

ACCOUNTING FOR LAWYERS

Fourth Edition

E. McGRUDER FARIS, JR.

ACCOUNTING FOR LAWYERS

Fourth Edition

by

E. McGRUDER FARIS, JR.

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FOREWORD TO FOURTH EDITION

In order that the reader, at the outset, see something of the evolutionary nature of accounting and of this Fourth Edition, I hereby incorporate by reference the Forewords of the Second and Third Editions. You might read the Third one first.

This Fourth Edition has several objectives:

(1) The Third Edition is updated on many points about which there have been recent changes in either Generally Accepted Accounting Principles (GAAP) or in federal tax law.

(2) A new Chapter 22, Current Value Accounting, has been added to underline the significance of this still developing issue.

(3) Some chapters have been shortened to permit a more rapid progression. There has been no sacrifice of basics.

(4) Some tax references have been eliminated because periodic changes make it infeasible to stay fully current on these matters. Nevertheless, the reader should be acutely conscious that tax requirements, whether more or less stringent than Generally Accepted Accounting Principles, are significant influences on actual accounting practices.

(5) Some additional Exhibits have been set up to permit more minor insertions by the readers in an effort to give them a further feel for practices and concepts. These small "do-it-yourself" devices tend to engrain fundamentals.

(6) A Table of Abbreviations has been added at the beginning of the book.

(7) A Glossary Reference to AICPA Terminology has been added as Appendix D.

I express my thanks to all who helped in the preparation of this Fourth Edition, especially to my wife; to my student research assistants, Phil Peterson and Dana Carlson; and to my publisher's editorial coordinator, Jocelyn Thach.

I gratefully acknowledge the permission granted by the Financial Accounting Standards Board to quote portions of their copyrighted materials. Complete copies of FASB materials can be obtained from FASB, High Ridge Park, Stamford, Conn. 06905.

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October 11, 1982

FOREWORD TO THIRD EDITION

If you are not familiar with the 1964 Revised Edition of *Accounting For Lawyers*, it is suggested that you read the Foreword to it (p. ix hereof) in order to get a setting for the comments which follow. Some of the preliminary observations made in 1964 are still applicable to financial accounting in general and to this new edition's approach to that broad subject. One continuing basic premise bears repeating at the outset: "... The best way to comprehend accounting theories is to relate them closely to the mechanical procedures that make them work. In actual practice, the progression in accounting analysis is as often from the mechanical to the theoretical as it is from the theoretical to the mechanical; and the [third edition] will continue to correlate these two inseparable aspects of accounting."

In several ways this edition is more than a mere update of the 1964 revision. Some of the changes are outlined briefly as follows:

(1) Many repetitive illustrations and exhibits have been omitted or shortened. While the more extensive examples used in the earlier versions were designed to give a broad exposure to various business accounting situations, classroom experience with the 1964 revision has convinced me that many exhibits could be pruned without the sacrifice of fundamentals. There is still an abundance of illustrative material to help the reader develop a working knowledge of accounting and business practices.

While the main purpose of the illustrations is to give a realistic factual setting for the application of accounting theories, I have observed in the classroom two related uses for the examples. First, many can be used as the basis for class discussions on miscellaneous legal issues that arise out of various relationships, thus permitting a transaction approach to financial and legal matters. Second, I have been told by students, whose prior exposure to business affairs was quite limited, that they have been helped in other courses (such as business associations, commercial transactions and taxation) by the vicarious exposure to realistic business events, as well as by a familiarity with the applicable accounting rules.

(2) In later chapters, many exhibits contain blanks to be completed by the reader, either for his own satisfaction or for that of his professor. Most blanks are indicated by a triangle symbol (◄) similar to that used on federal tax forms to designate key items. All answers are readily apparent, and the substance of the discussion is not affected even where the blanks are not completed. In rare instances, blanks in the text material facilitate written answers to questions about the matter under consideration. In a way, then, there is a modest "workbook" component within the covers of this volume. If a professor wishes to require completion of the blanks, a photocopy of a student's work may satisfy checking procedures. The same applies to chapter-end problems.

(3) Several principal cases have been added at the end of later chapters. While I do not think that a casebook is the best way to present accounting theories and practices, the analysis of a few judicial opinions can be helpful. The cases were selected because of their business environment bases as well as for their legal principles. Placed at the end of chapters, they can be used or omitted as the wishes of the reader or the professor decree.

(4) Old Chapter 24, a minor one on Specialized Financial Statements, has been replaced by a new one describing various reports on *changes in financial condition*. These statements have increased in importance in recent years, during which the true value of money has lessened and interest rates have gyrated.

(5) Three wholly new chapters have been added: Chapter 28 on *Lease*

Accounting (containing a special analysis of the present value of money); Chapter 31 on *Business Combinations* (describing the “pooling” and “purchase” problems arising from the merger binge of the 1960’s); and Chapter 34 on *Professional Responsibility* (sketching the spectre of the professional malpractice phenomenon).

(6) Considerable use is made of extensive quotes from the primary sources of accounting rules — these being pronouncements of the American Institute of Certified Public Accountants (AICPA), the Tax Regulations of the Internal Revenue Service, and the Accounting Rules (S-X) of the Securities and Exchange Commission. In chapters using these primary materials, comments introducing the technical quotes give several reasons why they can be learning tools superior to mere paraphrasings of the rules. Not the least of these reasons is that the official pronouncements reveal a continuing evolution of accounting theories and practices, many as dramatic as changes in other areas of law.

Another reason developed by classroom experience is that the present generation of law students can “leap” from the fundamental to the very sophisticated. Consequently, many subjects are given a general description, which description is immediately followed by the technical primary materials. This enables the reader promptly to master the language of the experts as well as the general concepts under analysis. Before leaving this matter, I hereby gratefully acknowledge the assistance of the AICPA in granting permission to quote from their copyrighted publications, which are issued at a steady flow in keeping abreast of new developments in financial accounting and auditing.

(7) Two new appendices have been added and one has been updated and modified. Appendix A is a modified version of the SEC Accounting Rules. New Appendix B contains the full text of the AICPA’s Rules of Conduct, as well as a few selected interpretations of those rules. New Appendix C is a short bibliography. Most law review and book citations, however, are placed in context throughout this revision.

(8) Tax laws, SEC rules, and AICPA references have been checked for new developments and are cited at the appropriate places. In some instances reference is made to the three appendices or to the chapter-end cases for elaboration.

In summary, I trust that the new curtailment of some basic illustrations and the expansion of the more technical material (which can be used or omitted with ease) will permit an expeditious coverage of fundamentals while affording ready access to the more complex theories and practices. The growing movement that holds attorneys and accountants to increasingly strict standards of care in protecting the investing public from false or inadequate financial reports makes it imperative that the attorney master the basics and be aware of the esoteric. This need is recognized by many groups, as is evidenced in the next paragraph.

Two quotes from diverse sources serve to underscore the importance of financial accounting to non-accountants and to emphasize the ever-changing nature of accounting. On the first matter, the Pre-Law Handbook of the American Association of Law Schools states:

“Accounting. This is a practical study of which lawyers must have some appreciation, as it is in many respects the very language of business. The student would be wise to learn it in college, but, if he has not, he will probably want to master at least its rudiments in law school.”

On the ever-changing nature of accounting practice and theory, Price Waterhouse states in the first of its Accounting Events and Trends:

“A lot is happening in accounting these days, and the fast pace of events can

only get faster. Even accountants find it increasingly hard to keep up with developments, and for the business executive the task of sorting out the ones that vitally affect financial reports — and even the way business is managed — is almost impossible without some sort of help.” *ACCOUNTING EVENTS AND TRENDS* (Jan. 15, 1974).

Next, a word about whether non-lawyers can profit from “Accounting For Lawyers.” I think they can for several reasons. One is that both lawyers and laymen are aliens in the mysterious world of financial accounting. Thus, laymen and lawyers occupy similar positions when approaching financial accounting as non-accountants. Secondly, since the text purports to give a broad overview of financial accounting, moving from the basic to the advanced, it is possible for businessmen, bankers, financial advisors, and students in these and related fields to use the book for self-study or classwork in much the same way as do lawyers and law students. Consequently, it is unrealistic for the title to suggest use exclusively by lawyers. The basic information is useful to any non-accountant.

Further, there is special reason that laymen may profit from an accounting book with a slant toward lawyers. Throughout there is much law-related material, and the layman will get an extensive exposure to areas where law and accounting merge, especially in the area of income taxation, corporate finance, securities regulation, trusts and estates. In a way then, the non-lawyer gets a “two-in-one” perspective of accounting and law. As the present national chairman of the Association of American Law Schools Section on the Teaching of Law Outside of Law Schools, I have a special interest in the possibility that some non-lawyers will learn herefrom a bit more about law and lawyers, as well as more about accounting and accountants. We all have a lot of interdependent interests and objectives.

In a general way, I acknowledge my appreciation to those many students of my accounting classes whose questions and concerns about key issues have helped to shape this revision. In a very specific way, I express my special gratitude to the following persons who have assisted in various ways with manuscript preparation: Messrs. James Cox, William Greathouse, Randal Koder, Mark Maland, Bruce T. Royal, and Frank A. Viteritto, my student research assistants at the Wake Forest University School of Law; Mrs. Mildred C. Berthrong, my secretary; Dr. Delmer P. Hylton, Chairman of the Department of Business and Accountancy of Wake Forest University; and James R. Gillespie of the Bobbs-Merrill Publishing Company. Each has given of his time and talents in many ways, and I am grateful to each of them.

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FOREWORD TO REVISED EDITION

The first edition of *Accounting For Lawyers* by the late Professor A. L. Shugerman embodied the premise that the way for a lawyer to learn the functions of accounting is to study accounting and not to merely "study about" accounting. From personal experiences, and from the observations of other law professors and practicing attorneys, I, too, have come to adopt the view that the best way to comprehend accounting theories is to closely relate them to the mechanical procedures that make them work. In actual practice, the progression in accounting analysis is as often from the mechanical to the theoretical as it is from the theoretical to the mechanical; and the revised edition will continue to correlate these two inseparable aspects of accounting.

Basically, the text is directed to those with little or no previous formal training in accounting practices. In order to assist these people in an understanding of the functions and principles of accounting, the approach is somewhat similar to that used by professional accountants in their own preliminary preparation. It is believed that by adopting the accountant's approach to the subject, the attorney will be in a better position to communicate intelligently with his associates in the accounting profession.

To facilitate the lawyer's "feel" for accountancy, factual illustrations and accounting exhibits are freely used to demonstrate the principles presented. Further, an accompanying problem book is available to permit the reader to try his own hand at transcribing financial facts into accounting data. Though a reasonable mastery of mechanics will not assure a comprehension of theories, it is even more certain that an appreciation of theories can seldom be obtained without a sound understanding of the mechanics.

In accounting study, perhaps as much as in any other subject, the ideal pedagogical approach would be to cover the fundamentals in the first chapter; and then, with the fundamentals mastered, to turn to a more thorough and analytical consideration of the minutiae. The fundamentals of accounting, however, are too complex to permit such a preliminary perusal. The alternative adopted in the revised edition is to set forth in the first fifteen chapters a concise discussion of basic principles and procedures, and to follow these with more detailed study.

This was the approach adopted by Professor Shugerman, and the "gateway" chapters have been retained in modified form. In most instances the chapters of Part I have been slightly abbreviated in order to permit a rapid progression to the more advanced material. For example, Chapters 8 and 10 of the first edition have been combined in revised Chapter 14 (Working Papers).

In another respect, Part I, dealing with basic concepts and procedures, has been expanded. Specifically, four new chapters have been added: Chapter 3 — Outline of Accounting Procedures and Records; Chapter 10 — Depreciation and Depletion; Chapter 11 — Inventories; and Chapter 12 — Accounts Receivable and Bad Debt Expenses.

A further addition is the Appendix which contains accounting excerpts from Regulation S-X of the United States Securities and Exchange Commission.

Emphasis in the revised edition has been in several areas:

1. The up-dating and enlargement of tax material necessitated by significant changes in, and the increased influence of, this body of law which so emphatically affects accounting principles and practices.

2. Additional references in the text to new and alternative accounting terminology.
3. Additional citations to court decisions, statutes, and regulations affecting accounting practice or the use of accounting records as evidence.
4. Greater emphasis on the analysis of financial data for business and legal decision making.

I acknowledge my gratitude to those law professors who graciously shared with me their observations on the original edition and on the teaching of accounting to law students. The suggestions of Professors D. Orville Lahy (University of Richmond), William B. Peden (University of Louisville), James W. H. Stewart (Washington and Lee University), and Robert J. Kennedy (Salmon P. Chase College of Law) were especially helpful.

My thanks go also to the American Institute of Certified Public Accountants (Charles E. Moyes, Director of Publications) for permission to quote certain passages from its professional publications.

To the following persons I express a special appreciation for the encouragement and assistance given to me in the preparation of the manuscript and in the checking of printer's copy: Messrs. Richard M. Hutson, II, and Joseph R. Radzius, law students at Wake Forest College; Dr. Hugh W. Divine, Professor of Law, Wake Forest College; Professor Delmer P. Hylton, Professor of Accounting, Wake Forest College, School of Business Administration.

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June 1, 1964

FOREWORD TO FIRST EDITION

Lawyers have long used accounting . . . ever since the days when Thomas Jefferson meticulously maintained his own books of record. Today, accounting has so entwined itself in the fabric of law that it would be hard to find a field of law without at least some accounting tinge. This naturally applies to the older fields, such as corporations, partnerships, damages, estates, trusts, and agencies. To an even stronger degree, it also applies to the newer administrative law fields. In these new areas of law practice, the impact of accounting has been so marked that much of a lawyer's everyday practice revolves around accounting concepts, reports, and evidence. This is particularly noticeable, for example, in taxation and finance. A knowledge of accounting has always been helpful to a lawyer . . . today, such a knowledge is becoming increasingly indispensable.

The present treatise accordingly embraces both an editorial and an explanatory approach. It is editorial in that the various fields of accounting have been combed for accounting concepts that are germane to the practice of law. It is explanatory in that every effort has been made to explain these concepts in a simple, easily understood manner. Hypothetical illustrations, exhibits, and actual legal applications have been liberally used. Brevity has been stressed. And at all times, simplicity has been a foremost consideration. It is assumed, of course, that the reader has no previous accounting background. And in fact, it is only assumed that the reader has an inquisitiveness to examine accounting principles and procedures.

Accordingly, the first twelve chapters discuss the most fundamental of such principles and procedures. These are really the gateway chapters. Collectively, they convey the basic touchstones of accounting; and it is recommended that the reader first familiarize himself with these twelve chapters. After that, one can jump to any individual subsequent chapter. For example, after reading the first twelve chapters, one can turn to the chapter on corporations. Or, one may jump directly to the chapter on estates and trusts.

In this respect, the index can prove to be especially valuable. Thus, today's law practice often involves an understanding of accounting terminologies. By referring to the index, the reader is quickly referred to that part of the text that explains (and most ordinarily illustrates) these technical terms.

Finally, it should be emphasized that accounting, like law, has a procedural and a substantive aspect. In the chapters that follow, both aspects will therefore be stressed. Both are important. And their relative importance will depend on how an individual lawyer plans to use accounting in his own practice.

A. L. SHUGERMAN

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December 4, 1951

ABBREVIATIONS TABLE

AICPA — American Institute of Certified Public Accountants.
ACS — AICPA Professional Standards, Current Text.
APB — Accounting Principles Board.
ASR — Accounting Series Releases of SEC.
FASB — Financial Accounting Standards Board.
GAAP — Generally Accepted Accounting Principles.
IRC — Internal Revenue Code.
IRS — Internal Revenue Service.
Regs. — Internal Revenue Code Regulations.
Regs. S-X — Securities and Exchange Accounting Regulations.
SEC — Securities and Exchange Commission.

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