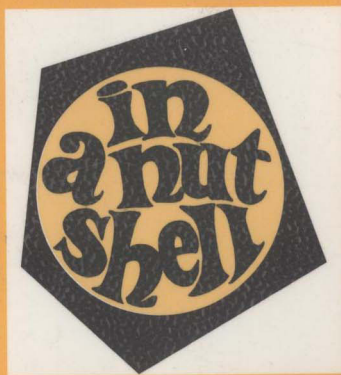


# Accounting and Finance for Lawyers



®

CHARLES H. MEYER

# **ACCOUNTING AND FINANCE FOR LAWYERS IN A NUTSHELL**

By

**CHARLES H. MEYER**

Director-Taxes and

Tax Counsel

GE Capital Aviation Services



ST. PAUL, MINN.  
**WEST PUBLISHING CO.**  
**1995**

*Nutshell Series, In a Nutshell*, the Nutshell Logo and the WP symbol are registered trademarks of West Publishing Co. Registered in the U.S. Patent and Trademark Office.

COPYRIGHT © 1995 By WEST PUBLISHING CO.

610 Opperman Drive  
P.O. Box 64526  
St. Paul, MN 55164-0526  
1-800-328-9352

All rights reserved

Printed in the United States of America

**Library of Congress Cataloging-in-Publication Data**

Meyer, Charles H.

Accounting and finance for lawyers in a nutshell / by Charles H.

Meyer.

p. cm. — (Nutshell series)

Includes index.

ISBN 0-314-04763-8

1. Accounting. 2. Corporations—Finance. 3. Lawyers—Handbooks, manuals, etc. I. Title. II. Series.

HF5635.M5857 1995

657'.024344—dc20

94-39430

CIP

ISBN 0-314-04763-8



TEXT IS PRINTED ON 10% POST  
CONSUMER RECYCLED PAPER



To  
Joseph, Lisa, and Pat  
In Memory of  
Howard Meyer

\*

## FOREWORD

---

In the area of nonlegal disciplines, few bodies of knowledge have more widespread relevance and day-to-day impact for business and commercial lawyers than the areas of accounting and finance. Accounting and finance are important for attorneys working on many types of major acquisition and financing transactions. Concepts from these areas frequently arise in a wide range of private and public contractual arrangements. Trial lawyers who work on securities litigation or accountants' malpractice cases are constantly exposed to accounting and auditing issues. Income tax laws employ numerous accounting and finance concepts such as depreciation and other accounting method issues and the application of the financial concept of time value of money as evidenced by the original issue discount rules and economic accrual concepts.

This book is intended to be a useful outline and reference tool for the law students who, in the author's opinion, are wise enough to take the typical accounting for lawyers course offered by most law schools. In addition, this book can serve as a useful learning tool for those lawyers who have not had the opportunity to pursue a formal course in accounting. Finally, this book should serve as a useful review tool for lawyers who have had training in accounting but wish to sharpen their skills and update themselves on the constantly shifting sands of "generally accepted accounting principles."

## FOREWORD

The author is indebted to Wm. Douglas Kilbourn, Jr. for his inspiration and leadership in bringing the knowledge of accounting and finance to law students and the legal profession. I am also grateful for the assistance of Jan Harvey in the preparation of the manuscript for this Nutshell. Finally, I wish to acknowledge the valuable contribution of my family through their patience and support during the process of writing this Nutshell.

The selection of the material covered and the depth of analysis in this Nutshell are based on the author's experience with accounting and finance issues in private practice and as a corporate attorney. In addition, the author is the co-instructor of a one-day course on accounting for lawyers that has been presented in cities across the country and has also taught as an adjunct professor at the University of Minnesota Law School.

CHM

Shoreview, MN  
November, 1994

**ACCOUNTING  
AND FINANCE  
FOR LAWYERS  
IN A NUTSHELL**

\*

# OUTLINE

---

	<b>Page</b>
FOREWORD.....	V
<b>Chapter 1. The Basic Financial State- ments</b> .....	<b>1</b>
A. The Balance Sheet .....	1
1. Assets .....	2
2. Liabilities .....	3
3. Owners' Equity .....	4
4. The Balance Sheet Equation .....	5
5. Balance Sheet Format .....	6
B. The Income Statement .....	7
1. Revenues and Gains .....	7
2. Expenses and Losses .....	8
3. Format of the Income Statement .....	8
C. The Statement of Owners' Equity .....	10
D. Statement of Cash Flows .....	10
E. Additional Information .....	13
1. Footnotes .....	13
2. Supplemental Disclosures .....	14
3. Audit Report .....	14
<b>Chapter 2. The Accounting Process</b> .....	<b>16</b>
A. Source Documents .....	16
B. Journal Entries .....	17
C. Ledgers and Posting .....	19

## OUTLINE

	Page
D. Adjusting Entries .....	24
1. Accrued Revenues and Expenses .....	25
a. Accrued Revenues .....	26
b. Accrued Expenses .....	27
c. Accounting for Actual Receipt of Payment .....	28
d. Reversing Entries .....	29
2. Deferred Revenues and Expenses .....	30
a. Deferred Revenues .....	31
b. Prepaid Expenses .....	33
3. Depreciation Expense .....	35
4. Recognizing Cost of Goods Sold .....	37
E. Revenue and Expense Accounts .....	39
F. Closing the Books .....	42
G. Preparation of Financial Statements .....	45

<b>Chapter 3. Generally Accepted Accounting Principles</b> .....	<b>46</b>
A. Official Sources of GAAP .....	47
1. FASB Statements .....	48
2. APB Opinions .....	49
3. Accounting Research Bulletins .....	50
4. Enforcement of Official Standards .....	50
B. Other Sources of GAAP .....	51
C. Governmental Regulation of Accounting ..	51
1. SEC .....	51
2. Regulatory Agencies .....	52
D. Income Tax Accounting .....	53
E. Some Fundamental Accounting Concepts	55
1. Historical Cost .....	56
2. The Going Concern Assumption .....	58
3. Yearly Reporting .....	59
4. Revenue Recognition and Matching ...	61

## OUTLINE

	Page
E. Some Fundamental Accounting Concepts—Continued	
5. Conservatism .....	61
6. Materiality and Cost-Benefit Analysis	63
<b>Chapter 4. Recognition of Revenues and Expenses</b> .....	65
A. Revenue Recognition .....	67
1. Sale of Goods or Services .....	68
2. Revenue From Services.....	69
a. Specific Performance Method .....	69
b. Proportional Performance Method	70
c. Completed Performance Method ..	70
3. Long Term Contracts .....	71
4. Revenue Recognized With the Passage of Time .....	72
5. Revenue Recognized Based on Receipt of Cash .....	73
6. Completion of Production.....	74
7. Changes in Market Value.....	74
8. Asset Writedowns.....	76
B. Matching.....	77
1. Direct Matching.....	78
2. Immediate Write-Off .....	79
3. Systematic and Rational Allocation ...	79
<b>Chapter 5. Current Assets and Liabilities</b> .....	81
A. Cash .....	82
1. Cash Equivalents .....	82
2. Restricted Cash .....	83
3. Petty Cash .....	84
4. Internal Controls .....	84
B. Marketable Securities .....	85

## OUTLINE

	Page
C. Receivables .....	86
1. Trade Receivables .....	86
2. Other Receivables .....	88
3. Reporting Receivables .....	89
4. Bad Debts .....	89
a. Percentage of Sales Method .....	90
b. Aged Receivables Analysis .....	91
5. Financing and Sales of Receivables ...	92
6. Notes Receivable .....	94
7. Imputing Interest .....	95
8. Receivables From Related Parties ....	96
D. Prepayments .....	96
E. Accounts Payable .....	98
1. Reporting Accounts Payable .....	98
2. Imputing Interest .....	100
F. Short Term Borrowings .....	100
1. Interest on Notes Payable .....	100
2. Currently Maturing Amounts of Long Term Debt .....	101
G. Accrued Liabilities .....	103
H. Deferred Revenues and Deposits .....	104
I. Estimated Liabilities .....	106
J. Contingent Liabilities .....	108
<b>Chapter 6. Accounting for Inventories ..</b>	<b>112</b>
A. Determining Physical Quantities on Hand	113
1. Periodic Inventory System .....	114
2. The Perpetual Inventory System .....	116
B. Determining Inventory Values .....	118
1. Specific Identification .....	119
2. Cost Flow Assumptions .....	119
a. First In, First Out Method .....	120
b. Last In, First Out .....	121

## OUTLINE

	Page
B. Determining Inventory Values—Continued	
c. Average Cost .....	123
d. Application to Perpetual Inventory Systems .....	124
e. Retail Inventory Methods .....	125
C. Applying Lower of Cost or Market .....	125
1. Determining Market .....	126
2. Effect on Inventory and Cost of Goods Sold .....	127
D. Manufacturing Companies .....	128
 <b>Chapter 7. Property, Plant, and Equipment and Depreciation</b> .....	 130
A. Accounting at Acquisition .....	131
1. General Rule .....	131
2. Exchanges for Other Property .....	132
3. Acquisitions of Multiple Assets .....	135
4. Self-Constructed Assets .....	136
B. Accounting for Depreciation .....	138
1. Useful Life .....	140
2. Salvage Value .....	140
3. Method of Depreciation .....	141
a. Straight Line Method .....	141
b. Sum-of-the-Years'-Digits Method .....	142
c. Declining Balance Method .....	144
d. Units of Production Method .....	146
e. Depletion of Natural Resources ...	147
f. Other Methods .....	148
C. Repairs and Improvements .....	149
D. Disposal of Fixed Assets .....	151
 <b>Chapter 8. Intangible Assets</b> .....	 153
A. Identifiable Intangible Assets .....	153

## OUTLINE

	Page
A. Identifiable Intangible Assets—Continued	
1. Types of Identifiable Intangible Assets.....	153
a. Patents.....	153
b. Copyright.....	154
c. Trademarks, Service Marks, and Trade Names .....	154
d. Franchises .....	154
e. Deferred Charges.....	154
2. Accounting for Purchased Identifiable Intangible Assets.....	155
3. Accounting for Internally Created Identifiable Intangible Assets .....	156
a. Research and Development .....	157
b. Computer Software Costs .....	157
B. Unidentifiable Intangible Assets.....	158
 <b>Chapter 9. Accounting for Investments</b>	 160
A. Investments in Bonds .....	160
1. Acquisition of Bonds at Face Value...	161
2. Acquisition of Bonds at a Discount or Premium .....	164
a. Straight Line Amortization of Bond Discount or Premium .....	164
b. Effective Interest Method of Amortizing Bond Discount and Premium .....	167
3. Changes in Value After Acquisition...	170
B. Accounting for Stock Investments .....	172
1. The Cost Method .....	172
a. Dividend Income.....	173
b. Changes in Value After Acquisition.....	174

## OUTLINE

	Page
B. Accounting for Stock Investments—Continued	
c. Stock Splits and Stock Dividends	175
2. The Equity Method .....	176
3. Consolidated Financial Statements ....	179
C. Other Investments .....	183
1. Land .....	183
2. Cash Value of Life Insurance .....	184
3. Sinking Funds and Other Permanent Funds .....	185
 <b>Chapter 10. Accounting for Long Term Debt</b> .....	186
A. Forms of Long Term Debt .....	186
B. Accounting for Long Term Debt Issued at Par Value .....	187
1. Issuance on an Interest Payment Date .....	187
2. Issuance of Bonds Between Interest Payment Dates .....	189
C. Accounting for the Issuance of Bonds at Other Than Par Value .....	190
1. Bonds Issued at a Discount .....	191
2. Bonds Issued at a Premium .....	192
D. Bond Issuance Costs .....	193
E. Retirement of Bonds Prior to Maturity ....	194
1. Actual Retirements .....	194
2. In-Substance Defeasance .....	196
F. Restructuring of Long Term Debt .....	197
1. Restructuring With No Gain or Loss	199
2. Restructuring With Recognition of Gain .....	200
G. Convertible Debt .....	201
1. Conversion—Book Value Method .....	201

## OUTLINE

	Page
G. Convertible Debt—Continued	
2. Conversion—Market Value Method ...	202
3. Induced Conversions.....	203
4. Debt Issued With Stock Warrants .....	204
<b>Chapter 11. Accounting for Leases .....</b>	<b>206</b>
A. Introduction .....	206
B. Characterizing and Accounting for Leases	208
1. Accounting by the Lessee .....	209
2. Accounting by the Lessor .....	214
C. Special Rules .....	217
1. Leveraged Leases .....	217
2. Leases Involving Real Estate .....	218
3. Sale/Leasebacks.....	218
D. Disclosures Regarding Leases .....	221
<b>Chapter 12. Accounting for Other Long</b>	
<b>Term Liabilities .....</b>	<b>222</b>
A. Accounting for Income Taxes.....	222
1. Temporary Differences.....	223
a. Types of Temporary Differences ..	225
b. Deferred Tax Liabilities.....	226
c. Deferred Tax Assets.....	228
d. Analysis of Deferred Taxes .....	229
e. Multiple Period Effects.....	230
2. Net Operating Losses .....	233
3. Valuation Allowances on Deferred	
Tax Assets.....	234
4. Reporting Deferred Tax Liabilities	
and Assets in the Balance Sheet ....	236
5. Intraperiod Tax Allocation .....	237
6. Permanent Tax Differences .....	239

## OUTLINE

	Page
B. Accounting for Retirement Plans .....	241
1. Defined Contribution Plans .....	241
2. Defined Benefit Plans .....	244
a. Components of Pension Expense .....	245
(i) Current Service Cost .....	245
(ii) Interest Cost .....	245
(iii) Amortization of Transition Cost .....	246
(iv) Prior Service Cost .....	246
(v) Actuarial Gains and Losses .....	247
(vi) Expected Return on Plan Assets .....	248
b. Pension Assets and Liabilities .....	249
c. Minimum Liability .....	250
d. Disclosures .....	252
C. Accounting for Other Post-retirement Benefits .....	253
 <b>Chapter 13. Accounting for Stock and     Stockholders' Equity</b> .....	 256
A. Contributions to Capital .....	256
1. Contributed Capital Accounts .....	256
2. Issuing Stock for Cash .....	257
3. Issuing Stock for Noncash Property ..	258
4. Stock Subscriptions .....	259
5. Stock Issuance Costs .....	260
B. Accounting for Retained Earnings .....	262
C. Accounting for Dividends and Other Dis- tributions .....	263
1. Key Dates Related to Dividends .....	263
2. Cash Dividends .....	264
3. Property Dividends .....	265
4. Stock Dividends .....	266

## OUTLINE

	Page
C. Accounting for Dividends and Other Dis- tributions—Continued	
5. Distributions of Stock Rights.....	267
6. Stock Splits .....	268
D. Other Adjustments to Retained Earnings	269
1. Prior Period Adjustments.....	269
2. Appropriations .....	270
E. Accounting for Treasury Stock.....	270
1. The Cost Method .....	270
2. The Par Value Method .....	272
F. Convertible Stock .....	274
G. Compensatory Stock Options and Stock Appreciation Rights .....	275
1. Stock Options .....	275
2. Stock Appreciation Rights .....	278
3. Disclosures .....	281
<b>Chapter 14. Partnership Accounting</b> ....	282
A. Capital Accounts .....	282
B. Defining a Partner's Interest in Profits and Losses.....	284
1. Allocating Individual Items of Income or Loss.....	284
2. Recognizing Different Forms of Part- ner Contributions.....	285
a. Salary for Services .....	286
b. Interest on Capital.....	286
c. Residual Income and Loss Shar- ing Ratios .....	287
C. Admission of New Partners .....	288
1. Transfer of Partnership Interests.....	288
a. No Adjustments to Partnership Net Assets .....	289