Accounting in the Law Schools

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In 1930 the first course in accounting at any law school was offered by Professor Willard J. Graham at the University of Chicago. The course was developed after a survey of the opinions of several hundred lawyers as to the importance of accounting in their law practice. When I came to the School, Mr. Graham invited me to join him in writing Accounting in Law Practice, which was the first book on accounting written especially for lawyers.

In 1952 the lawyer's need for knowledge of accounting is everywhere admitted. Accounting is a favorite subject for Bar Association institutes and courses for practicing lawyers. In the last two years three accounting books for lawyers have been published—books by Oehler, Shannon, and Shugerman. College study of accounting is generally considered as an important part of prelegal education. Courses in accounting have been introduced in many of the strongest law schools, and two collections of cases and other teaching materials are now available for such courses. In the Harvard Law School curriculum accounting has been made a required subject. At the University of Chicago the course is elected by most of the students.

With an increasing number of legal subjects to be crowded into a three-year program, how can addition of instruction in accounting be defended? If familiarity with accounting is necessary for study of fields like taxation and corporation law, why not merely require college study in the field before admission to law school? One difficulty is with the type of material covered in elementary accounting courses in most colleges and undergraduate schools of business. Much time is devoted to bookkeeping procedures and subjects which are of little concern to the lawyer. Many of the topics most important for the lawyer's work are dealt with only in advanced courses.

Few prelegal students are able to fit into their program of general education enough study of accounting to reach the level needed in the study of law. Furthermore, rigid prelegal course requirements have never been an effective way of assuring uniform preparation of law students. With reference to accounting, therefore, the trend is to include a brief but concentrated introduction in the law school program. Students preparing for a law school with such a program may therefore devote their college years to more basic liberal arts preparation.

Some of the courses and books have been given the title "Legal Accounting." This phrase suggests that there is a particular kind or branch of accounting with which lawyers are concerned. What the lawyer needs, however, is a critical understanding of general accounting theory. A course or text designed for law students or lawyers is suitable also for others who need an introduction to accounting rather than training for accountancy. Thus at the University of Chicago in World War II, law students and graduate students in economics were grouped together for their study of accounting.

The course at The Law School now covers approximately 33 class hours. In this period it is possible to cover the material most essential for law study and to prepare students for further study of accounting problems "on their own" and for effective consultation with professional accountants. The pace of instruction has to be rapid, and ways must be found to exercise the fear of figures which seems always to turn up in about one-third of the class.

We begin by studying the two basic financial statements, the income statement and the balance sheet, and the relation between these statements. The "double-entry" technique can be taught in a very short time, and with very little "paper work," if the procedures are constantly related to the resulting financial statements.
The accounting concept of income is next studied, and the determination of periodic income as a process of matching items of revenue and expense through the techniques of accrual and deferment. In recent years great strides have been taken by accounting associations in rationalizing and standardizing accounting procedures. Research bulletins of the American Institute of Accountants (an organization principally of practicing accountants) furnish excellent teaching materials on a number of topics. The same is true of some of the formulations of accounting standards developed by the American Accounting Association, the organization of teachers of accounting. The accounting profession has reached the stage of group "restatement" of its principles.

Problems of inventory valuation are considered in some detail, including the controversy over "last-in-first-out" and "first-in-first-out." Considerable time is also devoted to problems of depreciation, including the current controversy over the effect of recent price-level changes and the problem of financing replacements. In this connection attention is given to the recommendations of the "Study Group on Business Income," a group of accountants, lawyers, and economists who wrestled with the problem for several years. Professor Blum has reviewed their report in the January issue of the Tax Law Review.

In dealing with such problems, students come to understand that choice among alternatives is made primarily with a view to a meaningful income statement. Decisions thus made also govern the showing of related items on the balance sheet, but determination of balance-sheet "values" is not the primary objective.

It is often necessary to contrast the general accounting concept of income with the concept of taxable net income. This is difficult with students who have not yet studied income taxation and who thus know little of the considerations which account for the divergencies, considerations of administrative convenience, and security in the collection of taxes.

The various classes of reserves are studied in some detail. These items are among the most confusing to the uninitiated reader of financial statements and are items which often feature in litigation. After learning how to distinguish the very diverse types of reserves, students are not surprised to learn that accounting societies are advocating the abandonment of the confusing term "reserve."

One of the important areas of controversy in accounting circles deals with the practice of by-passing the income statement by charging or crediting various unusual items of gain or loss directly to the earned surplus or retained income account. Here is a matter of great importance for lawyers, because of its bearing on the application of provisions in contracts, corporate charters, and other documents which require determination of the "income" or "profits" or "earnings" of a period. This is the type of controversial topic to which college teachers of accounting often give little attention in elementary courses. In one recent intermediate text it is said: "Until the issue is more clearly resolved, an instructor is thoroughly justified in suggesting the adoption of either point of view, if for no other reason than to achieve class uniformity." Imagine a law-school instructor trying to make "class uniformity" his objective in dealing with problems on which the law is not yet settled!

One topic which is often deferred to advanced courses is that of consolidated statements. Corporation lawyers are constantly dealing with such statements and should know what they purport to show and something of the procedures by which they are prepared. By use of simplified materials it is possible in two or three class hours to make students familiar with some of the most troublesome points, such as the elimination of intercompany profits, debts, and stock holdings and the treatment of divergence between the cost of the parent's holdings of stock in the subsidiaries and the book value of these holdings on the books of the subsidiaries.

Increasing use of partnership forms of business organization has given partnership accounting a new importance for the lawyer. Tax considerations often motivate the selection of the partnership form, and these considerations, in turn, are often tied up with accounting treatment of items such as admission and retirement of partners, adjustments for partners' "salaries," and distribution of partnership assets in kind.

Lawyers need also some introduction to the use of accumulation and discount tables for annuities and single sums. Such calculations are involved in amortization loan transactions, in various types of business valuations based upon earnings projections, in inheritance tax valuation of life estates and remainders, and in many other situations. Understanding of these calculations also facilitates understanding of problems of bond discount and premium and their amortization and the treatment of unamortized balances upon redemption or refunding.

One subject which can be given only passing reference in a brief course is that of cost accounting. It is not that this specialty is unimportant for the lawyer. Cases under the Robinson-Patman Act often turn on cost comparisons as justifying price discrimination, and "renegotiation" of profits under government contracts usually requires complicated study of contract costs. Cost accounting techniques are of great intricacy, however, and little more can be done in an introductory course than to indicate their importance and their relation to the valuation of inventories of a manufacturing business.

Renegotiation cases have also required of lawyers an understanding of the techniques of ratio analysis of financial statements and of the use of comparative statements for a series of years. The significance of principal balance-sheet and income-statement ratios can be presented with a few illustrations, and students can be thus prepared to pursue the subject further in the specialized books on statement analysis.
It is important to develop not only the usefulness of the two basic statements but also their limitations. One of the most important limitations is in relation to study of adequacy of working capital. Material contained in balance sheets and income statements is not arranged so as to facilitate its use for this purpose. In corporate annual reports these statements are often supplemented by a statement of flow of funds. Study of such statements is desirable for a number of reasons including the light thus thrown on the relation between periodic accounting for depreciation (amortization of cost) and the provision of funds for replacements.

Security prospectuses and annual reports to shareholders are used as stimulating and realistic material for presenting many of the topics covered. Students are introduced to SEC Regulation S-X, the general regulation governing statements filed with the Commission, and to the accounting series of releases.

A number of important areas of accounting are left untouched because they are better studied in the law courses themselves. This is true of accounting for issuance and reacquisition of shares, for dividend distribution, and for formal reduction of capital stock and so-called "quasi-reorganization." The same is true of the peculiarities of public utility accounting and of accounting in relation to segregating principal and income when property is held in trust.

As already suggested, the lawyer requires a critical approach to accounting concepts. As an illustration of such an approach, the readings include an imaginative and witty article by Walton Hamilton on the limits of accounting concepts and techniques. To test student understanding of the article, I like to raise the question as to whether Hamilton's attitude is one of hostile debunking. Last year a student immediately answered that such a characterization would be quite unfair—that Hamilton merely applies to accounting concepts the approach familiar to our students from their study of Dean Levi's Introduction to Legal Reasoning.

Experience has suggested that a few students have to be warned against expecting too much from their knowledge of accounting. They need to be reminded that legal questions concerning income usually involve questions of interpretation which accounting principles, however well settled, do not foreclose. Thus if it should become recognized that as a matter of accounting depreciation expense should be increased to take account of inflationary change in purchasing power, the resulting concept of income would not necessarily be applicable under an income bond indenture. To apply such a concept of income would give shareholders a protection from the impact of inflation at the expense of bondholders whose maximum return is not adjusted in relation to decreased purchasing power. In learning something of accounting analysis, law students must remember to think like lawyers.

Book Reviews—Home and Abroad


Modern Real Estate Transactions: Cases and Materials.

Concerning this book, the author, a professor of law at the University of Chicago, says that its objective "is to bring together for teaching purposes the legal concepts and institutions of the marketing of land"; that "it is organized on the basis of problems in house marketing." House-building problems are not dealt with. Starting with the raw material, namely, the land on which the housing structure is finally to stand, the problems of processing the land for its intended use—zoning and other restrictions imposed by public authority—are first considered. Next come controls imposed by private agreement—easements, equitable servitudes and covenants running with the land. Here are considered problems of basic policy as to what restrictions and covenants may be enforced, such as restraints on alienation, racial restrictions.

Problems in house marketing occupy some two-thirds of the book. This is as it should be, since few of the students who use this book will ever represent subdividers or wholesale builders, but all of them will have to do with problems affecting the sale or leasing of housing structures. This practical approach is typical. The student will find nothing here about the the Statute of Uses, or De Donis, or Quia Emptores. He will find something about the Statute of Frauds, for that is an element entering into almost every transaction affecting real property.

In a review of reasonable length, it is possible only to mention some of the house marketing problems dealt with. They cover a field of an extent which will surprise the lawyer who has dealt with such matters piecemeal as they arise in practice. To enumerate a few: Who participates in these transactions—buyer, seller, broker, mortgagee, escrow agent, attorneys for any or all of these—and the laws or customs affecting their participation; documents and papers; when title passes; what constitutes performance; remedies of the parties; title prob-