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Fiflis & Kripke: Accounting for Business Lawyers

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BOOK REVIEW

ACCOUNTING FOR BUSINESS LAWYERS. By *Ted J. Fiflis* and *Homer Kripke*. St. Paul, Minn.: West. 1971. Pp. 687. $14.

This book might well be subtitled "What every lawyer should know about accounting but hasn't taken the time to learn." The authors state that their purpose "is not to teach a field of law as such but to teach Accounting and the relationship of law to Accounting" (p. 82). They present an admirable compilation of concepts and problems in modern business accounting to which the lawyer must be privy.

Knowledge of accounting principles and the meaning of accounting terms has always been a useful tool for the business lawyer. Since business is the process of earning money expressed in accounting terms, business transactions and laws applicable thereto necessarily employ accounting terminology. The business lawyer is frequently called upon for counsel and draftsmanship in transactions involving sales or purchases of businesses, contracts to allocate or distribute profits, sales of securities both private and public, financing agreements, and liability for income taxes. Each of these problems and a host of others require the lawyer to understand accounting. The lawyer must be particularly alert to the variations possible in the application of accounting principles. As the authors state, "A newcomer to Accounting who has supposed that it is a precise system will be amazed at how much is unsettled on how to account for financial events" (p. 82).

To most lawyers, the processes of accounting, its language, and the nuances of its principles are a sort of mystical forest, which is the private domain of the accountants. The average lawyer avoids even the outer fringes of that forest for fear of getting hopelessly lost or of being set upon by the accountant denizens resentful of any foreign intruder. To the uninitiated, accounting terminology is indeed a foreign language. Yet it is a language with which the business lawyer must deal. Nothing short of complete familiarity with the language as well as the techniques of the accounting process is adequate for the sound business lawyer. It is important to understand the precise meaning of the accountant's report on the balance sheet and the operating statement of the business that is being bought or sold. Only by understanding the perimeters of the accounting process and its capacity for imprecise limitations can the lawyer adequately protect the interests of his client.

The book is written as a teaching tool in the form of a casebook in some sections and in the form of a hornbook of legal and accounting principles in other sections. It commences with the basic explanations of the double-entry system of bookkeeping and the components of a balance sheet and of an operating statement. The materials presented do not pretend to qualify as a complete course in accounting. Assuming only a minimal knowledge of elementary bookkeeping, however, the materials are sufficient to introduce the student to the basic meaning of an accountant's statement of business operations.

After explaining the fundamentals of the recording processes of accounting, the authors present a myriad of significant problem areas that the businessman is likely to confront in the accounting field. His lawyer likewise must cope with these problems in formulating the business transaction. The nature and breadth of some of these problem areas are discussed below.

I. Reported Profits

"Profits" is a commonly used term in law and business. The value of a business is basically dependent upon its success expressed in terms of profits. Yet, in accounting, profits can be a misleading measure, for the term encompasses many variables that do not appear on the face of the accountant's statement. For example, profits may be reported either on an accrual basis or on a cash basis. The variance in result can be very significant. Furthermore, whether, when, and how much profit is recorded depend upon many varied and imprecise accounting principles. For instance, the year-end inventory must be valued in order to ascertain the profits for the year. Many methods for valuing the inventory are permissible, including a choice between the first-in, first-out method, and the last-in, first-out method and a choice of including or excluding overhead expenses in the valuation of work in process. The choice of one method of reporting over another can have an important effect on the resulting level of reported profits.

To take another situation, let us assume land was bought at 1,000 dollars an acre and is now worth 2,000 dollars an acre. If it has not yet been sold, presumably no profit has been recorded. But in a realistic sense, the profit is already there. Moreover, suppose the land that was bought for 1,000 dollars an acre is sold for 5,000 dollars an acre under a long-term contract with only five per cent down. The entire profit may be shown as realized in the year of sale or it may be deferred on an installment basis. The profit reported for the year is materially affected by the method of accounting that is used. Yet the method used may not appear on the accountant's report of operations.

It should be noted also that the profits may be affected by the depreciation that has been charged against the current year's operations. The permissible variances in the depreciation rate can alter materially the recorded profits. Likewise, the decision to record an expenditure as a repair rather than as a capital expense can materially affect profits, and it must be understood that there is a wide area of judgment in determining whether to record the expenditure in one form rather than the other. Similarly, an expenditure for advertising may be charged as a current expense or capitalized as a good-will item within a broad range of discretion. A good-will item once recorded can in turn permissibly be amortized over a short or long period with a potentially significant effect on recorded profits.

The establishment and recording of proper reserves is another judgment factor permitted wide latitude. In sales of merchandise on credit, it is common practice to set up a bad-debt reserve. Because this reserve depends on factors of judgment rather than mathematical precision, it may or may not prove to be adequate. Many other varieties of permissible reserves can be established for contingencies. The accountant's report of operations may not always disclose such contingencies or the adequacy of the reserves.

In the event of a merger or acquisition, pooling-of-interest accounting is at times permissible or required. This accounting method enables the use of historical costs of the acquired business rather than cost at time of acquisition, with a resulting effect on profits reported by the combined business. This type of accounting has frequently been used in recent years in the course of acquisitions by conglomerates. The lawyer must understand such accounting to achieve a sound formulation of the transaction.

II. Balance Sheet

The balance sheet purports to list the assets and liabilities of a company. The lawyer must understand that the assets are generally listed in relation to historical cost and not present value. Property carried as an asset at 1 million dollars may conceivably have a present value of anywhere from zero to a figure far in excess of its listed value. For instance, if a company owns a building, that building will appear as an asset at its depreciated cost of 1 million dollars even though it may currently be worth 2 million dollars. On the liability side, a mortgage of 1 million dollars might also be listed; thus, what looks like no asset, based on depreciated cost and offsetting mortgage liability, may in fact be an asset of 1 million dollars. To deal with this type of problem the authors urge the development of accounting principles that would report present values rather than historical cost.

Moreover, significant assets, such as favorable contracts or good will, may not appear on the balance sheet at all. Likewise, the liabilities listed on the balance sheet are not always complete. Many contingent liabilities or agreements for future performance need not appear on the balance sheet. If, for example, a company has entered into a twenty-year lease at 200,000 dollars per year rental, neither the existence of the lease nor the 4 million dollar future rental liability may appear on the balance sheet. The company might also have guaranteed a lease or other indebtedness of its subsidiary which need not be shown on the balance sheet.

Furthermore, the balance sheet may represent only the parent company's assets and liabilities or it may be a consolidated statement of the assets and liabilities of both the parent and all or a portion of its subsidiaries. To refer to a balance sheet without more specific definition is thus to leave open a wide area of uncertainty. The trained business lawyer must ever be aware of such problems.

III. Tax Problems

Income taxes represent such a large factor in the determination of ultimate business profits that every significant business transaction must be approached and formulated with an eye to its tax consequences. In mergers and other acquisitions and dispositions, the tax consequences are often the determinant factor in the feasibility of the transaction. Generally, it is the lawyer rather than the accountant who is initially involved in the structuring of the transaction; but a sound formulation usually requires coordination between the accountant and the lawyer. Both of them must be aware of the applicable tax laws and their relationship to the pertinent accounting principles.

When an income tax liability is asserted by the government, it is the lawyer who must defend his client. To do so effectively, he must usually work with the accountant to apply accurately the tax laws to the transaction that the accountant has recorded on the client's books and to answer the accounting contentions made by the taxing authority.

IV. Sale of Securities

When representing corporations with publicly held securities, the lawyer must work in close tandem with the accountant in preparing a prospectus for sale of securities. The application of variable accounting principles must be understood to describe the company and its securities accurately as part of the disclosure requirements. Hence, the method and degree of disclosure required in a prospectus or in proxy material is often the problem of both the accountant and the lawyer, with each fully conversant with the applicable professional disciplines of the other.

V. Formulation of Accounting Principles

The authors persistently urge that the legal profession must involve itself more closely in the formulation of generally accepted accounting principles to meet the ultimate test of a fair presentation of the business activity. Professor Kripke reiterates his oft-expressed view that "[a]ccounting principle is too important to be left exclusively to accountants. . . . Accountants have claimed the privilege of determining accounting principle with scarcely any consultation with other disciplines which, in my opinion, should be equally entitled to a voice as to how our economic activity is to be symbolized in dollars" (p. 593). The authors urge that not only lawyers, but also businessmen and governmental regulatory agencies, particularly the Securities and Exchange Commission, be involved in the determination of sound accounting principles.

VI. Accountant's Legal Liability

A number of the judicial decisions presented in the book deal with the legal liability of accountants to public-security holders. Recent cases indicate a widening scope of liability for accountants in their certification of financial statements.[1] The long-established concepts of legal liability of accountants were predicated largely on limitation of that liability to persons in privity with the accountants. In practice, this limitation meant that the accountant's liability was restricted to the company that hired him. That liability has now been extended to public-security holders who purchase stock in reliance on the accountant's reports.[2] The duty of accountants was further limited to the presentation of reports in conformance with generally accepted accounting principles. That duty also has been extended in recent years to encompass the principle that the accountant's financial statement should contain such disclosure as "fairly presents" all of the relevant facts.[3]

It may be questioned whether the latest judicial decisions have extended the accountant's liability beyond reasonable limits, although this query is not discussed by the authors. Compliance with generally accepted accounting principles should be all that is required of the accounting profession absent a clear indication that the information so provided does not "fairly present" an adequate explanation of the facts. If the test of the accountant's liability is to

1. Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y 1968). *See also* cases cited in notes 2 & 3 *infra.*

2. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

3. United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970).

include the duty that it "fairly present" the facts, such liability should not be imposed unless it is perfectly clear that additional information was requisite to discharge the duty of fair presentation. To limit the scope of the legal liability of the accountant in this manner seems entirely warranted in view of the right of the accounting profession, like all other honorable professions, to be free of liability when performing in accordance with the accepted standards of the profession.

VII. Summary

As recently stated by Professor Kripke, "modern accounting has become increasingly complex."[4] Responding to this development, the authors have rendered an invaluable service to the legal profession by presenting a fine teaching tool for accounting problems with which the business lawyer must be conversant. This book should be required reading not only for students but for practicing business lawyers as well. Indeed, some of the problems presented in the book seem somewhat involved and abstruse for adequate understanding by the novice law student; but the book serves as an invaluable source for the business lawyer who must increasingly learn to cope with accounting problems. The authors are to be commended for a notable contribution to a field that requires far more attention from the legal profession than it has received in the past.

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4. Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. Rev. 1151 (1970).