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Book Review

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Accounting and Financial Disclosure: A Guide to Basic Concepts. By Stanley Siegel and David A. Siegel. St. Paul, Minnesota: West Publishing Co. 1983. Pp. 259. $8.95.

Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases.[1]

THIS statement by Judge Friendly, though made more than twenty years ago, is still a valid observation. Despite the long tradition of courses on "Law and Accounting" in a great number of law schools, accounting is today more than ever an almost exclusive domain of business schools rather than law schools. The overemphasis by some texts on the mechanical aspects of bookkeeping, the view that mathematical formulae are not drawn up for lawyers ("iudex non calculat"), the highly technical language of accountants, as well as the complex and too often complicated structure of financial statements, have tended to discourage law students and lawyers from learning accounting.

This development is regrettable in light of the growing legal significance of accounting. Accounting issues play an increasingly important and decisive role in bankruptcy cases, securities law actions, and private liability litigation such as individual, class, and derivative actions against accountants and independent auditors. Accounting issues also may be crucial in arbitration involving, for example, valuation of corporate stock, as well as in legal consulting and, to a lesser extent, criminal proceedings such as securities fraud cases. In view of the interdependence of law and accounting,[2] knowledge of accounting is thus a must for all lawyers who counsel clients in business matters.

Furthermore, knowledge of accounting has become essential for the independent understanding of corporate financial statements. Separation of ownership and control as well as the complexity of modern business life have rendered traditional corporate control devices inefficient. As a result, financial disclosure has become one of the most effective watch-dog devices imposed from outside the corporate system.[3] Since accounting is the basis for financial disclosure, a solid knowledge of accounting provides one with access to one of the most effective control devices within the corporate governance system, both nationally and internationally.

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1. United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961).
2. *See* W. Ebke, Wirtschaftsprüfer und Dritthaftung 297 (1983).
3. For a more detailed exposition of this view, see Grossfeld & Ebke, *Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe*, 26 Am. J. Comp. L. 397, 421-33 (1978).

From this perspective, *Accounting and Financial Disclosure* follows a commendable approach. Written by a law professor and a certified public accountant, the book deliberately avoids unnecessary technical details;[4] rather, it seeks to make the reader fluent in accounting. The authors' goal is to make the reader "familiar with [accounting's] vocabulary, conversant with the structure and meaning of financial statements, comfortable with analysis of financial information, and aware of the strengths and limitations of the accounting process" (p. v.)—a truly ambitious objective for a book of roughly 250 pages. Yet, to anticipate the conclusion drawn by this review, Siegel and Siegel have succeeded in achieving their goal.

I. SYNOPSIS

The authors discuss central themes of accounting and financial disclosure. The first of the book's fifteen chapters introduces the reader to financial disclosure. The authors explain the form and purposes of financial statements, the sources of accounting rules, such as the definite accounting pronouncements of the FASB, SEC, and IRS, and the role of the accountant and auditor in preparing and attesting to financial statements. From this general foundation the authors turn the reader's attention to specific problem areas of accounting such as the creation of financial records (ch. 2) and the accrual system of accounting (ch. 3).

Chapter 4 is directed toward an understanding of the left side of the balance sheet, the "assets" of the company. The chapter begins with a discussion of the two categories of assets that are central to a wide variety of mercantile and industrial businesses, "inventories" and "fixed assets." The reader is made familiar with the various inventory flow conventions, such as FIFO, LIFO, and weighted average, as well as the reasons why a choice among inventory techniques is generally accepted. The authors repeatedly emphasize that judgment plays an important role in the determination of inventory values. The role of judgment is also emphasized in chapter 5, where the authors discuss the accounting valuation of "fixed assets" as well as the concepts of depreciation and depletion. Since depreciation methods, like inventory techniques, affect both the statement of income and the balance sheet, the effects of depreciation calculations become of utmost importance in practice. The authors present an example on this point that illustrates how dramatic the differences can be (p. 54). The sixth chapter expounds in detail the concept of "other assets," including cash and cash equivalents, marketable securities, and other investments. The following chapter, devoted to the right side of the balance sheet, deals comprehensively with current and long-term liabilities, interests and discounts, deferred income taxes, loss contingencies, and pension plans.

The pedagogically well drafted eighth chapter provides insight into capital accounts of both partnerships and corporations. Those readers who

4. For those readers who want to study the elements of bookkeeping, from original entry of financial transactions through closing of the book and preparation of financial statements, the authors have provided two appendices (pp. 191-251).

have no, or only a limited, background in the law of business associations are introduced to the basics of partnerships and corporations. Terms that even for many lawyers are too often nebulous, such as "common" and "preferred" stock, "watered stock," "no-par stock," "paid-in capital," "capital surplus," and "retained earnings," thus become visual concepts of law.

The reader can acquaint himself not only with individual items in the financial statements but also with the analysis of the relationship among these items, both present and past.[5] The inclusion of a separate chapter on the analysis of financial statements (ch. 9) is commendable because this analysis gives readers at least some reliable insights into the solvency, stability, growth, and profitability of the enterprise. The analysis of financial statements thus becomes an efficient means for the protection of shareholders and creditors, both potential and present, as well as other persons interested in the enterprise's status and performance. Though the book introduces only the most commonly used analytical tools, it acquaints the reader with a fairly wide variety of comparisons, trends, ratios, and calculations that are presently employed to analyze financial statements.

So far, the reader has been made familiar only with the balance sheet and the income statement as the traditional pillars of financial statements. While focusing on status and income, both balance sheets and income statements do not show the flow of current assets and current liabilities. These operational results are highlighted in the "statement of changes in financial position" (ch. 10) which, following the United States pattern, more and more countries have added to the balance sheets and income statements.[6] While the statement of changes in financial position is criticized by some commentators in this country,[7] Siegel and Siegel point out that "cash and fund flow appear destined to occupy an increasingly important role in accounting and financial analysis" (p. 127).

The next two chapters (chs. 11 and 12), dealing with auditing and the auditor's and accountant's liabilities, deserve the special attention of the reader. A book on accounting and financial disclosure can no longer be written without some reference to auditing and the auditor's function. Auditors, once primarily engaged to inform management of irregularities and inefficiencies, have become independent external evaluators of financial statements in the public interest. The change in the auditor's function from that of a watch-dog for management to that of an "agent of social

5. To allow a comparison of a company's most recent financial statements with those of previous years, annual reports filed with the Securities Exchange Commission must contain comparative financial statements. W. EBKE, *supra* note 2, at 108.

6. *See* INTERNATIONAL SURVEY OF ACCOUNTING PRINCIPLES AND REPORTING PRACTICES position 205 (R. Fitzgerald, A. Strickler & I. Watts eds. 1979).

7. Heath, *Let's Scrap the "Funds" Statement*, 146 J. ACCT., Oct. 1978, at 94, 97. The main criticism is that the statement of changes in financial position contains little information not already present in the company's balance sheet and income statement. *Id.* at 102-03.

control"[8] is the direct consequence, on the one hand, of the "informativeness" aspect of financial statements, that is, their ability to communicate to investors, creditors, and other interested persons relevant information about the enterprise, and, on the other hand, the inability of many of the interested persons to assure the adequacy and fairness of financial statements. Recent court decisions reflect the increasing responsibility of auditors at common law,[9] particularly to third parties with whom the auditor is not in privity of contract.[10] Some observers say that recent changes in federal law have opened fresh avenues for even more litigation.[11] The exposure of auditors to enormous civil liabilities should not discourage the book's young readers from joining the accounting profession; it should make them aware, however, of the specific hazards that this professional engagement today may include.

The last three chapters of the book are devoted to specific questions of accounting: consolidated statements (ch. 13), accounting for inflation (ch. 14), and federal income tax accounting (ch. 15). Since most of the corporations that fall under the federal securities regulation have a controlling financial interest in other corporations, the authors' remarks on consolidated financial statements and especially on the different accounting methods, such as pooling of interests versus purchase of assets, not only are worth reading from a theoretical point of view but also are of great practical significance. The same is true with regard to the chapter on accounting for inflation. Traditionally, accounting is based upon nominal dollars and historical costs. In our inflationary times, however, historical cost accounting becomes deceptive to one who is not familiar with its limitations. The accounting profession and commentators have wrestled with the problems of inflation and deflation for more than fifty years, but not until 1976 did definitive support for inflation adjustments of financial statements arise. Nevertheless, many difficult and controversial technical issues remain to be solved in the area of inflation accounting.[12] The authors focus on the methods of current cost accounting and constant dollar accounting since current cost and constant dollar information now must be disclosed as supplementary information in financial statements.

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8. *See* THE COMMISSION ON AUDITORS' RESPONSIBILITIES: REPORT, CONCLUSIONS, AND RECOMMENDATIONS 4 (1978).

9. H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 145 (N.J. 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis. 1983). For a discussion of these cases, see Brodsky, *Accountants' Liability*, N.Y.L.J., Sept. 21, 1983, at 1, col. 1. *See also* JEB Fastener Ltd. v. Marks, Bloom & Co., [1981] 3 All E.R. 289, 289 (accountants' liability to third persons dependent upon knowledge and foreseeability), *aff'd*, [1983] 1 All E.R. 583 (C.A.).

10. For the range of views, see Ebke, Accountants' Liability to Third Parties at Common Law and Under Federal Securities Laws: Evolution, Developments, Perspectives (1978) (unpublished master thesis, University of California at Berkeley School of Law (Boalt Hall)). *See also* D. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS (rev. ed. 1982 & Supp. 1983); R. GORMLEY, THE LAW OF ACCOUNTANTS AND AUDITORS: RIGHTS, DUTIES AND LIABILITIES (1981); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 256 (1983).

11. *See* Morrison, *CPA Suits Are Adding Up*, NAT'L L.J., May 16, 1983, at 1, col. 1.

12. *See, e.g.*, Cohen, *Establishing Inflation Accounting Standards in the United States: A Developmental Process*, 4 J. COMP. CORP. L. & SEC. REG. 305, 314 (1982).

The final chapter familiarizes the reader with the basics of federal income tax accounting. The authors ask, *inter alia*, why tax accounting differs from financial accounting. Pointing to the recent United States Supreme Court decision in *Thor Power Tool Co. v. Commissioner*,[13] they note that the differing goals of financial accounting and tax accounting, meaningful disclosure versus raising of revenues, sometimes require different principles. The Supreme Court may have exaggerated the flexibility of financial accounting and overstated the certainty of tax accounting rules and regulations in *Thor*. Nevertheless, the United States follows basically a comparatively flexible approach with respect to financial disclosure. Therefore, the United States cannot rely on the same "true and fair view" accounting principles for tax purposes. This situation is in stark contrast to that which exists in other countries. For example, in Germany a legalistic and highly codified system of accounting rules permits, as a general rule, reliance upon one set of accounting principles for both financial disclosure and income tax accounting.[14]

II. Critique and Conclusion

The preceding survey presents a general idea of what the reader can expect from the authors' cross-disciplinary expertise in relevant fields of accounting and financial disclosure. A text like the present one has long been overdue. The book provides the reader with a balanced exposure to both the theory and practice of accounting and financial disclosure. Rather than becoming lost in the contemplation of narrow technical points, the authors systematically elaborate basic concepts without paying too high a price in terms of generalization and oversimplification. Since the uninformed public too often expects an unrealistic degree of certainty in financial statements, in both a numerical and an economic sense, the text properly demonstrates not only the uses of accounting but also its limitations. Given that numerous aspects of accounting must be based upon opinions, assumptions, and estimates rather than objectively verifiable facts, accounting is far from being an exact science. This natural limitation does not diminish the value of accounting as long as attempts are made to bring this cognition to the attention of those who are not familiar with it. The well-informed, sophisticated public has, I think, long abandoned the belief that financial statements provide the key to securities selection or credit granting.

In the era of "efficient markets," the less informed investor will discover that information that is new to him is already reflected in the price at which he trades. Nevertheless, I agree with Siegel and Siegel that the efficient market hypothesis does not require abandonment of the financial dis-

13. 439 U.S. 522 (1979).

14. According to § 5(1) of the German Income Tax Code (Einkommenssteuergesetz), the accounting principles applied to financial accounting are also relevant for tax accounting purposes (so-called "Principle of Relevancy"). This principle, however, has numerous exceptions.

closure mandated by the federal securities regulation, since the interaction of firm-based information and macroeconomic factors still allows the reader to gain value from financial statements (*see* pp. 11-12). Another question is, of course, whether, in view of the efficient market hypothesis, the regulation of corporate disclosure should be reconsidered and readjusted.[15] I admit that it is not easy to justify opposition to extensive disclosure requirements, especially in light of the concept enunciated by Justice Brandeis that publicity, like sunshine, cleanses.[16] Still, it appears not only appropriate but also vitally necessary to familiarize the students of accounting and financial disclosure with the basic question of what, and how much, disclosure is really needed to serve the public interest in today's economy. To answer this question requires a thorough investigation into the genuine costs and competitive disadvantages that are caused by complex and overly detailed requirements of disclosure. Without knowledge of these basic questions lawyers will not be able to play an active role in the present process of remodelling the legally and economically important field of financial disclosure. This is not to criticize Siegel and Siegel's text; a book that aims at the teaching of basic concepts rather than the overall socioeconomic framework cannot be expected to discuss or even answer conceptually unsettled problems of financial disclosure. Those who use Siegel and Siegel's book as a principal or supplementary text for courses in accounting, business associations, or business planning, however, should face the problems mentioned.

Instructors using Siegel and Siegel's text should also, I think, put more emphasis on the concept of valuation. The authors' discussion of the methods of historical cost and current cost accounting certainly focuses on very important aspects of this concept. During the periods of inflation and unsurpassed technological development, as in the area of computers, that have characterized recent years, the historical cost of assets on a company's balance sheets bears little resemblance to their replacement costs. In such times replacement cost information can prove to be helpful for assessing the present value of an asset, particularly when there is a market of fungible replacement assets. Therefore, article 33(1) of the European Economic Community's Fourth Company Law Directive[17] provides that the member states may require companies to base their financial statements upon cur-

15. For a detailed discussion of this problem, see H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 83-88 (1979).

16. L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

17. The Fourth Directive was proposed in 1971 and formally adopted in 1978. It aims at an EEC-wide system of financial reporting, the main features of which are the concept of true and fair presentation patterned after the English model, the going concern and matching concepts, valuation at replacement cost of limited life tangible fixed assets, disclosure of differences in inventory values determined by FIFO, and considerable improvements in disclosure including a great deal of segment reporting. The Fourth Directive is part of the EEC Commission's efforts to harmonize the company laws of the EEC member states. For a discussion of these efforts, see C. SCHMITTHOFF, THE HARMONIZATION OF EUROPEAN COMPANY LAW (1973); Schneebaum, *The Company Law Harmonization Program of the European Community*, 14 LAW POL. INT'L BUS. 293 (1982); Silkenat, *Efforts Toward Harmonization of Business Laws within the European Economic Community*, 12 INT'L LAW. 835 (1978).

rent cost accounting rather than upon historical cost accounting. The German government has already indicated, however, that German law will remain firmly rooted in historical cost accounting.[18]

Historical cost accounting and current cost accounting are, no doubt, significant facets of the concept of valuation. Value determination, however, also becomes crucial in a great number of other respects. Investors may, for example, want to measure the preservation of their capital by the value of the future flow of earnings. This value determination entails highly difficult problems surrounding the predictions of the amount, timing, and risk of the expectable cash flow. Other users of financial statements may be interested in a business's liquidation value. Since these values can be of great importance for investment strategies, even those who want to study only the basic concepts of accounting should acquaint themselves with these techniques of valuation. This will be easier than many may expect as valuation, to a large extent, requires the type of analytical and conceptual thinking, and the weighing of interests, for which lawyers are well trained.

Unlike some modern European texts, which illuminate both the national and international background of accounting and financial disclosure, Siegel and Siegel's book is exclusively devoted to the American aspects of accounting and financial disclosure. This is particularly astonishing since United States rules now call for consolidation in the mother company's financial statements of all majority-owned subsidiaries, including foreign-organized subsidiaries, absent special circumstances that require the foreign-organized subsidiary to be kept separate. The inclusion of foreign-organized subsidiaries causes unique problems such as translation of foreign currencies and transfer pricing. Thus the picture of consolidated financial statements is incomplete without some references to these frequently arising international accounting problems.

Similarly, the text fails to mention the impact on accounting and financial disclosure of international conventions such as the Guidelines of the Organization for Economic Co-operation and Development (OECD) for Multinational Enterprises of 1976/1979.[19] The Guidelines are certainly not "instant public international law" since they are not directly

18. *Cf.* W. EBKE, *supra* note 2, at 326. In view of this decision more and more commentators in the Federal Republic of Germany strongly suggest a statutory requirement for the disclosure of supplementary replacement cost information in annual reports ("Geschaeftsbericht"). *Id.* at 326-29 (listing further references). The Unternehmensrechtskommission, a corporate law revision commission appointed by the Federal Minister of Justice, has generally taken a favorable view of supplementary current cost information. *See* BUNDESMINISTER DER JUSTIZ, BERICHT UEBER DIE VERHANDLUNGEN DER UNTERNEHMENSRECHTSKOMMISSION 926-28 (1980). Whether these suggestions will come to fruition through legislative enactment remains, of course, to be seen. The proposals have to be seen in the broader context of the transformation of the EEC's Fourth Company Law Directive, which one may expect to become law in the Federal Republic of Germany in 1985 or 1986.

19. The guidelines are reprinted at 75 DEPT. STATE BULL. 83 (1976) and 15 INT'L LEGAL MATERIALS 969 (1976). For the 1979 revision of the guidelines, see 18 INT'L LEGAL MATERIALS 1171 (1979).

binding. The Guidelines do contain, however, international standards of public policy that in the course of time and frequent application pass into the general corpus of customary public international law.[20] Thus they stand for what may come in the future. Even today, however, the OECD Guidelines should not be underestimated. Experience shows that in spite of their nonbinding legal character, the Guidelines are enjoying increasing respect in the business community.[21]

Apart from the limitations mentioned, Siegel and Siegel's text will prove to be equally challenging reading for those lawyers and economists, students and professionals who have not been exposed to, but who do recognize the compelling need for a knowledge of, accounting and financial disclosure.

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20. *See also* Ebke, *Double Taxation*, 8 ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW (1984).

21. Ebke, Book Review, 25 DIE AKTIENGESELLSCHAFT 286, 287 (1980); *see also* Horn, *Codes of Conduct for MNEs and Transnational Lex Mercatoria: An International Process of Learning and Law Making*, in LEGAL PROBLEMS OF CODES OF CONDUCT FOR MULTINATIONAL ENTERPRISES 45, 52 (N. Horn ed. 1980).

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