Basic Legal Accounting classnotes, Fall 2004. Professor MacDonald.

Table of Contents

Tuesday, August 24

Basic principles

- The uses of financial statments:
  - Comparability, both between entities and over time.
  - Consistency.

- GAAP, GAAS, FASB, and AICPA.
  - These are all sources of regulation in a largely self-regulated profession.
  - GAAP provides *conventions*, not rules.
  - MacDonald wonders, do we need a codification?? Or can the industry really regulate itself??

- Objectives and fundamental principles (pp8-10)
  - The matching principle: which is related to consistency.
  - The conservatism principle: "when in doubt, understate."
  - The materiality principle: don't worry about what's not important (i.e., *de minimis*).

Thursday, August 26

- Note the similes used to capture the essence of:
  - Balance sheets—snapshots.
  - Income statements—motion pictures.

Auditing

GAAS

- Who are auditors? They are outside, independently-owned business firms paid by companies to audit the companies' books.
  - But, n.b., how independent can they really be if they're getting paid by the company they're auditing?!
- Do they prepare the financial statments? *No.* (See ¶1p16.)
- So, what *do* they do?
  - They will sample and test the financial statements to verify them. They *certify* the company's financial statements.
    - Who needs verified financial statements?
      - Investors
      - Financiers (e.g., banks)
      - The SEC and other government agencies
      - Dealmakers (e.g., company A that's buying company B)

    - See the standard auditor's CYA report on p16—read and study it, along with the accompanying text.
- Why not just trust the company itself?
    - Dishonesty aside, there are other pressures that mean that we can't trust the company itself:
        1. Management has incentives to show high profits so that they look good.
        2. Management has incentives to make taxable income look *lower*, also, though.
        3. Management is under pressure to make statements look good to be in a better position to bargain with labor.
        4. Management is under pressure to move stock prices up.
        5. Management has incentives to increase executive income.
    - What can auditors do if management pressures them to cook the books?
        - They can issue *adverse opinions* (see pp16-17). But this is really, really rare. Much more commonly, the auditor will just issue no opinion at all.

<u>Friday, August 27</u>

<u>Non-standard audit reports</u>

- Theoretically, auditors can issue adverse opinions and disclaimers. But this almost never happens. Usually auditors just issue no opinion and walk away if they can't verify the statements.
    - Also, usually if there's a problem found along the way, the company will correct it before any opinion is issued.
    - Why no adverse opinions?
        1. Management chooses and pays for the "independent" CPA firm.
        2. GAAP conventions aren't codified—there's no real laws here.
        3. Usually, there's more than one way to treat any financial transaction.
        4. Management is ultimately in control of the facts (i.e., the books) on which the auditors base their opinions.

N.b., the textual analysis of the standard audit report on p16-18: the auditor is not insuring anything. Any fraud is the responsibility of the company itself.

- An auditor checks on the company's *own* bookkeeping practices. "Is management following an efficient internal system of accounting?" they must ask.

N.b., that GAAP is the substantive rules of accounting, whereas GAAS is *procedure* for auditing.

Bookkeeping

The fundamental (and mundane, MacDonald says) equation:

Assets = Liabilities + Equity

Remember: accounting is not bookkeeping.

- What's bookkeeping?
    1. Making daily journal entries,
    2. then posting those entries to T-accounts (ledgers),
    3. and then making financial statements from the ledgers.

<u>**Tuesday, August 31**</u>

The accrual system of accounting

What's the practical distinction between accounting for something as an asset and as an expense?

- An asset does not offset income.
- An expense does.

Or,

- An asset is something that will contribute to income for more than a year.
- An expense is something that, if it contributes to income at all, will do so for a year or less.

What's the accrual system of accounting? Well, it's as opposed to the cash method (like the way people balance their checkbooks).

<u>The standard accounting year</u>: the end users of a business's financial statements can't wait until the dissolution of the business to see the statements. So, we have a standard accounting year, equal to one year, and broken into the calendar months. (So, n.b., there are 12 possible fiscal years.)

- *Interim statements* are statements issued during the fiscal year, e.g., quarterly reports.
- The most common fiscal year is the calendar year. But some businesses won't want to use the calendar year—why? Well, e.g., retail won't, because of christmas, which is a high-volume non-accounting work time. Typically, you

want to end your fiscal year during a quiet time.
- IRS rules for fiscal years:
    - It must end on a month boundary.
    - You must get the IRS's permission to change your fiscal year.
- When you start or end a business, you may have *short* years—but you can never have a *long* year.

GAAP and the IRS *require* the accrual method. You cannot use the cash method, unless you're an individual, or certain personal services businesses.

What is accrual and deferral? Two sides of the same coin, for one thing—in both, income is determined by entering it pro rata.

<u>Thursday, September 2</u>

Inventory accounting

How are ending inventory and income related?

COGS = BI + P – EI
Income = Revenue – COGS

So, as EI increases, income increases—i.e., there's a direct relationship. This creates incentives to understate EI for tax purposes, and to overstate it to investors.

<u>Inventory accounting methods</u>
- Average cost
- FIFO
- LIFO

LIFO is the most commonly used. Why? Because over time, prices are generally rising. See the example on p77.

Friday, September 3

What are the benefits of LIFO (and the defects of FIFO)?
- Theoretically, there's better matching with LIFO.
- Also theoretically, LIFO is more conservative.
- LIFO means less taxes (but, it also means lower income reported to investors).

Why might you want to use FIFO, then?
- To build investor confidence.

- To obtain a higher stock price.
- When management's income is tied to earnings, management might want FIFO.
- To prevent hostile takeovers (by keeping stock prices high).

But, nevertheless, LIFO predominates.

N.b., the *constant dollar assumption* (which is not mentioned on pp9-10 with the other assumptions): this assumption assumes away inflation.

<u>Tuesday, September 7</u>

Depreciation accounting

- Expense, or capitalize?
  - MacDonald suggests the 12-month test—will it have an impact more than 12 months in the future? Or is it a one-time expense?
    - N.b., the "shenanigans" this can allow for. See ¶5p454.

- Now, if you capitalize something, you've got to make three more decisions:
  1. Useful life
  2. Depreciable basis
  3. Method of depreciation

  - How do we figure out what the useful life is?
    - GAAP (non-tax)
    - Tax: the tax code has the MACRS system. These are shorter write-off periods than GAAP allows for, or that good faith guesses would come up with, even.

    At any rate, determining useful life is an educated guess, based on convention. Useful life doesn't necessarily correspond to real-life wearing out.

    Note that with depreciation, you *can* keep two sets of books—one for investors and one for the IRS. (This is unlike inventory accounting, where you *have* to use to the same system).
      - This creates a problem in your GAAP books—you ahve deferred tax liabilities there.

    Why are the MACRS useful life periods shorter than GAAP or even real life?
      - Because MACRS is an instance of tax policy. The MACRS

useful life periods stimulate investment in fixed assets, leading to greater investment in productive capital assets. (Does this favor the investment class? Or does this *fairly* trickle down? Whatever it does, it *does* make the pie bigger.

What about mid-course changes in useful life? Basically, if you have to do that, you start over when you need to make the change—you *don't* recompute anything for prior years. I.e., you make *prospective* adjustments only. (See p98.)

- How do we figure out the depreciable basis?
  - DB = historical cost – scrap value.
  - Except, n.b., in declining-balance depreciation and MACRS you *don't* have a scrap value. There, DB = historical cost.

- How do we pick a depreciation method?
  - The depreciation method is just the shape of the curve, basically.
  - Most businesses today use:
    - Straight-line for GAAP
    - MACRS for tax

    Sum-of-years' digits and double-declining-balance are sort of old-fashioned, nowadays.

<u>Thursday, September 9</u>

<u>Depletion</u>

N.b., first:
- Fiscal policy: taxing and spending.
- Monetary policy: interest rates and money supply.

What is congress trying to do with depletion deductions?
- These industries (oil and gas, timber, etc.) are dealing with *wasting assets* (assets where, once you get it, it's gone). And that is high-risk, congress believes. So, for our society to have the optimal amount of these national resources, these industries need tax incentives.

<u>Cost depletion</u> (see p109)
- This is a GAAP method.
- Rather than a useful life, you have a certain number of units of the resource, which you write off *as you recover* those units.

Percentage depletion

- This is a tax method—it provides even more incentive beyond cost depletion. This is a purely economic and political method—it has absolutely nothing to do with reality.
- Why do we need this additional incentive? Well, because congress thinks that cost depletion doesn't provide enough incentive so that society has an optimum amount of these resources.

The percentage depletion method is: you get a deduction equal to x% of the gross income you get from the resource. The value of x varies on the resource involved.

- Three problems with percentage depletion:
    1. Under cost depletion, you can't recover, through deduction, more than 100% of the resource recovery cost. But with percentage depletion, there's *no limit*—it's not tied to original cost at all.
    2. Percentage depletion has been extended to *all mines*—including sand, gravel, peat, stone, e.g., all of which *aren't* costly to find or extract. I.e., those don't need tax incentives—society will have the optimum amount anyway.
    3. The benefits of percentage depletion go to the legal owners and interested parties (e.g., the investors). So, this is a trickle-down idea.
        - MacDonald asks, why don't we aim tax benefits at actual exploration?? Because, I mean, as it is, these benefits just encourage further production of *already* discovered resources.

Timber: see Reg. 1.611-3(b).

- Initial write-off cost does *not* include any part of the cost of the *land*.
- Cost, not percentage, depletion must be used.
- N.b., the term *scaling*: computing the actual amount of timber out in the forest.

Tuesday, September 14

Miscellaneous topics

Receivables

- The temporal convention used to classify balance sheet items:
    - The most "current" items are listed first.
    - The most long-term items are listed last.

Accounts Receivable is a fairly current asset.

- (N.b., that "contra accounts" are used in dealing with Accounts Receivable.)

Intercompany ownership

- N.b. the distinction between bonds and debentures.
    - Bonds are debt secured by specific interests.
    - Debentures are *unsecured* debt.

- Accounting for equity ownership of other companies:
    - < 20% ownership, which is called holding "marketable" securities.
        - Contrast this ownership with the ownership of fixed assets:
            - Fixed assets are recorded *at cost*.
            - Marketable securities are recorded at market value, in their carrying value, and updated. (For tax purposes, this unrealized gain/loss doesn't matter—but for GAAP, that is disclosed, in the name of *transparency*.)
    - > 20%, < 50% ownership, where the "Equity Method" is used.
        - As ownership interest increases, the owning company's influence on the owned company increases as well. Thus, the owned's influence on the owning's bottom line also increases.
        - The Equity Method is a kind of stop-gap treatment between situations where there is no consolidation and situations where there is obvious consolidation.
        - The Equity Method: the owning company takes a pro rata share of the owned's income/loss. That income/loss is incorporated into the owning's income statement, and carrying values are adjusted appropriately.
    - > 50% ownership, where the Consolidation method is used.
        - Here, all infra-group transactions must be eliminated from the books (not doing this allows for certain ways of cooking the books).

Note, however, the the 20% and 50% thresholds are just guidelines. The real question is "How much control does the owning company have?" That is, an owning company could have actual, working control with only a 45% ownership interest.

Thursday, September 16

Intangible assets

- Goodwill: before goodwill can be shown on a balance sheet, it must be actually *paid* for. That is *paid* (past tense) for.
    - How do you value goodwill? It is the excess of what you paid for a business over the value of that business's non-goodwill assets.
    - Do you depreciate goodwill?
        - GAAP: you don't have to, unless the assessed value of the goodwill *actually* declines. (So, something bad would have to happen, such as an "impairment loss," before you have to write it off.)
        - Tax: you can write it off over a period of not less than 15 years.

        (Note how this is an instance of GAAP trying to reflect financial reality, whereas tax is more concerned with public policy and incentives.)

<u>Derivatives</u>

- N.b., hedging—is this gambling?, MacDonald asks.

<u>Leases</u>

- When we have a *legal* liability to pay under a lease do we always have an *accounting* liability? No. We do not have an accounting liability when it's an *operating lease*. (Note that when we do have an accounting liability (i.e., when it's a *capital lease*) due to a lease, the balancing *asset* would be the contract itself.)
    - So, an operating lease does *not* show up on a balance sheet—this is pure off-balance-sheet financing.
    - What incentives are there for taking an operating lease rather than a capital lease? I.e., what incentives for off-balance-sheeet financing, generally?
        - Borrowing power.
        - Your own securities don't get devalued (because there's no change in your debt-to-equity ratio).
        - Sometimes you have covenants requiring you to keep certain ratios up and/or total liabilities down.

        All of this, note, because with an operating lease your liabilities for the lease don't show.

    - When is it an operating lease and when is it a capital lease? Use the *red-flag approach*, demonstrated with the bullet points on p130.

- Note that there are some important non-accounting, non-tax issues with leases.
    - Such as the lessor's expectation of a reversion. For example, what happens if a nominative "operating lease" is recharacterized as a capital

lease (i.e., an installment purchase)?

Friday, September 17

- With this kind of reclassification, a putative "lessor" becomes a seller. That can change the lessor/seller/creditor's recovery priority (in your liabilities priority line). So, you need to *record* the transaction at the recorder's office and do a UCC art. IX filing.

- Tax consequences of leases:
  - Operating leases:
    - The lessor has rental income and keeps the depreciation deductions.
    - The lessee deducts the entire lease price as a business expense.
  - Capital leases:
    - The lessor has a gain/loss and may have interest income.
    - The lessee has a partial deduction, for interest, and gets to take the depreciation deductions.

Long-term debt

- One of your current liabilities will be the "Current Portion of Long-Term Debt."
  - (N.b. that "Non-Trade Debt" is also disclosed, along with some other disclosures noted on p131.)

"Employee matters" (retirement and compensation plans)

- Tax considerations:
  - "Qualified Plans": with these, the employer gets a current deduction for what it pays into the trust. In that way, these payments are just like additional salary, from the employer's perspective. *But*, the employee does *not* realize current income on those payments!

Tuesday, September 21

- Stock option compensation
  - (Compared to other systems around the globe, this is a uniquely American form of greed. MacDonald asks: does this type of greed have morality problems associated with it?)
  - Until recently, stock option compensation wasn't shown on the balance

sheet, or on any other financial statement, for that matter. Now, you have to show an expense item when options are granted. Also, there are now more sophisticated, accurate methods of valuing outstanding options.

- Tax treatment:
    - If it's a qualified plan, the receiver doesn't have income until the option is actually exercised, yet the company gets to expense these (and take deductions) when they are granted.
    - (N.b.: why hasn't the tax treatment of option plans changed to adhere to GAAP? MacDonald says it's mainly for political reasons.)

<u>Loss contingencies</u>

- N.b., pp414–423, discussing the relationship between contingent liabilities and lawyers—that is, it's accountants versus lawyers, both trying to CYA.

Capital accounts

- First, some terms that are becoming anachronistic, from the legal capital regime:
    - Stated capital: total par value of all issued shares.
    - Capital surplus (paid-in surplus): value paid for issued shares less stated capital.
    - Retained earnings (earned surplus): total earnings less any dividends paid out.
    - Par value

- What's the current state of the law? MBCA-type (see pp146-154 for relevant MBCA sections).

- "Capital": does it have a meaning in itself? Not really—though maybe you could say it's the sum of everything in the Owner's Equity section of a balance sheet.

<u>Thursday, September 23</u>

[missed class]

<u>Friday, September 24</u>

- Problems with the legal capital regime:
    - The mistaken belief that it protects creditors—are creditors going to even *look* at the balance sheet for par value when they're making decisions? I.e., par

value isn't going to tell them much at all.
    - It's arcane and complicated.
- N.b., “watered stock”: stocks that's issued for a price less than par value. Holders of watered stock can be held liable to the corporation's creditors for the difference between par value and the issuing price.

- “No par” stock: stock without par value; the rule in the new, MBCA regime.
    - What happens to the accounts?
        - No allocation is made between stated capital and paid-in surplus—all value paid for shares is attributed to paid-in surplus.

- <u>Dividends</u>
    - (N.b. how cash dividends prejudice creditors.)
    - (N.b., that it is a business judgment as to how much or whether to pay dividends.)

    - Dividend limits
        - Approaches
            - “Earned suplus” only: this allows *no* invasion of contributed capital.
            - “Any surplus” only: most corporation statutes allow this *if* the corporation's articles provide for it.
            - “Nimble dividends”: where dividends can be paid out of *any* earnings—without regard to surplus.
                - This is mainly a special interest rule applicable only to public utilities.
                    - Why do we have it?
                        - Because we want constant investment in public utilities—and nobody will buy public utility stock unless they can get dividends.
                        - Also, because there's not a real high danger that public utilities won't be able to pay off their creditors (i.e., everybody needs electricity).

            (Note that dividend limits also apply to repurchases. (As MacDonald says, “a distribution is a distribution is a distribution.
                - Why repuchase, ever?
                    - In order to consolidate control.
                    - In order tor recover preferred stock carrying a dividend preference above the prevailing interest rate.)

            - MBCA dividend limits:

- § 6.40 (pp150-151): which is based on practical, debtor protection and business notion.
  - Equity insolvency test: you can't pay dividends out to the extent that it would make you unable to pay your creditors.
  - Balance sheet test: you have to be able to cover any liabilities and preferences outstanding. That is:

$$\text{Assets} \geq \text{Liabilities} + \text{Preferences}$$

(Note that generally, dividend payments will increase the market value of shares.)

- Stock dividends: where the corporation actually issues new stock to existing shareholders. Thus, if your stock has a par value, you have to increase stated capital (balancing the increase with a decrease in earned surplus).
  - Here, you only have to amend the articles if you're going to exceed the authorized number of shares.
- Stock splits: where the corporation splits existing shares, rather than actually issuing new shares. Thus, if you stock has a par value, the articles have to be amended to reduce the par value of the shares proportionately.

Tuesday, September 28

Capital accounts in partnerships

- Each partner's capital account =

  All contributions he's made +

  His share of income/loss –

  Any draws he's made

  - How do we know what his share of income/loss is? First, look at the partnership agreement to see if something's specified. If not, look at the statute to find the default rule (usually, it's equal proportions).
  - (N.b., draws are sort of like corporated dividends.)

- Hypo: $40K in furniture is contributed by a partner to the partnership, then sold for $110K.
  - Accounting: $70K gain, income to the partnership.
  - Tax:

- Contribution to the partnership is not a taxable event—so, this is carryover basis, not a step-up.
- Partnerships are not taxable entities—so the tax basis in the furniture is the contributing partner's basis. That is almost certainly lower than the $40K contribution assessment, which is just something the partners agreed on.
  - So, assume the contributing partner's basis is $20K. Thus, there's a $90K taxable gain. Do the two partners just split this?
    - Well, if they did, then the contributing partner would get a better deal than his partner, because the other guy is splitting the tax on the $20K-to-$40K gain that occurred *before* he came into the picture.
    - However, if the partnership agreement doesn't say anything, that's what will happen—the gain will be split.
    - So, the partnership agreement needs to provide that:
      - The contributing partner pays tax on the $20K-to-$40K gain.
      - The two split the tax on the $40K to $110K gain.

<u>Thursday, September 30</u>

- How do you close out the year for parnership accounts?
  - Capital account = contributions + profit share – draws.
  - Let's say you have $60K profit, and partner Y had $20K in draws, and partner Z had $25K in draws. Since inception, Y has contributed $60K and Z has contributed $40K. Then, the capital accounts are:

Y: $60K + $30K – $20K = $70K
Z: $40K + $30K – $25K = $45K

Financial statement analysis

- We want to know how to read income statements and balance sheets for *particular purposes*.
- Mostly, we will be making comparisons:
  - Over time, wrt. the same business.
  - At a specific time, wrt. to multiple businesses.

Investor ratios

- Earnings per share: which is the primary component in calculating P/E ratio. It's of limited value by itself, though, since the companies you're comparing may have widely different numbers of shares.

- P/E ratio: price of a single share / earnings per share. This is basically the market price for a dollar earned. I.e., it tells you how much people are paying for this income stream.
    - This allows for a lot of manipulation:
        - The "denominator problem," as MacDonald calls it. Aka "dilution." This is where you manipulate earnings per share. EPS = E / # shs. So, consider, e.g., convertible debt. When do you include it in the # of shares? When the conversion price is lower than the share price? When the conversion price is higher than the share price?
        - N.b., then, "common stock equivalents." See ¶3p184.
        - (N.b., "warrants": this is a fancy form of stock option. They're certificates for options, and so they can be publicly traded.)

Creditor ratios

- A lender will be more interested in balance sheet ratios than in income statment ratios.

- Current ratio: current assets / current liabilities. This is the most widely-used creditor ratio.
    - E.g., 1/1 would show that the company has exactly enough to cover the payments that are coming due right away. That's basically insolvency.

Friday, October 1

- Another way of looking at the same thing that current ratio looks at is with "working capital." WC = CA – CL. This, however, doesn't filter out the information about the *size* of the business—current ratio does.
- Both working capital and current ratio are a way of measuring *debt service capacity*.
- Too much working capital (e.g., current ratio of 100/1) is a problem. It shows that you're not getting the maximum value out of all that capital. You can solve this by putting that capital in short-term investment securities (i.e. commercial paper).

- Quick ratio
    - QR = (CA – (I + P.E.)) / CL. That is, you subtract from current assets stuff like inventory and prepaid expenses, which you can't actually pay your debts with.

        - This ratio is often used instead of current ratio.

- <u>Debt-to-equity ratio</u>
    - A high D-E ratio means the company is highly leveraged (see the example on p185).

<u>Management (internal) ratios</u>

- <u>Inventory turnover ratio</u>
- <u>Accounts Receivable turnover ratio</u>

- Disclosure and fraud
    - MD&A (management's dicussion and analysis)
        - This is a mandatory filing for public-held companies.
        - The lawyer's role:
            - For one thing, MD&A are written or reviewed by lawyers, usually.
        - It facilitates disclosure—investors should have full and fair information—and it prevents fraud.
        - MD&A is a form of "soft" information disclosure.
            - It used to be, following accounting's conservatism principle, that it was bad to make predictions about the future, like MD&A do.
            - Then, the SEC began to allow this kind of "soft," speculative information in filings.
            - Now, the SEC requires some "soft" speculation.

- N.b., "segment reporting": a response to corporate conglomeration.

Cash flows

- N.b.: the statement of cash flows is important in accounting, but it's not nearly as important to lawyers as the balance sheet and the income statement are.

- Cash flow—what is it?
    - Cash flow ≠ income/revenue.
        - Consider payroll (where cash is actually changing hands) versus depreciation (where no cash is actually leaving the business).

<u>Tuesday, October 5</u>

- Again, income ≠ cash flow. There are two main differences:

1. Income includes noncash deductions, where income is affected but cash flow is not.
2. Some cash transactions don't affect income (but they do, of course, affect cash flow).

- Cash flow statements: these show:
    - Sources of cash.
    - Applications of cash.

    You can't get either of these items from a balance sheet or an income statement.

    - Cash flow statements are not so much a lawyering tool as they are a warning tool for:
        - Management
        - Creditors
        - Investors
        - Analysts

- Note how you can have *too much* income—in fact, some companies have basically gone bankrupt from too much income. They did this by converting income into non-cash assets and ending up cash poor. That's a big problem if you have a lot of debt.

Valuation

- The time value of money—a byproduct of:
    - Utility
    - Risk
    - Opportunity

- Compounding interest—both annually and semiannually (in which the process accelerates).
    - Future value computation
    - Present value computation: figuring the present value of a known amount you're going to have in the future.
        - You can do this with respect to both lump sums (p246) and annuities (p248).
        - Wrt. present value computation, what would be the "interest" rate is called the "discount" rate.
    - N.b., the "rule of 72s" for calculating how long it will take for a sum to double in value.

- Note that any *true* attempt to value a future sum or income stream meets with additional complications:
    - Interest rate changes
    - Tax

- Inflation

(N.b., problem 10 on pp258-260.)

Thursday, October 7

Valuation techniques

- Possible valuations
  - Salvage value
  - One year of earnings
  - One year of earnings multiplied by fifteen years
    - (Which doesn't work because the future value isn't discounted.)
  - Market value
    - (Which doesn't work unless there's an efficient market.)
  - Book value (i.e., the value from the balance sheet)
  - Capitalized earnings
  - Discounted cash flow

  Most investors—especially equity investors—are interested in these last two.

(N.b., Table 11-2 on p281, showing the relationship between P/E ratio and capitalization rate. (They are reciprocals of one another.))

(N.b., problem 11, especially problem 11A, part B.)

Friday, October 8

- Valuation by the courts
  - Should we even do this?
    - Should the judge pick among the expert valuations?
      - E.g., baseball arbitrators, who must pick one from the two side's proposals.
    - Or should the judge develop his own, independent valuation?
      - E.g., Delaware law requires that judges develop their own, independent valuations.

- *Wilson*, *Rolling Stone*, and *Le Beau*: in each of these cases, the issue is what the cash-out share price ought to have been—that is, some shareholders are complaining about inadequacy of consideration.
  - These cases are here mainly to show valuation methods as they play out in context/practice.

- *Rolling Stone* is a good review of the two steps in the capitalized earnings valuation method:
    1. Determine earnings
    2. Determine an appropriate capitalization rate
- *Le Beau*: which is the most sophisticated among these cases, MacDonald thinks.
    - Here, the judge goes through a variety of valuations proposed by the parties' experts and rejects all but one. Is this consistent with the Delaware statute requiring the judge to make an independent valuation? (See ¶3p325 and the conceptual question on p347). *Should* the Delaware statute require an independent valuation? Or are experts better for the job? Or what about appointing special masters?
- (N.b., the "short form merger," where one board can approve the transaction, unilaterally. This is only allowed where the one corporation owns the other corporation that it's going to merge with.)

<u>Tuesday, October 12</u>

Integrity of financial reporting

- Here, we have three main concerns:
    1. Auditors as legal clients (see, e.g., the *Monroe* negligence standard)
    2. The lawyer's role in responding to auditor's inquiry letters.
        - Openness in accounting versus client privilege in the legal profession.
    3. Shenanigans

- *Monroe* (p383)
    - Some typical contexts for these kinds of liability concerns:
        - SA § 11: providing for fraud wrt. to prospectuses.
        - SEA § 10(b) and Rule 10b-5: providing for liability, generally, wrt. securities fraud, but requiring *scienter*, and so has a higher threshold than SA § 11.

        - Accounting firms, as here, are held to a negligence standard (and their conduct is compared to GAAP, GAAS, etc.).
        - The issuing company is held to a strict liability standard.

- *Central Bank* (1994) (pp388, 389, in text)
    - Here, SCOTUS says that there is no aiding and abetting liability in securities violations.
        - Who *could* aid and abet, anyhow? Well, mainly accountants and lawyers. (But these are the only people who could really police a lot of this stuff!! So, if there's no A&A liability, what motivation will they

have to police it?!!, MacDonald asks.)

- Some people have attributed the corporate fraud problems of the late 1990s to this case.
    - The federal response to that fraud was Sarbanes-Oxley.

- Sarbanes-Oxley: ushering in a new world of corporate governance.
    - Now, e.g., auditors have to audit, not only the books, but also the corporation's internal accounting controls.

- Auditor independence (p396)
    - MacDonald asks: can we really expect the private sector to audit itself? E.g., imagine income tax without the IRS.
    - How good is the term limits proposal—where we only allow firms to audit a particular corporation for a certain period of time?
        - (Note that there is already a requirement that firms rotate personnel *internally*.)

<u>Thursday, October 14</u>

The lawyer's role

- To start with, see tables 16-2 and 16-3 on p420 and note all the CYA that's going on.

- The lawyer has a serious role to play in giving information that will allow an auditor to provide an unqualified opinion—there are lots and lots of business deals that *depend* on there being unqualified opinions.

- *Arky, Freed* (p421): basically, itc. says that the client is ultimately in control of what the attorney must disclose. At the very least, the attorney just has to follow the ABA/AICPA standard.
- *Wilkie, Farr* (p423): the question here is whether an attorney's report to an audit committee is discoverable.
    - The court says it is—it's no protected by the work-product rule, and, here, the attorney-client privilege was (inadvertantly) waived.

- Sarbanes-Oxley internal whistleblowing for lawyers: Sarbanes gives an attorney a protocol for whistleblowing—you go up the corporate ladder.
    - But what if you don't get a response even at the top?
        - Noisy withdrawal?
        - External whistleblowing?

        Is this intractable?

* Multi-disciplinary practice (MDP): where a single firm provides business, legal, financial, and tax services under a single roof.