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Mutual Points in Law and Accounting

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Every representative business transaction involves two separate and distinct features; the legal or contractual when the transaction is entered into; the accounting when the deal is consummated. Out of these ordinary business transactions has grown a greater demand for legal and accounting services in the commercial field. Federal taxes and industrial financing programs have added very materially to the work of the attorney and accountant during the last decade.

The reason for the demand on these professions may be briefly stated. The doctor, the dentist, the theologian, are professional men, each a member of a recognized profession, but the services of these men are rendered principally for the benefit of individuals, while the services of the attorney and accountant are required by individuals, professional men and commercial concerns. The greater part of their work relates to commercial rather than individual services. By way of comparison; one group may be classed primarily as a personal profession, while the other group may be classed as a combined personal and industrial profession. The engineering profession may also be properly classed in the latter group.

In many cases the need for legal and accounting services is inseparable. Chiefly among these we find Corporate Reorganizations, Incorporations, Increases in Capital Stock, Receiverships, marketing an issue of Bonds, Estates, Interests of Stockholders, etc. All of these and many other types of transactions involve legal and accounting problems of sufficient magnitude so that firms or individuals find it advisable to employ both the attorney and accountant, trained to work out and assist them in carrying through their plans. Kindly note that Federal Taxes have been omitted. This important subject will be discussed briefly at the close of the article.

In discussing the relation of the attorney and accountant, I have in mind only those practicing in the accounting profession as Certified Public Accountants, who have acquired the right to practice as such by and under the authority of any one of the states.

Corporate Reorganizations, Consolidations and Mergers.

Corporate reorganizations occur quite frequently. This term includes a reorganization of a company in being, which for some reason desires to reorganize, consolidate or merge with another or group of other corporations. The purpose of a merger or consolidation is primarily to give the company a greater purchasing and marketing power, reduce its general overhead and acquire additional working capital. Usually a corporation through a reorganization, consolidation or merger will be put on a profit-making basis, whereas before it was a losing proposition to its stockholders. The element of management is an important factor in a reorganization of this kind, but being foreign to this subject will not be discussed here.

Having decided to merge a corporation with one or more others, the stockholders contemplate the transfer of their present shares for those of the new corporation as soon as the plans can be worked out. This is the common method used in present day corporate financing. This method requires a
very definite handling of the legal and accounting points involved, so the at-
torney and accountant are called in for advice. The attorney is first consulted
about the legal principles involved in the merger, the accountant is consulted
about the value of the company's assets, the amount of its liabilities, and
other accounting features. While the plans for the merger are under way a
very common question arises, viz: What value must be placed on the stock
in order that the present holders may receive a like value in the stock of the
new company?

The accountant must of course examine the accounts to determine if all
assets shown in the company's Balance Sheet are actually on hand and owned
as of that date. Also, if all liabilities are taken up and property reflected in
the accounts. This information is vital, because if the merger is effected on
a certain valuation of stock, and it later develops that the value of the stock
of one company was grossly overstated, the stockholders of that company will
have received a greater value pro rata of the new stock than the stockholders
of the other companies who determined the correct value of the stock before
distribution was made.

The value of the stock is always dependent on the total net worth of the
company, which may be easily overstated by including a large item of Good-
will, Appreciation of Fixed Properties, etc., which in fact have a very ques-
tionable value. This is especially true where these amounts have been arbi-
trarily set up on the books without having been determined on a sound and
logical basis.

When the merger has been finally agreed upon and the plan accepted by
all companies involved, a logical and equitable basis for distribution of the
stock of the new company among the present holders must be determined.
The amount of stock which will be authorized, and issued by the new com-
pany in return for the stock of the old companies may be dependent on the
value of the old stock or the amount requested to be authorized by the new
company may be determined independently of the value of the combined
stock of the old companies. Quite frequently the stock authorized in the
new company will exceed by far the value of the combined stock of the old
companies, thus providing a means of acquiring additional working capital for
future operations and expansion. Which of the two plans is most desirable
is a point to be decided by the committee effecting the reorganization.

The accountant examines the accounts of each of the companies and finds
it necessary to adjust the surplus account in order that the value of the stock
may be correctly shown. The reduction of the surplus simultaneously reduces
the value of the individual shares. The attorney, in working out the reorgan-
ization plan, will generally be guided by the adjusted value as shown in the
accountant's report on the financial condition of each of the various com-
panies. Having obtained these reports from dependable sources the attorney
and the reorganization committee will be assured of a logical basis on which
the plans for the merger may be worked out with a definite degree of fairness
to all stockholders. The stock of the new company may then be issued ac-
cording to the ratio determined by the committee. This discussion presents
only one of many ways where the attorney and accountant are employed for
the purpose of working out a reorganization plan.
Receiverships.

Quite frequently an attorney is appointed receiver for an insolvent concern. Here again the need for combined legal and accounting services is very evident. When the attorney takes charge of a large company for the purpose of winding up its business or to conserve its properties pending a plan of reorganization and continued operation, he invariably appoints an accountant to determine the value of the assets on hand and liabilities owing and an engineer to determine the present physical value of the operating properties. Should the committee, in the best interest of the stockholders, decide to discontinue operations, the attorney may use these same values in his later distribution among creditors and stockholders. It would be rather a dangerous undertaking to distribute any of the assets even among creditors before first determining from authoritative sources the exact amount available for distribution. If the assets were all bona fide and free from claims this would be an easy matter, but such is not always the case. Quite frequently the Accounts Receivable are pledged as collateral to a loan; inventories on hand have a small market value; investments are over-valued; the properties are subject to a lien, obsolete or greatly depreciated in value; a large contingent liability exists with respect to Notes Receivable discounted; undisclosed contingencies in the form of suits pending on patent infringement or breach of contract; as a matter of fact, many other features which would affect the final distribution to creditors and stockholders. Knowing that in many cases the facts disclosed in the books are unreliable or omitted entirely, the attorney recommends that an accounting be made before liquidating any of the liabilities or distributing the residue of the assets among the stockholders. If a distribution is made on the basis of the accountant's report, the attorney generally considers his part of the work has been greatly aided by first knowing the values he has taken over as a receiver, and then working out his plan of distribution accordingly.

Bond Issues.

Another important phase of the professional relation presents itself in working out the details of a bond issue. Those who have studied finance or have come in contact with the same principles in actual business practice will no doubt be familiar with the many legal and accounting phases involved in preparing and marketing an issue of bonds or short term notes. The question is primarily one of finance. Those familiar with present day financing, know that Bonds and short term Notes constitute one of the principal methods of financing the medium sized and larger enterprises. This is particularly true of railroads and public utilities. Bond financing is also quite prominent among the larger individual owners of office buildings, hotels and apartment houses, although of quite a different nature than that found among our representative industries.

The importance of Bond financing cannot be too strongly emphasized. The legal and accounting points involved are equally important, because without proper legal provisions and verification of assets, liabilities and earnings, the issue may be of little value to the holders. We find quite frequently that a thousand-dollar bond has an economic value equal to that of a piece of waste paper of the same dimensions and quality. This, however, is
very seldom the case when the issue is carefully gone into before it is sold, unless there has been an abrupt turn in economic conditions after the issue is marketed. A reputable broker or syndicate will not float an issue of bonds or notes unless they are first assured of its validity. The bonds must also be supported by a reasonable margin of security and a good earnings record for a period of years.

The validity may be determined by the attorney, the security by the accountant; combining the work of both professional men we form the basis on which the entire issue will be accepted or rejected. To understand this point clearly we must first know what is meant by the term security. It is the property and earning power underlying the mortgage on which the bonds are issued. One having purchased bonds is no doubt familiar with these points, if not he should be before getting too deeply into the matter.

One of the important legal points in preparing a bond issue is determining the company's title to the property. This is generally considered to be one of the most important legal features involved in the issue. Next in the order of importance we have the Trust Agreement. Bonds are usually issued under a trust agreement which designates the property incumbered by the mortgage and the conditions under which it is made; the amount of the issue; whether it is to be redeemed serially or at the end of a specified term of years; denominations to be issued; term of the issue; rate of interest; amount, if any, to be placed in a sinking fund to redeem the bonds when due; if convertible on redemption date into stock of the company; name of Trustee, and other special features peculiar to this type of financing. The entire trust agreement must be prepared by the attorney.

We will now consider the accountant's part of the work. In most instances he is called in by a broker who intends to market or participate in marketing the issue. His report is usually very broad in its scope and during recent years has gone even beyond the strict accounting features and now includes some phases of Industrial Engineering as well. I might say in passing that the value of incorporating the engineering and accounting features in the same report is now generally recognized by leading banks and brokerage houses. Where the engagement is large enough to warrant a study of the engineering features it should be strongly urged by both attorney and accountant.

In making a Financial Investigation for the purpose of reporting to a banker or broker, the accountant must cover a sufficient number of years to show the general trend of the business, or what might be termed a representative period. This usually extends over a period of five to ten years. Where the investigation covers a long period of time, a Balance Sheet at the beginning and end of the period with comparisons, accompanied by the report on Balance Sheet items will show the general financial trend of the business for the period intervening between the prior and current date. There is, however, another phase equally or even more important, viz., that of the earning power over the same period of years. The earning power alone may determine the value of the bonds as will be presently explained.

A corporation must depend on its earnings for its corporate existence. If the earnings are insufficient to meet the operating expenses, provide for depreciation of its properties, pay the interest on its indebtedness, and add a rea-
sonable amount annually to the surplus account, then it cannot be considered a successful corporation.

The Balance Sheet does not disclose this information, hence the accountant must examine the operating accounts for a period of time to determine if adequate Depreciation Reserves have been provided; provision made for bad Debts in the respective years; and also if adequate provision has been made for additional Federal Taxes which may be due the Treasury Department on a later audit of the returns. If the company carries a large item of good will, patents or trade-marks on the books, the value should be properly determined and the amounts adjusted to agree with the sound value or actual worth to the company. Oftentimes large items representing intangibles have a very small intrinsic value when determined on the basis of their actual worth to a going concern.

By presenting a Statement of Profit and Loss for a suitable period of years (usually five to ten, depending, of course, on the length of time the company has been operating) with appropriate comments, accompanied by a Comparative Balance Sheet as previously explained, the accountant has laid a foundation on what the broker may safely accept or reject the issue. Should the earnings or security underlying the issue be inadequate, the broker may reject the issue and the corporation will be forced to look elsewhere for marketing its bonds, or seek another form of financing. Where an issue of bonds fails through lack of security the corporation may be forced to float a speculative form of security or offer the issue at a substantial discount. This of course is a matter of financing and does not come strictly within the scope of this discussion.

Summing up the relations of the attorney and the accountant in this class of work, we find the legal and accounting features are closely related. One will not suffice without the aid of the other, and the success or failure of the issue is dependent on the work of both the attorney and accountant. Without the legal work the issue could not be properly written up and marketed; without the accountant's report the underlying security would be questionable, and if the report is unfavorable the whole issue may fail. One can see at a glance the importance of having each of these phases carefully gone into by men well qualified to handle this class of work.

Enforcing a Stockholder's Statutory Right.

Another case of mutual employment of the attorney and accountant occurs when a stockholder of a corporation wishes to exercise his statutory right in examining the corporation books. Feeling that he has been defrauded and intending to bring suit to recover, the stockholder employs his attorney to start legal proceedings. The attorney starts the action or perhaps suggests first that an accountant be employed to determine if the stockholders assertions are well founded. The accountant makes a cursory examination, finds that certain transactions are in line with the clients allegations and makes an arrangement for the necessary accounting work. The attorney brings the suit and when the fraudulent transactions have been disclosed by the accountant as a result of his examination, the books may be brought into court. The accountant must then qualify as an expert witness, after which he may explain the nature and amount of the various transactions in question and read them into the record as evidence.
After ascertaining the amount of the stockholder's claim from the findings of the accountant's report, the attorney uses this as a basis for determining the amount due his client and sets this up as the amount of his claim. This procedure is quite frequent among stockholders of closed corporations, where the stock is held within the family circle. This illustrates one more phase of professional work where the services of the attorney and the accountant are necessary in order that the suit may be prosecuted in the best interests of the client.

I have attempted to point out briefly some of the more common forms of service requiring both the attorney and accountant. Any one of these features may be used as the basis for an elaborate discussion, but the purpose of this article is to merely show the relation without pursuing in detail all of the work involved in each. There are many others of equal importance which the practitioner will readily recognize, but time and space will not permit a discussion of all the other branches.

In passing, it is only fair to mention Federal Taxes as an important branch where a combined knowledge of law and accounting is valuable. On account of the complex accounting problems presented in the more important divisions of Federal Taxation, one can hardly expect to deal with the situation fairly unless he is qualified to handle both phases of the work. For this reason, some having the combined knowledge have found it profitable to specialize in tax work. I regret the necessity for limiting the discussion on this very important branch of professional work. An entire article could be written on Federal Taxation without exhausting even a small number of the important facts of interest to members of both professions.

HOMECOMING.

Another page of Chicago-Kent's unique history will be completed after the evening of March 4th when the College celebrates its First Annual Homecoming. We have thousands of Alumni in and about Chicago and we expect to reach all of them, and have them on hand that evening. This is a great undertaking, and in order to put it across with our customary degree of success, all of the students of both the law school and junior college must give their support and co-operation. Tell all of the old boys you know, and see that they get around.

The affair will be held at the Broadway Armory at Thorndale and Broadway. The program will be swelled with plenty of home talent and also numerous professional acts. There will be boxing, a class scrap, track events, stunts, side shows, and everything that goes to make up a real big time; one that you will tell your grandchildren about. Bring the girl, or stag it; any way you like. Get a date now and have her meet the boys. She'll love you all the more.

There will be a dance in conjunction with the other events, so that our co-eds may have all the comforts of a real party. Just get out the little red book and mark down March 4th at 7:30 and the place, and you have it. Everybody out for this famous gathering of the members and potential members of the Bar. If you couldn't get to London last year for the convention of the American Bar Association, don't deprive yourself of coming to the homecoming of Chicago-Kent.

HOMECOMING COMMITTEE.