

ACCOUNTING ISSUES FOR LAWYERS
LAWS 6281
Spring 2010
Professor Wayne M. Gazur

November 2, 2009 Version

Required Materials:

David R. Herwitz & Matthew J. Barrett, ACCOUNTING FOR LAWYERS, CONCISE FOURTH EDITION (Foundation Press 2006), ISBN 978-1-59941-040-1; and

David R. Herwitz & Matthew J. Barret, ACCOUNTING FOR LAWYERS, Combined 2009 Supplement (Foundation Press 2009), ISBN 978-1-59941-628-1 (the “Supp.”).

As far as study aids are concerned, the nutshell (Charles H. Meyer, Accounting and Finance for Lawyers in a Nutshell (West 4th ed. 2009)) is current and adequate.

No Accountants! Students with Prior Accounting Training Cannot Enroll:

This is a course in accounting fundamentals for attorneys. Students who have three (3) or more credit hours of college or graduate study accounting courses should not take the course (use your law school time to greater benefit).

Objectives of the Course:

Accounting is the language of business, and attorneys are advisors to businesses as well as being business persons themselves. Accounting issues arise in a number of contexts, including: (1) determining taxable income and deductions (indeed, the federal income tax return forms for business entities such as Form 1120 (corporations) and Form 1065 (partnerships and LLCs) are arranged as an income statement, a balance sheet, and a reconciliation of owners’ equity); (2) “forensic” accounting in an embezzlement, financial fraud, or bankruptcy matter; (3) enforcement of criminal sanctions against financial crimes such as embezzlement and financial fraud (i.e., prosecutors and defense counsel need to know a little about these concepts); (4) requirements under lending covenants and security agreements; (5) business buy-sell agreements, particularly clauses that set the price; (6) dissolution of marriage, particularly where business assets are involved; (7) corporate distributions (legality under state corporate law); (8) interpreting limited liability company and partnership agreements; (9) securities law litigation involving misstatements of financial results; (10) commercial leases where a tenant must prove gross sales or maintain a certain level of net worth; (11) representations and warranties in purchases and sales of businesses; (12) cost amounts in construction contracts; (13) the application of financial ratio analysis in investment and lending assessments of businesses; (14) business reports, such as for corporate franchise taxes, that impose taxes on assets, on capital, or other measures; and (15) acquainting you with accounting so that, hopefully, your law firm’s bookkeeper will not embezzle or otherwise fleece you.

A search of the Westlaw “Forms All” database using the phrase “generally accepted accounting principles” if it appeared somewhere in the document, reported 1,639 results (site visited on October 12, 2009). When some legal issue turns on a quantification of expenditures, profits, assets, or liabilities, the drafter’s instinct is to tie the valuation to generally accepted accounting principles, or “GAAP.” One objective of the course is to learn about some of those principles. But, an equally important objective is to gain an appreciation of the uncertain, malleable nature of those principles.

The aim of this course is not to transform you into an accountant in a semester, even if that were possible. Rather, the objectives of the course are: (a) to acquaint you with the mechanics of basic bookkeeping—these terms and concepts will be yours for a lifetime; (b) to review several accounting concepts and principles that are of particular relevance to attorneys; (c) to examine certain applied situations where accounting rules play a legal role; and (d) to have some fun doing this.

Class Attendance:

Class attendance is very important and, as discussed below, will be reflected in your final grade. I expect you to diligently prepare, keep up, **do the assigned problems before class**, think about the materials, and ask me questions as they arise.

Starting Thursday, January 14, I will begin taking attendance using my copy of the seating chart. You are required to attend at least 80 percent of our classes, which means 21 or more of our 28 regularly scheduled classes (I will not count the first day). If you do not, I will lower your final course grade three points (*e.g.*, from an 86 to an 83). However, in addition to the three-point reduction described in the preceding sentence, I reserve the right also to impose in cases of very excessive absenteeism: (i) a five point total reduction in your final course grade; or (ii) the “20% Rule” prescribed by Law School Rule § 3-3-1, with the result that you would be unable to take the final examination for the course. Please note that the 80 percent calculation begins with the second class, even if you add this course to your schedule after that date. I may also raise grades for sustained and exceptional class participation throughout the semester.

The attendance requirement applies regardless of your other commitments such as to dependents, to jobs, etc., except for illness, job interviews, legal aid clinic appointments, or religious observance (with respect to excused absences please email me in advance of your absence). This means you must plan ahead and save your permitted absences for when you need them.

The responsibility for good recordkeeping is on you, but I will email you if I find you are close to violating the 80 percent rule or the “very excessive absenteeism” rule.

Final Examination:

The written final examination will be about three hours long (no longer than 3 ½ hours, but no shorter than 3 hours). The final examination may include short-answer problems, essays, or

multiple-choice answer problems. Reference materials during the examination are limited to your copy of the casebook (annotated as you wish), any instructor required/purchased/distributed materials, prints of any materials posted on TWEN, any notes or outlines that you prepare, and a calculator. The examination will cover the entire course. **Only students who appear on the seating chart are eligible to take the final exam.**

Copies of Past Exams:

This is the first semester I have taught this course. However, the SBA Final Exam Bank on TWEN offers a collection of Professor Fiflis' examinations, which would resemble my approach.

Optional Paper:

If there are fewer than thirty-five (35) students enrolled in the course, the Law School rules require that I offer an optional writing project. If the enrollment is below 35 students, then the optional paper, if a student so chooses, would supplant fifteen (15) of the final examination points, such that the final examination would be worth eighty (80) points. The optional paper requires a written analysis, typewritten, not to exceed 15 pages, double-spaced, of an issue relevant to the course. The optional paper would be due by 5 PM, Friday, April 9, 2010. Please provide me with advance notice of your interest in this option by March 1, 2010, so that I can prepare a formal problem memorandum. The optional paper may consist of a current topic or the solution of an extended bookkeeping problem.

Office Hours:

My office is 403 at the Law School. My telephone number is (303) 492-7013, and my e-mail address is Wayne.Gazur@colorado.edu. My spring office hours are: Tuesdays and Thursdays 2:30-3 PM; or by appointment. I will post material from time to time on The West Education Network ("TWEN") at lawschool.westlaw.com so please register for the course on TWEN.

Class Policies:

Disability accommodations. The University of Colorado has a written policy on accommodating people with disabilities. Disability Services determines accommodations based on documented disabilities. Contact: 303-492-8671, Willard 322, and www.Colorado.EDU/disabilityservices. For additional assistance, you may also contact the Law School's Assistant Dean Lorenzo Trujillo (303-492-6682, lorenzo.trujillo@colorado.edu).

Religious accommodation. The University of Colorado has a written policy on accommodations for religious observances and obligations. The policy requires that faculty make every effort to reasonably and fairly deal with all students who, because of religious obligations, have conflicts with scheduled exams, assignments or required attendance. In this class, if you need an accommodation, please notify me at least one week in advance so we can work together on an appropriate accommodation. For the details of the University's policy,

please see http://www.colorado.edu/policies/fac_relig.html

Classroom behavior. The University of Colorado has a written policy on classroom behavior. Students and faculty each have responsibility for maintaining an appropriate learning environment. Students who fail to adhere to such behavioral standards may be subject to discipline. Faculty have the professional responsibility to treat all students with understanding, dignity and respect, to guide classroom discussion and to set reasonable limits on the manner in which they and their students express opinions. Professional courtesy and sensitivity are especially important with respect to individuals and topics dealing with differences of race, culture, religion, politics, sexual orientation, gender variance, and nationalities. See policies at <http://www.colorado.edu/policies/classbehavior.html> and at http://www.colorado.edu/studentaffairs/judicialaffairs/code.html#student_code

Sexual harassment. The University of Colorado at Boulder policy on Discrimination and Harassment (<http://www.colorado.edu/policies/discrimination.html>), the University of Colorado policy on Sexual Harassment, and the University of Colorado policy on Amorous Relationships apply to all students, staff and faculty. Any student, staff or faculty member who believes s/he has been the subject of discrimination or harassment based upon race, color, national origin, sex, age, disability, religion, sexual orientation, or veteran status should contact the Office of Discrimination and Harassment (ODH) at 303-492-2127 or the Office of Judicial Affairs at 303-492-5550. Information about the ODH and the campus resources available to assist individuals regarding discrimination or harassment can be obtained at <http://www.colorado.edu/odh>

The sexual harassment policy requires all supervisors, which includes all faculty members, who experience, witness or receive a written or oral report or complaint of sexual harassment or related retaliation to promptly report it to the campus sexual harassment officer. This means that as a faculty member, I must report all allegations of sexual harassment that come to my attention; however, there are several offices on campus that can provide free, confidential guidance to faculty, staff and students who believe they have been sexually harassed. A complete list of these offices can be found at: <http://www.colorado.edu/sexualharassment/resources.html>

Assignments:

It is important that you complete the assigned problems for discussion in class.

First Day of Class (January 12, 2010) Read pages v-xiv of the preface to the textbook. The Enron list of lessons is a bit misleading, as it suggests that accounting is important only for public corporations, but the information is nevertheless valuable. Read the “Objectives of the Course” heading above for other contexts. Read pages c-1 through c-5 of the textbook’s appendix. Then read, but don’t study in great depth, the Starbucks 10-K in the appendix, focusing on the composition of the four basic financial statements at pp. 40-43 (earnings statement (aka income statement), balance sheet, statement of cash flows (on p. 109), and statement of shareholders’ equity). If you were a financial analyst trying to analyze Starbucks’

potential as an investment, what would you focus on? If you were a lender, what would you focus on? Can you find the explanation of what is considered “cost of sales” versus “store operating expenses”? Although for convenience we will use the 10-K in the book this time, one can access all of the Starbucks (and other reporting companies) filings (for free) on the Securities and Exchange Commission’s easy-to-use EDGAR database, at <http://www.sec.gov/edgar.shtml>. Pronouncements of the Financial Accounting Standards Board can be found on its website at <http://www.fasb.org/st/>. The Law Library also has hard copies of accounting pronouncements in the basement, in the general area of HF 5667.A55 and HF 5616.U5 F 537.

CHAPTER I--INTRODUCTION TO FINANCIAL STATEMENTS, BOOKKEEPING, AND ACCRUAL ACCOUNTING

Note: It is easier to complete bookkeeping problems using column paper, usually 2 to 6 columns on a page. One can print this type of paper, for free, from the following link- <http://incompetech.com/graphpaper/ledger/>

1. (January 14, 2010) The Balance Sheet and Double-Entry Bookkeeping; “T Accounts”; the Accounting Equation

Read pp. 1-26; do Problem 1.1B (to aid in checking your work, the balance sheet columns should each total \$19,900). Read Problem 1.1A. Assume you are a potential creditor considering a loan to E. Tutt, Esq. What asset(s) are omitted from the balance sheet?

Every action has an opposite, equal reaction in accounting (sounds like something from physics class). An expenditure must be matched by a source of funding. Revenue must be matched by an increase to some asset, and so forth. There are therefore two sides to every transaction. This action/matching reaction concept is the basis of double-entry bookkeeping. The “debits” (left side of the T) for a transaction must always equal the “credits” (right side of the T) for a transaction. Which account balances (i.e., assets or liabilities) are reported as debits or credits is simply a matter of accepted convention, not a rule of nature. Based on my long experience with accounting (I had a childhood fascination with this material, passed the CPA Exam in 1976, and spent some time at Arthur Andersen & Co.), I recommend that you always first compose a transaction as a general journal entry (see p. 21) before posting it to the T-accounts; it helps you to determine which accounts are involved and whether the context of each adjustment is a debit or a credit. Although we are using “pen and ink” paper bookkeeping, these principles are the basis of popular small business PC and Mac-based electronic accounting software products such as QuickBooks and Peachtree (which cost approximately \$200-\$400, but perform the functions of a 6-figure priced custom mainframe system from the 1970s).

2. (January 19, 2010) The Income Statement

Read pp. 26-38; do Problem 1.2B (to aid in checking your work, the income statement should show \$440 in net income and the balance sheet columns should each total \$11,640). The closing process is a little confusing upon the first encounter. This is an area where it is particularly important to actually perform the steps, as in Problem 1.2B. Question: Do you believe that the \$3,000 ascribed to Mr. Stief's Library reflects economic reality? A trial balance, six-column worksheet helps in closing the income and expense accounts to the balance sheet; we address that in the next assignment.

A bookkeeping shortcut—if a total of some numbers is “off” by a multiple of 9, there likely is a transposition error in posting the numbers. E.g., $15 + 26 + 32 = 73$; $51 + 26 + 32 = 109$; the difference of 36 arising from the transposition of the 1 and the 5 is a multiple of 9.

3. (January 21, 2010) The Trial Balance and Six-Column Worksheet; Statement of Changes in Owner's Equity

Read pp. 39-42; do Problem 1.3A (assuming that the accounts receivable are current assets and the accounts payable and notes payable are current liabilities, please prepare a classified balance sheet); Read pp. 43-50. Look at the Starbucks 10-K again on pages 42 and 43 of the textbook appendix. Let's not get caught up in the adjustments, but do see that the Statement of Shareholders' Equity can be somewhat involved.

4. (January 26, 2010) Partnership and LLC Accounting; Introduction to Accrual Accounting

In the prior assignment the textbook explained the capital account concept for partnerships (and LLCs). I have posted two sample LLC agreements on TWEN (they are highly simplified for educational purposes—do not use them for any other purposes). Read those agreements, getting a sense of how profits and losses are applied to the capital accounts, as well as capital contributions. You will find that the federal income tax consequences (and the attendant boilerplate) have taken center stage, which, unfortunately, is very common for partnership and LLC agreements. Then read pp. 50-58 and Supp. pp. 2-3. Fair value accounting is a continuously-emerging issue brought into focus by the recent financial difficulties of financial institutions (we will address that later with respect to investments). With respect to the “going concern” assumption raised on p. 54, go to EDGAR and read the fourth paragraph of the accountants' opinion (and note 1 to the financial statements) with respect to the Crocs, Inc. (ticker: CROX) fiscal-year 2008 report.

5. (January 28, 2010) Deferral of Expenses: Capitalized Costs and Depreciation

Read pp. 58-64, 537-562; Supp. pp. 127-128, 130-131; do Problems 9.1 A & 9.5B. We address the expense deferral rules later in the course and the concomitant problems of income manipulation.

6. (February 2, 2010) Deferral of Income and Accrual of Expenses and Income
Read pp. 64-73; do Problem 1.4B.
7. (February 4, 2010) Income Tax Accounting and Bookkeeping Problem
Read pp. 73-88; do Problem 1.5B(a) (to aid in checking your work, the income statement should show \$3,245 in net income and the balance sheet columns should each total \$124,125).
8. (February 9, 2010) Inventory Accounting
Read pp. 89-96; 491-535; Supp. pp. 125-126; do Problem 8.2B.

The Supplement speaks to Exxon Mobil's LIFO accounting, and one finds other assessments. According to an article in the October 26, 2009 Businessweek, at p. 35: "*Use of the LIFO method—which is legal—boosted Exxon Mobil's \$45 billion bottom line by \$341 million last year, according to securities filings. . . A LIFO Coalition, formed in 2006, when the accounting method was first considered for repeal, has been showcasing smaller businesses that use LIFO, such as grocers and jewelers.*" We could verify that Exxon Mobil tax benefit by looking at EDGAR filings.

9. (February 11, 2010) Comprehensive Bookkeeping Problem
Read pp. 96-103; do Problem 1.6A.
10. (February 16, 2010) Statement of Cash Flows; Consolidated Financial Statements
Read pp. 103-112; Supp. pp. 3-5; text pp. 112-119.

Goodbye to bookkeeping!

CHAPTER II--THE DEVELOPMENT OF ACCOUNTING PRINCIPLES AND AUDITING STANDARDS

11. (February 18, 2010) Generally Accepted Accounting Principles; International Financial Accounting Standards; GAAP Hierarchy Read pp. 121-149; Supp. pp. 7-25, do Problems 2.1 A & 2.1B.
12. (February 23, 2010) Independence; The Audit Process, including Internal Control and the Establishment of Generally Accepted Auditing Standards Read pp. 149-168, Supp. pp. 26, 28-31, 32-35. Do Problem 2.2B.
13. (February 25, 2010) The Expectation Gap; Audit Reports; Alternatives to Audits; Sources of Authority; Accountants Legal Liability Read pp.168-204, Supp. pp. 38-39, 40-42. One of the audit procedures that directly impacts a business lawyer is responding to auditors' requests for information regarding pending litigation and

other contingent liabilities. The nuanced dance between the auditor and attorney (which balances financial disclosure with litigation confidences) is examined later in Chapter VII.

CHAPTER III--THE TIME VALUE OF MONEY

14. (March 2, 2010) Introduction to the Time Value of Money Read pp. 205-225; Supp. pp. 43-44; do Problems 3.1A-3.4A.
15. (March 4, 2010) Time Value of Money (continued) Do Problems 3.4B-3.6B.

CHAPTER IV--INTRODUCTION TO FINANCIAL STATEMENT ANALYSIS AND FINANCIAL RATIOS

16. (March 9, 2010) Introduction to Financial Statement Analysis and the Balance Sheet Read pp. 229-246; Supp. pp. 45-46; do Problems 4.1 & 4.2.
17. (March 10, 2010) The Measurement of Income; Pro Forma Metrics and Comprehensive Income Read pp. 246-270; Supp. pp. 46-47; do Problems 4.3A, 4.3B, & 4.3C.
18. (March 16, 2010) Ratio Analysis; The Statement of Cash Flows; Management's Discussion and Analysis Read pp. 270-289; Supp. pp. 48-52. Read Section 4 of the loan agreement found at OHFT § 25:13 in the Westlaw Forms-All library, as well as Sections 4.6 & 6.3 of the loan agreement at ADVSBF § 13:17 in the same library. Also, read the Starbucks credit agreement at pp. 64-71 of the Supp. and do the questions on Supp. p. 71.

CHAPTER V--LEGAL ISSUES INVOLVING SHAREHOLDERS' EQUITY AND THE BALANCE SHEET

19. (March 18, 2010) Statutory Restrictions and the GAAP Interface; Drafting Legal Documents Containing Accounting Terminology and Concepts Read pp. 291-307; Supp. pp. 53, 54-55; do Problems 5.1A & 5.1C; Read pp. 307-316; Supp. pp. 55-64. Read the buy-sell agreement found at ADVSBF § 21:5 in the Westlaw Forms-All library. Can you find an indirect reference to the ability of the corporation to make the redemption payments?

Spring Break!

CHAPTER VI--REVENUE RECOGNITION AND ISSUES INVOLVING THE INCOME STATEMENT

20. (March 30, 2010) Introduction to Revenue Recognition; Expenses Read pp. 317-337;

Supp. pp. 73-81; do Problems 6.1B, 6.1C, 6.1D, & 6.5.

21. (April 1, 2010) Exchange Transaction Requirement; Deferred Payments Read pp. 337-376; Supp. pp. 84-93; do Problem 6.2.

22. (April 6, 2010) Investments Read pp. 376-393; Supp. pp. 96-107. The continuing mark-to-market controversy lives here. Do Problem 6.6B (p. 418). Please read a short (27-page) law review article on this topic. John Patrick Hunt, *One Cheer for Credit Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating-Dependent Capital Regulation*, 60 S.C.L. REV. 749 (2009).

23. (April 8, 2010) More Income Recognition Issues Read pp. 393-417; Supp. p. 108. Do Problem 6.6A.

24. (April 13, 2010) Accrual of Expenses and Losses; Drafting and Negotiating Contracts Containing Accounting Concepts and Terminology; Intangibles and Big Bath Read pp. 419-438; Supp. pp. 109-112; do Problem 6.9A; 569-591; Supp. pp. 129-130; 131-132; do Problems 9.8 & 9.10A.

The “Big Bath” is a recurring issue. The title of an article in the October 26, 2009 issue of Businessweek sums it up: *Banks: Pain Now, Profits Tomorrow—By recognizing loan losses preemptively, companies are setting the stage for better earnings next year*. The article discusses the big banks’ current practice of taking large loan loss reserve charges during the bleak times (although this is encouraged by the regulators—conservatism, another longstanding accounting principle, is also involved) to support better earnings in the future.

CHAPTER VII--CONTINGENCIES

25. (April 15, 2010) Contingencies; FAS #5 Read pp. 439-470; Supp. pp. 113-119; do Problem 7.1 (consider the perspectives of management, outside counsel, the independent auditor, a lender, shareholders, plaintiff’s counsel, and the SEC (assuming that X Corp. was a registrant)).

26. (April 20, 2010) Auditor Requests for Information Read pp. 471-490; Supp. pp. 119-120; do Problem 7.3.

27. (April 22, 2010) Last Day of Class; Review Session.