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Law and Accounting: Cases and Materials (Front Matter)

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Accounting is a tool that provides conceptual organization to economic exchange. The tool facilitates analyzing legal, business and public policy aspects of the transactions that accounting addresses. Materials in this book illuminate why transactions are pursued and related decisions made, economic aspects of transactions, and the conceptual underpinnings of the activities of measuring, classifying and reporting on them. Law and Accounting thus emphasizes the intersection of the two subjects. It is neither accounting for lawyers nor law for accountants. It is both. It is not accounting qua accounting being presented, but a conception of law and accounting bearing an authentic interdisciplinary sense.

Law and Accounting is also an appreciation of how accounting problems morph easily into what are essentially legal issues. As examples, an accounting principle must be (a) referenced to establish or interpret certain contractual or property rights, (b) complied with to discharge various disclosure obligations imposed by federal securities law, or (c) understood to determine the legality of some decisions governed by state corporation law. When departures from applicable accounting standards are inadvertent, negligence liability can result; when departures are intentional, potential fraud liability, both civil and criminal, arises; and when departures violate contractual provisions, strict liability looms. Remedies range from regulatory censure and consent decrees to money damages and prison terms.

Accounting materials govern transactions engaged in by individuals, business enterprises, governmental entities, and not-for-profit organizations. They raise issues in every field of human endeavor, including all aspects of law. For example, materials in this book raise issues considered in nearly every law school class, including Contracts, Property, and Torts; Commercial, Intellectual Property, Insurance, and Environmental Law; as well as Corporations, Partnerships, and Securities Regulation. Several Chapters in this book address subjects to which entire law school courses are devoted: Mergers & Acquisitions (Chapter 9), Corporate Finance (Chapter 10), Labor (Chapter 13), and Tax (Chapter 15). Business school courses on Accounting (including Auditing) also engage related legal contexts presented in this book.

In addressing the world’s transactions, accounting is ambitious. It simultaneously responds to and shapes developments of an endlessly-dynamic world bursting with exchange. Not only does accounting measure and influence the mix of debt and equity capital used in businesses, for example, it also measures and influences the scope and form of employee compensation, benefits and pensions. Accounting plays a role in determining the types of business combinations that enterprises form as well as in generating new financial products, financing devices, and exchange transactions.

Materials in this book reflect accounting’s dynamism. Most materials presented were published since 1990. They respond to forces such as globalization, the rising significance of intellectual property, technological transformation, financial innovation and numerous political-economic cross-currents. On the other hand, plus ça change, plus ça la même chose: the materials all build on concepts first formalized 500 years ago (and these,
in turn, were built on truly ancient practices). To single out one general example, today’s world increases pressure to generate an internationally recognized system of accounting rather than defer to country-specific standards. This harkens back to the earliest days of international trading when similar efforts originated to facilitate cross-border exchange.

As a business lawyer in the late 1980s and early 1990s, I encountered many of the transactions considered in this book, including developing some discussed in Chapters 7 and 11 (on Asset Securitizations and Derivatives, respectively), and worked directly on those covered by topics in Chapters 9, 10, 12, 17, and 18 (on Deals, Debt, Leases, Contractual Provisions, and Disclosure, respectively). My legal work then, and in subsequent consulting assignments, involved topics addressed in nearly every Chapter. As a legal scholar, I have written about most of the subjects and find them to be fascinating. As a law professor and academic dean, I notice how these subjects cross-fertilize with topics throughout the law school curriculum. Based on this variety of experience, I know that readers will be (nearly) as handsomely rewarded by studying these materials as I have been by organizing them.

Accounting materials essentially are original pronouncements of officially-designated or recognized standard-setting bodies. These are the functional analogue of legislative enactments and should be approached as statutes. Managers are responsible for applying these principles and auditors are charged with promoting compliance. Disagreements concerning application are thus resolved, in the first instance, between managers and auditors. For public companies, moreover, further disputes concerning compliance may be resolved by interaction with the United States Securities and Exchange Commission (SEC), the chief legal authority in the United States with jurisdiction over accounting matters. Most disagreements with the SEC are resolved informally between parties and the SEC’s accounting staff but when this avenue fails to resolve them, SEC enforcement actions can result. External users of financial statements may also challenge compliance in private litigation, resulting in traditional judicial opinions.

The purpose of all materials in this book—including original standards, SEC enforcement actions and judicial opinions—is to illustrate accounting principles, departure from which can constitute violations of law or breaches of contract. Materials are edited to focus on underlying transactions and related accounting. Thus portions of SEC materials describing sanctions for violations usually are omitted. Materials are presented principally for pedagogical purposes. As a result, citations and headings often are deleted without indication (though paragraph numbers to authoritative accounting pronouncements are retained because they are used as critical reference points both in the materials included and in accounting literature generally). Despite these pedagogically-driven editing decisions, the book should provide a reliable reference for researchers and practitioners alike.

Illustrating some of the foregoing themes, early Chapters treat the reader to an appreciation of accounting as law by tracing the accounting standards-setting process in the

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1 See also Ecclesiastes 1:9-10 (“The thing that hath been, it is that which shall be; and that which is done is that which shall be done: and there is no new thing under the sun. Is there any thing whereof it may be said, See, this is new? It hath been already of old time, which was before us.”).
United States, to which Congress, the SEC and private accountants and other professionals (including lawyers) contribute. A sense of both dynamism and stability emerges when the reader is shown how accounting is akin to traffic laws and cartography (ancient concepts) as well as to pharmaceutical drug trials and scholastic aptitude tests (modern concepts). Even a sense of romance appears when encountering reflections on a Franciscan friar of 15th century Venice who codified the double-entry bookkeeping still in use today, as captured here using the records of a merchant-mariner of that era.

The theme of accounting responding to contemporary national crises emerges early in this book’s materials as well, with Congress enacting the Foreign Corrupt Practices Act in 1977 to stem widespread bribery that was concealed within accounting records. Accounting had to deal with the hyperinflation of the 1970s and address that era’s energy shortage. Society confronted legal-accounting challenges in dealing with: the sovereign Third-World debt crisis during the early 1980s; proliferation of debt financing of the latter 1980s; innovation in financial instruments of the early 1990s; and waves of mergers, asset transfers and corporate restructurings throughout these periods. Increasing consciousness of environmental degradation raised legal-accounting challenges in the last two decades. The expanding role of private enterprise in funding the needs of the workforce has posed significant issues of law, accounting and public policy, particularly as to accounting for retiree benefits and the implications of this accounting for the level of benefits provided.

Readers also encounter legal-accounting problems arising against the backdrop of global events. Examples include the case of a dispute between a military contractor (Litton) and the U.S. Navy over shipbuilding contracts during the waning days of the Vietnam conflict and the case of an aeronautical design firm’s difficulties, as the Cold War drew to a close, in shifting from making aircraft for the U.S. Army designed to resemble Soviet aircraft to making models for the Taiwanese government based on a U.S. design. Readers confront a forest-products concern valuing new property in the Brazilian rain forest, apparently bought from a land swindler, as well as new property bought in Nicaragua that was soon expropriated by that country’s government. Upheaval in Brazil amid its hyperinflation of the 1980s posed legal-accounting issues for a leading maker of earthmoving, construction, and materials handling equipment (Caterpillar) when newly-elected President Fernando Collor de Mello instituted sweeping economic and monetary reforms. Loans to sovereign countries in the Third World posed enormous legal-accounting consequences for a large financial services firm (First Chicago).

A smaller firm faced legal-accounting issues as it tried to exploit globalization’s promise by increasingly selling its aerospace and automotive software in the Far East. Computer challenges associated with the Y-2K problem presented significant legal-accounting issues to one of the country’s most venerable consumer products concerns (Avon Products). Systemic consequences can be significant, creating national news. Examples include the speculator fraud and bankruptcy of Towers Financial in the early 1990s and the even more spectacular fraud and bankruptcy of Enron Corp. in the early 2000s.

Legal-accounting issues arise from financial and regulatory change. The telecommunications boom of the latter 1990s presented considerable legal-accounting problems to the entire sector, when numerous participants used a variety of leases and other
instruments to swap network capacity or sell excess network capacity to others (McLeod USA Inc.). Financial engineering—and the limitations of related accounting and law—figured prominently in cases involving interest-rate risk management at one of the world’s leading greeting card companies (Gibson Greetings); management of palladium supplies necessitated by federal environmental laws at a leading automobile manufacturer (Ford Motor Co.); and management of energy prices amid California’s early 2000s energy crisis by an electric and gas utility company (Reliant Resources).

Circumstances within organizations may produce legal-accounting challenges. Incentive compensation arrangements for senior managers can create pressure to adopt favorable accounting policies when choices are possible and can also lead to fraudulent behavior. Bank loan agreements invariably contain covenants requiring borrowers to maintain financial characteristics measured using accounting concepts, such as minimum earnings or maximum debt. Pressure can be strong to make accounting decisions to avoid triggering defaults under such agreements. Preventing such pressure from producing misconduct often requires an organization to maintain an adequate system of internal control, posing matters of both law and accounting.

Materials exhibit how legal-accounting problems are addressed by such widely-recognized enterprises as among the world’s leading: software producers (Microsoft); copier makers (Xerox); toy manufacturers (Mattel); consumer products purveyors (Sunbeam); garbage collectors (Waste Management); Internet service providers (America On-Line); semi-conductor chip makers (Cirrus Logic); and telecommunications concerns (WorldCom). Such problems equally face a broad range of smaller enterprises, including makers of surgical products, computer graphics, semi-conductor testing equipment, document finishing systems and bar-code scanners; as well as biotechnology concerns, home-builders, foreign car replacement parts businesses, sweater makers, golf apparel enterprises, ice cream sellers, brokerage firms, rare coin dealers, rental centers and car dealers.

Lawyers are usually in the middle of these stories, whether concerning negotiating or disputing customer contracts, business purchase agreements or loan agreements, or assisting clients in providing disclosure. A leading example from the 1970s concerned a major law firm (White & Case) as an accomplice to one of the most notorious legal-accounting scandals ever (National Student Marketing); it faced public humiliation for its role when consenting to a decree addressing its compliance with professional standards of legal ethics. Accountants are always in the middle of these dramas, whether as accounting managers preparing financial statements or auditors examining them. This involvement adds considerable social value by facilitating capital formation and economic exchange; it can subtract value by conduct ranging from ordinary carelessness provoking regulatory reprimand to colossal criminal frauds provoking public condemnation.

Human dramas underlay many of the forensic accounting stories appearing in this book, epitomized by the late president of a brokerage firm whose suicide note confessed to 24 years of fraudulent securities sales. (Ernst & Ernst v. Hochfelder.) Another such drama concludes the book: the case of the ex-husband who ran away with his bookkeeper. When he moved to terminate his maintenance obligations to his former wife, however, neither he
nor his lawyer had sufficient accounting data (or knowledge) to persuade the court to grant
the motion. (*General v. General.*)

Many financial frauds (notice the implicit overlap of accounting and law in that
phrase) may be traced to fraudsters exploiting cracks between the accountancy and legal
professions. A dramatized example occurs when the fraudster falsely tells his lawyer that
his accountant approved an approach to a transaction, while simultaneously lying to his
accountant that his lawyer also signed off. If neither does so, but each is convinced of the
reliability of the other’s reported judgment, the fraudster can evade deterrence and
detection that these professionals otherwise provide. Students of law and accounting help
seal such cracks, understanding its interdisciplinary character, ambitions and quest to
conceptualize economic activity.
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ACRONYMS AND ABBREVIATIONS

As with other technical disciplines, accounting is replete with acronyms to designate various bodies, pronouncements and other references. Following is a partial list, capturing designations frequently appearing in this book.

AAER   Accounting and Auditing Enforcement Release (of the SEC)
AICPA American Institute of Certified Public Accountants
APB   Accounting Principles Board (which issued Opinions)
ARB   Accounting Research Bulletin (issued by CAP)
ASR   Accounting Series Release (of the SEC)
CAP   Committee on Accounting Procedure (which issued ARBs)
EITF  Emerging Issues Task Force (of FASB)
FASB  Financial Accounting Standards Board (current accounting standard-setter)
GAAP  Generally Accepted Accounting Principles
GAAS  Generally Accepted Auditing Standards
MD&A  Management's Discussion and Analysis (in SEC filings)
PCAOB Public Company Accounting Oversight Board
SAB   Staff Accounting Bulletin (of the SEC Staff)
SAS   Statement on Auditing Standards (of the AICPA)
SEC   United States Securities and Exchange Commission
SFAC  Statement of Financial Accounting Concepts (of FASB)
SFAS  Statement of Financial Accounting Standards (of FASB)
SOP   Statement of Position (on Accounting, of AICPA)

The foregoing are standard abbreviations for items designated and are used in this book’s headings and editor’s materials. Other shorthand designations are sometimes used for these items, including in materials reproduced in this book. A frequent example concerns Statements of Financial Accounting Standards, designated above as SFAS, which are sometimes variously designated as: FAS, FASB Statement, or simply Statement. As common, Statements of Financial Accounting Concepts, designated above as SFAC, are sometimes variously designated as FASB Concepts Statement, Concepts Statement, or CON. The SEC is often referred to as the Commission, particularly in legislative and administrative materials. Original materials reproduced in this book that use these alternatives are not generally changed for conformity, unless the context would otherwise obscure the intended reference.
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