Accounting As History

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For many of us, there is a mystique associated with accounting. Lawyers and business people struggle with it, especially if they have no formal training. Accounting can be extremely confusing—some would go so far as to call it enigmatic.

Yet, this system of recording and summarizing business and financial transactions, and later analyzing, verifying and reporting the results, is a special type of history. It is a history told by an accountant, signifying nothing, unless you understand its special code of principles and standards. Once you do, however, accounting can be a rich, complex, diverse (and even—dare I say it?—interesting) financial history.

Recently, I attended Practicing Law Institute's seminar on *Accounting for Lawyers*. Billed as an introduction, it undertook the daunting task of surveying Bob Cratchit's world. PLI faculty expertly explained accounting principles and standards involving a bevy of abbreviations, short-cut code, colored-pencil marks and intricate numerical computations.

A seminar on accounting for lawyers seems particularly timely, in view of the frequent interaction between the professions and the inevitable overlay to tax and corporate transactions accounting rules have. Recently,

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the Treasury released its Second Draft Report of the Advisory Committee on the Auditing Profession (73 FR 44315–50). It's not exactly a Dan Brown or John Grisham potboiler, but it does reveal accounting as something you might see on The History Channel, a financial history.

We have long heralded history as a compass of comprehension, a directional pointer toward understanding the past, explaining the present and projecting the future. Accounting does these things, a kind of Da Vinci Code for the business world. It is not only a chronological record of events, but also an analysis of their importance. It stands as permanent evidence of (and information) about a business.

If you view accounting as history, much of its threat disappears. Plus, with a kind of glass-half-full optimism, you can comprehend that accountants as historians present their field as a continuum of events occurring in succession, leading from past to present, and even into the future. In accounting, these events are interrelated, none distinct or distinguishable from adjacent events.

Guiding Principles and Standards

The modern lingo of accounting would have made British codebreakers at Bletchley Park proud. One must talk levels of care, and myriad tones and approaches. Various bodies oversee accounting intricacies, and here you'll be playing alphabet soup. There's AICPA. SEC, FASB, PCAOB, IASB, to name a few. Some address public companies, some private, some foreign. In addition, there is a wealth of literature emanating from these various bodies. Accountants have their own *lingua franca*, including releases, FRRS; bulletins, SABs; and standards, GAAS. These founts on high make pronouncements or communicate positions on certain procedures.

Although technically some of this literature applies only to public companies, it tends to trickle down to private companies too. In accounting, there are few circumstances under which a private company would treat an accounting or disclosure item quite differently from a position recommended by the SEC.

Also arising from these overseers are the systematic guiding lights generally known as GAAP, GAAS, FAS and SAS, and for foreign companies, IAS and IFRS. GAAP sets the standard framework of guidelines used in the United States. It not only accommodates variations in applied accounting methods, but also embodies the historical elements of transactions.

One cannot hope to master GAAP and GAAS in a two-day program. Still, just getting a broad overview can help these concepts emerge into the light. After all, these ruling principles practically define accounting. Within them, you find the significance of the vast array of accounting permutations.

Financials

The financials are the actual history. Within them we find the chronology, the analysis and even victories and defeats. This is where the various procedures and guidelines are applied. The financials are the principal means of communicating financial information.

A company's financial statements consist of four main parts: balance sheet, income statement, statement of cash flows and notes. Each are interrelated, containing significant information necessary to an understanding of the financial history.

The *balance sheet* is generally analogized to be a snapshot of an entity's financial condition at a point in time. It measures the financial condition including total assets, total liabilities, shareholders' equity and the resulting net worth. Likewise, it reflects many assumptions and estimates.

The *income statement* is the place where analysis begins. It is traditionally the first financial statement presented after the auditor's opinion letter. It measures results of operations and summarizes earnings or losses based on all sources of revenue and expenses during a defined period of time, typically a full operating cycle. It allows evaluation of financial health, as well as historical growth. As with the balance sheet, it reflects many assumptions and estimates.

The *statement of cash flow* traces the sources and uses of cash, and records performance in three different areas: operations, investments and finances. The statement deals with transactions where cash is actually exchanged. In general, businesses use this statement to predict future cash flows and to plan a budget. Auditors and lenders use it to illustrate a business' ability to pay back loans and interest. Investors also analyze it to judge whether a business is financially sound.

The *notes* are disclosures. Many law school professors are fond of saying that the real legal meat is in the footnotes of judicial opinions. Accountants have a kind of parallel here: "The numbers giveth and the notes taketh away."

Although the notes, like the financials, have essentially the same objectives, each provides different kinds of information. The numbers that make up the financials are quantitative in nature. The notes are more qualitative. As such, they focus on risks and uncertainties that could significantly affect the numbers reported. Estimates and assumptions are generally explained in the notes.

As with all financial information, you need to understand what's behind the numbers, and whether they need to be adjusted for the issue at hand. The notes increase the usefulness of the numbers by identifying certain events or circumstances and explaining their financial effects. Likewise, they explain the risks inherent in the different methods of accounting, the overriding concepts and the issues associated with substance over form.

Audit

The audit itself is designed to provide a reasonable assurance that material errors or irregularities are detected. It is seen as the examination of all the work, a process by which an independent person collects and evaluates evidence regarding financial information. Yet, it is NOT an examination of each transaction.

Instead it is meant as verification of management's accounting assertions. An audit tests the assertions, searches for material misstatements, provides reasonable assurances and evaluates management. Audits are governed by strict protocol and adherence to GAAS.

Lawyers and Accountants

PLI's Accounting for Lawyers is offered at different times of the year, in multiple cities and *via* Web cast. It is rather obviously targeted at lawyers, with coverage of such topics as *How Lawyers Can Best Use Accountants as Experts*; *Lawyers' Use and Misuse of Financial Language: Avoiding Legal Landmines*; *Fraud and Financial Disaster: A Forensic Accountant's Overview*; *Current SEC Enforcement Actions, Accounting and Disclosure Issues*; and *Legal and Accounting Ethical Issues.*

Even for those familiar with accounting protocol, some of these sessions were very informative, if only to remind us of the methodology, language and perspective accounting disciplines can bring. In large part, however, even accomplished professionals can derive some benefit from these sessions.

- **Accountants as Experts.** In legal matters, if the work involves money and numbers, perhaps an expert with specialized knowledge and training should provide some guidance and even give testimony. Make no mistake—accounting remains a labyrinth of varying shades of grey.
- **Use and Misuse of Financial Language.** There is a world of potential problems in business negotiations, damage calculations, mergers and acquisitions, contracts and many other areas. Common mistakes in financial language can lead to serious consequences. It may be best to let someone *else* decipher EBITDA (earnings before interest, taxes, depreciation and amortization).
- **Fraud and Financial Disaster.** Intentional misstatements or misapplication of accounting principles can constitute fraud with disastrous consequences. Yet, it is extremely difficult to *find* fraud by simply reading financial statements. Even Sarbanes-Oxley is only a preventive measure.
- **Current SEC Enforcement Actions, Accounting and Disclosure Issues.** In 2007 there were 656 financial reporting and issuer disclosure actions filed (score-keepers

should note that's the second-highest total in nine years). Recent cases involved options, accounting fraud, financial fraud, aiding and abetting financial fraud and auditor liability.

- **Legal and Accounting Ethical Issues.** In any investigation or litigation concerning accounting issues, it is important for attorneys to understand the accountants' ethics rules and regulations, and how these relate to parallel concepts in the legal profession. There are potential conflicts of interest, attorney-client privilege issues, work product and even the engagement between attorney and accountant.

Conclusion

PLI's *Accounting for Lawyers* provides a wealth of information, a rich, complex, diverse and yes, interesting field of study. For details, *see www.PLI.com.*