy must

call upon law for the determination of some of the questions arising under these rules. The assistance thus rendered to accountancy is the third contribution by law, and it is found in opinions of counsel furnished to the accountant. It is with this aspect of the relationship that this paper is chiefly concerned—the accountant's duty to uncover questions of law in order that law may supply the answers.

The final contribution of law to accountancy is the regulation of its practice, and this involves the certification or registration of accountants, the recognition of accountancy as a profession, and the definition of the accountant's relation to his client. The certification of accountants is a live topic today. It interests us here, however, only in so far as it requires a knowledge of law as one of the technical requirements. The recognition of accountancy as a profession is assured; the proposal that accountants as witnesses be given the same privilege allowed to lawyers, physicians and clergymen is one manifestation of the demand for a right inherent in such professional status.

The accountant's relation to his client has been considerably clarified by certain recent cases in this country. It is perhaps fair to state that an accountant must use such care and professional skill as are reasonable in the circumstances of each case, but he is not an insurer. When he fails to use the required degree of care, the client may recover from him the fees which the client paid him, but the accountant need not pay to the client the amount of a defalcation which his audit failed to disclose. This latter position follows from the application of a rule of law—the negligence of the accountant in failing to discover the defalcation was not the proximate cause of the loss. But the law is not any too well settled. In the latest case, one in New York, a dissenting opinion urged that the accountant be made liable for the defalcation because he had failed to perform his contract to save the client from such a loss. Some accountants have insured themselves against losses of this kind.

Other litigation affecting the relation of the accountant to his client is that in which the accountant sues the client for his fees. Occasionally this takes the form of an action for the recovery of a reasonable fee in the absence of a definite agreement. This indicates a tendency in what seems to be the right direction—away from per-diem charges and towards a fee which is reasonable in view of the value of the services rendered. Litigation by third

persons against the accountant when they have suffered losses through their reliance upon his certificate which was improperly given may be expected. The relation between the accountant and his client is involved also in the fairly common situation in which the accountant is an expert witness or a witness as to facts in actions between the client and third persons.

Accountancy in turn makes two contributions to the science of law and one to the art of law's practice. To the science of law it furnishes theories of business control and administration, and it assists in developing certain terminology; to the practice of law, it opens an avenue of fact-finding through the use of accountancy in procuring and presenting evidence.

Law, of course, had theories of business control long before accountancy was conceived, but accountancy is slowly modifying some of them to meet modern needs. The most marked instances are in the field of principal and income and arise from the corporation and the estate or trust. Some time ago law became willing to require the amortization of premiums on bonds purchased by a trustee. A case is now in the courts involving a trustee's duty to accumulate discounts on bonds purchased by him. In the appellant's brief in this case, one legal writer and two accountancy writers were quoted at some length. No decisions were found and thus it is believed that this is the first time that a court of record has had the question squarely presented. It is gratifying to note accountancy's influence in one more pivotal litigation.

The influence of accountancy in framing part of law's terminology is being felt, but it is by no means as potent as the needs of business require. Occasionally we still find a court holding that "the term profits . . . denotes what remains after paying every expense including loans falling due." In making these contributions to the science of law, accountancy acts directly through accountants as expert witnesses, and indirectly through its literature which suggests ideas to bench and bar. This influence moves in a circle, accountancy proposing the idea and law moulding it into a rule which in turn binds accountancy. Accountants therefore should be careful not to support unsound theories or practices which through crystallization by law may be saddled on accountancy in the future.

Accountancy's contribution to the practice of law through the field of evidence is not as common as is generally supposed, because many bits of evidence attributed to accountancy should be

credited entirely to bookkeeping. Books and records themselves often are introduced in evidence; sometimes under the simple case of the shop-book rule but often under the more complicated situation of entries in the regular course of business. But whether the introduction is simple or complex, accountancy is not involved; the assistance rendered here is by bookkeeping alone. Practically the only use made of accountancy is through the accountant as an expert witness. His usual function is to testify to accounting conclusions which he draws from facts already in evidence or to facts which he as an expert has disclosed from bookkeeping and other records which he has examined.

The relationship among law, accountancy and economics may be symbolized by a pyramid, the base of which is economics, or those fundamental principles which control the general relations of man to man. Based on economics and narrower in its scope is man-made law which controls the particular relations of man to man. Since law is based on economics, it can never be enforced successfully for any length of time if it violates economic principles. Based on law and considerably more narrow in its range is accounting which defines the particular relations of man to man. Standing at the top of this pyramid is the accountant who applies a complete knowledge of accounting, a fair knowledge of law and a general understanding of economics. The work which he does is accountancy.

In all of his relations with law, and especially after he has uncovered a legal question, the accountant should remember that however sound his grasp of fundamental legal principles, he has neither the trained skill nor the library facilities for passing final judgment on questions of law. The accountant's function is somewhat like that of a scout in war time. His mission is to discover where the enemy, Mistake, lies hidden; but he should let the combatant forces, the legal infantry, lead the actual attack. Specifically he should report questions of law to his client and recommend that advice of counsel be secured. Once having run across an interesting legal question, he should discuss it—of course without relation to the particular accounting engagement—with his lawyer acquaintances, preferably with teachers of law whom he will find more sympathetic and more interested in abstract questions of principle. Whenever possible, the accountant should write up the question and his theories as to what the answer ought

to be, for accountancy literature. One learns more by giving out information than by hoarding it.

The function of the accountant in bringing to light questions of law as well as of fact is a highly important one. In it he can act as a sort of interpreter between his client and the client's attorney, neither of whom sometimes fully understands the other. It is probable that at least 90% of the business troubles of the world come from honest misunderstandings. The accountant should make every effort to reduce that percentage. If the honest misunderstanding could ever be eliminated, business life would be comparatively easy, because the majority can always be trusted to control a reprehensible minority which deliberately seeks to make trouble.

It was said of Emerson that he never let go the string of his balloon. He never let it rise too far above the atmosphere of facts. So let us haul down our balloon to the discussion of when, how and to what extent the accountant should uncover questions of law. Let us experiment by considering cases in the same way as we would experiment to find out whether a weight three times greater than another would fall three times as fast. Instead of arguing like scholars and gentlemen, we could drop the two weights out of the window and observe what happened.

The "how" of uncovering questions of law requires no comment. All that is needed is the kind of knowledge of law described above plus the naturally acute powers of observation found in every effective accountant. The "when" is the first big question and this resolves itself into the question, When is he likely to be in a position to find something to uncover?

Let us first see what he might find when engaged professionally upon auditing or investigation work, including in this class all tax engagements except personal appearances before the board of tax appeals. Assume that the client is a corporation which has made money during the current year but had a deficit at the beginning of the year and is about to distribute its current earnings in dividends. There is a question of law which the accountant should uncover but not attempt to answer. The English view is that such dividends may be paid because they are from current earnings and do not reduce the capital any further than it has already been reduced. Capital once lost is lost forever and a dividend out of current profits means merely that the corporation to that extent has failed to make good the loss. The English

courts take the naïve position that dividends of this kind are not out of capital because capital had previously been lost. "You can not pay dividends out a thing which you have lost because it isn't there to pay dividends out of." The American rule is not so clear, but it probably is opposed to the declaration of dividends until prior deficits have been made good. The accountant has one obvious course: to advise his client that here is a question of law upon which the client's attorney should pass.

Now let's carry this identical question into a trust estate. Instead of a corporate capital not to be impaired by dividends, we have a trust fund to be preserved for a remainderman, the income to be paid to a life tenant. The rules of law for ordinary situations are pretty well established. Dividends are allocated to principal or income, according to what they really distribute—their form, as cash or stock, is ignored. If they represent earnings after the date of the creation of the trust, they are given to the life tenant. If they represent earnings prior to that date they belong to principal, because all accumulated earnings at that time constitute part of the principal of the trust fund. It is the extraordinary dividend, one distributing profits made both before and after the creation of the trust, that causes difficulty. The theory is simple—merely that the dividend should be divided so as to give to principal the earnings prior to the date of the trust, and to income the earnings after that date. In the main, the decision of the board of directors as to the date of the earnings will be accepted by the court in the absence of evidence that the directors were not acting in good faith in the exercise of business judgment. Let us analyze a case decided last month which raised the question of restoration of capital before distribution of dividends. This is a type of question to be uncovered by the accountant, even though someone else may have uncovered it before he was engaged on the case.

Testator died March 9, 1919, leaving a trust fund consisting of capital stock of the Singer Manufacturing Company. In the fall of 1920 the Singer company distributed to its stockholders, including of course the trustee, shares in the International Securities Company, a subsidiary corporation, all of whose stock was owned by the Singer company, and also a stock dividend of 50% on the Singer company shares. In the allocation of these dividends between principal and income were questions of law which needed uncovering because there were differences of opinion concerning

them even among the numerous judges of the various courts which passed on the case.

When it was shown that the International Securities Company stock had been acquired by the Singer Manufacturing Company prior to March 9, 1919, out of its accumulated surplus, the usual rule was applied and this stock was given to the principal of the trust. As to the stock dividend of 50%, however, the case was not so simple.

It appeared that the Singer company had had Russian investments of $80,000,000 which had been written down on the books of the company until at December 31, 1918, they were carried at $12,000,000. After March 9, 1919, this balance of $12,000,000 was charged off and the question immediately arose whether or not this loss had actually occurred prior to that date. If it had occurred prior to March 9, 1919, although written off thereafter, the real value of the principal of the trust at that date would have been reduced by $12,000,000 and a comparison of its then value with its value after the distribution of the stock dividend would not have shown a shrinkage of $6,000,000.

On this point the court held that it, the court, had no basis for forming an opinion as to whether or not the Russian investments were worth $12,000,000 on March 9, 1919. The court stated that the directors of the Singer company would be presumed to have acted in good faith in the exercise of business judgment, in the absence of evidence to the contrary. Accordingly it was held that the loss occurred after March 9, 1919, and with this decision there was no substantial disagreement.

But there was substantial disagreement with the law which the court applied. During 1919 and 1920 the Singer company had made profits of $38,000,000, the greater part of which had been added to a "realization reserve," thus making good the capital loss. It was out of this added surplus that the stock dividend was declared in the fall of 1920. This stock dividend was allocated to principal, although it was out of profits earned after the creation of the trust, on the ground that the directors may not only make good the loss of principal out of income but if they subsequently distribute that surplus so made good, the portion of the dividend representing capital at March 9, 1919, belongs to principal.

The chief justice of the court wrote a strong dissenting opinion in which he points out that the law does not require capital losses

of a trust fund to be made good out of income. Capital gains or increases belong to principal to the exclusion of the life tenant; to charge capital losses to the life tenant would mean that he could not win in either turn of fortune, and testator's intention to provide an income for him would be hindered if not completely blocked.

Still keeping in the field of trusts, let us consider another case in which the accountant should uncover a question of law which is merely a variation of one of the points in the preceding case. Assuming that an extraordinary dividend is to be apportioned as of the date when the trust became effective, is this date the day of decedent's death when the trust fund consists of the residue of the estate, or is it the day when securities representing the residue are turned over to the trustee? It should be noted that this case has not yet reached the highest court in New York. It was decided first by the surrogate, who is the probate judge, and his decision has just been reversed by the next higher court in the line of appeal. If it is carried still higher by a further appeal, it is entirely possible that the law as we understand it today will not be the law a few months hence. In view of this, could the accountant be expected to do more than merely to uncover or disclose the question?

In this present case, testator died December 23, 1916, leaving the residue of his estate in trust. Beginning January 29, 1917, the executor made monthly payments of income to the trustee, but he did not deliver to him certain stocks forming part of the residue until June 24, 1918. Thereafter a stock dividend was declared and the court was asked to fix the date as of which the apportionment between principal and income was to be made. This date was held to be June 24, 1918, and not the date of death. The court's opinion was not highly satisfying. It consisted chiefly of a statement of its understanding of precedent cases on the strength of which the court felt constrained to decide as it did, although both the majority opinion and a concurring opinion expressed the judges' personal preference for the date of death.

In this last case, the executor had paid over income to the trustee practically from the date of testator's death, but an accountant engaged by the trustee should not assume that all of this income necessarily belongs to the life tenant. He should raise a question of law as to how much, if any, forms part of the residue itself and thus is principal, so far as the trust is concerned.

Income during administration earned on the assets forming the gross estate frequently is substantial in amount. All of it must be given to the trustee when the residue of the estate has been left in trust, but the trustee has three possible ways in which to treat it. He may regard all of it as income of the trust, all as principal, or he may apportion it between income and principal. England, Massachusetts and New York have taken differing positions on this question, the decisions in each jurisdiction are inconsistent among themselves, and it is known that the practice, in New York at least, is not always in accord with what is supposed to be the rule of the jurisdiction. Logically, all of this income is not income on the bare residue because part of it has been earned by funds temporarily retained by the executor for the payment of debts, legacies, taxes and expenses. These funds form no part of the residue which constitutes principal of the trust, and the life tenant is entitled only to interest earned on this thus far undetermined residue. Apportionment is likely to require the use of algebra. Here is a first-class question of law to be uncovered by the accountant.

The examples of questions of law thus far mentioned are merely typical. Practically there is no limit to the number of them which can be uncovered because the possible combinations of facts are infinite and almost every combination is capable of concealing a question of law. So far, only the accountant's work in auditing and investigating has been covered, and no mention has been made of the obvious opportunities of uncovering questions of law concerned with title to assets, legality of liabilities—especially contingent ones—and the proper treatment of income and expense items, of capital stock, notably when it is non-par stock, and of surplus and its reserves.

Questions of law can be uncovered by the accountant engaged on systematizing work. In providing for shipments on consignment, he may note an ambiguity in the contractual arrangement with the consignee. In designing insurance records, he may find no compensation or liability insurance. When the accountant is called upon for general business advice, he may unearth many questions of law—failure in New York to file a certificate for the use of a trade name; ambiguity in partnership agreements or outright error such as charging one partner with interest credited on the capital of another partner; attempts to define income resulting in hopeless confusion with cash receipts; the operation of a

corporation as if it were a partnership with a complete ignoring of all corporate restrictions.

The accountant can uncover questions of law while he is engaged in the study of accountancy problems, either as an individual teacher or student, or as a member of a committee representing an accountancy society. One of the state societies of C. P. A's. recently had a committee working on bankruptcy problems in conjunction with a committee of credit men. It was recognized at once that the law did not require adequate schedules of debts and assets, in that no summary was prescribed to bring the figures together to show the amount which was expected to be available for unsecured creditors. The summary then required was little more than an index to the supporting schedules. Under the English bankruptcy acts, both a statement of affairs in technical form and a deficiency account are used. The committee raised the question of law as to the advisability of modifying the summary of debts and assets by the addition of a column for offsetting items and another for net debts and net assets. Then by the use of subtotals, the estimated amount available for unsecured creditors can be shown.

The questions of law which the accountant should uncover must obviously lie within the limits of the knowledge of law with which he may fairly be charged. In estate cases, for instance, he should not be expected to question a proposed distribution per capita on the ground that he thinks that perhaps it should be per stirpes. If he is able to raise a real question of law on such a point, it is so much the more to his credit, but ability to do so can hardly be expected of him. He should, however, recognize that the premiums on a trustee's surety bond are chargeable usually to income. Boards of C. P. A. examiners might well refrain from asking such questions as, "Can a foreign corporation avail itself of the statute of limitations of the state of New York in an action brought in the New York courts?" Questions of this type are a long way from the field of accountancy.

Somebody said once that everyone is presumed to know the law—and there are laymen who take this seriously. He or she would indeed be a very knowing person in whom this presumptive knowledge was actually found. What really was meant was that ignorance of the law excuses no one. Ignorance of those parts of the law which an accountant should know can not excuse him if he fails to uncover questions of law within that field.