

ACCOUNTING FOR LAWYERS

FIFTH EDITION

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*To Kate, Kevin, Wilson, Luke, and Maggie;
my mother; and David*

*In memory of my father; William G. Barth, CPA;
and Judge Cornelia G. Kennedy*

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PREFACE TO THE FIFTH EDITION

Is there any such thing as “accounting for lawyers?” No matter how you answer that question, these materials attempt to highlight the importance of issues involving accounting to the practice of law.

In 2013, three professors at Harvard Law School (“HLS”) surveyed 124 practicing attorneys at the eleven law firms that have hired the largest number of HLS graduates in recent years. When asked to rate the usefulness of seven business-methods classes currently offered at HLS, the practicing lawyers gave the highest overall score to “Accounting and Financial Reporting.” When asked to select the three most important business-methods courses, “Accounting and Financial Reporting” again ranked first among both *corporate or transactional lawyers and litigators*. See John Coates et al., *What Courses Should Law Students Take? Harvard’s Largest Employers Weigh In* (Feb. 17, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2397317. Especially after the financial frauds involving Enron Corp. (“Enron”), WorldCom, Inc. (“WorldCom”), and numerous other companies in the late 1990s and early 2000s, clients increasingly expect lawyers to have developed at least some working knowledge of accounting. See, e.g., Lawrence A. Cunningham, *Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadows*, 57 BUS. LAW. 1421 (2002) (asserting that every competent business lawyer should understand basic accounting principles, arguably as a matter of professional responsibility). Accordingly, law students who acquire this knowledge enhance their attractiveness to potential employers and clients. This text seeks to facilitate that process.

Accounting issues can arise in the practice of law in many different ways. Accounting has long been called “the language of business.” In addition, accounting has been described as “the language of corporate governance.” Joel Seligman, *Accounting and the New Corporate Law*, 50 WASH. & LEE L. REV. 943, 945 (1993). Virtually every lawyer represents businesses, their owners, or clients with adverse legal interests, such as creditors and customers. Could you effectively practice law in China if you did not speak, or at least understand, Chinese? Moreover, accounting issues also arise regularly in the representation of not-for-profit enterprises, including governmental bodies, and even in private individual matters, such as local rent control. Almost all lawyers, therefore, will encounter financial statements at some time in their professional careers or personal lives. At one time or another, every lawyer will draft, negotiate, or sign an agreement or other legal document containing accounting terminology or concepts. Perhaps most importantly, however, potential discovery issues related to contingencies and audit inquiry letters affect every lawyer or law firm that represents businesses or legal interests

adverse to those businesses. Finally, all competent lawyers should recognize certain “red flags” that suggest that their client or another party has committed financial fraud. Businesses often misstate their inventories or other assets, record revenues before they are earned, allocate expenses to the wrong accounting period, or fail to record or disclose liabilities.

Accounting issues constantly arise in different practice areas. Litigators encounter accounting issues when calculating damages in contract and tort cases, throughout securities fraud cases, and in discovery. Transactional lawyers frequently draft and negotiate contracts and other legal documents involving accounting terminology. Securities lawyers frequently advise clients about the disclosure requirements under the federal securities laws. Environmental lawyers face significant cost allocation issues and often need to disclose environmental loss contingencies. Tax lawyers, in particular, must understand the time value of money, and they depend upon accounting concepts to determine taxable income. Labor lawyers often draft, negotiate, or litigate profit-sharing agreements, while intellectual property lawyers do the same with licensing agreements. Domestic relations law frequently requires lawyers to interpret financial statements in property settlement, alimony, or child support matters. Trust, estate, and probate laws often encounter fiduciary accounting, which must distinguish between income and principal. Regulatory lawyers, whether representing clients in the health care, insurance, or public utility industries, use accounting to resolve reimbursement issues, to establish reserves, and petition for rate approvals. “White collar” crime, especially financial fraud, has become increasingly important to criminal lawyers.

These materials strive to make accounting as teachable as possible to law students, recognizing that many law students approach the subject with considerable trepidation and have not previously studied accounting. This edition treats its audience as the law student with no accounting background. In that regard, this edition continues to omit lengthy excerpts from official accounting publications. At the same time, the text discusses many sophisticated topics, so that more advanced students can also benefit from these materials. I hope that this book will instill confidence in its readers so that they can begin to master the principles of accounting and develop command of the basic tools that lawyers need so that they can “care about accounting, as lawyers.” Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards*, 28 N.C. J. INT’L L. & COM. REG. 847, 877 (2003).

To accomplish this objective, I continue to develop the materials around explanatory text designed to lead the students through the subject’s technical aspects. Each chapter begins with a section that explains the topic’s importance to lawyers. Wherever possible, I have attempted to lay out the bookkeeping alternatives, illustrating the various entries in some detail, in the hope that students can direct their efforts more to analyzing the various alternatives’ comparative merits and less to the accounting mechanics. To serve as vehicles for such analysis, I have again included alternative problems

in each section, and both the materials and the problems seek to highlight the lawyer's role in dealing with accounting issues.

Before beginning the second edition, I wrote to our colleagues across the country who had taught an Accounting for Lawyers course and asked them for their response to the question: What are the top ten things that *every* lawyer should know about accounting? Grateful for the many insights that our colleagues shared and as an overview to this fifth edition, I offer my own updated list of critical accounting concepts for lawyers, arranged in the general order that these topics appear in the chapters that follow:

1. Together with the accompanying notes, the balance sheet, the income statement, the statement of changes in owners' equity, and the statement of cash flows constitute a complete set of financial statements. Accountants use these four different financial statements and the accompanying notes to describe an enterprise's financial condition and the results of its operations. The balance sheet presents an enterprise's financial assets and liabilities, and owners' equity, at a particular moment in time, and it reflects the fundamental accounting equation:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

The income statement shows the extent to which the enterprise's operations and other changes in assets and liabilities from peripheral activities affected the amount of owners' equity, or net assets, over a period of time. The statement of owners' equity more fully reconciles the income statement with the net changes in owners' equity during the period by describing investments by, and distributions to, owners. In addition, most enterprises currently use the statement of owners' equity to report comprehensive income, an amount that summarizes all increases and decreases in net assets during a period, except those changes resulting from investments by, and distributions to, owners. Finally, the statement of cash flows explains the change in the enterprise's cash and cash equivalents during the particular period.

2. Financial statements currently use a "mixed-attribute model," which increasingly requires enterprises to report certain financial assets and liabilities at fair value. Until recently, financial accounting primarily used historical costs, rather than current values, to record financial transactions. Financial statements, therefore, have historically presented, at best, a retrospective picture of an enterprise's financial condition and the results of its operations. Increasingly, financial accounting requires enterprises to use fair value or current market value, rather than historical cost, to report certain financial assets and liabilities in an effort to provide more contemporary or prospective information. At the same time, however, financial statements do not reflect many important "assets" and "liabilities." For example, the value of an outstanding management team, good morale among the enterprise's employees, and loyal and satisfied customers do not appear on the financial statements; nor do the financial statements list weak management, labor problems, unsatisfied customers, or a poor reputation in the community as "liabilities."

3. Poor accounting can violate the law. An enterprise's financial statements represent the "ends" in a process that accountants refer to as "double-entry bookkeeping." As the "means" in this bookkeeping process, business enterprises use journals, ledgers, accounts, debits, credits, trial balances, and worksheets to prepare financial statements. As a result of the Foreign Corrupt Practices Act of 1977 and related amendments, even domestic businesses that keep poor accounting records may violate the federal securities laws.

4. When reading financial statements, pay careful attention to the accompanying notes and, if applicable, Management's Discussion and Analysis, usually called simply "MD&A." Accounting is an art, rather than a science. Accountants, like lawyers, constantly exercise judgment. Even though we often hear accountants referred to as "bean counters," accounting often involves estimates and does not always provide precise rules. Generally accepted accounting principles typically provide alternative choices or may not address a particular situation because business transactions evolve more rapidly than accounting principles. Like lawyers, accountants must examine and interpret statutes, regulations, administrative cases, and official pronouncements of accounting bodies for answers to accounting and auditing questions. Lawyers should know where and how to find and apply this body of authorities. As a general rule, an enterprise's management selects the accounting principles that the enterprise will use from among the acceptable alternatives. The notes to the financial statements address and explain these choices and judgments. MD&A gives readers an opportunity to view the business "through the eyes of management" and may provide forward-looking information about the business and significant trends, commitments, or uncertainties.

5. Generally accepted accounting principles can, and often do, change or evolve. Lawyers should specifically consider this possibility when drafting contracts and legal documents involving accounting terminology. In particular, lawyers in the new millennium should pay attention to the emergence of international accounting principles and their use and acceptance in the United States.

6. An audit does not guarantee the accuracy of financial statements. Even an unqualified audit report provides only "reasonable assurance" that the financial statements fairly present, in all material respects, the enterprise's financial condition, results of operations and cash flows. In addition to auditing financial statements, accountants also often render review and compilation services. Reviews offer only limited assurance, and compilations provide no assurance that the financial statements provide fair representations.

7. A dollar today is worth more than a dollar tomorrow. Remember the time value of money.

8. Different sets of accounting rules can apply for different purposes. An enterprise may use one set of rules for preparing financial statements for creditors and investors, another set for reporting to a

regulatory agency, and still others for tax purposes. Different rules or accounting measurements may also apply for specific contracts or for trust accounting, or to determine the legality of distributions to owners, such as a dividend to corporate shareholders. As a result, enterprises may keep different sets of accounting records to maintain information necessary for the various sets of rules or accounting measurements that may apply to the enterprise.

9. Be aware of the legal issues involving contingent liabilities. Be careful when responding to an auditor's requests for information about pending or threatened litigation, claims, or assessments. You probably waive the attorney-client privilege as to any information that you provide to the auditor. Although numerous states have enacted an accountant-client privilege, no such privilege exists under federal law or under the common law. Wherever possible, seek information about a litigation opponent's reserve for a contingent liability during discovery, by examining the opponent's financial statements and public filings, books and records, and tax returns, or by requesting such information from your opponent's auditor.

10. Various lawful and unlawful motivations can influence the discretionary, and often difficult, cost allocation issues that underlie financial statements. Small businesses and their owners generally prefer accounting principles that reduce income in order to reduce income taxes. In contrast, a publicly traded enterprise may select accounting treatments that increase earnings so that management can report higher earnings to investors. All businesses incur costs that they must classify as either assets or expenses. Enterprises expect assets such as inventories, long-lived assets, and intangibles, which appear on the balance sheet, to produce future revenues or other benefits. Expenses like selling commissions, repairs, depreciation, depletion, and amortization, in contrast, offset current revenues on the income statement. Many smaller businesses use the "cash method" of accounting for tax purposes, which requires the taxpayer to report income when actually or constructively received and allows the taxpayer to deduct expenses when actually paid. The cash method, however, does not match expenses with the revenues that they produce. Financial accounting requires the "accrual method," under which a business recognizes revenue when it has completed, or has at least substantially completed, the earnings process and matches the expenses necessary to generate those revenues.

During the eight years that have elapsed since the publication of our fourth edition, lawyers have watched as the stock option scandals developed, the collapse in various subprime lending markets in the United States developed into a global financial crisis, and the Securities and Exchange Commission ("SEC") announced a proposed "roadmap" for adopting International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). Although the SEC later issued a statement in support of global accounting standards, the Commission failed to meet the timetable established in the roadmap and the agency's ultimate decision regarding IFRS remains pending. Collectively, the credit crisis, the Bernard Madoff scandal, the Dodd-Frank Wall Street Reform and

Consumer Protection Act of 2010, and the Jumpstart Our Business Startups Act have demanded the SEC's time and attention. Although far less publicized in the popular press, the Financial Accounting Standards Board ("FASB") completed a multi-year project to develop a single authoritative source of generally accepted accounting principles for nongovernmental entities in the United States. Effective for financial statements for interim and annual periods ending after September 15, 2009, the FASB Accounting Standards Codification (the "Codification") assembles all authoritative guidance in one place and affects the way enterprises reference accounting policies in their financial statements and related notes.

Shortly after the publication of the third edition, the country watched as corporate and accounting fraud led to the sudden collapse in late 2001 of Enron, then the nation's fifth largest company in terms of revenue. Even if you know very little about the Enron scandal, the corporation's collapse painfully illustrates the importance of financial accounting to *all lawyers and law students*. While accounting rules have become increasingly complex, and few law students or lawyers receive formal training in accounting, lawyers can, and should, watch financial statements and related disclosures for "red flags." Accordingly, I continue to include in this preface the following listing of my top ten accounting lessons for lawyers from the Enron scandal:

1. Where's the beef?

A complete set of financial statements includes an income statement, a balance sheet, a statement of cash flows, a statement of changes in owners' equity, and the accompanying notes. The Enron crisis accelerated when the company's 2001 third quarter earnings press release on October 16, 2001, provided only an income statement, and not a balance sheet, statement of cash flows, or statement of changes in shareholders' equity. (Remarkably, Enron failed to provide the other financial statements in its earnings releases beginning in 1996.) In response to questions from analysts, Enron's management later disclosed that Enron recorded a \$1.2 billion reduction in shareholders' equity. Because the income statement does not reflect this item, without a balance sheet or statement of changes in shareholders' equity, investors could not see a complete and accurate picture of Enron's financial condition and operating results. In addition, the cash flow statement, possibly the lawyer's best friend in such situations, also would have alerted a careful reader to problems, including the business's declining profitability. As Enron's collapse demonstrates, a missing financial statement may indicate that the enterprise seeks to hide disappointing results. Enron's eventual issuance of its missing balance sheet, and the large write-down of shareholders' equity in that financial statement, triggered a loss of investor confidence, which caused Enron's share price to fall, accelerated debt repayment obligations, and ultimately led to Enron's bankruptcy. The Enron scandal illustrates that *each* financial statement offers important information necessary to maintain investor and creditor confidence. A lawyer should ask probing questions any time an enterprise does not provide a complete set of financial statements, plus accompanying notes.

2. *Old dogs, new tricks.*

Generally accepted accounting principles (GAAP) often offer choices in financial accounting treatments. Although the “consistency principle” generally requires enterprises to use the same accounting principles to treat the same transactions similarly from year-to-year, this consistency requirement does not apply to new business activities. The business community refers to the “rules” governing the compilation of accounting data into financial statements and the accompanying notes as “GAAP.” GAAP, however, typically allows choices among permissible alternatives and almost always requires estimates and assumptions that affect the amounts shown in the financial statements, including the reported amounts of assets, liabilities, revenues and expenses. Especially in today’s world, business transactions and practices evolve more rapidly than rule-makers can promulgate accounting rules. For several reasons, therefore, GAAP does not provide a set of black-and-white rules that produce a single “bottom-line” number that a lawyer can use natural law to verify. Commonly referred to as “earnings management,” corporate managers can often use GAAP’s flexibility to show operating results in line with projections and expectations. Especially when an enterprise’s business changes (witness Enron’s evolution from a regional natural gas company to a global energy and commodities trader), lawyers should pay particular attention to the accounting principles an enterprise uses to account for transactions arising from the new business activities.

3. *Looks aren’t everything.*

Pro forma reporting can distort an enterprise’s financial appearance. In its 2001 third quarter earnings release, Enron reported “recurring” net income of \$393 million. Such “pro forma” reporting, which provides numbers “as if” certain (often undescribed) assumptions apply, does not follow GAAP. Even a simple analysis of the earnings release reveals that Enron actually suffered a \$618 million *net loss* under GAAP. By labeling \$1.01 billion as “one-time” or “non-recurring” charges, mostly related to investment and asset write-downs and restructuring charges, the company turned its \$618 million net loss, purportedly using GAAP, into \$393 million in net income. Such write-downs and charges, however, would seem to represent normal business expenses and losses.

In an effort to focus investors on results from “normal” business operations, an enterprise may, knowingly or innocently, mislead investors. Initially, pro forma reporting can hide troubling financial results. For instance, in its 2000 fourth quarter earnings release, Enron boasted a 25 percent increase in earnings per share (“EPS”) for the full year 2000 over 1999 and a 32 percent increase in earnings per share for the 2000 fourth quarter over the 1999 fourth quarter. Buried in the last section of its earnings release, however, the company told a very different story. Enron disclosed that EPS for 2000, including non-recurring charges, increased only from \$1.10 per share in 1999 to \$1.12 per share in 2000. These amounts translated to an increase of only 1.8

percent, compared to the 25 percent increase Enron reported at the beginning of its earnings release. Next, Enron disclosed that 2000 fourth quarter EPS, after non-recurring charges, totaled \$0.05, a *decrease* of 83.8 percent from the 1999 fourth quarter, in contrast to the 32 percent increase it reported at the beginning of the release. Interestingly, earlier in the quarter, Enron predicted that it would post fourth quarter EPS of \$0.35. Excluding what it called non-recurring items allowed Enron to exceed those expectations. If Enron had included the non-recurring items, its results would have fallen below that prediction.

Second, an enterprise can use pro forma reporting to manage earnings. Earnings management typically tries to increase net income (or reduce the size of a loss), relative to what the business would otherwise report under GAAP. Enterprises, however, sometimes exclude non-recurring gains in an effort to report lower net income, which translates to smaller profit-sharing payments to employees (or reduced income tax obligations). Lawyers drafting agreements that rely on earnings to set prices or trigger payments, for example, should distinguish pro forma earnings from net income calculated in compliance with GAAP. Without distinguishing between the two benchmarks, parties to such an agreement can manipulate earnings by labeling some items as one-time or non-recurring.

4. *Sometimes, looks are everything.*

Auditor independence matters—both in appearance and in fact. During the late 1990s, the largest public accounting firms increasingly provided non-audit services, such as consulting, internal audits, and tax advising, often for the very enterprises they audited. During 2000, Enron paid \$52 million to Arthur Andersen—\$25 million for auditing services, and an additional \$27 million for non-auditing services—and ranked as Andersen's second largest client. In addition, an internal Andersen memo regarding the retention of Enron as an audit client refers to \$100 million a year in potential revenues from Enron.

Unlike lawyers who must zealously represent their clients, auditors' real responsibilities flow to the investing public, not the enterprise that hires them. By evaluating an enterprise's financial statements and expressing an opinion as to whether those statements fairly present, in all material respects, the enterprise's financial position and operating results, an auditor seeks to help maintain investor and creditor confidence. To satisfy generally accepted auditing standards, an auditor must remain independent from any enterprises it audits—both in fact and in appearance. When non-audit fees comprise a substantial piece of an auditor's income from the audit client, those fees might tempt an auditor to overlook an enterprise's "aggressive" accounting simply to retain the client's non-audit business. At a minimum, substantial fees paid to auditors for non-audit related services call the appearance of independence into question. Even if the auditor continues, in fact, to exercise objective judgment, such relationships impair the appearance of independence. As the recent malaise that has afflicted the stock markets in the United States ably demonstrates, even the *perception* of a lack of independence can shake investor

confidence in the quality of financial statements. Because investors view a lack of independence, whether in appearance or in fact, with a critical eye, lawyers should encourage clients to preserve independence, both in fact and in appearance. Lawyers should also carefully scrutinize financial statements, disclosures, and transactions that involve an auditor who may have compromised independence, whether in fact or in appearance.

5. With friends like these, . . .

Related-party transactions, especially those involving a special purpose entity (“SPE”), can distort an enterprise’s apparent financial condition and operating results. Although related-party transactions may increase efficiency in transacting business, they may also allow an enterprise to manipulate its earnings by the way the enterprise sets prices or allocates expenses. Similarly, an enterprise may use SPEs for legitimate purposes, such as to limit exposure to risk in certain investments, including credit card receivables or residential mortgages. An enterprise, the “sponsor,” generally forms an SPE to transfer risks from such investments to outside investors.

Enron’s transactions with its SPEs, including the so-called Chewco and LJM partnerships, highlight the dangers that can arise from related-party transactions. As a small, but relatively simple example, Enron sold an interest in a Polish company to LJM2 for \$30 million on December 21, 1999. While Enron intended to sell the interest to an unrelated party, the company could not find a buyer before the end of the year. The sale allowed Enron to record a gain of \$16 million on a transaction that Enron could not close with a third party. Remarkably, Enron later bought back LJM2’s interest for \$31.9 million after it failed to find an outside buyer. Another deal allowed Enron to *report* a \$111 million gain on the transfer of an agreement with Blockbuster Video to deliver movies on demand, even after Enron realized that no real profits would ever flow from the underlying agreement.

The related-party transactions with SPEs, often occurring at the end of a fiscal period, allowed Enron to manipulate its reported earnings, to close deals at desired amounts quickly, to hide debt, and to conceal poorly performing assets. Such transactions, which frequently closed at the end of a quarter or year, allowed Enron to meet its earnings expectations and to sustain its stock price. In fact, Enron sometimes even backdated such transactions to the previous period, in an effort to “manufacture” income for that period. Because Enron entered into those transactions with “friendly” related parties, the company could quickly and easily negotiate terms that allowed its earnings to appear on target. In addition, Enron used its earliest SPEs to obtain financing, without showing the related liability on its balance sheet. Finally, Enron used SPEs to move poorly performing assets off of its balance sheet. By transferring such assets to SPEs, Enron could hide later declines in the value of those assets.

GAAP requires an enterprise to disclose information about material related-party transactions in the notes to the financial statements. In particular, an enterprise must disclose: the nature of any relationships involved; a description of the transactions for each period for which the

financial statements present an income statement, including any information necessary to understand the transactions' effects on the financial statements; the dollar amounts of the transactions and the effects of any changes in the method used to establish terms when compared to those followed in the preceding period; and amounts due from or to related parties on each balance sheet date and the related terms governing those amounts. The disclosures should not imply that the transactions contained terms equivalent to those that would have prevailed in an arm's-length transaction unless management can substantiate that claim. Enron did disclose various related-party transactions in the notes to its financial statements, but not in any detail.

Lawyers who assist in related-party transactions should carefully examine the transactions and their client's securities disclosures in an effort to assure that those disclosures accurately describe the transactions' true nature and effects on the financial statements. Likewise, lawyers negotiating other transactions or pursuing other claims, especially when future or past earnings determine legal rights and obligations, should keep in mind that an enterprise can use related-party transactions to manipulate earnings.

6. Details, details, details.

Corporations should develop and adhere to internal controls (both administrative and accounting). Administrative controls generally refer to an enterprise's plan of organization, procedures, and records that lead up to management's approval of transactions. Accounting controls, by comparison, describe the plans, procedures, and records that an enterprise uses to safeguard assets and produce reliable financial information. Enron's administrative controls included policies designed to minimize conflicts of interest and to ensure that transactions fairly benefitted the company. Not only did recent events prove Enron's administrative controls inadequate, but those events also showed that Enron failed to follow the controls that it had put in place. For example, when Enron's board approved a policy that allowed the company to enter into transactions with certain entities owned by Enron officers, the implementing procedures explicitly required management to use a "Deal Approval Sheet." By requiring certain disclosures and the approval of Enron's chief executive officer, the Deal Approval Sheets sought to ensure that the contractual provisions in such transactions would closely resemble the terms that would have materialized in an arm's-length transaction. In fact, the chief executive officer's signature does not appear on the sheets for several specific transactions. Moreover, the current absence of sheets for other transactions suggests that Enron did not complete any such document in those transactions. As another example, Andrew Fastow, Enron's former chief financial officer and, for a time, the general partner of the several partnerships that entered into transactions with Enron, reportedly earned more than \$30 million from his investments in those enterprises. Even though the board seemed to recognize the conflict of interest inherent in such related-party transactions, the board failed to require that Mr. Fastow report his profits from the partnerships to the company. Such disclosures almost certainly would have alerted the board to the possibility that the underlying transactions unfairly benefitted the related parties, to the detriment of Enron and its

shareholders. Other items in this list document that Enron failed to implement adequate accounting controls.

Although top management bears the initial responsibility to develop, implement, and, when necessary, revise adequate internal controls, overall oversight falls to the board of directors, who often rely on lawyers for advice. Internal controls work effectively only when those who bear responsibility for developing, implementing, and overseeing those controls stress the need to adhere to all policies and procedures and lead by adhering to those rules themselves. In recent years, the SEC has brought administrative actions and imposed so-called “tone-at-the-top liability” under the Foreign Corrupt Practices Act, which applies to all SEC registrants, including enterprises that engage only in domestic operations. Strong internal controls enhance the likelihood that the enterprise will engage in sound, beneficial transactions and reduce the chances that an enterprise will incur the enormous losses that can result from internal control failures.

7. If it walks like a duck, . . .

In recognizing revenue (and accounting generally), substance prevails over form. Under GAAP, an enterprise cannot recognize revenue until the business has substantially completed performance in a bona fide exchange transaction. If a transaction does not unconditionally transfer the risks that typically accompany a “sale,” the enterprise may not recognize revenue.

Enron’s announcement regarding a \$544 million after-tax charge to earnings in October 2001 revealed a serious flaw in its prior financial statements: Enron had improperly recognized revenue from transactions with its SPEs. In short, Enron recorded revenue after transferring certain assets to those SPEs, even though credit guarantees, promises to protect the purchasers from any loss from decline in value, or buyback agreements caused the company to retain the risks of ownership even after the transfers. As a result, Enron had not truly “earned” the revenue it reported.

Enron’s “sham” transactions resemble schemes that ultimately led to the demise of Drexel Burnham and the imprisonment of Michael Milken, that appeared so frequently during the savings and loan crisis, and that accompany most financial accounting frauds today. Milken ultimately pled guilty to charges involving “parking,” whereby Drexel Burnham purchased securities from third parties with the understanding that the investment banking firm would quickly resell the securities back to the third parties at a fixed price. Similarly, the Federal Home Loan Bank Board (FHLBB) took control of Lincoln Savings & Loan Association in 1989 after discovering, among other things, that Lincoln or its affiliates had recognized income on sales of real estate even though the funds for the down payments had emanated from Lincoln itself. In substance, Lincoln or its affiliates had retained the risks of ownership and could not recognize revenue from the sales.

The issue of substance over form applies not only to managers and accountants, but to attorneys as well. The litigation that follows financial

frauds can impose enormous financial costs. In addition, a lawyer who fails to investigate, or perhaps spot, a “red flag,” such as a side agreement or guarantee, can face staggering personal liability for malpractice. Whether drafting, negotiating, or interpreting contractual provisions that refer to “net income” or “earnings,” performing “due diligence” to determine whether a particular transaction will further a client’s best interests, or rendering a “true sale” opinion regarding whether a transferor that retains some involvement with the transferred asset (or the transferee) has surrendered economic control over the asset to justify treating the transaction as a sale for financial accounting purposes, substance over form requires an attorney to look beyond the form of a transaction and to try to identify any arrangements that may affect the transaction’s economic realities. In particular, understanding the motivations for a transaction offers an important clue to the transaction’s substance. Enron often transferred assets to SPEs to hide losses or to remove liabilities from its balance sheet. Although most clients or adversaries will not expressly state such desires, such effects should also alert attorneys to issues of substance over form.

8. Promises, promises.

Any time an enterprise guarantees the indebtedness of another in material amounts, the enterprise must disclose the nature and amount of the guarantees in the notes to the financial statements. When Enron’s SPEs sought credit, the lenders often required that Enron guarantee the debt. On several occasions, Enron guaranteed amounts that various SPEs borrowed by promising to pay cash or to issue additional common shares to repay the debt, if the market price of Enron’s common shares dropped under a set amount or if Enron’s bond rating fell below investment grade. While the notes to Enron’s financial statements disclosed guarantees of the indebtedness of others, Enron did not mention that its potential liability on those guarantees, which shared common debt repayment triggers, totaled \$4 billion. When material, GAAP specifically requires an enterprise to disclose the nature and amount of guarantees of the indebtedness of others. Again, inadequate disclosure can subject enterprises to liability and lawyers to malpractice claims.

9. If it sounds too good to be true, . . .

An enterprise cannot recognize income from issuing its own shares and generally should not record a net increase in shareholders’ equity when it issues stock in exchange for a note receivable. At the risk of oversimplifying, Enron used related-party SPEs to hedge, or to protect itself from declines in the market value of, certain investments that Enron used current market prices to value on its books. In these arrangements, Enron transferred its own stock to an SPE in exchange for a note or cash. In addition, Enron guaranteed, directly or indirectly, the SPE’s value. The SPEs in turn hedged the underlying investments, using the transferred Enron stock as the principal source of payment for the hedges. The value of the underlying investments decreased, but the hedges allowed Enron to recognize a corresponding increase, resulting in a wash. The SPEs, however, could

reimburse Enron for any decline in value of the investments only as long as the market price of Enron's common shares remained stable or increased. When the value of Enron's common shares fell, Enron had to issue additional shares pursuant to its agreements with the SPEs and the related guarantees. These additional shares reduced Enron's stock value, which triggered additional guarantees. In the interim, Enron recognized about \$500 million in revenues from the hedges, which had really arisen from the issuance of the company's own shares. GAAP, however, does not allow an enterprise to record gains from the increase in the value of its capital stock on its income statement.

As previously mentioned in the first item, Enron announced on October 16, 2001, that it had recorded a \$1.2 billion reduction in shareholders' equity, arising, in large part, from an accounting error. When Enron issued its common shares to several SPEs in exchange for notes receivable, Enron recorded the notes receivable as assets, thereby overstating shareholders' equity by \$1 billion. Although GAAP usually allows an enterprise to record notes receivable as assets, a different rule applies when an enterprise issues stock in exchange for the notes. GAAP states that an enterprise should treat any notes received in payment for the enterprise's stock as an offset to shareholders' equity. Only when the obligor pays the note can the enterprise record an increase in shareholders' equity for the amount actually paid.

Many credit agreements allow the lender to accelerate the repayment of the debt if the borrower's debt-to-shareholders' equity ratio exceeds a certain level or if the borrower fails to maintain a certain credit rating. Although Enron's \$1.2 billion reduction in shareholders' equity did not itself trigger any debt repayment obligations, investment ratings companies immediately placed Enron on review for downgrade. Soon after, the ratings companies downgraded Enron's credit rating to below investment grade. Because provisions in many of Enron's credit agreements required the company to maintain an investment grade credit rating, the downgrades triggered debt repayment obligations, which accelerated Enron's bankruptcy.

10. When the going gets tough, . . .

Lawyers' duties to their clients include an obligation to object when a client proposes or uses questionable accounting policies or practices. In Judge Stanley Sporkin's well-publicized opinion in the *Lincoln Savings and Loan* case in 1990, Judge Sporkin asked where the lawyers were when Lincoln consummated various improper transactions, wondering why they did not attempt to prevent those transactions or disassociate themselves from them. About a decade later, the legal profession heard similar questions directed to Enron's lawyers. While Enron's lawyers, both in-house and outside counsel, did question some practices, Enron officers and employees often either ignored the lawyers' advice, or changed the transactions just enough to get around the lawyers' particular concerns. In some cases, Enron's lawyers apparently helped to complete the very transactions they questioned.

The attorney-client privilege prevents lawyers from disclosing client confidences. That privilege, however, does not prevent lawyers from discussing concerns with their clients, attempting to persuade their clients to choose