Journal of Accountancy

Volume 66 | Issue 4 Article 9

10-1938

Legal Notes: Duty to Preserve Accounting Records

Harold Dudley Greeley

LEGAL NOTES

EDITED BY HAROLD DUDLEY GREELEY

Duty to Preserve Accounting Records

THE books of account of a business are usually admissible in evidence, when properly authenticated, to assist in proving or disproving a controverted fact. Even though only a small portion, for example, one account or one item in a book of original entry, may be needed, the portion offered in evidence must be properly tied in to the bookkeeping system and shown to have been made in the regular course of business. Therefore, the duty of preserving accounting records becomes an important one. The Court of Appeals of New York wrote in *People* v. *George Henriques & Co*, 267 N. Y. 398, 404, 196 N. E. 304, 306: "Here it is undisputed that the defendants kept records and books of their proceedings from the time they began business in March, 1932. Businessmen who have nothing to conceal ordinarily safeguard carefully the records and books of their business transactions, at least for a reasonable time. Only under extraordinary circumstances does a businessman lose or part with control of his business records. Thus unless a credible explanation is given for failure to produce, the inference is almost irresistible that a failure to produce books and records is wilful. The burden of producing evidence which would constitute explanation or excuse then shifts to the parties who alone have knowledge of the actual facts. . . . The destruction by the defendants of their books and records or the failure of the defendants to produce such books and records if in their possession or control would be evidence of a consciousness of guilt."

What constitutes a reasonable time for the preservation of accounting records is a matter requiring judgment in each situation. Certainly the minimum requirement should be the number of years specified by the statute of limitations in the state where the business is conducted and, presumably, where a cause of action would arise. The statutes of most states specify various terms of years for various types of action. In New York, for example, the following actions must be commenced within six years after the cause of action has accrued: action on an ordinary contract obligation, an action to recover a piece of personal property, an ordinary action to recover damages for a personal injury, an action on the ground of fraud (the six-year period beginning to run when the fraud is discovered), and certain other actions not ordinarily arising out of the conduct of business. Other types of action must be commenced within one, two, three, ten, fifteen, and twenty years, respectively. Accounting records should not be destroyed if any possibility of their being needed can be foreseen. It is less expensive to pay storage than to lose a law suit.

If books of account have been lost or destroyed, any other competent evidence can be introduced to prove facts of which the book records would be the most convincing verification. This applies also to corporate records. The Superior Court of Pennsylvania held, in *McCay* v. *Luzerne and Carbon County Motor Transit Co.*, 189 Atl. 772, 774: "Nor is the absence from the minutes of the resolution authorizing the execution of the note in suit necessarily fatal to its validity if corporate action was, in fact, taken. The rights of McCay, whether the absence of the proper record was by design or neglect, cannot be thereby prejudiced. The minutes were not conclusive; they did not constitute the only evidence that the directors approved the execution of the notes. Corporate action may be proved by parol evidence where no formal resolutions appear in the minutes." Despite the fact that theoretically a party's rights are not prejudiced by the lack of book-record evidence, practically the rights may be lost through inability to prove facts in support of them. Even when the books themselves are not to be introduced into evidence, they may be needed to refresh the memory of witnesses who are to testify orally. In 1911

the editor of this department wanted to prove the amount of cash turned over by a lessor street-railway corporation to a lessee corporation on October 14, 1892, but a thorough search of warehouses and of receivers' files, an examination of reports to the Board of Railroad Commissioners, and an inspection of the records of several banks where the lessor had maintained accounts failed to disclose the fact, and no person could be found who remembered the amount sufficiently well to be a credible witness.

Material facts can be proved by any properly admissible evidence and a party does not lose the right to prove them merely because he has failed to provide the best kind of evidence. Thus, accounting facts may be proved even though not recorded on the books of account where they normally would appear. In *Commissioner of Internal Revenue* v. *Union Pac. Ry. Co.*, 86 Fed. (2nd) 637, 639, a circuit court of appeals stated: "The petitioner contends that there was no evidence that these items were accrued on the respondent's books. But that fact is immaterial; actual bookkeeping entries do not control in the determination of the question of whether an item is income or deductible on an accrual basis, but the facts do."

But where facts are properly recorded, the written records constitute the best evidence and other evidence ordinarily will not be admitted. *National-Ben Franklin Fire Ins. Co.* v. *Stuckey*, 86 Fed. (2nd) 175, was an action on a policy which contained a warranty to keep a set of books recording all sales, both for cash and on credit. A record of sales on credit was kept in a separate book, but this book was not introduced into evidence. Oral testimony showed that the insured made 10 per cent profit on cash sales and 20 per cent profit on credit sales. "The amount of stock on hand was arrived at by mathematical calculations after deducting the customary profits from the aggregates of cash and credit sales. This was error so far as the credit sales were concerned, because . . . the missing book contained the best evidence of the credit sales of which the case was susceptible." Similarly, in *Wright* v. *Union Ins. Co.*, 13 Fed. (2nd) 612, 613, the court wrote: "It was not permissible for plaintiff to show by his oral testimony that he sold at a profit, because the parties stipulated that the books should present a complete record of business transactions, including all sales." In this case the court found the record of sales in the ledger insufficient because there was no identification of goods sold and thus no way to determine whether sales had been at a profit or at a loss. "If plaintiff sold at a loss, the stock of goods destroyed by fire was smaller than it would have been if he had sold at cost, or at a profit."

Not only should books of account be correct and complete, but financial statements prepared from them should not be so condensed as to be incomplete. This was emphasized in a bankruptcy case, *In re Keller*, 86 Fed. (2nd) 90. A discharge in bankruptcy is not obtained as a matter of right, but a discharge is granted as a privilege and in the discretion of the judge. A discharge may be refused if the bankrupt has "obtained money or property on credit, or obtained an extension or renewal of credit, by making . . . a materially false statement in writing respecting his financial condition." The materiality is a matter of degree depending upon the facts in each case. In the Keller proceeding, it was held that the omission of a liability from a financial statement is not rendered immaterial, and the statement is not rendered less false by the omission of an asset of the same amount.

When the books of account of a party to a litigation are needed in evidence, but the party refuses to produce them, their production can be compelled by the service of a subpoena *duces tecum*. This is a writ or process of the court requiring the person on whom it is served to attend in court and to bring with him and produce to the court the books, papers, or other things specified in the subpoena. Obviously an accountant cannot be required to produce books of account belonging to a client, but he can be compelled to produce his own books of account. With respect to a client's books, which can be procured by serving the subpoena upon the client, it is well settled in most states that "An accountant, unlike a lawyer or physician, cannot claim a professional privilege against disclosure of confidential communications, and he may be made to testify and produce his records without the consent of the client." *Aronson* v. *Fenster*, N. Y. City Court, 97 N. Y. Law Journal 2971, 6/12/37.