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Michael Bromwich
Anthony Hopwood

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and

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Foreword

The relationship between accounting and the law is one of increasing significance. Although legal processes have played an important role in delineating acceptable accounting practices for a long period of time, the part played by statute law in that process has been a relatively limited one. With the influence of European Directives, law is now starting to have a much greater impact on both the form of corporate accounting and reporting, the institutions for its regulation and the structures of influence upon these matters. Serious questions are also now being asked of the legal responsibilities of auditors and the relationship between the law and standards of desirable accounting practice. Many of these developments are relatively new but they promise to be a major element on the agenda of accounting policy makers.

This volume deals with issues whose potential importance is now widely recognized. Based on the proceedings of a conference held at the London School of Economics and Political Science which was sponsored by Coopers & Lybrand Deloitte and the Research Board of the Institute of Chartered Accountants in England and Wales, the collection of papers assembles the thoughts of a distinguished group of accounting and legal scholars on a number of themes related to the multi-faceted relationship between accounting and the law.

The Research Board welcomes the contributions by scholars from Australia, continental Europe and the United States of America. It is increasingly important that we seek to learn from the experience of others beyond our shores. When there are pressures on us to rethink our own views of the way in which accounting is embedded in legal processes and wider structures for institutional governance, it is important that we should try to understand the experiences of those who have different ways of managing these interrelationships. It is equally important that we should seek to learn from those with a more direct knowledge of the law.

Of course, such listening does not itself provide an imperative for change. That is far too simple. However, the careful thought which comparative analyses can encourage is capable of introducing an appropriate element of realism into debates, as well as providing a wider variety of institutional options to consider.

Collections of the type of studies assembled in the present volume reflect the Research Board's commitment to encouraging questioning analyses of the contemporary condition of accounting thought and practice. At a time when there are increasing demands for accounting both to account for itself and to respond to new circumstances it is important that accounting scholars and practitioners should reflect on the basic institutional structures within which they operate.

John Arnold

Director of Research

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The objective of these meetings is to provide an opportunity for academics and senior practitioners to discuss important areas of accounting, and to enhance mutual understanding of academic and practising perspectives.

We are pleased to acknowledge the generous support of Coopers & Lybrand Deloitte and the Research Board of the Institute of Chartered Accountants in England and Wales. The continuing support of both sponsors of this series of symposia is most welcome.

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Michael Bromwich
Anthony G. Hopwood

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The intertwining of accounting and the law

Michael Bromwich and Anthony G. Hopwood

For most countries the question is not whether the law impacts on external accounting and on private sector accounting policy making. Rather, it is whether the existing balance between the two is appropriate for the country and its culture.

In some countries – Germany and France are examples – state regulation is predominant, although means can often be found for introducing some degree of flexibility within the rigidities of the law. Such regulation is based on statute; however the more detailed specifications of practice may be made through tax regulations and a variety of delegated ministerial ordinances. Isabelle de Kerviller and Peter Standish illustrate this type of regime (see Chapter 9). In France, it can reasonably be said that accountability is highly centralized. Accounting requirements are laid down by statute, backed by a very authoritative body, which prescribes detailed rules. Even so, the present, relatively unconstrained rules for consolidation allow enterprises considerable freedom in this otherwise restrictive environment. Indeed, de Kerviller and Standish suggest that the accounting regime in France is changing to adapt to new global financial markets and other contemporary influences.

In most countries, the form and content of external accounting reports are determined using what might be called a mixed system of law and private sector standard-setting in the same sense as economies are often described as mixed in terms of their balance between government regulation and the use of the market system.

The legal pressures on external accounting

In most countries, we must view as a whole the activities of the

government and its agencies, the judiciary, standard-setters and any other private sector accounting policy-makers. In most commercially developed countries, accounting policy is not the sole preserve of a self-regulating profession. Rather, standard-setters and accounting policy-makers can be seen as building on the law and generally dealing only with items that have not been addressed in any detail by the legislature, its executive agencies and the courts.

The modes of regulative accounting found in particular countries, and the precise ways in which accounting, the law and professional regulation intersect, reflect differing social, political and economic environments. The development of accounting, as Colin Gilmore and Hugh Willmott illustrate (Chapter 10) with reference to the United Kingdom, cannot be considered outside the wider context of the industrial and commercial system, social and political attitudes to the corporation and those expectations for corporate accountability which have come to be regarded as legitimate. Peter Miller and Michael Power (Chapter 13) also make clear that accounting is not and never has been an autonomous practice. It is something that is deeply implicated in its wider context, including that of the law.

A diverse set of legal influences may affect accounting. Statute law has the strongest force and may be very detailed, as in France and Italy, or set a framework for external reporting in more or less detail. The situation in the United Kingdom prior to the Companies Act 1981, which introduced the EC Fourth Directive into UK law, provides an example of the use of a fairly basic statutory framework. This Act introduced a much more detailed statutory framework for accounting.

An historical perspective suggests that statutory changes to accounting were often of a form that the accountancy profession, at least initially, opposed. Matthew Patient in a wide-ranging chapter (Chapter 2) considers some of the legal milestones in the development of accounting in the United Kingdom, and suggests that the role of the law in accounting matters has progressively increased, especially by enshrining in statute what had become good accounting practice, but was not being universally applied.

Recently, in the United Kingdom and in some other countries, where accounting standards are important and accounting principles well developed, there has been a trend towards writing into the statute law those accounting standards and accounting principles that have served a longish apprenticeship and presumably are thought useful, albeit often with some amendment. SSAP 2 dealing with general accounting principles provides a UK example of this process. In so far as similar principles formed part of the Fourth Directive this can be seen as a more general process.

In the United Kingdom the statutory framework may be augmented by ministerial regulations. Tax laws and regulations have a profound effect on accounting in a number of countries. In many Continental European countries, tax benefits can only be claimed if appropriate accounting methods have been used in the published accounts (de Kerviller and Standish discuss this situation as it prevails in France). Many countries also have government agencies or government-backed agencies, usually involved in the regulation of the securities industry, which can lay down accounting regulations for their own purposes. The Securities and Exchange Commission (SEC) in the United States has this power by statute. The use of this delegated power by the SEC provides an interesting example of how legal powers can evolve and interact with other types of regulation as the SEC has agreed to accept generally accepted accounting principles (GAAP) for its purposes.

Areas where the law and accounting intersect are discussed in a number of chapters in this book. Napier and Noke (Chapter 3) adopt an historical perspective, as does Patient (Chapter 2), who also looks at some contemporary problems in this area. Napier and Noke cite the emergence of professional accountancy in the bankruptcy laws of the mid-nineteenth century and chart the uneven and slow process of the legal regulation of company accounts during the next 150 years, encompassing a detailed consideration of the effects of enacting relevant EC Directives. Michael Bromwich (Chapter 6) considers whether relying on the legislature to regulate accounts has advantages or disadvantages relative to entrusting this task mainly to a self-regulatory profession. Tom Hadden and Denis Boyd (Chapter 4), in the course of providing a legal perspective on accounting and the law, consider the effects of certain statutes on accounting. They doubt whether legal intervention in the accounting area has been successful overall and question whether it will be in the future.

One little considered area where the law and accounting interact is that of government contracting, which, at least in conditions of war, has been an influential source of accounting change. Here, governments and their purchasing agencies frequently require that suppliers adopt specific accounting procedures which are then often utilized in the suppliers' published accounts. Another area neglected by researchers interested in the influence of the law on accounting is the government's use of accounting reports in times of major economic crisis. The use of accounting statements in this way is exemplified by the United Kingdom's counter-inflation policy in the mid-1970s. Here a detailed format was prescribed for cost statements, which had to be consistent with the audited accounts for use in justifying price increases.

The outcomes of court cases and of tax tribunals are another way in

which law can act upon accounting, especially in common law countries. Napier and Noke and Hadden and Boyd review a number of particularly important cases in shaping accounting. The courts have had a major influence on accounting, especially in the Anglo-Saxon countries, when determining the liability of auditors for negligence. The legal findings in the United States and United Kingdom on this subject are addressed by Gwilliam (Chapter 11) and by Hadden and Boyd (Chapter 4).

The UK courts have not yet ruled on the authority to be accorded to accounting standards. The legal aspects of the current standard-setting arrangements in the United Kingdom will be considered further in this Introduction.¹ Mary Arden (Chapter 5), Doreen McBarnet and Christopher Whelan (Chapter 7) use a legal perspective to consider whether giving accounting standards more authority in law is a sensible way to ensure compliance with standards. This is especially relevant in the United Kingdom. Following the suggestions of the Dearing Report (1988), which proposed a new standard-setting arrangement, the statute law has given standards a little more authority, though not as much as the Dearing Report proposed. Arden looks at a specific case and suggests that legal enforcement is unlikely to solve all the problems faced by standard-setters. The courts will consider only the questions in the cases before them and will not generally seek to determine general accounting principles (see Arden). This does not bode well for current attempts to give accounting standards more authority by providing some legal backing. Bob Walker's chapter on the Australian standard-setting scene (Chapter 8) also throws light on this debate. These three chapters and others in this volume suggest that giving legal authority to accounting standards is not a panacea.

The chapters by legal authors in this volume suggest another way in which the law can impact on accounting: namely, by the production of authoritative legal opinion. Indeed, the current view of the legal status of accounting standards in the United Kingdom is substantially based on an opinion given in 1983 to the Accounting Standards Committee (ASC) by L. Hoffman and M. H. Arden, the latter a contributor to this book.

Bodies representing lawyers also have given opinions on matters relating to accounting. For example, the Law Society has on a number of occasions sought to suggest that accounting standards should not put a gloss on the law. Matthew Patient illustrates this debate with reference to the accounting standard dealing with acquisitions and mergers (SSAP 23). The existence of accounting standards, and indeed generally accepted accounting principles, permits accounting to impact on the work of lawyers. Accounting standards and accounting principles that supplement the law impinge on the advice that lawyers might give to clients and widen the authorities that can be called upon.

However, this book suggests that it is law which affects accounting rather than vice versa. Law emerges as the dominant discipline. This is in part because the authors are writing for accountants rather than for lawyers, but it is not unfair to say that the law itself seems substantially unaffected by accounting thought. Few accounting concepts seem to have influenced the general law, especially as the concept of substance over form seems to be claimed by both disciplines. Moreover, the courts have not hesitated to follow their own views where these are at variance with accounting opinion, even though they normally follow generally accepted accounting opinion. Indeed, as Hadden and Boyd and Napier and Noke make clear, the courts have formulated many accounting concepts which are still very important today, for example, in defining capital maintenance concepts and in determining when profits are available for distribution.

A final way in which law and accounting may impact on each other is in the area of legal and accountancy training. Students of both disciplines generally now learn something of the other subject, but the focus is mainly on techniques. It is therefore unlikely that much of the conceptual foundation of the subject is acquired.

Katherine Schipper (Chapter 12) introduces the final perspective employed in this volume. She considers the question of obtaining evidence on regulatory issues and reviews the evidence that regulatory decisions in accounting affect enterprise operating decisions. She evaluates attempts to determine the stock price effects of some Financial Accounting Standards Board (FASB) pronouncements in the United States. Schipper also outlines the difficult methodological problems that have to be solved in undertaking this type of study. Such research is very important because it allows at least part of the debate on regulation in accounting to be subjected to empirical testing.

One important lesson, which emerges here, is that it is important to appreciate the multidisciplinary character of accounting. Accounting matters generally cannot be resolved using only an accounting perspective. Law, culture, the general economic environment and problems of making choices for society in terms of taking decisions affecting the distribution of resources, income and wealth all attend important accounting decisions. A portfolio of perspectives has to be employed when seeking to analyze the problems caused by the intertwined influences of a number of disciplines on major accounting problems. Thus, for example, Gwilliam, in examining the effects of the law on auditing, needs to have considerable recourse to economics, while Napier and Noke, when charting aspects of the history of the relationship between accounting and the law, have to deal not only with these perspectives but also with the changing economic and commercial