Foreword

When I began practicing law as a business lawyer about 45 years ago, I soon realized that I needed to understand financial statements to do a good job. Continuing education courses were not as widely available in those days, and I embarked on a self-taught course. I wish I had had Bob Dickie and Pete Russo's book available then—it would have made my trek a lot easier and more informative.

The need to have a deep understanding of financial statements and accounting applies to all of the areas that a business or litigation lawyer might get involved in:

- Mergers and acquisitions
- Debt financing
- Capital markets
- Private equity
- Employment
- Distribution agreements
- Sales agreements
- Franchise agreements
- Commercial litigation
- Tort litigation
- Securities litigation

These issues come up in:

- Terminology
- Calculation of payments under an agreement
- Drafting of financial covenants
- Securities disclosures
- Financial damages
- Representation of assets and liabilities on financial statements

Let's go through a few examples.

Terminology. Many agreements provide that when the agreement uses an accounting term, the term has the meaning given to it under accounting terminology. Accounting terminology is designed to serve the goals of the presentation of accounting information. Those meanings may not be the same as the ones that businesspeople are thinking about when negotiating the terms of an agreement. It is important for the lawyer drafting an agreement to understand

the client's business goals and whether the use of accounting terminology fits into the terms of the agreement as the client understands its business goals.

Merger and acquisition agreement. A key set of facts when a potential buyer values a target company are the target's net assets and profits. Often the seller will provide representations and warranties concerning the financial statements. The lawyer representing the buyer will want to understand how they are calculated, what effect modifications to EBITDA (and the like) have on the results, and the effect of "exceptions" taken by the seller.

Securities offering materials. Similarly, investors in an offering of securities want to understand the issuer's financial status and profitability. Often companies will design their own metrics to evaluate their financial success. The lawyer preparing the offering materials cannot describe how the metrics vary from accounting principles without first understanding the accounting principles. Sometimes the regulators of an industry have their own accounting rules that overlay the regular accounting rules. This came home to me many years ago when representing an issuer that was the holding company of an insurance company. The insurance regulators had accounting principles that also had to be applied, and then the financial statements generated by those principles had to be included in the offering materials. Finally, the lawyers had to describe the differences between the two and why they mattered. A keen understanding of accounting rules and why the insurance regulators had a modified approach was necessary to do the right disclosure job.

Sales agreements. Accounting rules don't always follow legal rules because the policies implemented in one area are not necessarily the same as in another one. Years ago, a client had an agreement with covenants relating to "inventory" levels as shown on its financial statements. Under accounting rules then in effect, purchased goods would not be included in inventory until the buyer (the client) had title to the goods. The contracts under which it purchased many of its goods gave extended payment terms and had retention-of-title clauses. Under this accounting rule, the goods would not show up as "inventory" in the financial statements until the price had been paid. Under the Uniform Commercial Code, such a retention-of-title provision is treated as creating a security interest and not getting in the way of the buyer obtaining the ownership of the goods. Thus, if accounting rules applied to the covenants mentioned above, the client might fail to satisfy them. But if the UCC's rules applied, the goods would be counted as "inventory" and the covenants might well be satisfied. A strong familiarity with how accounting rules work would assist in negotiating contracts of that type.

Opinion letters. Lawyers often do "true sale" opinions for securitization transactions. The meaning of "sale" under accounting rules often looks to whether a transaction is a "sale" for commercial law purposes, and the commercial law cases often refer to how the seller and buyer treat the transaction for accounting purposes. The factors that an accountant might look at—such as the seller's continued ability to collect the sold accounts—might not jibe with the factors that a court would look at when doing a commercial law analysis.

Audit letters. Each year, often in the first months of the year, auditors for a client are preparing the client's financial statements. Clients request their lawyers to identify certain contingent claims where the lawyers are representing the client. It's important for lawyers preparing responses to these requests to understand the role that response plays in the auditors' preparation of the financial statements, in particular how financial statements deal with contingent liabilities. This understanding will produce a more effective response.

Litigation. Every one of the above examples can morph into litigation. A litigator working on one of these cases (for the plaintiff or the defendant) should have the same understanding of accounting in order to do a good job representing her or his client.

So, I suggest that lawyers—particularly newer lawyers—go through this valuable book and begin their understanding of how financial statements play a role in the day-to-day life of a lawyer. Then, with that raised sensitivity, they can come back to the book when they spot an issue (which they might have missed before) and engage in an in-depth understanding of the issue.

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