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COMMENTARY

THOUGHTS EVOKED BY "ACCOUNTING AND THE NEW CORPORATE LAW"*

TED J. FIFLIS**

A. INTRODUCTION

Imagine that I.M. Counsel, the outside general counsel of Microscript, Inc., a manufacturer of computer hard disk drives, has just reviewed the draft of the current Annual Report to Shareholders, which includes income statements reporting a third consecutive year of net income increases of 20-25% over each prior year. As she flips through the other financials I.M. also notes three consecutive years of positive cash flows. She pulls her feet down from the top of her heavy walnut desk and spins in her chair, brushing the top of the lush carpet. "Fantastic!" She is jubilant. She congratulates herself again on having landed her firm's largest and most profitable client.

The coup of securing Microscript as a client occurred a little over three years ago and resulted from Counsel's very skillful representation of Venture Funds, Inc. in a friendly takeover of Microscript. Venture had rescued Microscript from a working capital squeeze with a $20 million capital infusion and obtained a voting arrangement and convertible preferred with rights to 20% of the common stock, sufficient to gain control. Venture Funds also immediately had ensconced Quentin Fixx, a turnaround specialist, as Chief Executive Officer, who appointed Malcolm Bath as Chief Financial Officer. Both men were also principals in Venture Funds. Together, they quickly cut asset carrying values in half, substantially reduced and reorganized the administrative and accounting staffs, and put the fear of God into division managers. Fixx had reversed a rather laid-back culture at Microscript and let the managers know that it would take a 25% annual growth in their divisional earnings to support their bonuses and perquisites and, in addition, lacking that growth, there was reason to fear dismissal for failure. Fixx replaced the former auditors at the same time.

Finally Counsel's years of hard work were paying off; last year's billings by Counsel for legal work had exceeded $2 million, although payments were regularly many months late.

Counsel turns to her calendar to snatch a few moments to fantasize about her well-deserved trek in Nepal next month. She brings out her checkbook to write the $15,000 nonrefundable check to her travel agent. Just then, the telephone rings and Penrod Whistleblower, an assistant to

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* This article was prompted by a reading of the manuscript by Joel Seligman, *Accounting and the New Corporate Law*, 50 WASH. & LEE L. REV. 943 (1993).

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the Microscript controller, in a hauntingly despairing voice asks to see her right away. He mentions "cooked books," fear of wiretapping, and that it will take him an hour to get to Counsel's office.

Counsel soberly returns her unopened checkbook to her briefcase and calls in a young new associate, Bobbie Catchett, who is known to have a good knowledge of accounting issues. When Counsel tells Catchett that she may want Catchett to sit in on the meeting with Whistleblower, Catchett's eyes begin to shine with excitement. Counsel notices her own involuntary sensation of mild disapproval, but nevertheless relates the Microscript data.

Catchett, on hearing all, breathes out a subdued "Wow," and impulsively tells Counsel that based on what she had learned in her law school accounting course she would have suspected income manipulation two years earlier.[1] Catchett suggests that because Counsel may have been on notice of the fraud, she may wish to consider whether she might have an ethical problem in interviewing Whistleblower, who may become a codefendant with her in criminal, civil, or administrative proceedings. Catchett also relates that innocent directors and managers may have been negligent in failing to see the red flags suggesting possible fraud.

At this point, Counsel decides that she certainly does dislike Catchett, but dismisses the suggestion concerning criminal implication as an inexperienced indiscretion.

Counsel narrows her eyes slightly and informs Catchett that the audited financial statements show high profits and cash flows. In response Catchett reviews the comparative cash flow statement in the draft Report and points out that it shows the operating cash flow has been negative for at least two years and that only the sale and leaseback of the firm's factory buildings made overall cash flow positive. She also observes that the sale and leaseback were with another client of Venture Funds and although this was disclosed, it may raise a problem because related parties' transactions do not have the protections of arm's-length deals.[2]

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1. Catchett may have been recollecting the class discussion of the REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987), chaired by former SEC Commissioner James C. Treadway, Jr. [hereinafter TREADWAY COMMISSION REPORT]. Included in that report, at 125 app. E, is a Harvard Business School case study in cooked books which bears a remarkable resemblance to the details of the Miniscribe case, on which the Microscript hypothetical is based. Connolly v. Hambrecht & Quist Group, Civ. No. 91-M-170 (D. Colo. Jan. 17, 1991). Even more remarkably, the Miniscribe case did not arise until three years after the preparation of the case study. This suggests that the Miniscribe-type measures are well known to managers bent on fraud and that knowledgeable counsel would be able to recognize the use of these measures and be alerted to what they portend. For some of the interesting facts of Miniscribe, see Lee Berton, *How Miniscribe Got Its Auditors' Blessing on Questionable Sales*, WALL ST. J., May 14, 1992, at A1.

References here and in later portions of this paper to the Miniscribe case are largely based on personal knowledge because the author was a consultant to the Special Committee of the board of directors and thereafter to the trustee in bankruptcy.

2. See TED J. FIFLIS, ACCOUNTING ISSUES FOR LAWYERS 142-44 (1991); ACCOUNTING FOR LEASES, Statement of Financial Accounting Standards No. 13 (Fin. Accounting Standards Bd. 1990) (concerning sales and leasebacks between related parties).

As to the impressive earnings, Catchett notes that balances of inventories had increased in extraordinary amounts relative to sales over the prior year's levels for each of the last two years. She relates that inflation of inventory, especially after the establishment of large reserves and when early obsolescence is endemic, is a common fraudulent device and that if the figures were false, earnings before taxes would be false on a dollar for dollar basis.[3] She further suggests that the auditors should have been put on notice of the need to look more closely by the standard "analytical review" whereby they calculate inventory turnover rates.[4]

While the two of them wait for Whistleblower, Catchett explains that turnaround specialists almost always take "big bath" write-offs at the outset of a job to (a) reduce future costs of goods sold, depreciation, and amortization charges[5] and (b) establish reserves that may be raised or lowered to facilitate upward smoothing of the earnings trend.[6] Catchett also tells Counsel that excessive write-downs may violate Securities Exchange Commission (SEC) accounting requirements.[7] Further, Catchett relates that shuffling the accounting staff is a way of diminishing internal controls[8] and that the change of auditors is troublesome despite Counsel's assurance that the Form 8-K SEC filing disclosing the change indicated it was "by mutual agreement" only.[9] Catchett states that a high pressure "tone at the top" involving incentive compensation keyed to earnings targets with personal sanctions for failure to meet those targets commonly motivates executives to "cook the books" and that weak internal controls facilitate such fraud.[10] In response to Counsel's protestations that the auditors stated few defects in controls in their management letter,[11] Catchett says that the auditors have

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3. *See* FIFLIS, *supra* note 2, at 215-20.

4. *See id.* at 216 (prob. 4-1), 682-83.

5. *See id.* at 286-87. At this writing IBM's new CEO has just announced an $8.9 billion charge for costs associated with a planned, but not yet executed, reduction in the work force resulting in a quarterly loss of $8.04 billion. *See* Laurie Hays, *IBM Posts $8.04 Billion 2nd Period Loss*, WALL ST. J., July 28, 1993, at A3.

6. Write-downs are highly discretionary in both timing and amount, so abuses are frequent. *See* FIFLIS, *supra* note 2, at 287:

> On this question, a major abuse is the "big bath" write-off. The concern of the SEC has been with excessive write-downs which would have the effect of improperly increasing future reported profits because of lower depreciation charges in the future years. As a result, as noted previously, the Commission's accounting staff places a maximum limit on the write-down to the discounted expected net cash flow. The minimum write-down the Commission believes should be to *un*discounted expected net cash flow. This is a very broad range for any long-lived asset.

7. *Id.* at 286-87.

8. The belief that this occurred in Miniscribe was a substantial basis for the claims against auditors and management.

9. A change of auditors must be disclosed to the Securities Exchange Commission (SEC) within five days on Form 8-K. 17 C.F.R. § 240.13a-11(a), -.15d-11 (1985); Form 8-K, item 4; 17 C.F.R. § 229.304 (1986).

10. TREADWAY COMMISSION REPORT, *supra* note 1, at 11.

11. Auditors have customarily reported to management their suggestions for improving

a limited duty to find the weaknesses and may have only a duty to report them orally.[12] Counsel is aware that these venture funds usually aim at cashing out after five years with at least 20% compound annual returns—a fact which emphasizes the funds' interest in short-term performance.

Whistleblower arrives with documentation and spends three hours detailing a massive inventory fraud, proving Catchett's worst suspicions. Furthermore, it appears that top management is heavily involved.

Catchett is distressed at the likely involvement of management—it may preclude Microscript from recovering against its auditors for their failure to detect the fraud. She cites the *Cenco* case, but states that subtle nuances in the facts may preserve the action.[13]

If Counsel had had Catchett's knowledge of accounting, as Catchett initially implied, Counsel presumably would have been put on notice some time ago of what Catchett suspected immediately. Two questions now come to mind and are addressed here: Would it be reasonable to expect that Counsel, as corporate counsel, should have had these accounting skills? And, should law schools at least offer an elective curriculum that would provide the basis for these accounting skills?

B. Seligman's "Accounting and the New Corporate Law"— Is It Enough?

In his article, *Accounting and the New Corporate Law*,[14] Joel Seligman does not address these questions but does make clear that for purposes of proper governance, corporate managers and directors rely on managerial accounting, with its emphasis on internal controls and planning—functions that are essential to the fulfillment of their duty of care. ("Control" includes monitoring the use of resources to assure that management's directions are observed. It also encompasses operating and monitoring record-keeping processes to assure their integrity. "Planning" involves such matters as budgets, logistics, pricing, compensation, and strategic decision-making about production, marketing, financing, and investments.) Seligman then urges teachers in the corporations course to focus on accounting (managerial accounting, in fact) in discussion of the duty of care of directors and managers.

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internal controls in a memorandum known as a "management letter." *Internal Control Related Communications*, Statement on Auditing Standards No. 60 (Am. Inst. of Certified Pub. Accountants 1988), greatly expanded auditors' responsibilities to report these. *See* Fiflis, *supra* note 2, at 692-94.

12. Fiflis, *supra* note 2, at 118-19, 692-94.

13. *See id.* at 224 (note 4-4); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1987) (holding that company damaged by its top management acting to defraud investors and creditors may not recover for negligence or breach of contract in action against auditors). In Miniscribe, *Cenco* was strongly urged as controlling, but in the end the auditors settled for $95 million because of distinguishing features.

14. Joel Seligman, *Accounting and the New Corporate Law*, 50 Wash. & Lee L. Rev. 943 (1993).

Practitioners, understandably, were ahead of academics in recognizing the importance of concepts of managerial accounting to corporate governance. This is evidenced in a statement made a decade ago by former SEC Commissioner James Treadway, also a lawyer:

> I would characterize corporate governance as an approach to management of a public company which has as its essential premise the idea that the corporation should institute and enforce adequate controls and procedures to assure that the corporation is operated solely for the benefit of stockholders. Sound corporate governance requires a structure and procedures which will preclude undesirable activity prior to its occurrence or, if it does not preclude it, will detect and remedy it with promptness. More specifically, corporate governance means oversight of management by an active and questioning Board of Directors and the use of whatever other mechanisms of oversight, reporting and review—such as independent Audit and other Committees at the Board of Directors' level and appropriate counterparts at other levels within the corporation—as are necessary to assure that corporate managers at all levels are properly sensitive to and discharge their paramount duty to stockholders.[15]

Similarly, Seligman suggests that a corporations teacher who fails to integrate accounting concepts in the duty of care portion of the course is remiss. I strongly agree, and would like to illustrate the facility with which an instructor can accomplish this goal using the existing casebooks.

In many corporations casebooks, one of the three or four duty of care cases is *Bates v. Dresser*,[16] with its classic opinion by Justice Holmes. Like Molière's *bourgeois gentilhomme*, who was surprised to learn that he had been speaking prose for over forty years, many corporations teachers may be surprised to learn that in addressing the duty of care through *Bates* they have been teaching the adequacy of internal accounting controls.

The facts in *Bates* were that the bookkeeper for a bank, Coleman, opened an account in the bank and then was allowed to receive from the clearinghouse all checks drawn on the bank. He would then negotiate but not charge his own checks against his account but would either charge them against other customers' accounts or decrease the credits for deposits of other customers. The result was an understatement of liabilities to other customers and an overstatement of the liability to Coleman.

"T" accounts may be used to illustrate each of Coleman's techniques. Here we are aided by the fact that most students understand what is meant when a bank "credits" one's account. For example, to illustrate undercrediting other customers' accounts, assume that before the fraud Coleman's

15. James C. Treadway, Remarks to American Soc. of Corp. Secretaries, Inc. (Apr. 13, 1983), *in* FIFLIS, *supra* note 2, at 623-24. The accounting profession's most controversial debate today is over the role of auditors with respect to internal controls. *See* Thomas P. Kelley, *The COSO Report: Challenge and Counterchallenge*, J. ACCT., Feb. 1993, at 10.

16. 251 U.S. 524 (1920).

balance is $100 and those of all other depositors aggregate $1000. In executing the fraud, Coleman negotiates a check for $50. In addition, other customers deposit $100. Coleman's fraudulent failure to debit his own account and under-crediting of other accounts for only $50 would appear as follows:

Coleman Account		
	Opening balance	$100

Other Customers' Accounts		
	Opening balances	$1000
	New deposits	50
	New balance	$1050

The nonfraudulent accounting would have been:

Coleman Account		
Payment $50	Opening balance	$100
	New balance	$ 50

Other Customers' Accounts		
	Opening balances	$1000
	New deposits	100
	New balance	$1100

The fraud was to understate both payments and deposits, so that Coleman's account was over-credited and other customers' accounts were under-credited.

Adequate controls to defeat this scheme, mentioned in the opinion, would have been:

(a) for the cashier to receive the checks from the clearinghouse and compile their amounts for comparison with Coleman's debits to depositors' accounts;
(b) for the cashier to compare the total of deposits received by the bank with the total deposits credited by Coleman; or
(c) for an internal or external auditor to confirm with each depositor the amounts shown in the depositors' accounts. (Here Justice Holmes thought that might be done by calling in the passbooks, but that was unnecessary.[17])

Justice Holmes pointed out that any of these measures would have exposed the fraud. However, finding that this kind of fraud was theretofore unknown and the controls therefore not required by common experience, he upheld the finding of due care by the directors.

In my corporations course I analyze *Bates* as above to describe the concept of internal controls, and point out that modern standards would

17. Coleman's alternative technique, charging (debiting) payments for his checks to other customers' accounts, would not result in under- or overstatement of aggregate payments or deposits.

Nevertheless the confirmation device, (c), would work to expose the fraud. Other control devices for this technique would include such measures as having the cashier compile the checks drawn on individual accounts and reconcile his or her figures with the bookkeeper's individual account balances as recorded.

have required at least procedure (c), and probably all three. I also use it to point out that if the bank were subject to the 1934 Securities Exchange Act reporting requirements, the question would be whether the controls were "sufficient" under section 13(b)(2) of the Act, which establishes a federal minimum standard of care.[18]

Many other cases found in the casebooks further bear out the thesis that the duty of care largely involves internal controls. For example, *Joy v. North*[19] involved numerous defective controls: the audit committee was not composed of independent directors but included the CEO; it kept incomplete minutes; the CEO was domineering and dismissed unsubmissive subordinates; he distributed no materials or agendas at board meetings, and left requests for long range planning documents unanswered. In addition, the company, a bank, had inadequate procedures for obtaining appraisals and feasibility studies for a real estate loan exceeding the legal limit of 10% of its capital, which was the cause of the loss in that case.

Still another classic, usually found in the casebooks, is *Francis v. United Jersey Bank*,[20] in which there were inadequate controls on cash disbursements.

A fourth is a Rule 10b-5 case, *Ernst & Ernst v. Hochfelder*.[21] The "mail rule" employed by the company in that case, prohibiting employees from opening mail addressed to Mr. Nay, involved an internal control which was arguably defective.

Bringing internal controls to the forefront in discussing the duty of care, as Seligman demonstrates, is enlightening for students. Among other effects, it forms a basis for suggesting that in cases like *Bates* the courts today may well believe that the standard of care for directors would not be deemed to have been met—which in effect is what the more modern cases of *Joy* and *Francis* hold.

This treatment also raises the question of how modern auditing practices concerning internal controls might impact the business judgment rule. In *Bates*, the officers did nothing when apprised of the cash shortages. This nonfeasance might not invoke the business judgment rule since no exercise of a judgment occurred. But if the now customary auditor's management letter had specified the weaknesses in control and the audit committee had decided to do nothing about them, the rule presumably would apply because a "judgment" would have been made. The facts in *Bates* permit a fruitful discussion of whether this decision to do nothing would satisfy the require-

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18. 15 U.S.C. § 78m. The record-keeping and internal control provisions of § 13(b)(2) are perhaps the single greatest federal intrusion into corporate governance, establishing civil and criminal responsibility. *Cf.* William Cary, *Federalism in Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

19. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

20. 432 A.2d 814 (N.J. 1981).

21. 425 U.S. 185 (1976).

ment of the rule that the directors must rationally believe that a decision is in the best interests of the corporation.[22]

Doubtless Professor Seligman would applaud this kind of attention to accounting concepts as precisely the type of approach which he suggests in his article for teaching the duty of care cases.

However, the above treatment of *Bates v. Dresser* alone would take up at least one class hour, of perhaps three hours that typically are allocated to covering all aspects of the duty of care. Is the one-hour discussion of *Bates* enough to convey a sufficient knowledge of accounting? Clearly not. Students will not even adequately understand the function of internal accounting controls or an audit from this illustration. Nor will an understanding of the internal control requirements of § 13(b)(2) be obtained. At most it sensitizes them to the importance of this realm. And there is much more accounting beyond internal controls that is important to lawyers. For example, even if treated to the above analysis of *Bates v. Dresser*, I.M. Counsel in the Microscript hypothetical above would not have been prepared to perceive most of the red flags which Bobbie Catchett saw.

Professor Seligman does not purport to say that one can provide lawyers with all they need to know about accounting by teaching the duty of care cases. What he does do very effectively is to illustrate how accounting knowledge can be extraordinarily enlightening in a single corner of the law. I am prompted to suggest here that just as law students can benefit greatly from this interdisciplinary knowledge when considering directors' and officers' duty of care, they may profit equally in innumerable other areas of the law from further exposure to accounting concepts.

C. Should Law Schools Undertake to Supply to Law Students Some Degree of Expertise in Accounting Issues?

1. *Accounting Skills Benefit Many Areas of Law Practice.*

Seligman has demonstrated that lawyers can be greatly enlightened about the duty of care by an awareness of internal controls; so too can they be assisted in an extraordinary variety of practice problems by other accounting concepts.

For example, accounting issues predominate in many damages suits. In one mammoth case with which I am familiar, alleging injuries to over 6,000 individuals from exposure to asbestos fibers, the issues for punitive damages purposes include calculation of profits on the asbestos product when the manufacturer also produces other related products. To make the calculation, one must consider "joint costing"—how a firm allocates to its various products the joint production costs of its manufacturing operations. In

22. See Principles of Corporate Governance § 4.01 (Proposed Final Draft 1992) for one statement of the elements of the business judgment rule.

addition, the defendant corporation's equity is negative as the result of a recapitalization that included a huge cash dividend. The defendant is intimating pauperism as evidenced by this "deficit." An explanation of how Generally Accepted Accounting Principles (GAAP) are based on historical cost, not fair market values, will be useful to the jury in understanding the true meaning of this "deficit," *i.e.*, that in fact no deficit exists when fair market values are used in lieu of historical costs. The coverage of both these issues is standard in a course on accounting for lawyers.[23]

Further, a law school course in accounting clearly is essential for a minimal understanding of disclosure issues in securities law. To illustrate, the Management's Discussion and Analysis[24] required in most disclosure filings with the Securities and Exchange Commission[25] is the disclosure item of primary concern to the SEC and the securities law plaintiffs' bar. It therefore is standard practice now (a change from a few years ago) for corporate counsel to be intimately involved in its drafting, along with the chief financial officer, other top managers, and the auditors. The Management's Discussion and Analysis is an accounting and financial disclosure matter that provides a sophisticated analysis of the meaning behind the financial statements.[26] Only a thorough grounding in financial statement analysis can equip a lawyer to perform this task adequately.

Indeed, it is generally acknowledged that accounting is at the heart of the entire securities law disclosure system. As a result, securities lawyers must acquire substantial accounting expertise.

The same is true for tax lawyers, and I suspect most bankruptcy lawyers would echo this view. Even domestic relations matters often involve accounting issues in property settlements. In fact, my experience is that business law enters into the work of most lawyers, and knowledge of accounting will be useful in virtually every type of practice.

2. *The Preservation of the Roles of Lawyers as Advisers to Management May Depend on Lawyers Having Accounting Skills.*

Lawyers as a group also have a pecuniary reason for having accounting expertise. E. L. Kitrell Smith, a corporate executive and turnaround specialist who is also a lawyer and a Certified Public Accountant, in 1992 conducted a survey of the teaching of accounting in law schools. In a letter to the author dated June 15, 1993, he states:

> We, the legal profession, are in competition with the accounting profession. We compete for our joint client's confidence so that

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23. *See* FIFLIS, *supra* note 2, at 125-54, 224-25, 248-54.

24. Regulation S-K, 17 C.F.R. § 229.303 (1982).

25. See, for example, registration statements (*e.g.*, Form S-1, item 11(h)), and proxy disclosures in annual reports to shareholders. 17 C.F.R. § 240.14(a)1 to -3(b)(5)(ii) (1992).

26. *See* FIFLIS, *supra* note 2, at 517-23.

> the referral of business matters will be addressed to our attention. Well, our profession is losing that competitive race. One-fourth of the CPA exam is devoted to an understanding of our profession, and yet we persistently deny that we need to know anything about them. My goodness! That's a very short sighted approach to the protection of our profession. As confirmation of the fact that accountants are winning the race, just look at the new branch of accounting "management advisory services". That new approach to the client by accountants may have started as offering computer expertise and incorporating audit procedures in the computer programs of clients, but the services offered have extended far beyond this original concept. I ought to know, for as a business man I will call my accountants at least ten times more frequently than my lawyers.[27]

3. *Nevertheless the Law Schools Are Generally Uninterested in Offering an Appropriate Accounting Course.*

Despite the apparent benefit to lawyers, the law schools, with less than a handful of exceptions, ignore teaching accounting skills. Smith further stated in his letter:

> You will recall that one of the questions in the survey was whether the particular school being surveyed participated in a joint degree program wherein a student could receive an MBA as well as a JD degree. In those instances where such degrees were offered, the respondents indicated that the teaching of accounting theory was left to the "other side," the MBA program, and the student receiving the joint degree might or might not have taken an accounting curriculum. Joint curriculums were offered in approximately 50% of the schools responding. . . .
>
> In those schools not having a joint degree program, there was little, if any, interest expressed in the teaching of accounting theory to law students. Basically the schools took the position that such theory was learned in an undergraduate curriculum and was not a proper subject for the law school to teach. If it was taught, and less than 5% of the schools responding taught the subject, it was covered in a two hour course or combined with other fundamental courses offered through the law school as subject matter to which the law student should have "some exposure". Any such courses offered were being taught by professors with law degrees, but without any required expertise in accounting.

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27. Letter from E. L. Kitrell Smith to Ted J. Fiflis (June 15, 1993) (on file with author). In England, accountants, not lawyers, for many years have been the primary advisors in sophisticated business transactions.

> . . . Other schools, but still in the 5%, responded favorably to the survey, but their programs were either in their infancy or were desired objectives to be presented to faculty planning meetings in the fall.
>
> After reviewing all survey results, I concluded that law schools generally were uninterested in the subject matter of accounting or had abdicated responsibility for the teaching of the subject matter to their counterparts within an MBA program. . . .[28]

4. *Why Aren't Law Schools Offering an Adequate Accounting Course?*

If lawyers can provide very substantial benefits to their clients from accounting skills, why is it, as Smith has found, that the law schools largely are uninterested in offering the course? Is the simple explanation offered to Smith by those schools a satisfactory one—that law students should learn their accounting as undergraduates or in MBA programs? Here Smith offers his own opinion:

> To say that the law student is exposed to the subject matter through the undergraduate curriculum is to hide one's eyes to the obvious, that students are in law school because they hate "math", can't add, and want nothing to do with numbers. To say that the MBA curriculum covers such subjects also misses the mark. It's very possible to receive an MBA degree with little, if any, accounting exposure. And so, we persist in turning out "business lawyers" who don't understand the language of business. . . .[29]

One may add that a comprehensive one-semester course covering internal controls, cost accounting, recognition of revenues and the myriad other accounting issues of great relevance to lawyers described in Part D below simply is not offered in the undergraduate or MBA programs.

Nor are most accountants or business school accounting instructors equipped to teach a course for lawyers. Selecting out the matters relevant to lawyers demands expertise not only in accounting but also in law. Only a course designed by and for lawyers can provide them what they need.

In my experience, there are a number of other elements at work here to explain the apparent lack of enthusiasm for such a course offering:

> (a) First, few law teachers are skilled in accounting;
>
> (b) Many of the few who are skilled have no interest in teaching the accounting course. This may be due to a teacher's natural hesitancy to offer a course in the face of student antagonism toward "hard" courses or courses they believe (mistakenly) to be less than

28. *Id.*
29. *Id.*

intellectually challenging. It is my belief that it may also be due in part to many teachers' own failure to appreciate the challenges and value of the course;
(c) Perhaps the overarching reason for the limited inclusion of an accounting course in the law schools is that it may be the quintessential victim of the current antipractical mind-set that is now affecting legal education.[30] In an age when teaching *any* legal doctrine is attacked by numerous academics,[31] there is even greater opposition to the much misunderstood accounting course.

5. *Accounting Is Too Important to be Left to the Accountants.*

For me the solution has been to try to understand the profound importance of accounting to society, and then to attempt to convey that understanding to students.

For example, accounting practices have a great impact on the distribution of wealth in this country in numerous ways. One of these is the income tax laws' use of the realization convention for recognizing taxable income. If unrealized appreciation in the value of securities and other properties were taxed, instead of taxing it only when realized by sale, and then only if sale is before the owner's death, the tax rates could be substantially reduced on earned income.[32] This is an obvious subsidy to property owners by those who earn their income through salaries or wages.

Another mode of wealth redistribution occurs from the accounting principle calling for regulated entities to "normalize" tax expense for purposes of ratemaking. The result is to force ratepayers to pay billions of dollars to utility companies to cover "taxes" that the companies need never pay. This obviously shifts wealth to corporate constituents other than the ratepayers. The explanation is too lengthy and technical to merit coverage here, but it is, again, part of a law school accounting course.[33]

Other illustrations abound.

In addition to wealth distribution effects, accounting also affects the allocation of productive resources. An important current illustration is the proposal to require for tax purposes amortization of intangible costs, including goodwill, over a period of fourteen years. Many "high tech" companies whose research and development has a much shorter useful life will incur a substantial tax increase if the fourteen-year period is adopted. This will cut profits and therefore decrease investors' interest in those

30. *See, e.g.*, Harry T. Edwards, *The Growing Disjunction Between Legal Education and the Legal Profession*, 91 MICH. L. REV. 34 (1992).

31. One is reminded of the incident upon the occasion of the retirement of one of the giants of the Harvard Law School when an earnest young faculty member asked the retiree if he regretted having wasted his life in writing and teaching doctrine.

32. *See* FIFLIS, *supra* note 2, at 124.

33. *See id.* at 274-80.

companies. On the other hand, those same investors may rush to buy some of the firms which are now bloated with the goodwill acquired in prior merger binges that has not until now been tax-deductible. Thus an investor might sell his computer software company shares and buy RJR-Nabisco, thereby voting to produce more crackers and less software.

Not only do accounting treatments affect wealth redistribution and productive resource allocation, but they also affect risks of one socioeconomic group vis-à-vis another. The savings and loan debacle is the most dramatic illustration. Because of regulatory and disclosure accounting choices in the 1980s, $250-$500 billion in losses have been shifted from insured depositors to taxpayers.[34]

Wider recognition of the impact that accounting has on all of us would doubtless engender more intellectual interest on the part of students and would help attract more highly qualified teachers.

D. The Appropriate Content of a Course in Accounting Issues for Lawyers

What should be the content of this amazingly fascinating course for lawyers?

1. The Double Entry Bookkeeping System

The first question is whether it is necessary to teach a student the double entry bookkeeping system—how basic financial statements are developed from the myriad activities of a business and how the statements articulate. By beginning with the common sense proposition that a business's assets less its liabilities must always equal its net worth, students learn that every transaction has two aspects. For example, if an asset is added to a business, thereby increasing that factor of the equation, either some other asset will be subtracted (such as cash used to pay for the acquisition), or some liability (such as accounts payable) or net worth account will be increased. The recording of these two aspects is double entry bookkeeping. Everything else in accounting derives from this beginning—it is the big bang of accounting.

For example, from this, students perceive that the financial statements "articulate." By articulation, accountants mean that the statements (such as the balance sheet, cash flow and income statements) directly correlate. Thus one may derive income and cash flow for a period by comparing certain elements of the balance sheet accounts (or their underlying ledger accounts) at the beginning and end of that period. To illustrate, income (or loss) is the difference between balance sheet equity at the end and the beginning of a period.

34. *See id.* at 136, 149-52, 317-18.

Skilled accountants, because they understand this articulation, also understand how recognition of an item or a change in the measurement of a particular account affects the other financial statements. This facility is also useful for lawyers. Thus, for example, a lawyer can get a better grasp on inventory fraud by realizing that for every dollar by which inventory is overstated, net income before taxes is overstated.[35] He or she will also know that net income after taxes may or may not be affected identically.[36]

By way of further example, a lawyer advising in a merger or acquisition transaction, if familiar with bookkeeping, will understand why "purchase" accounting, which results in booking a fair market valuation for acquired assets, including the newly acquired goodwill, will result in reported income that is usually less than the aggregate of what the two firms' income would have been without the combination.[37] He or she will also understand why a "pooling of interests" accounting will have no such effect but will aggregate the two firms' incomes even for the year of the combination no matter how late in the year the combination occurs.[38] These features are not alternative options and the availability of one or the other accounting treatment will frequently make or break deals.[39] Therefore, the lawyer must understand them.

My own view, and one generally held, is that understanding how financial statements articulate and how they are impacted by various transactions requires an understanding of the bookkeeping process. For this reason the course as I offer it requires about three weeks devoted to that process. For students who have had no background in it, this requires intensive effort, while those who studied accounting for a year or more as undergraduates need spend very little time. If teachers make the students aware of this schedule at the outset, and promise the beginners that thereafter they will be on a level playing field with the CPA's in the class, the beginners are able to tolerate it.[40]

Most students are greatly interested in being initiated into this new language of business about which they previously had been mystified. Further, the familiarity with double entry bookkeeping makes them more receptive to all accounting knowledge, thus easing the way for the rest of the course.

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35. *Id.* at 215.

36. Inventory for tax purposes may be carried at a different dollar amount from inventory for financial accounting purposes, although for "last in first out" (LIFO) accounting there is a "booking" requirement calling for use of LIFO for financial reporting purposes if it is used for tax purposes. *See id.* at 231-37.

37. *Id.* at 449-53.

38. *Id.* at 453-58.

39. *Id.* at 456-57.

40. Other law teachers have a lesser regard for the need to teach students the bookkeeping process but seek to achieve the same ends otherwise. *See* Stanley Siegel & David A. Siegel, Accounting and Financial Disclosure (1983).

2. *Who Makes GAAP? The Functions of Auditing and Control*

Just as lawyers need to know the sources and the hierarchy of law, so too they must know who makes generally accepted accounting principles, what accounting principles are, the hierarchy of authority, and where to look to find accounting principles when their work calls for it. These are taught in a conventional law school course, although not generally taught in business schools.[41] A few class hours spent on these subjects will make students aware of these resources for solving legal issues that involve accounting.

In addition, as more and more litigation arises it has become apparent, as Professor Seligman has pointed out, that lawyers, not only as litigators but also as advisors to management, must be aware of the audit function and its dynamics,[42] as well as the concept of internal controls and how they apply in audits and under § 13(b)(2) of the 1934 Act—the accounting provisions of the Foreign Corrupt Practices Act.[43] An hour or so is merited on this topic at a minimum.

3. *Income Recognition and the Realization Convention*

Perhaps the portion of the course meriting the greatest amount of energy and time is that dealing with the various conventions of realization of income (including both revenues and expenses) and when that income is to be recognized for financial reporting, taxation, contractual interpretation, rate regulation, management, etc. This material is inherently interesting because income recognition analysis is very similar to legal analysis. I usually spend about five weeks on this material.

Legal, economic, financial, and accounting scholars devote careers to determining when the fruit of a capital investment is mature enough to be separable from the capital as income. That is because a vast proportion of the functioning of our society is based on the concepts of capital and income. A homely example is the "cooked books" phenomenon of our Microscript hypothetical—cooking the books largely involves plucking the fruit before it is ripe.

There are many examples of the importance of drawing the line between income and capital: financial reporting under the securities laws focuses on income, as does income taxation, regulation of public utilities, and regulation of other entities involving a public interest including financial institutions such as banks, insurance companies, mutual funds, pension trusts, securities brokerage firms, and private trusts. In all of these areas, law and lawyers are heavily involved.

The purposes of legal controls on income recognition and realization in these various realms differ. For example, the function of financial reporting

41. *See* FIFLIS, *supra* note 2, at 83-106.
42. *Id.* at 106-17, ch. XIV.
43. *Id.* at 118-19, 676-83.

is to enable investors to make investment decisions, whereas the function of income taxation is to provide the government with funds in a feasible way.[44]

Because of the variety of issues, it is necessary to teach students about the fundamentals of income recognition and how the conventions may be altered depending on the particular function involved. Clearly the best vehicle for this process, because it is the most developed in its details and is usually the presumed basis for interpreting the particular regulation, is income recognition under generally accepted accounting principles.

Thus, students should be taught that income realization is a matter of convention, not immutable principle—as may be demonstrated by GAAP's historical development from realization only by cash receipt, to realization when substantial completion of the product or services and a market transaction have occurred. They also should be aware of the historical trend away from requiring a market transaction, evidenced most recently by the move to "marking to market" for financial assets and liabilities.[45] They should be alerted as well to sham transactions as well as transactions among related parties who must nevertheless account separately for income.

Further, the unsolved problem of accounting for income from services in the vastly expanded service sector of our economy is likely soon to test the continuing viability of accounting in its present form and lawyers should know of this tremendous weakness in accounting thought.[46]

4. *Regulation of Distributions to Stockholders*

Since practitioners in every state deal with corporations organized in other states, a modicum of familiarity with the laws of the various states concerning corporate distributions is required.[47] Most corporations casebooks

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44. An example of a disastrous result of lawyers' naiveté about accounting for income is the Alaska Native Claims Settlement Act, 43 U.S.C. § 1601 et seq. (1971). For example, § 1606(i) provided for the aggregation and redivision of 70% of "all revenues" among the 12 Regional Corporations—paying absolutely no heed to expenses, although presumably the drafters meant "income" not "revenues." Thus the Arctic Slope Native Association might have $50 million of revenues and $5 million of expenses or $45 million income, and the Tanana Chiefs Conference might have the same revenues, but $45 million of expenses or $5 million income. Assuming, for illustrative purposes only, those were the only two Regional Corporations and they had an equal number of members, the Arctic Slope corporation, which had income of $45 million, could be entitled to keep it all while the Tanana Chiefs would get only $5 million; *i.e.*, no redivision would take place at all—presumably not the intended result. (In fact the litigation over the poorly worded statute gave the lawyers much revenue. Presumably no one sued the lawyers responsible for the inept legislative drafting).

45. *See* ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Financial Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993); DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, Statement of Financial Accounting Standards No. 107 (Fin. Accounting Standards Bd. 1991).

46. All of these matters are covered intensively in FIFLIS, *supra* note 2, chs. III-VII.

47. *See id.* ch. VIII.

deal inadequately with this topic in that they do not fully explain how GAAP do or do not apply and the effects on the dividend pool as GAAP change over time. Further, developments such as the adoption by approximately fifteen states of the Revised Model Business Corporation Act (MBCA) provisions on distributions and the recapitalization boom of the late 1980s has changed the ball game substantially, as many companies became highly leveraged.[48] The Revised MBCA introduces new interpretation problems. The recapitalization movement caused much development of dividend lore as lawyers were asked for legal opinions on the validity of dividends when a deficit in net worth resulted under GAAP. Thus this area of the law has been revitalized and requires attention once more.

With all the developments in other areas of corporate law in recent years, it seems inappropriate to devote attention to this subject in the corporations course. It is better covered in the accounting course in which the necessary matrix of accounting has been supplied to permit a sophisticated understanding of the subject.[49]

In addition, the course must deal with the fact that contractual limitations on distributions in debt instruments are now the most important subject for study.[50]

5. *Financial Analysis*

Lawyers traditionally have assumed the role of private financial advisor to clients who need or seek such advice. More recently, because all public companies subject to reporting and registration requirements under the federal securities acts must publish a Management's Discussion and Analysis of financial data,[51] counsel to such companies have inherited a substantially increased need to be familiar with financial analysis. For this reason, it appears to be an essential part of the law school accounting course and requires a few class hours.[52]

These five areas of study would provide at least the beginning of wisdom for law students who wish adequately to prepare for the practice of law.

E. Conclusion

Virtually all lawyers need a modicum of skills in accounting in order to practice law well. To some extent this knowledge may be supplied in

48. *Id.* at 382.

49. One suspects that some lawyers may be unaware that the terms "net profits," "surplus," and "capital" in the statutes on distributions often do not refer to the accountants' parallel concepts. See William P. Hackney, *Accounting Principles in Corporation Law*, 30 Law & Contemp. Probs. 791 (1965), which brilliantly exposes the sources of potential misunderstandings.

50. *See* Fiflis, *supra* note 2, at 431-43.

51. *See supra* text accompanying note 24.

52. *See* Fiflis, *supra* note 2, ch. X.

various other law school courses such as the corporations course. But corporations covers only a small part of what lawyers need to know and cannot provide sophisticated coverage. Yet most law schools ignore this need for reasons that seem to me insupportable. A specially tailored course in accounting issues for lawyers seems necessary and desirable and can reward both students and teachers. The contents of that course should include a sophisticated treatment of accounting issues as they commonly arise in law practices.