The issues, effects and consequences of the Berle–Dodd debate, 1931–1932

John C.C. Macintosh *

Department of Administration Studies, Atkinson College, York University, Toronto, Ontario, Canada M3J 1P3

Abstract

This paper re-examines the debate by Adolf A. Berle and E. Merrick Dodd on corporate accountability. Berle argued that corporate managers should be solely responsible to shareholders whereas Dodd saw them as trustees for both shareholders and society. They concluded that in the absence of shareholder control, the only check on corporate management was the full disclosure of information. This became the basic philosophy of the American securities legislation that had far-reaching effects and consequences for financial reporting. © 1999 Elsevier Science Ltd. All rights reserved.

In the 1930s two American law professors, Adolf A. Berle Jr and E. Merrick Dodd Jr, publicly debated the issue of “to whom are corporations accountable?” Berle argued that the management of a corporation could only be held accountable to shareholders for their actions whereas Dodd held that corporations were accountable to both the society in which they operated and their shareholders.

The views expressed by Berle were those that he had previously held and which were reiterated by him with Gardiner C. Means, an economist, in *The Modern Corporation and Private Property* (1932). These views are generally believed to have provided the philosophy on which the US securities legislation of 1933-1934 was based (Carey, 1969; Chatfield, 1974; Hessen, 1983). The views of Dodd, on the other hand, were similar and equally important in recognizing the broader reporting responsibilities of corporate management.

Even though the debate took place in the USA, it was the first in a sequence of events that had a major effect on the worldwide development of accounting and financial reporting. This paper re-examines the conditions under which the debate took place, the issues raised in this debate, the effect on accounting regulation in the USA, and the consequences of this regulation for financial reporting and accounting.

1. The conditions under which the debate took place

During the 1920s, the American economy was dominated by a few large corporations in which the managers exercised considerable power. The extent of their influence is reflected by the fact...
that it was estimated that in 1929 the 200 largest business corporations owned 49% of all corporate wealth (or roughly 38% of all business wealth) in the U.S.A. (Berle & Means, 1932). Cases of the excessive use of corporate power were common and it was often necessary for shareholders to look to the courts to redress their grievances. In the case of Dodge vs Ford Motor Co. (1919), for example, the court ruled that the defendant company must pay dividends to its shareholders rather than use the profits to further purposes of a humanitarian nature favoured by Henry Ford.

The growth of these giant corporations had been mainly financed through the issue of securities and the widespread use of corporate pyramid-building. Certain companies were also organized as investment trusts in order to hold securities in other companies as a means of “manufacturing” more securities to sell to the public. For example, in 1929, Goldman, Sachs & Co. organized and sold nearly a billion dollars worth of securities in three interconnected investment trusts1 which soon became virtually valueless. The result was that the ownership of corporations became so widely dispersed that, by 1929, it was estimated that there were approximately 18 million stockholders in the US, up from four million in 1900 (Berle & Means, 1932).

At this time, the regulation of US corporate activity was by the individual states and the incorporation laws varied considerably from one state to another. They were also difficult to enforce. The incorporating of businesses was also a profitable venture for some states and they competed with one another in soliciting business by allowing the registration of corporations with unlimited powers and freedom of action. For example, the Ohio General Corporation Act allowed corporations to be formed “to do anything and everything that a group of individuals could do” (Berle, 1926–1927). All states except Nevada did, however, provide some protection to investors for new issues of securities. These “blue sky laws,” as they were known, reflected a pronounced lack of uniformity and their effectiveness was hampered by relatively little interstate traffic in securities (Weidenhammer, 1933).

The provision of information to shareholders was also on a voluntary basis. For example, Delaware only required annual reports that did not have to disclose the corporation’s financial affairs while those incorporated in Arizona did not have to present any public statements at all.2 Some corporations, like the US Steel Corporation had issued a full report on its activities in 1902 and every year from then onwards (May, 1933). There were, however, many exceptions and some corporations manipulated their earnings through the use of different accounting methods and withheld information from investors under the guise that the provision of information would affect their competitive position (The Accounting Review, September 1933). This lack of corporate accountability, coupled with the widespread dispersion of stock ownership, gave management virtually complete control over corporations.

The extent of corporate power and the lack of corporate accountability generated little public concern in the period of unprecedented economic growth and stock market activity which took place in the early- to mid-1920s. For example, in 1922 when the President of the New York Stock Exchange advocated full publicity in connection with the issue of securities along the lines of that required in Britain (Carey, 1969), it fell on deaf ears.

The way in which corporate management was acting towards stockholders appalled Berle, a young lawyer, and in 1923 he reacted to it. His first step was to draw attention to the legal rights of the holders of non-cumulative preferred stock and the nature of the stock itself (Berle, 1923). Preferred stockholders rights had been frequently ignored by interpreting the term “non-cumulative” to mean that the preferred stockholders only had a right to current profits when the directors chose to declare a dividend. His next step was to criticize the issuing of no-par value shares at any price that had the effect of diluting the interests of the holders of par value shares (Berle, 1926–1927).

1 Namely, Goldman Sachs Trading Corporation, Shenandoah Corporation, and Blue Ridge Corporation.

2 See Ripley (1927) for an excellent review of the situation.
In 1925, Berle was asked to lecture in finance on a part-time basis at the Harvard Business School (Berle, undated). As he became familiar with the financing practices of Wall Street, he realized that the entire handling of corporate law, both academically and in the courts, was outdated. It was based on the principles of ownership and control applying to the small closely-held corporations of the 1880s and not the large corporations of the 1920s (Berle, undated) in which the ownership of corporations was almost completely divorced from control.

Towards the end of 1925, the views of William Z. Ripley, a professor of economics at Harvard University, received considerable attention. In an address to the American Academy of Political Science, Ripley attacked the issuing of “management shares” whereby a minority of stockholders could exercise control over a corporation by holding a relatively small class of stock having exclusive voting rights (New York Times, 29 October 1925). This issue was taken up by Berle (1926a) who argued that, where such a separation of ownership from management and control had occurred, there were no legal safeguards to ensure that the holders of the “management shares” would protect the interests of those who had no say in the running of the corporation. The holders of these “management shares” should, therefore, be placed in a position where they were subject to the same type of control as persons acting in a fiduciary capacity towards others. He based his argument on the legal principle of equity by stating that:

... It has been almost universally true, since [the] development of courts of equity, that a person having the control of property, the beneficial ownership of which belonged to another, was not permitted to exercise such control except for the benefit and with due regard to the interests of the beneficial owner (Berle, 1926b, p. 681).

As Berle (undated) later explained, the objective of his paper was to assert the doctrine that corporate managers were virtually trustees for the shareholders. As such, they had a responsibility to act in a manner that would place the shareholders’ interests above everything except the law. As he stated later, this, resulted in “… the beginning of the fiduciary theory of corporations …” (Berle, undated).

Berle continued to draw attention to the lack of control over corporate management. He charged that even though prevailing legal theory held that corporate charters safeguarded the rights of shareholders and defined the duties of management, this was not the case because the powers of corporate management were unlimited (Berle, 1926, 1927). He pointed out that the Maryland General Corporation Act empowered the board of directors of companies to issue no par value stock at such price and for whatever consideration they deemed proper, to buy and sell or cancel the corporation’s stock without limit, and to reclassify its unissued stock by granting it any preference, redemption rights, or fixed annual dividends, as well as the power to place it ahead of any issued stock. Management could also control stock prices by having unlimited power to buy and sell a company’s stock and to dilute shareholders’ earnings by dividing the distribution of profits between new and old shareholders.

Being concerned with the situation, Berle (1926–1927) proposed that safeguards should be introduced in law before the abuse of corporate powers became a common occurrence. He also suggested...
that “… standards of dealing [with shareholders] must be embodied in rules of law and in common ideas of ethics whose breach will entail both legal liability and social condemnation” (p. 429). While acknowledging the difficulty of establishing rules of conduct for the business community, Berle (1926–1927) proposed that, as a possible means of control, the stock exchanges could suspend or withhold listing privileges from those companies where corporate powers were being abused.

In the interim, Ripley had continued his crusade. In January 1926, he had called for the “publicizing” of corporate affairs by requiring the full disclosure of their activities as the only way of curbing managements’ powers to run corporations in their own interests (Ripley, 1926b). He also suggested that the easiest way to ensure that the management of corporations were held accountable for their actions was to place the matter under the control of the Federal Trade Commission that had been formed in 1914 to enforce the antitrust laws.

This latter suggestion evoked an angry reply from George O. May (1926a), of Price, Waterhouse & Co., who stated that American shareholders were provided with adequate information and certainly more than the average English stockholder who received audited financial reports. It also led May (1926b) to state that extending the independent audit to all corporations whose securities were publicly traded would be preferable to governmental supervision and that there should be co-operation between the American Institute of Accountants (now the American Institute of Certified Public Accountants) and the leading U.S. stock exchanges on the entire issue of corporate reporting. He also voiced the concern that “… unless steps are taken to meet criticisms like that expressed by Professor Ripley, the result will be some sort of bureaucratic control …” over the financial community (May, 1926c, p. 4).

Soon afterwards, in 1927, the AIA attempted to set up May’s proposed joint committee to study the issue but it met with little success. It was only at the 1930 Annual Meeting of the AIA, that it appointed a committee under the chairmanship of George May to co-operate with the NYSE in examining “… all problems which are of common interest to investors, [stock] exchanges and accountants” (The Journal of Accountancy, October 1930, p. 4).

At that time, the examination and presentation of financial statements was based on the Verification of Financial Statements (1929), a bulletin which had been issued jointly by the Federal Reserve Board and the AIA in 1917. This bulletin was, however, based on the widespread belief that the responsibility of auditors was limited to the corporation which employed them and not to the general public (Henderson, 1934).

It was only the failure of the Kreuger and Toll group of companies in 1931 that drew attention to the shortcomings of the current situation. Here, the final report of Price, Waterhouse & Co. (1932) concluded that the perpetration of frauds on so large a scale over the period of fourteen and a half years, would have been impossible but for the acceptance of Kreuger’s claim that complete secrecy in relation to important transactions was essential to the success of his projects. It also specifically stated that these frauds could not have remained undetected had the audit examination been over the group as a whole rather than being restricted to the individual corporations. As a result of these revelations, the NYSE imposed the requirement that all new listing applications from corporations must be supported by the certificate of independent public accountants certifying as to the of the balance sheet, income statement, and surplus statement for the most recent fiscal year and cover all subsidiary companies (The Journal of Accountancy, February 1933). Even though this represented a step in the right direction, audits still followed the Verification of Financial Statements (1929). There was also little uniformity in reporting practices and, in some cases, corporations did not even provide shareholders with their income statements (Kaplan & Reaugh, 1939).

In the interim, Ripley (1927) had published a book, Main Street and Wall Street, in which he restated the views he had previously expressed on the shortcomings of corporate law, the financing practices of Wall Street, and the lack of control over corporate management. Even though the book was well received, it was virtually totally
ignored by the accounting profession. It did, however, make a lasting impression on Berle.

At about this time Berle was awarded a grant by the Social Science Research Council to carry out a study of the role of the modern corporation in American society at some recognized University. In 1927, after being turned down by Yale, Berle joined the Columbia Law School and left the Harvard Business School at the end of that same year.

It was in researching the methods of financing being carried out on Wall Street during 1927–1930, that Berle (undated) realized that the public was totally unprotected and that the views expressed by Ripley (1927) in *Main Street and Wall Street* had proved to be correct. As Berle (undated, p. 21) stated: “The freewheeling corporation could do anything it pleased with no consideration for either production or the public …”.

At this time, the U.S. economy was showing signs of being in trouble. What had occurred was that in the search for profitable outlets for the accumulation of the wartime profits of 1914–1918 and those from the early 1920s, manufacturers had substituted machinery for men (Kolko, 1976). In the period 1919–1929, manufacturing output rose by two-thirds but the profitability of American business dropped as more and more goods were produced by a labour force that remained relatively constant despite a substantial growth in population. As the demand for labour fell, unemployment rose and the disparity in income distribution was such that the richest 20% of the recipients received over one-half of the personal income. Both local and foreign investment had become important in sustaining the “capital-saturated productive system”, giving rise to widespread stock market speculation. But, of all the finance raised by the issue of securities in the late 1920s, only about one-third went into building new productive facilities. Eventually, the investing public lost faith in the system and this led to the “Great Depression” of the 1930s.

This occurred with the crash of the NYSE. It started on 3 October 1929, with greater than normal sales of stock which soon gave way to panic selling and, even though the market rallied briefly, by mid-November the stocks listed on the NYSE had fallen in value by over 40%. This continued and stocks that had been valued at $89 billion on 1 September 1929, dropped to $17 billion by the end of 1931. Customers attempted to withdraw their money from the banks and the entire commercial banking system virtually broke down. Unemployment rose from 4 million in 1930 to 8 million in 1931 leaving one out of every six workers without a job; this rose to 12 million or one out of every four workers by the end of 1932.

There was widespread resentment against the government of President Herbert Hoover that was seen as having been preoccupied with the need to balance the budget rather than creating employment and providing adequate relief to those in need (Schlesinger, 1957). Of particular importance was that the business community was viewed as having been looking after its own interests at the expense of the workers and, consequently, it had failed to provide employment and a rising standard of living (Jacoby, 1973). The existing economic and social order was questioned as the misery of the depression unfolded. There was a leaning towards socialism in certain circles but, as Kolko (1976) pointed out, left-wing political groups were never strong and there was never a political threat from the working class. In 1932,
Franklin D. Roosevelt, the Governor of New York State, was elected President after campaigning on the promise of a “new deal” for the American public.

During his initial term of office, Roosevelt sought to make political capital out of the popular disillusionment with business by making it the scapegoat for the errors of federal economic policies that deepened and prolonged the depression (Jacoby, 1973). Even in his inaugural speech delivered on 4 March 1933, he laid the blame for the Great Depression squarely at the feet of those in business, whom he described as “unscrupulous moneychangers desecrating the temple of America” and stated that it was time to restore that “temple” by the proper application of social values (Podell and Anzovin, 1988, p. 6).

It was at this time and in these conditions that the Berle–Dodd debate took place.

2. The actual debate

The Berle–Dodd debate commenced in 1931 when Berle published a paper in the Harvard Law Review on the powers granted in law to corporations or to the managers of corporations. In that paper, Berle (1931) contended that these powers should be exercised entirely for the benefit of shareholders and in a manner similar to that applying to persons acting in a fiduciary capacity towards others (i.e. as trustees). In particular, Berle (1931, p. 1049) stated that:

It is the thesis of this essay that all power granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all shareholders as their interests appears . . . (emphasis added).

In presenting this viewpoint, Berle made it clear that where the responsibility to run a corporation has been delegated to management by the shareholders, corporate management has the responsibility to exercise the powers granted to it and only in the interests of the shareholders. And, to ensure that there was no doubt as to his viewpoint, he concluded his thesis statement by stating:

... that, in every case, corporate action must be tested twice: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a cestui que trust [i.e. a trust created for a beneficiary] to the trustee’s exercise of wide powers granted to him in the instrument making him a fiduciary.

To support his argument, Berle carried out a comprehensive analysis of the powers of corporate management. In doing so, he stressed that the exercise of corporate power should revolve around the principle of equity to ensure that corporate management would act in the utmost good faith towards all shareholders in a manner similar to that of a person acting as a trustee. As far as he was concerned, corporate law was “... in substance a branch of the law of trusts” (Berle, 1931, p. 1074). However, in putting forward his viewpoint, he acknowledged that the application of corporate power should be less rigorous than that applying in a trust situation because greater flexibility was required to run a business corporation.

During the following year Dodd (1932), described by Hessen (1983) as the rising star of corporate law at Harvard University, responded to Berle. He argued that this situation exists because where the owner of a business employs a manager to assist him in carrying on the business, that manager owes not only a contractual duty towards his principal but is also

---

10 Four papers make up what is referred to by Kripke (1981) and others as the “Berle–Dood debate”; two by Berle (1931, 1932) and two by Dodd (1932, 1935).
“... a fiduciary who must loyally serve his principal's interests” (Dodd, 1932, p. 1145). When a number of owners are substituted for a single owner, or if the owners incorporate themselves, the position is no different and the managers continue to act on behalf of their principals. The relationship between them is, therefore, one of agency rather than trusteeship.

Dodd (1932) continued by pointing out that when the corporation is viewed as a separate legal entity, it is the corporation that enters into contractual relationships with outsiders and the directors and other agents are fiduciaries for it and not its stockholders. Consequently, the emphasis of the law should be on ensuring that corporations are accountable to the society in which they operate. He argued further that the law and public opinion tended to accept the broad social responsibilities of corporations. Corporate managers, therefore, had a responsibility to consider the interests of those affected by their operations. In this respect, Dodd (1932, p. 1148) stated that:

... public opinion, which ultimately makes law, has made and is making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future (emphasis added).

To support his viewpoint that corporations should be held accountable to society, Dodd examined the position of those persons affected by the operations of corporations. Here Dodd (1932, p. 1153) stated that, as far as he was concerned, those involved in business had responsibilities to society and that corporate managers “... who control business today should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfil those responsibilities.”

Dodd (1932, p. 1154) also suggested that public opinion had already had some effect on the attitude of those who managed businesses. In support of this point, he quoted from an address by Owen D. Young (1929) of the General Electric Company (a former practising lawyer), who stated that corporate managers were no longer merely attorneys for stockholders because they were becoming trustees for the corporation. Here, in answer to the questions of “If I am a trustee, who are the beneficiaries of my trust? “and “To whom do I owe my obligations?”, Mr Young stated that he believed he had a responsibility to the stockholders, the employees, customers and the general public.

In addition, Dodd (1932) was also in sympathy with Berle’s efforts to establish legal control over corporate managers to ensure that they would not divert profits into their own hands. He was, therefore, in agreement with many of the specific rules Berle had deduced from his principle of trusteeship but he felt that it was unwise, in the prevailing conditions, for Berle to have contended that the sole purpose of corporations was to make profits for their shareholders.

Berle reacted almost immediately. Within months he acknowledged Dodd’s viewpoints on the changing nature of corporate responsibility in relation to economic and social theory but did not accept that this had any effect in law. In this respect, Berle (1932) stated that from time to time the claims of other groups like organized labour had been recognized but only as a cost of doing business. Other than this, he refused to accept that corporations had any responsibility to consider the interests of persons besides their shareholders. He further submitted that corporate managers do not act in a manner that assumes responsibilities to society and that corporate advisors (like lawyers) do not carry out their duties in terms of social responsibility. Berle (1932, pp. 1367–1368), therefore, made it quite clear that, as far as he was concerned:

11 The term, agency, was used by Dodd in its legal and traditional sense to refer to a contractual relationship whereby a principal delegates the responsibility to another person (the agent) to act on his behalf (e.g. the delegation of responsibility by shareholders to the managers of corporations). The modern “agency theory” perspective that “An agency relationship exists when one or more individuals (called principals) hire others (called agents) in order to delegate responsibilities to them” (Baiman, 1990, p. 342) places a somewhat different and narrower interpretation on the term.
... you can not abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their stockholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else. ... Nothing is accomplished, either as a matter of law or economics, merely by stating that the claim of this group ought not to be "emphasized."

The final element of the debate occurred when Dodd (1935) questioned the effectiveness of the law in ensuring that directors would act in the interests of shareholders. It was, however, the reply from Berle (1932) that effectively ended the debate.

What is interesting is that, as time went by, the parties to the debate tended to change their positions. Some 10 years later, Dodd (1942) acknowledged that some of the views he had previously held on corporate accountability had been met by granting labour certain specific statutory rights and encouraging labour to organize itself so that it could bargain with management on something like equal terms. Similarly, years later Berle (1954), in recognizing changes in American society brought about by minimum wage, antitrust and other legislation, provided the epilogue to the debate by acknowledging the validity of Dodd's views by stating that "The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention."

It is also interesting to note that Berle (1960, p. xii) remained personally unconvinced because, although he had acknowledged that Dodd's viewpoint had been accepted, he stated that "It is one thing to agree that this is how social fact and judicial decisions turned out. It is another to admit that this was the 'right' disposition: I am not convinced that it was."

3. Discussion and analysis

The issues raised in the debate were quite clear. The stand taken by Berle was that corporate management should be required to act in the utmost good faith towards shareholders along the lines applying to a trustee's exercise of power granted to him in terms of the instrument making him a fiduciary. This is what he had proposed in 1926 in examining the position of the holders of "management shares" (Berle, 1926a). This was also in accordance with his viewpoint expressed at that time that the accountability of corporate management could only be ensured by the full disclosure of information because "... courts cannot act, and public opinion cannot operate unless the facts are disclosed" (Berle, 1926a, p. 263). It also re-affirmed his viewpoint, expressed in 1927, that individual shareholders were incapable of exercising any control over corporate management (Berle, 1926–1927) and, consequently, control had to be imposed by law. In this respect, he had argued that the widespread distribution of corporate stock together with the expense of enforcing any rights, or obtaining the information necessary to indicate that a violation of rights had occurred, would prove too difficult an obstacle for the average stockholder to overcome.

Dodd's position (1932) was more extreme. His argument was based on the principle of "managerialism" which holds that where control is dispersed over a large number of share-holders, management is not responsible for the pursuit of the interest of any specific group but has the responsibility to perceive and attain social objectives (Chen, 1975). His concerns were that some way would have to be found to ensure that management would act in a manner that safeguarded the interests of both shareholders and the public. He had, therefore, expressed the viewpoint that such responsibilities should be imposed on corporate management by law because the rights of shareholders had been eroded and "... any substantial assumption of social responsibility by incorporated business through voluntary action on the part of managers can not be reasonably expected" (Dodd, 1932, p. 1161). He, therefore, proposed that "managerialism" be accepted as a principle of corporate law because, if this were the position, both the law and public opinion would influence the conduct of those who direct corporate affairs.

As in the case of so many debates, the viewpoints of Berle and Dodd were quite compatible
They were both concerned about the lack of corporate accountability and that this had to be imposed on corporations by law. They had agreed there was a need to control the actions of corporate management and that they should be required to account for the proper discharge of their duties. The only major difference between them was whether these managers should merely act in a fiduciary manner towards shareholders or accept a greater trusteeship role. If, as Dodd (1932) contended, the law had started to recognize the changing role of the corporation then the wider responsibilities of corporate management should be required by law. However, this was rejected by Berle because he feared that any extension of their responsibilities would merely lead to greater power being vested in corporate management. The only way to ensure that this would not occur was, therefore, to require the “publicizing” of their activities through the full disclosure of information.

Despite the importance of these issues, they had little impact on those in the government until early in 1933 when Ferdinand Pecora, Counsel for the Senate Committee on Banking and Currency, took over the Senate Investigation into banking, security dealings, and the operation of the NYSE. What emerged from these investigations was a sordid story of how bankers and stock market dealers had avoided taxes through the creation of technical losses on their personal dealings in securities, the sale of bad investments to an unsuspecting public, the manipulation of stock prices, and insider trading. Share prices had been manipulated on a daily basis through the skillful marketing of “pools” of shares by organized groups of stock market dealers (Mayer, 1955).

What gave rise to the greatest concern was the uncovering of the “preferred list” of prominent persons, including a Judge of the Supreme Court and the Secretary of the Treasury, to whom J. P. Morgan & Co. had sold shares at figures far below market prices so that substantial profits could be made on resale of the securities—apparently, for favours to be rendered in the future (The New York Times, 2 February 1933, 3 February 1933). This information caused widespread public concern.

It was recognized that these practices could not continue. Considerable pressure was being brought to bear on the government to restore the confidence of the American investing public and to ensure that there would not be another stock market crash. It is, therefore, understandable why President Franklin D. Roosevelt called upon a number of lawyers to draft federal legislation to prevent any recurrence of these events.

The work of this group commenced in March 1933. It was overseen by Raymond Moley, who together with Berle and Rexford Guy Tugwell, comprised Roosevelt’s “brain trust” (Parrish, 1982). The first draft of what was eventually passed as the Securities Act was prepared by relatively junior bureaucrats and a former chairman of the FTC. According to Kolko (1973), it was such a mess that President Roosevelt asked Felix Frankfurter of the Harvard Law School to supervise an entirely new draft. Eventually, after the considerable changes made by Frankfurter, many of which were suggested by Berle (Berle, undated), a mutually acceptable bill was drafted that was described by the official historian of the Investment Bankers Association as a “conservative response to a widespread demand for reform” (Kolko, 1976, p. 139).12

The work of this team led, first, to the Securities Act of 1933 which required the full disclosure of information by the sellers of new securities and imposed severe penalties on those responsible for the omission or misstatement of any material fact in prospectuses. It also authorized the FTC, which administered the 1933 Act at that time, to prescribe the form and contents of the financial statements for those corporations whose securities were traded on U.S. securities markets. This was followed by the Glass–Steagall Banking Act of 1933 which required the banks to separate their commercial and investment banking activities from one another and introduced the federal guarantee of bank deposits. And, third, the passing of the Securities Exchange Act of 1934 which created the Securities and Exchange Commission to administer the Securities Act and to regulate the

---

various securities markets in the U.S., the marketing of securities, and the full disclosure of information by those companies whose securities were traded on those markets.\footnote{What is interesting is that the input of the accounting profession into the drafting of the \textit{Securities Act} was negligible. Accounting literature makes much of an article written by Mr J. M. B. Hoxsey, an employee of the NYSE, published in \textit{The Journal of Accountancy} in October 1930. This article drew attention to the change in the nature of corporations and the need for increased disclosure of information, and appealed to the AIA to co-operate with the NYSE to provide shareholders with the information they required “... to determine the true value of their investments” (Hoxsey, 1930, p. 252). However, even though it did result in the AIA appointing a committee to liaise with the NYSE on the issues, its impact must have been negligible because, as Carey (1969) reports, the introduction of the securities bill in 1933 came as something of a surprise to the accounting profession. Even though they had entered into discussions with the NYSE, they had no policy or strategy for dealing with the issue, no constructive proposals for inclusion in the legislation, and, as a result, they had no hand in drafting of the \textit{Securities Act}. At this stage, discussions with the NYSE were in midstream and it was only when they received word that the legislation was to be introduced, did the AIA create a committee to deal with it and arrange for Judge Covington in Washington to watch over the bills as they were introduced (Carey, 1969). In fact, Carey (1969) tells us that the AIA was so ill-prepared for the legislation that, probably on the advice of Judge Covington, it did not appear formally at the hearings on the securities legislation.}

The securities legislation was presented by the government with much fanfare as being in the public interest by satisfying the demands of the American public for increased corporate accountability. Even though there was very little evidence to support the claim, it was also seen as the means of remedying the perceived market failure arising from the lack of adequate corporate disclosure that led to the stock market crash of 1929.

Considerable scepticism, however, surrounds the motives of the government in the passing of this legislation. Was the emphasis of the securities legislation on the full disclosure of information an attempt to rectify the shortcomings of corporate law? Or was it nothing more than a cleverly designed ploy to place importance on investor needs to satisfy the public interest political platform of the day?

This scepticism is reflected by the arguments put forward by Watts and Zimmerman (1979) that the introduction and passing of the securities legislation was purely political in nature because it was based on self-interest. It, therefore, had little or nothing to do with safeguarding shareholder interests.

After a thorough analysis of the position, Watts and Zimmerman (1979) concluded that the securities legislation followed the “justification demand” or “public interest” pattern of regulating activities in society. This is merely a means of facilitating wealth transfers like the raising of taxes and the levying of tariffs and, to justify this regulation, politicians and bureaucrats claim that it is in the public interest, or that everyone is made better off, or that the action is fair. This justification is then used to buttress preconceived notions and, because the process is political in nature, there are numerous vested interests. As a result, those who propose regulation tend to seek out those persons who support their position. Once supported, direct or indirect government intervention follows in the form of regulation on the grounds that this is necessary to rectify perceived market failure. This regulation also creates a demand for normative accounting theories to support those accounting requirements that are supposed to lead to better decisions by investors and more efficient capital markets. The issue of safeguarding of shareholder interests through regulation is, therefore, purely co-incidental.

Evidence tends to support the views of Watts and Zimmerman (1979) because, despite widespread expectations, the securities legislation did not lead to adequate control over, and accountability, by management. The \textit{Securities Act} only covered the issue of new securities and did not follow Berle’s (1931) suggestion that corporate management should be required to act in a fiduciary capacity towards shareholders. The stated reason was that it would be too difficult for the courts to apply in practice and the alternative solution of attempting to increase stockholder democracy held far greater appeal (Hessen, 1983). This also fitted the government’s position that it was in the public interest because, if as Berle had claimed, corporate management was promoting its own interests, the solution was to encourage shareholders to play a more active role in nominating...
and electing directors who would influence the selection of the officers to run the corporations (Hessen, 1983). However, the attempt to increase stockholder democracy was not successful. Shareholder apathy and the solicitation of proxy votes still allowed directors to be elected by relatively few shareholders and the control of public corporations tended to remain in the hands of a select few.

The delegation of responsibility for regulating financial reporting to the SEC also enjoyed considerable acceptance in governmental circles. Ferdinand Pecora had been in favour of such a move (The New York Times, 4 February 1934) and all three members of Roosevelt’s “brains trust” (i.e. Berle, Moley and Tugwell) actively supported an increased role for the federal government in managing the economy (Parrish, 1982). It also fitted the government’s policies towards the business community because, as this community could do little to further the government’s social reforms at that time, it was necessary to regulate them so that they would act in the manner envisaged by the government (Jacoby, 1973).

This regulation, however, failed to ensure that the basic philosophy of the “publicizing” of corporate affairs occurred because financial reporting by corporations in the U.S.A. remained largely unregulated until the mid-1960s. The Securities Exchange Act, which was supposed to rectify this position, did not require corporations to use the same reporting requirements in reports to shareholders as it did in filings with the SEC. This only took place when the SEC extended its authority to cover the annual reports to shareholders following the failure of the Atlantic Research Corporation of America to report a large loss in its 1968 annual report to shareholders although it had been reported in its filings with the SEC (Benston, 1976).

In reviewing the situation many years later, Dodd (1941) conceded that the securities legislation of 1933–1934 did provide a system of legislative and administrative checks on corporate management even though these were considerably different from those envisaged by him. But, as far as Berle (1967) was concerned, the Securities Act did not go far enough because there was nothing in the Act that would have prevented the abuses of corporate powers that had led to his debate with Dodd. In fact, in re-examining the situation years later, he observed that other than the prohibiting of speculative activities by management, the securities legislation had “…essentially little to do with the conduct of the corporation’s affairs beyond requiring regular publication of information considered accurate by accounting standards …” (Berle, 1967, p. xxi).

Once in place, however, the securities legislation had far-reaching consequences for financial reporting. First, as documented by Watts and Zimmerman (1979), the emphasis on the “publicizing” of corporate activities through the full disclosure of information changed the way in which the objectives of accounting were viewed and, second, it stimulated the search for accounting principles.

In quoting from the objectives of accounting listed by American Accounting Association in A Statement of Basic Accounting Theory (1966), and the writings of Zeff (1972) and Horngren (1973) that detail the influence of the SEC in determining accounting standards for corporate disclosure, Watts and Zimmerman (1979) contend that the citing of the “public interest” caused the objective of accounting to shift away from the accountability or stewardship role to what is now referred to as the “information” or “decision usefulness” objective of accounting. To support their argument, they quote from Hendriksen (1977, p. 54) who stated that since the passing of the securities legislation, the objective of accounting had changed “…from presenting financial information to management and creditors to that of providing financial information to investors and stockholders.”

This situation is evidenced by the flurry of activity by the American Institute of Accounts in revising its reporting philosophy after the passing of the securities legislation. In 1934, following its discussions with the NYSE on the impact of the securities legislation, the AIA (1934) issued Audits of Corporate Accounts that placed the reporting emphasis on the income statement and not the balance sheet. Up until that time, the American corporate reporting philosophy was based on the notion that the objective of the reporting system was to reflect managements’ stewardship over
assets and the corporation’s ability to discharge its debts. The AIA also revised the Verification of Financial Statements in 1936 and re-issued it in a form which emphasized that the reporting system should cater for the needs of shareholders rather than being prepared for credit purposes. It also adopted an income statement emphasis that recognized that it was this statement and not the balance sheet that provided a measure of the firm’s performance and a basis for estimating the firm’s future earnings power.

The emphasis on the full disclosure of information also contributed directly to the development of accounting principles. For example, the “Letter of Invitation” dated 15 July 1935, sent by the Haskins & Sells Foundation to Thomas Henry Sanders of Harvard University, inviting him to chair a committee to accomplish two things. These were, first, to establish a body of principles to standardize the accounting practices considered necessary to satisfy the disclosure requirements of the Securities Act of 1933 and, second, to allow those accountants certifying financial statements filed with the SEC to express an opinion on those statements (Sanders et al., 1938). The resulting work, A Statement of Accounting Principles, is recognized as one of the first major works on the development of accounting principles. However, it was only after the SEC’s call for the adherence to accounting principles having “substantial authoritative support” in their Accounting Series Release No. 4 (Securities and Exchange Commission, 1938) that accounting literature begins to discuss the nature of accounting principles and the development of normative accounting theories to justify them (Watts and Zimmerman, 1979).

4. Concluding comments

The importance of the Berle–Dodd debate is that, despite the fact that it was a legal exchange of views, it drew attention to the purpose of financial reporting and the extent to which, and to whom, corporate management should be held accountable for its actions. Most important was that, even though the parties to the debate differed on the question of “to whom are corporations accountable”, it recognized in the absence of effective stockholder control, the full disclosure of information was the only effective means of ensuring that management would act in the interests of shareholders. This provided the full disclosure philosophy of the U.S. securities legislation and led to the regulation of American financial reporting.

There can be little doubt that the concerns of Berle and Dodd on the lack of corporate accountability were influential in the drafting of the securities legislation and, in particular, Berle’s contention that the only way to control corporate management was to “publicize” their activities. Both Berle and Dodd were both eminent members of the legal community and their concerns on the failure of American corporate law to safeguard the interests of investors had recently been expressed in the debate.

As far as Berle was concerned, he was actively involved in the formulation of government policy as a member of President Roosevelt’s “brain trust” and, in 1932, he had suggested that there should be federal control over security issues (Berle & Faulkner, 1932). His views and those of Gardiner C. Means on the shortcomings of American corporate law had also received considerable attention on the publishing in 1932 of The Modern Corporation and Private Property (Berle & Means, 1932). Furthermore, in 1933, he was appointed by President Roosevelt to the Roper Committee to evaluate the Securities Act of 1933 and propose stock exchange legislation (Berle & Jacobs, 1973). And, by his own acknowledgment, he contributed to the drafting of some of the securities legislation (Berle, undated).

Even though the views of Berle on the full disclosure of information tended to be the main focus of the securities legislation, those of Dodd were equally important in presenting the alternative viewpoint and stressing the need for greater accountability by corporations to society. As the rising star of corporate law at the Harvard Law School (Hessen, 1983), it is unlikely that he would not have been consulted by his colleague Felix Frankfurter on the drafting of the securities legislation. In addition, Dodd’s assertion that the relationship between corporate management and
shareholders was one of agency rather than trusteeship was expressed long before it was recognized by others. The basis of environmental and social responsibility accounting can also be directly linked to his contention that the managers of corporations are primarily fiduciaries for the institution and not necessarily for their members. It is, however, difficult to understand why Dodd's views did not receive the attention they deserved. Perhaps, it was as Littleton (1933, 1934) suggested, the passing of the securities legislation and the subsequent regulation of financial reporting in the U.S. was only part of the second of the three-stage evolution of accounting, falling between its development and the “socialization” of accounting.

Irrespective of the actual direct role of the Berle–Dodd debate on the drafting of the U.S. securities legislation, the basic theme of the need to “publicize” corporate activities through the full disclosure of information had a profound effect on the development of accounting. Up until the debate, accountability by management to shareholders was virtually nonexistent. However, once the need to “publicize” the activities of corporations was recognized and incorporated into the U.S. securities legislation, the emphasis of the reporting changed from meeting the requirements of management to those of satisfying the needs of investors. The income statement replaced the balance sheet as the most important statement. And, as the need to meet these reporting requirements was recognized, it led to the development of accounting standards and the normative accounting theories required to justify their use.

What is clear is that the Berle–Dodd debate marked a major conceptual shift in the entire philosophy of financial reporting. By drawing attention to the lack of accountability by corporate management to shareholders, it led to the recognition that reporting by management on the stewardship over assets was insufficient to meet the informational needs of American investors. And, once the need for the “publicizing” of corporate affairs had been articulated and incorporated into U.S. securities legislation, it made it possible for accountants to recognize the need for, and the development of, a wider informational objective of accounting.

References


