

THE IMPACT OF ACCOUNTING ON PARTNERSHIP AND CORPORATION LAW

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Much ink has flowed from the pens of both lawyers and accountants on the impact of accounting on law and law on accounting. Leaders in both professions concur that this influence has been mutually beneficial and of considerable significance. It seems rather ironic to me to learn of the efforts being made by the accountants themselves to eliminate commercial law as a field in which questions are to propounded in the Certified Public Accountants Examination. A recent Report of the Appraisal Committee expresses the reason for this in these words:

"The examination is not intended to measure competence to solve problems of law, but rather to determine whether the candidates recognize problems of law which are inherent in business transactions and in the audit thereof."¹

As professors of business law we may disagree with the policy but the accountants themselves appreciate that it would be impossible to recognize problems of law inherent in business transactions without some training in business law, if only to alert accounting students to legal problems and to acquaint them with the process of legal reasoning employed in their solution. It is to the credit of the accountants that they recognize and still insist that accounting students be exposed to all of the commercial law subjects.²

More alarming, however, is the effect certain reports on business education have had on the curricula of business schools.³ Some of the "new frontier" curriculum reformers have envisioned moving in two directions, first, to revise and combine a number of basic accounting subjects in some sort of "ersatz" accounting course and, second, to eliminate business law and substitute therefor courses in governmental regulation and control of business. The millenium will have been reached when the future CPA need only be exposed to a few courses in accounting buttressed by large quantities of statistics, marketing, behavioral sciences and government control of business. These may some day qualify the future accounting major to become a

¹*Report of the CPA Examination Appraisal Commission*, p. 9.

²*Ibid*, pp. 8, 9, 10.

³"The Education of American Businessmen," Frank C. Pierson and others: A Summary by Barbara D. Finberg.

Certified Public Accountant. Presumably the new curriculum with its pretentious claims of a broader approach will eradicate from the public mind Elbert Hubbard's concept of the typical accountant:

"cold, passive, noncommittal, with eyes like codfish . . . minus bowels, passion or a sense of humor."⁴

With this new look predicted by the reformers it is expected that the future businessman will have a broad training in the humanities and liberal arts and, in addition, become articulate in all specialized fields. It is quite conceivable that he may become expert in many things, but it is questionable whether he will be a master of his own profession. In a condemnation of the modern educational approach of overemphasis on the so-called modern democratic processes in education, Barzun demonstrates pointedly and forcefully in *The House of Intellect* the dangers and limitations inherent in such methods:

"But to encourage the utterance of opinion-unchecked, as in those 'social studies' classes where Supreme Court decisions are discussed in a free-for-all, does nothing to encourage thought. Rather, it strengthens the prejudices against thought, by permitting each child to think that everybody is entitled to his own opinion, especially me to mine!"⁵

It has been charged by the curriculum reformers that business law has been poorly taught as a mere cataloging of rules. To paraphrase the admonition of St. Luke, "Woe unto you, Lawyers," I would by way of exposition for this alleged low state of law teaching substitute the words of the Master, "Let him who is without sin cast the first stone." In the course of forty years of my teaching experience I have met teachers of finance, marketing, management, political science, economics and even sociology who all boast that they have had a hand in teaching business law. Might not one of the reasons for the criticism made about the teaching of business law have resulted from a dearth of competent teachers of law, necessitating deans in some institutions to draft members of other disciplines with no training in the law, no understanding of its nuances or appreciation of its historical development? In Universities fortunate enough to possess professors of law who have had the benefit of a liberal education, the subject is generally presented not as a decalogue of rules but with due appreciation and understanding of the relation of law to philosophy, history, government, economics, sociology and ethics, and all this without overlooking its essential function as an important instrumentality in the administration of justice to achieve the ends of good government.

I am not closing my eyes to the necessity for improvements, with perhaps some emphasis on the conceptual approach to the teaching of law rather than placing too much stress on the functional, but the basic ideas of commercial law cannot be taught to the future American businessman in any other way than in the rugged, realistic, traditional manner. Choses in action and in possession, the marshalling of assets, the rule against perpetuities, dividends and surplus in corporation law, have pe-

⁴T. A. Wise, "The Auditors Have Arrived," Part I, *Fortune Magazine*, November 1960, p. 151.

⁵Barzun, Jacques, *The House of Intellect*, (N.Y., 1959).

cularly legal meanings, not necessarily static, and can only be taught in lawyer-like fashion.

However we may differ as to what should go into the business school curriculum in order to turn out a well-rounded and skilled businessman, I venture to believe that all are agreed concerning the limitations of time within which the job must be done. How can we telescope the required business law courses into nine hours or even into six hours? Can this be achieved in a course on Government and Business? Some accounting departments have complained that business law instructors, in their effort to crowd too much material into their courses, are merely skimming over partnership and corporation law, both subjects constituting areas of deepest accounting penetration. At Loyola University, Chicago, departments of both law and accounting have met in joint meetings to determine where duplications can be eliminated to the end that valuable teaching time can be saved. From these meetings there has developed a mutual understanding and a better appreciation of the problems of the two professions.

It must be apparent from what has been said thus far that in discussing the topic assigned I have perhaps gone astray, and should, in the interests of logic and economy of time, have adopted one of three approaches to the subject. One, the inroads made by accountants on the practice of law which was perhaps what was intended by our program chairman; or two, the changes wrought by accounting in the past twenty-five years on partnership and corporation law; or third, how the accounting and business law departments can integrate certain areas of both partnership and corporation law to avoid duplication. I have already mentioned the latter and shall make a brief comment on the second involving the impact of accounting on partnership and corporation law.

Accounting and law have an effect one on the other often overlooked by the accountant, the teacher and the legislator alike. The accountant, by the introduction of a new approach, can change the law, for accounting propositions and their interpretations, while never really considered as law, are often accepted by the courts as a fixed procedure to be applied to problems arising in lawsuits where law and accounting are involved.⁶

The relationship existing between accounting and the law is somewhat obscured by that fact each discipline has its own practical field, and the practitioners in one field have hesitated to transgress into the other—and, in fact, in many places are prohibited from so doing. This, too, has caused sharp differences of opinion between accountants and lawyers as to their respective fields of competence.⁷ In the training given to a legal practitioner little time, if any, is spent on accounting, and similarly an accountant receives training that tends to isolate law as an independent subject. It is now recognized that law does and can have an influence on accounting just as accounting does and can have an influence on the law.⁸

⁶Field, Ernest R., "Legal Conflicts and the Study of Accountancy" (Teacher's Clinic) *Accounting Review*, V. 31, January 1956, p. 126-128.

⁷Griswold, Erwin N., "A Further Look At Lawyers and Accountants in Tax Practice," *Address, American Bar Association*, Aug. 21, 1955.

⁸McCreechie, H., "Accounting in Relation to Law," *Accounting Research* (Eng.) V. 7, October 1956, p. 367-379.

In good accounting practice a partnership is now generally treated as an entity.⁹ This approach has been accepted by the courts, but for legal purposes the partnership may or may not be an entity according to the branch of law applicable. The law still treats a partnership as an aggregate of persons. The individuals of a partnership, rather than the partnership, generally accept legal responsibility, but legal provision is made under modern practice acts for the partnership to be treated as a legal entity for some purposes: for example, when a partnership is being sued and the names of the partners cannot be ascertained.

In accounting the auditor must be aware of certain concepts of law not only for accurate accounting results, but because of their legal impact on accounting itself. The doctrine of "equitable conversion" as applied to partnership realty is of importance to the accountant, and its understanding by the accountant is essential in a partnership where the chief asset is partnership realty and the death of a partner has resulted in a dissolution.¹⁰ The "marshalling of assets," long applied in partnership accounting, is and should be familiar to the accountants. It is the law's approach to an equitable distribution of partnership and individual assets between individual and partnership creditors. Ascertainment of the values of the good will of a business never has been an easy problem. The law is also very clear that where a partner has wrongfully caused dissolution of a partnership and the business is continued under paragraph 2 (b) and (c) I and II of Section 38 of the Uniform Partnership Act, the ousted partner shall have the right, as against his co-partners and all claiming through them in respect of their interests in the partnership, to have the value of his interest in the partnership, less any damages caused to his co-partners by the dissolution, ascertained and paid to him in cash, or the payment secured by a bond approved by the Court and to be released from all existing liabilities of the partnership.¹¹ In ascertaining the value of the partner's interest, however, the value of the "good will" of the business is not to be considered. This is bound to present problems for the accountant, but it is one that is not insoluble. From what has been said thus far, little is needed to establish that the impact of accounting on partnership law has not been as great as it has been in the case of corporate law. While accounting undoubtedly has influenced the law, the latter also directs, influences and guides accounting practices. It is perhaps more accurate to say that both are mutually complementary.¹²

As has already been suggested, accounting has had its greatest impact in the corporation law. This has arisen in so many aspects of corporate activities that it would be impossible to undertake to discuss them within the compass of this short paper. Only a few may be superficially touched upon. It is said that the interplay of accounting and the regulation of corporations and corporate distributions is very close, so that mutual understanding between lawyers and accountants is essential.

⁹Smith & Roberson, *Business Law*, Vol. II, p. 2, (West Publishing Co.). Wyatt & Wyatt, *Business Law—Principles & Cases*, p. 617 (McGraw-Hill 1958).

¹⁰For "Marshalling of Assets" see Smith & Roberson, Vol. II, p. 103, and Wyatt & Wyatt, p. 659.

¹¹Sec. 38, Paragraph 2 (b) and (c) of *The Uniform Partnership Act*.

¹²Miller, Michael L., "Professional No-Man's Land—Where Law and Accounting Meet," *North Dakota Law Review*, V. 34, January 1958, p. 35-42.

Unfortunately it is only with considerable difficulty that the average lawyer understands the terms, concepts and policies of the accountant.¹³

The terms "capital stock," "stated capital," "shares," "surplus" and "profits" are often used loosely in statutes and judicial opinions. The Model Business Corporation Act reflects to a considerable extent the influence of recent accounting principles.¹⁴ It should be noted that today dividends are not usually restricted to profits. The surplus is to be determined by the balance sheet. These terms are used loosely in statutes and judicial opinions in the sense of any excess value over legal capital. Now surplus is to be determined from a proper setting up and interpretation of the balance sheet. In an article written by Sidney I. Simon, Assistant Professor at Rutgers University, he asserts:

"The courts have long been in agreement with the accountant that surplus includes every kind, not just earned. The United States Supreme Court concurred with the general accounting classification of surplus into earned and capital and revaluation, saying specifically that it might include 'paid-in surplus' (where the stock is issued at a price above par), it may be earned surplus (where it was derived wholly from undistributed profits) or it may, among other things, represent the increase in valuation of and/or other assets as a result of a revaluation of the company's fixed property. A dissenting opinion in a California case, however, took a different approach and included revaluation of assets among its items making up capital surplus."¹⁵

On such corporate problems as valuation, depreciation and depletion, the law impliedly adopts what may be termed good accounting practice. Professor Baker admonished lawyers in these words:

"Whether we like it or not the accountants may be making our law; on divided issues that involve inventory valuations judges are likely (even in the absence of such statutes as Pennsylvania, Sec. 702) to believe the matter ought to be controlled by good accounting practice. If the case is well tried, with submission of accounting literature as evidence and accounting testimony or depositions, what accountants of standing do and say may make the decision . . . Good accounting practice may be enough even though it falls short of being uniform accounting practice."¹⁶

In the end, however, it is to be noted that the Courts will make the final decision and ought, where a strictly legal problem is involved, to follow the law to accomplish the legal objective, especially where conflicting accounting opinions exist.

At the present time there are many federal statutes that have introduced and recommended the use of newer accounting approaches. Many of these are directed toward achieving the purposes of better regulation and control. In the area of public utilities, the Interstate Commerce Commission and Federal Power Commission

¹³Ballentine on Corporations, Chap. XV, p, 567, 8 et passim (Callaghan, 1946).

¹⁴Model Business Corporation Act, Sec. 2, Definitions.

¹⁵Simon, Sidney I., "Legal Decisions on the Accounting for Capital Assets," *The Accounting Review*, January, 1956.

¹⁶Baker, R. J., Hildebrand on Texas Corporations, A Review, 21 *Texas Law Rev.* 169, 190.

Acts, and many others, exercise important authority over utility accounting and valuation of assets received. Kripke, in "A Case Study in the Relationship of Law and Accounting, Uniform Accounts," pointed out:

"The recent decisions of the Supreme Court in the *Hope Natural Gas* case and the *Northwestern Electric* case focus attention more acutely than ever on the extent to which accounting concepts affect financial regulatory problems. The *Northwestern Electric* case strongly reaffirms the implication of earlier Supreme Court decisions that the effect of a prescribed system of accounts on the legality of dividends is not involved in considering the validity of the system; that the system does not preclude the keeping of other accounts for other purposes; and that the system does not prevent the assertion by the accounting company that it has property values and equity values differing from those shown by the accounts. The *Hope Natural Gas* case releases the regulatory commissions from the bonds of the "fair value" rule of rate base determination announced in *Smyth vs. Ames*. Unquestionably, except to the extent that the views expressed in the dissenting opinions of Justices Jackson and Frankfurter in the *Hope Natural Gas* case may affect administrative policy in the regulation of the natural gas industry, public utility regulatory commission will not increasingly adopt the "prudent investment" standard of rate base determination long advocated by Mr. Justice Brandeis."¹⁷

Under the Securities Act of 1933 and certain other statutes administered by the Securities and Exchange Commission, it has been given authority to prescribe by rules and regulations the form and content of financial statements which are required to be filed with them and the methods to be followed in the appraisal of assets and liabilities. In another article by Kripke appearing in the *Yale Law Review*, he points out the underlying reason for this:

"Under state and federal security legislation, the accountant is, in effect, obligated to protect prospective investors against promoters, underwriters and existing investors, and to afford existing investors security against corporate insiders In order to protect investors, the Securities and Exchange Commission has promoted standardization and reform of accounting practice Prescription of uniform systems of accounts is one of the most common regulatory devices in the public control of enterprise."¹⁸

The accounting requirements of the Securities and Exchange Commission as set forth in its regulations, its instructions, its decisions and its accounting series releases continue to be an influential factor in promoting frank disclosure. This new approach in accounting has been instrumental in lifting the level of accounting standards in corporate financial statements and reports to shareholders.

In practice, however, the calculation of the amounts available for dividends is made according to rules of accounting valuation and deduction which still continue to

¹⁷Kripke, "A Case Study in the Relationship of Law and Accounting, Uniform Accounts," 57 *Harvard Law Review* 433.

¹⁸Kripke, "Accountants' Financial Statements and Fact Finding in the Law of Corporate Regulation," 50 *Yale Law Review* 1180.

be in dispute. Need of some recognized authority to establish approved accounting standards as an important safeguard to creditors and investors is essential. It is only in this way that the independent stand of public accountants against the pressure of corporate management will be strengthened. It is here that law and accounting meet on common ground.

It is interesting to note also that in some areas accountants are using terms for accounting purposes differently from the way in which lawyers use them and as they are defined in the statutes.¹⁹ In the Accounting Research Bulletin No. 48 of January, 1957, there was issued by the Committee on Accounting Procedure of the American Institute of Accountants a series of statements entitled "Business Combinations." In paragraph 2 of the statement the Committee noted that the distinction between a *purchase* and a *pooling of interests* is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form such as "merger," or "a consolidation" or in the number of corporations which survive or emerge. Samuel R. Sapienza, in an article "Distinguishing between Purchase and Pooling," writes "the decision should not be made that one case is a pooling and another a purchase because there was an exchange of stock for assets, or stock for stock, or that new companies arose in the process in any of the myriad corporate forms the new combination might take."²⁰ To the lawyer the definitions of merger and consolidation seem clear cut, but accounting practices have made this a bit more difficult for the lawyer.²²

Professor Sapienza's summary is enough to demonstrate the impact this may have on corporation law. He states:

"There is little doubt that Bulletin 48 is being given a liberal interpretation in view of the above discussion at least in regard to certain points. This paper raises these issues:

1. The factor of relative size, whether in terms of net assets or stock equity interest, is gradually being reduced to a minor role in deciding a purchase or pooling application.
2. The decision to pool rather than purchase a company must turn on factors other than continuity of management or retention of most of the key personnel, since in many cases styled "purchases" management and key personnel are kept.
3. The avoidance of the booking of a large excess that might be attached to fixed assets, or set up as an intangible, with the attendant reduction in net profits after taxes, seems to be the major reason why one combination may become a purchase and the next one a pooling.
4. The switches in the interpretation of Bulletin 48 lead to a question as to its clarity and the possible need to a restatement."²¹

A better understanding of the task of the accountant, of his approach to accounting problems and how the results of his work are being utilized by top man-

¹⁹"Business Combinations," *Accounting Research Bulletin No. 48*, January 1957.

²⁰Sapienza, Samuel R., "Distinguishing Between Purchasing and Pooling," *The Journal of Accountancy*, June 1961.

²²See Sections 61, 62, 63, 64, 65 re Merger and Consolidation, Smith-Hurd Illinois State Statutes.

²¹*Ibid.*, p. 40.

agement in making important decisions, should enable the business law professor to mark out for his students the line of demarcation between the practice of law and accounting. This bone of contention has resulted in conflict between the two professions. Certainly the drafting of legal documents and their interpretation is one that calls for legal expertise, while the factual presentation of the material that goes into a balance sheet and its interpretation calls largely for the exercise of the accountant. The law professor can do much in clarifying the legitimate areas of operation of the lawyer and the accountant. It will lead to a better appreciation of the appropriate comment of Professor Magruder,

"In his new role the accountant is a diagnostician of our profit-and-loss system—a role far different from that of an advocate. In the contiguous areas where conflict may arise, both professions must serve a new profession—business. Like the two boys tied together in a three-legged race the success or failure of one is dependent on that of the other."²³

In conclusion I return to my original comment that to emasculate one or the other subject in fashioning new business school curricula is doing a positive disservice in the education of the future American businessman.

²³Backer, Morton, *Handbook of Modern Accounting Theory*. See Article by Bernard F. Magruder on "Law and Accounting," p. 97. See also Article by Maurice H. Stans, "The Future of Accounting," p. 583.