# Basic Legal Accounting outline, Fall 2004. Professor MacDonald.

## I. Accounting

### A. Foundations

#### 1. Assumptions

**a)** The separate entity assumption: you regard the entity you are reporting about as distinct from those who (actually) own it--even if it's not legally a separate entity (e.g., like with a partnership).

**b)** The going concern assumption: you regard the entity as continuing in operation indefinitely--and not about to terminate or liquidate.

**c)** The time period assumption: you regard the entity's activities as divisible into discrete time periods (e.g., months, quarters, years).

**(1)** The standard accounting year: end-users of financial statements can't wait until the company's dissolution to see the statements, so we break the company's activities into blocks of time; viz., into years--fiscal years.

**(a)** The most common fiscal year is the calendar year. Some companies, such as retail concerns, won't want this because the end of the calendar year is a busy non-accounting work time.

**(b)** Short years: when you start or acquire a business, you might have a short fiscal year. But, you can never have a "long" fiscal year.

**(c)** IRS rules for fiscal years require that they end at the end of a calendar month. If you want to change your fiscal year, you have to get the IRS's permission.

**(d)** Interim statements, e.g. quarterly reports, are issued during the fiscal year.

**d)** The constant dollar assumption: assuming inflation away.

#### 2. Principles

**a)** The matching principle: you should allocate expenses to the period where they will contribute to generating revenue.

**b)** The realization principle: you should only recognize revenue when the entity has completed (actually or virtually) the exchange that generates it.

**c)** The conservatism principle: when in doubt, understate (earnings, values, and cash flows).

**d)** The consistency principle: apply principles consistently within a set of financial statements.

**e)** The cost principle: report assets at their historical cost (*not* at higher market prices).

**f)** The monetary transactions principle: for any reported transaction, you have to be able to measure it in monetary terms based on some actual transaction.

**g)** The materiality principle: information in a financial statement should be meaningful to its users. Don't include *de minimis* things.

#### 3. Standards

**a)** GAAP (Generally Accepted Accounting Principles): developed my contributions of many in the accounting industry, mainly:

**(1)** FASB, the Financial Accounting Standards Board.

**(2)** AICPA, the American Institute of Certified Public Accountants.

**b)** The SEC (Securities and Exchange Commission), which tends to sanction GAAP rules from FASB.

**B. Accounts**

**1. Assets**

**2. Liabilities**

**3. Equity**

**C. Statements and other documents**

**1. Journals**

**2. Ledgers**

**3. Balance sheets**

**4. Income statements**

**D. Methods**

**1. Cash accounting**

**2. Accrual Accounting**

**a) ***Assets v. expenses**

**(1)** Assets are things that will contribute to income for more than one year. They don't offset income.

**(a)** Once you've decided to capitalize something, you must make three more decisions--because you have to depreciate it.

**(2)** Expenses are things that, if they contribute to income at all, will only do so for a year of less. The are offset against income.

**b) ***Accrual v. deferral**

**E. Specifics**

**1. Inventory**

**a) Cost of goods sold**

**(1) COGS = BI + P - EI**

**(a)** Since Income = Revenue - COGS, there's a direct relationship between EI and income. That means there's an incentive to understate EI for tax purposes and to overstate it to investors.

**b) Methods**

**(1) Average cost**

**(2) FIFO**

**(a) Reasons to use FIFO**

**i)** To build investor confidence (by showing higher earnings than LIFO would).

**ii)** To obtain a higher stock price (for the same reason).

**a.** High stock prices also will help prevent hostile takeovers.

**iii)** If management's compensation is tied to company earnings, management may prefer FIFO.

**(3) LIFO**

**(a) LIFO versus FIFO**

**i)** Theoretically, at least, there's better matching with LIFO.

**ii)** Theoretically, also, LIFO is more conservative.

**iii)** LIFO means less taxes (but so also lower reported income).

**c) Tax concerns**

**2. Fixed assets**

**a) Depreciation**

**(1) Process**

**(a)** Determine useful life: this is essentially an educated guess, based on convention. The useful life period does not necessarily correspond to real-life wearing out.

**i)** GAAP:

**ii)** Tax: use the MACRS (Modified Accelerated Cost Recovery System) tables. MACRS useful life periods are shorter than either GAAP or good-faith guesses would provide for.

**a.** Why are MACRS useful life periods shorter than GAAP or real life? This is tax policy. The shorter MACRS periods stimulate investment in productive capital assets. Whether this is a trickle-down policy or not, it does make the entire pie bigger.

**iii)** Changes to useful life: if useful life must be adjusted after depreciation for the asset has begun, you simply restart the depreciation using the new useful life estimate--you do *not* recompute anything for prior years.

**(b)** Determine depreciable basis:

**i)** GAAP: for all methods except declining-balance, DB = historical cost - scrap value. With declining-balance depreciation, you don't have a scrap value, so DB = historical cost.

**ii)** Tax: MACRS uses a declining-balance depreciation method, so DB = historical cost.

**(c)** Select a method of depreciation:

**i)** GAAP

**a.** Straight-line: simple; you annual depreciation expense = DB / useful life.

**b.** Sum of the years' digits:

**c.** Declining balance

**ii)** Tax: MACRS uses declining balance methods (double- and 1.5-).

**(2) Tax concerns**

**(a)** Separate books allowed: unlike with inventory accounting, the IRS allows you to keep two sets of books on depreciation--one for them and one for investors. Note, however, that this means that you will have deferred tax liabilities, due to different depreciation methods, in your GAAP books.

**b) Amortization**

**c) Depletion**

**(1) Methods**

**(a)** GAAP

**i)** Cost depletion: this is like depreciation, except that instead of a useful life, you have a certain number of units (of the resource), which you write of *as you recover* them.

**(b)** Tax

**i)** Percentage depletion: you get a deduction equal to x% of the gross income you produce from the resource. The value of x is set per the resource involved.

**a.** Problems with percentage depletion:

**1)** You can recover beyond your original cost.

**2)** Percentage depletion, though intended to encourage investment in risky wasting asset resource industries, has been extended to *all* mines, including ones like sand and gravel that aren't risky and don't need tax incentives.

**3)** The benefits of percentage depletion are reaped by the legal owners and the investors--it's a trickle-down idea. So, instead of encouraging exploration, percentage depletion may end up just encouraging further production of already discovered mines.

**ii)** Depletion of timber resources: you use cost depletion, but your cost can not include any part of the cost of the *land* where the timber is.

**a.** Scaling: computing the actual amount of timber in the forest based on timber cruise data.

**3. Capital accounts**

**a) Capital regimes**

**(1) Legal capital regime**

**(a)** Terms

**i)** Par value: an assigned value for equity shares, set in the articles of incorporation.

**ii)** Stated capital: the total par value of all issued shares.

**iii)** Capital surplus (paid-in surplus): the value of what's been paid for all shares, less stated capital.

**iv)** Retained earnings (earned surplus): total earnings less any dividends paid out.

**v)** Watered stock: shares issued for a price less than their par value. Holders of watered stock can be held liable to the corporation's creditors for the difference between par value and the issued price.

**(b)** Problems with the legal capital regime:

**i)** The regime operates under the mistaken belief that it actually protects creditors by giving them balance sheet accounts to look at that will indicate how much surplus the company has. This doesn't work because par value doesn't really mean anything--it's usually just a nominal figure. So creditors won't really pay heed to these accounts.

**ii)** It's arcane and complicated, anyway.

**(2) MBCA**

**(a)** Terms

**i)** No par stock: stock without a par value. Here, no allocation is made between stated capital and paid-in surplus--all the value paid is put in paid-in surplus.

**b) Dividends**

**(1) Types**

**(a)** Cash dividends

**(b)** Stock dividends: issuing new stock to existing shareholders. If the stock has par value, you must increase stated capital, docking whatever account your paying the dividend with. You only have to amend your articles here if you're going to exceed the authorized number of shares.

**i)** Stock splits: splitting existing shares into multiple shares. If the stock has par value, you must amend your articles to reduce the par value proportionately.

**(2) Dividend limits**

**(a)** Earned surplus only: contributed capital can not be invaded at all.

**(b)** Any surplus only: dividends must be paid from surplus accounts only. Most corporation statutes allow articles to provide for this.

**(c)** Nimble dividends: dividends can be paid out of *any* earnings, not just surplus. This is mainly for public utilities only.

**i)** Why do we have this?

**a.** Because be want investment in public utilities, and nobody will invest in that kind of stock unless they get dividends.

**b.** Because there's not a real danger that public utilities won't be able to pay off their creditors.

**(d)** MBCA approach: two tests, based on practical concerns of protecting creditors and facilitating business:

**i)** Equity insolvency test: you can't pay dividends if they would make you unable to pay your creditors.

**ii)** Balance sheet test: you can't pay dividends if they would make it so your assets couldn't cover the sum of your liabilities and preferences.

**c) Capital accounts in partnerships**

**(1)** Partners' individual accounts: each partner's account = contributions + income share - draws.

**(a)** Income share comes from either the partnership agreement or the statutory default (usually equal sharing).

**4. Cash flow**

**a) Cash flow accounting methods**

**(1) Direct method**

**(2) Indirect method**

**5. Other specifics**

**a) Receivables**: listed as a (fairly) current asset.

**(1)** ***contra accounts are used in bookkeeping A/R.

**b) Intercompany ownership**

**(1) Methods of accounting**: using the 20% and 50% thresholds as guidelines only--the question is: "How much control does the owning company have?" E.g., an owning company could have actual, working control--and thus use the consolidation method--with only a 45% ownership interest.

**(a)** Marketable securities (< 20% ownership): in your GAAP books, record these at *market value* (an anomaly, as fixed assets are recorded at cost)--this is done in the name of transparency.

**(b)** Equity method (> 20% but < 50% ownership): the owning company records a pro rate share, based on its ownership interest, of the owned company.

**(c)** Consolidation method (> 50% ownership): the owning and owned companies are treated as one, and all intra-group transactions are eliminated from the books.

**c) Financial instruments**

**d) Intangible assets**

**(1)** Goodwill: goodwill may only be accounted for if it has actually be paid (past-tense) for. The value of goodwill is the excess of what was paid for the business over the value of the company's non-goodwill assets.

**(a)** Depreciation of goodwill: for GAAP, you don't have to depreciate goodwill unless its value actually declines, e.g. due to an "impairment loss." For tax purposes, you may depreciate goodwill over a period of at least 15 years (this is more tax policy than real-life matching).

**e) Leases**

**(1) Accounting methods**

**(a)** Capital leases: these must be claimed as liabilities on the balance sheet.

**i)** Tax consequences: the lessor takes a gain/loss, and he may have interest income from the lessee's payments. The lessee gets interest deductions and gets to take the depreciation deductions.

**ii)** Red flag approach: it's a capital lease, and not an operating lease:

**a.** If, under the terms of the lease, the lessee gets to own the property at the end of the lease term.

**b.** If the lessee has the right to purchase the property near the end of the lease term for a "bargain price"--some price so low that the lessee will obviously buy it at that point.

**c.** If the lease term is 75% or more of the useful life of the property.

**d.** If the present value of the total lease payments is 90% or more of the property's FMV.

**(b)** Operating leases: these don't show up on the balance sheets--they allow for pure off-balance sheet financing.

**i)** Tax consequences: the lessor has rental income, but keeps the depreciation deductions. The lessee gets to deduct the entire lease price as a business expense.

**(2) ***Other lease issues**: note that a "lessor" can turn into seller/creditor if an operating lease is recharacterized as a capital lease.

**f) ***Long-term debt**

**g) Pension and compensation plans**

**(1) Pension plans**: "qualified" pension plans mean the employer gets a current deduction for what it pays in, but the employee does not realize current income on the payments.

**(2) Stock option compensation**

**(a)** Balance sheet treatment: before, stock options didn't show up on the balance sheet (or on any other financial statement, for that matter). Now, though, stock options must be shown as an expense item as they are granted.

**(b)** Tax treatment: like with pension plans, if stock option compensation is "qualified," the employee doesn't have income until he exercises his options, but the company gets to treat them as business expenses and deduct them as they are issued.

**h) Loss contingencies**

## II. Finance

**A. Analyzing financial statements:** we want to compare a business over time, and multiple businesses at a specific time.

**1. Investor measures**

**a)** Earnings per share: EPS = total earnings / total shares. This figure is of limited value by itself, since companies don't all have the same number of shares.

**(1)** Diluted EPS: EPS where the number of shares includes issuable, but not yet issued, shares, from things like options, warrants, stock-based compensation agreements, written put options, convertible debt, and contracts that can be settled with stock.

**b)** P/E ratio: P/E = market price per share / earnings per share. So, this tells you what people are paying for a dollar of (corporate) income from this company.

**(1)** The denominator problem: you can manipulate P/E ratios by manipulating EPS--the earnings per share.

**(a)** For example, what do you do with convertible debt? Should you include it in the number of shares? Only when the conversion price is lower than the share price? Only when its higher?

**2. Creditor ratios**

**a)** Current ratio: CR = current assets / current liabilities. This is the most widely used creditor ratio.

**(1)** Working capital: WC = current assets - current liabilities. This doesn't filter out company size, like current ratio does.

**(2)** Both current ratio and working capital are ways of measuring debt service capacity.

**(3)** Having too much working capital is a bad thing. It shows that you're not getting the maximum value out of your capital. So, if you have too much, like if you have a current ratio = 100, you should put some capital into short-term

investment securities.

**b)** Quick ratio (acid-test ratio) (liquidity ratio): like CR, but not including less current assets, like inventory and prepaid expenses. So, QR = (CA - I - P.E.) / CL.

**c)** Debt-to-equity ratio: DER = total debt / owners' equity. High DER means that the company is highly "leveraged."

**3. Management ratios**

**a)** Inventory turnover ratio

**b)** Accounts receivable turnover ratio

**4. MD&A**

**B. Valuation**

**1. Foundations**

**a)** The time value of money

**(1)** Causes of the time value of money

**(a)** Utility

**(b)** Risk

**(c)** Opportunity

**(2)** Present and future values

**(a)** Compounding interest

**i)** Interest rates

**ii)** Discount rates

**(3)** Additional complications

**(a)** Fluctuating interest rates

**(b)** Changing tax treatment

**(c)** Inflation

**2. Valuation techniques**

**a) Less important techniques**

**(1)** Salvage value

**(2)** One year earnings

**(3)** One year earnings multiplied

**(4)** Market value

**(5)** Book value

**b) The major techniques**

**(1)** Capitalized earnings

**(2)** Discounted cash flow

**3. Judicial valuation**

**a) Cases**

**(1)** *Wilson*

**(2)** *Rolling Stone*

**(3)** *Le Beau*

**III. Auditing**

**A. Foundations**

**1. Standards**

**a)** GAAS (Generally Accepted Auditing Standards)

**2. Purpose**

**a)** Who needs certified financial statements?

**(1)** Investors

**(2)** Financiers, such as banks

**(3)** SEC and other government agencies

**(4)** Dealmakers, such as company A that's buying company B

**b)** Why can't we just trust the company itself?

**(1)** Management wants to look good (by showing high profits).

**(2)** Management wants less taxable income (by showing lower earnings).

**(3)** Management wants to be in a good position to bargain with labor.

**(4)** Management wants to move stock prices up.

**(5)** Management wants to increase its own compensation.

**(6)** Dishonesty.

**B. Audit reports**

**1. Standard report**

**2. Non-standard reports**: these are rare. If an auditor can't verify a company's statements, they usually just walk away, issuing no opinion.

**a)** Adverse opinions: why don't we hardly ever see these?

**(1)** Because management chooses and pays for the "independent" auditing firm.

**(2)** Because GAAP isn't law.

**(3)** Because there's almost always more than one way to treat a given financial transaction.

**(4)** Because management is ultimately in control of the facts (i.e., the books) on which the auditor bases its opinion.

**C. Policy concerns**

**1. Cases**

**a)** *Monroe*

**b)** *Capital Bank*

**2. Sarbanes-Oxley**

**3. Shenanigans**

**D. The lawyer's role**

**1. Cases**

**a)** *Arky, Freed*

**b)** *Wilkie, Farr*

**2. Sarbanes-Oxley**

**3. Multidisciplinary practice**