



December 3, 2019

VIA EMAIL

Hellen Hong  
The State Bar of California  
180 Howard St.  
San Francisco, CA 94105  
[hellen.hong@calbar.ca.gov](mailto:hellen.hong@calbar.ca.gov)

**Re: Supplemental Information In Support of VLI's Reconsideration Request**

Dear Ms. Hong:

Thank you again for taking the time to meet with us on November 22, 2019 to discuss Veterans Legal Institute's ("VLI") request for reconsideration of the Legal Services Trust Fund Commission's (the "Commission") preliminary decision to deny VLI's request for IOLTA and EAF funding. We write to address the specific questions posed in Doan Nguyen's November 25 email.<sup>1</sup>

In the first section of this letter, we provide a brief description of each of the documents provided by VLI to address the Commission's specific document requests. We provide a bookmarked PDF file of all relevant documents with this letter, with references to the various documents denoted as "Tab \_\_\_" herein (which correspond to the number of each request in Ms. Nguyen's November 25 email). In the second section of this letter, we provide VLI's responses to each of the Commission's "Supplemental Questions."

**Description of Attached Documents**

In item 1 of the request, the Commission asked for documents constituting "VLI Board approval of the original 2018 audit and the revised 2018 audit." **Tab 1** contains a letter from the VLI Board Chair, Marc Hankin, which describes the Board's approval process for both audits. As Mr. Hankin explains, the Board reviewed, discussed, and approved the original audit in the regular course (though it did not hold a formal vote). Because the revised audit had to be prepared and submitted to the State Bar on extremely short notice, VLI's Executive Director,

---

<sup>1</sup> As we requested, in order to accommodate the Thanksgiving holiday, we are providing this response by close of business on December 3 rather than the initial November 27 requested deadline. We appreciate your and Ms. Doan's agreement to provide this additional time.

December 3, 2019

Page 2

Antoinette Balta, and Deputy Executive Director, KellyAnn Romanych, immediately discussed the proposed revision with Mr. Hankin and agreed to an expedited audit revision showing the amortization. Given that it was not a change in actual funds received or spent, but rather an amortization, and given that this is a common practice, the revision was approved orally by the executive committee and Mr. Hankin as Board Chair. VLI's Board has since formally approved both the original and the revised audit, so the approval will now be reflected in the minutes.

In item 2, the Commission asked for documents identifying “[t]he percentage of 2019 expenditures and projected 2020 expenditures attributable to providing free civil legal services for indigent persons as defined in Business and Professions Code section 6213(d) and State Bar Rule 3.672(A).” **Tab 2** contains an analysis conducted by Ms. Romanych, providing these percentages. As you will see from Ms. Romanych’s analysis, the percentage of 2019 expenditures (using data from the first three quarters of 2019 for unduplicated clients) is approximately (1) 60% if VLI uses the definition of indigence as provided in State Bar Rule 3.672(a), or (2) 76% if VLI uses the expanded definition of indigence as provided in Business and Professions Code section 6213(d), which incorporates the definition of lower income households from Section 50079.5 of the Health and Safety Code.<sup>2</sup> VLI expects 2020 expenditures to be at or greater than these levels based on the current and anticipated demand for VLI’s services.

In item 3, the Commission asked for “[i]nformation regarding the [September]<sup>3</sup> 2018 fundraiser for VLI’s spinoff organization, Center for Law and Military Policy, including promotional materials for the event, staff time and other costs associated with the fundraiser.” **Tab 3** contains (1) a chart breaking down the total income, expenses, and net funds raised in connection with the September 2018 fundraiser; and (2) a promotional flyer raising awareness for sponsorship opportunities for interested donors.

In item 4, the Commission asked for “[d]ocumentation or contract/agreements related to the transfer of money from the [September] 2018 fundraiser to the spinoff organization.” VLI includes in **Tab 4** copies of the checks constituting payment to the Center for Law and Military Policy (“CLMP”). Please note that the contract between VLI and CLMP is confidential, and VLI is contractually precluded from sharing it. We trust this will not be an issue for the Commission, but please let us know if it is so we can discuss how to provide you with the information you need without violating VLI’s contractual obligations.

As subpart (a) of item 4, the Commission asked for “[d]ocumentation/explanation of where the \$140,000 came from. Can the \$140,000 or any significant part of the \$140,000 be specifically tied to monies raised at the [September] 2018 fundraiser?” **Tab 4(a)** includes a copy of a check for \$80,000 from the Rothenbuehler Foundation, which constituted funds that VLI earmarked specifically for payment to CLMP.

---

<sup>2</sup> These percentages are based the number of indigent clients served divided by the total number of clients served, which VLI believes is a reasonable approximation of ultimate qualified expenditures.

<sup>3</sup> Ms. Doan’s November 25 email referenced a November 2018 fundraiser. We believe the fundraiser she intended to reference is the one held in September 2018.

December 3, 2019

Page 3

As subpart (b) of item 4, the Commission noted that “[a]t Friday’s meeting, KellyAnn referred to receiving a copy of documentation of the spinoff organization’s non-profit status in [or] around December 2018; can you also provide a copy of this documentation?” **Tab 4(b)** contains that documentation.

In item 5, the Commission asked for “[d]ocumentation to support reasoning for amortization chosen (5% of total-\$7000 per year) and documentation to support on-going provision of benefits to VLI by the spinoff organization.” We are not aware of any specific literature supporting the particular amortization schedule that Mr. Zhang used for the \$140,000 pass-through payment. This is because, as accounting scholars have noted, developing an amortization schedule of expenditures on intangible assets “is a challenge” given their speculative nature, and should be approached “in a way that helps rather than hinders the analyst who wishes to value the firm.” **Tab 5**, Stephen Penman, “Accounting for Intangible Assets: There is Also an Income Statement,” 45 *ABACUS* 358, 365, 370 (2009); *see also id.*, Gabriel A.D. Preinriech, “Valuation and Amortization,” 12 *The Accounting Review* 209, 210 (1937). Accordingly, Mr. Zhang used his experience to determine that a 20-year amortization was reasonable and appropriate in order to minimize the impact on VLI’s financial reporting in any given year, and VLI reasonably relied on Mr. Zhang.<sup>4</sup> Had the one-time payment been made to a for-profit entity rather than a non-profit, then the payment likely would have been treated as an investment and amortized in a similar way. Mr. Zhang remains available to answer any questions the Commission may have about his audit.

In item 6, the Commission asked for “[a]ny reference or source documentation to support the practice of amortization for donations to another nonprofit.” **Tabs 5 and 6** contain several academic articles that discuss amortization of expenditures on intangible assets, a practice that is described as “very much alive.” **Tab 5**, Penman, “Accounting for Intangible Assets” at 370. *See also* **Tab 6**, Catherine L. Hammond, “The Amortization of Intangible Assets: § 197 of the Internal Revenue Code Settles the Confusion,” 27 *Conn. L. Rev.* 915 (1995) (noting that amortization is proper for any intangible asset that “has an ascertainable value, a limited useful life the duration of which may be estimated with reasonable accuracy, and is not self-regenerating”).

The Commission also requested the following “additional documents”: (1) “[c]opies of agendas and minutes for all board meetings in 2018 and 2019 (to date),” which can be found in **Tab 7**; (2) VLI’s 2018 and 2019 Client Eligibility Guidelines,<sup>5</sup> which can be found in **Tab 8** (and are the same for both years); and (3) VLI’s eligibility screening procedures for clients, which can be found in **Tab 9**.

---

<sup>4</sup> Notably, even if a much shorter amortization period had been used, more than 50% of VLI’s expenditures still would have qualified under Business and Professions Code section 6213(d) and State Bar Rule 3.672(A).

<sup>5</sup> In setting its eligibility guidelines, VLI uses two alternative guidelines. The first is the definition of “indigent” set forth in State Bar Rule 3.672(a). The second is an expanded eligibility guideline, which takes into account the veteran’s level of disability assistance, which may otherwise disqualify him or her from free legal services.

December 3, 2019

Page 4

### **Responses to Supplemental Questions**

Below, we have reproduced each of the Supplemental Questions submitted to VLI by the Commission in *italicized* font. VLI's responses to each question follow immediately in regular font.

- 1. Was Dwight Stirling an employee of VLI at any time in 2018? If yes, were all of Mr. Stirling's activities as an employee of VLI in 2018 for the provision of free civil legal services for indigent persons as defined in Business and Professions Code section 6213(d) and State Bar Rule 3.672(A)? If Mr. Stirling did not expend all of his time providing free civil legal services as defined in Business and Professions Code section 6213(d) and State Bar Rule 3.672(A), please provide the portion of Mr. Stirling's salary and related non-personnel cost for the non-qualifying work in 2018. Please also explain how the cost was calculated.*

Mr. Stirling was an employee of VLI for eight months in 2018. His official activities during those eight months related to the provision of free civil legal services to VLI's veteran clients. It was through his work for indigent veterans that Mr. Stirling observed that victims of military sexual trauma faced systemic barriers that prevented them from seeking effective legal recourse. His think tank (which ultimately became the spin-off entity, CLMP) was born out of that observation. To the extent he spent time developing the think tank as part of his PhD research, he did so largely on his own time and with the help of unpaid volunteers. As the Commission undoubtedly knows, it is not uncommon for an employee or officer of a pro bono provider to have outside public interests to which he or she dedicates some time. At most, Mr. Stirling spent a *de minimis* amount of time laying the groundwork for the discussion forum that CLMP would later provide to military sexual trauma survivors. After Mr. Stirling's departure from VLI on August 31, 2018, no work was done for CLMP.

- 2. At the November 22 LSTFC meeting, we believe that VLI staff stated that the "think tank" work was new activity for the spinoff organization, and that such work was not performed by VLI prior to the spin off. However, in VLI's communication to staff regarding the 2018 monitoring visit and in review of the 2019 application (in 2018), staff understood that think tank activities were ongoing before the split. Additionally, on page 13 of Mr. Garner's September 27, 2019 letter, he indicates that the decision to spin off think tank activities was "due to the development and growth of a veterans think tank within VLI[.]" This suggests that VLI engaged in think tank work in 2018. What think tank activities did VLI engage in in 2018 and 2019? Does VLI consider all or any of its "think tank" work in 2018 qualifying under Business and Professions Code section 6213(d) and State Bar Rule 3.672(A)? If yes, please explain why it is qualifying? If no, please calculate the personnel and non-personnel cost associated with these activities in 2018 and explain how the cost was calculated.*

VLI does not take the position that Mr. Stirling's think tank work is qualifying under Business and Professions Code section 6213(d) or State Bar Rule 3.672(A). However, as stated above, Mr. Stirling's official activities during the eight months of his employment with VLI were



December 3, 2019

Page 5

qualifying activities. Any time Mr. Stirling spent working on his think tank while at VLI was so *de minimis* that quantifying it would be impracticable.

3. *Please describe all fundraising activities for VLI in 2018 and 2019 (to date).*

VLI is a grassroots organization, and fundraising includes individual donations, events, and grant awards. In 2018, VLI hosted two main fundraising events, Lawyers for Warriors in April and a Gala in September. Also in 2018, VLI was a partial beneficiary from third parties of a Freedom Bowl in June, the annual golf tournament of the Association of the United States Army in September, and Patriots Promise in November. In 2019, VLI hosted Lawyers for Warriors in September and was the partial beneficiary for Patriots Promise in November. Ongoing grant awards in 2018 and 2019 included the State Bar, the County of Orange in conjunction with CalVet, The Orange County Bar Association Charitable Fund, Judicate West, Edison, and Bank of America.

4. *Any and all previous work conducted by Mr. Zhang for VLI in the past 5 years.*

Mr. Zhang's company, HZ CPAs & Advisors, performed VLI's audit for the years ended December 31, 2016 and performed audit and tax filing for the years ended December 31, 2017 and 2018. Mr. Zhang and his company have not at any time provided to VLI non-audit services, including bookkeeping, financial information systems design and implementation, appraisals or valuation services, actuarial services, internal audit outsourcing services, management functions or human resources, investment advising, or legal or non-audit expert services. *See* <https://www.sec.gov/info/accountants/audit042707.htm> (listing prohibited non-audit services).

5. *Documentation of/explanation of estimated percentage of qualified expenditures in 2019 and 2020 spent on the provision of free legal services to indigent (as defined by the IOLTA statute), in California.*

As set forth in detail in Tab 2 (referenced above), the percentage of 2019 expenditures (using data from the first three quarters of 2019) is approximately (1) 60% if VLI uses the definition of indigence as provided in State Bar Rule 3.672(a), or (2) 76% if VLI uses the expanded definition of indigence as provided in Business and Professions Code section 6213(d). VLI expects 2020 expenditures to be at or greater than these levels based on the current and anticipated demand for VLI's services.

\* \* \*

We hope this information is helpful in the Commission's review of VLI's application and, in particular, its determination of whether VLI met the State Bar's primary purpose calculation for grant year 2020. We remind the Commission, however, that the issues surrounding VLI's audited financial statements – and questions about the independence and qualification of VLI's auditor, Jinhong Zhang of HZ CPAs & Advisors, P.C. (based in Buena Park, California) – only became relevant after State Bar staff concluded that VLI's one-time asset transfer to the spinoff entity did not constitute a "pass-through" under the State Bar's Application Instructions, and instead had to be counted as an expense in performing the primary purpose calculation. As

December 3, 2019

Page 6

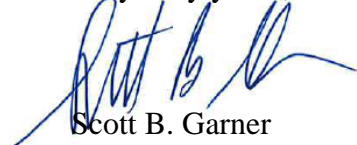
quoted to the Commission previously, those Application Instructions (the only place we are aware of “pass-through” being defined by the State Bar) define a pass-through as:

[f]unds that are passed through from the applicant to another organization, for which the applicant has no involvement, oversight, or engagement in the execution of the funded work (e.g. program simply cuts a check to another organization but is not involved in decision-making and does not have oversight responsibilities. . . .

Of course, as we previously pointed out and discussed further at the November 22 Commission meeting, this precisely describes the one-time payment and the relationship between VLI and the newly created spinoff. Indeed, the very section of the Application Instructions discussing pass-through entities appears to have been included precisely for this situation: “This section has been created in response to concerns that pass-through funds should be considered outside of the primary purpose calculation.” If the Commission agrees that the payment at issue qualifies as a pass-through, then the issues surrounding the amended audit (which VLI only undertook after State Bar staff rejected treatment of the payment as a pass-through) become moot.

Please let us know if there is any additional information that would be helpful to the Commission as it reconsiders VLI’s application. We look forward to your response so that VLI can continue serving its important and unserved client population.

Very truly yours,



Scott B. Garner  
Umberg Zipser LLP

cc: Doan Nguyen

## **TAB 1**

## **HANKIN PATENT LAW, APC**

12400 Wilshire Boulevard, Suite 1265

Los Angeles, CA 90025

Telephone: (310) 979-3600

Facsimile: (310) 979-3603

Marc@HankinPatentLaw.com

December 3, 2019

The State Bar of California

180 Howard Street

San Francisco, CA 94105

### **Re: Veterans Legal Institute 2018 Audit and 2018 Revised Audit**

To Whom It May Concern:

I write in response to questions that have been received by Veterans Legal Institute from the State Bar regarding Veterans Legal Institute's obtaining two audits for the 2018 tax year by an independent auditor. I am currently the Chair of the Board of Directors of Veterans Legal Institute ("VLI") and have served as the Chair of the Board since March 2018. I have been a practicing attorney in the State of California for more than 25 years.

As background history, the Board of VLI always has supported obtaining an independent audit for purposes of financial transparency and stewardship and has agreed to invest approximately \$5,000 each year to make sure the audit is done correctly. In 2018, the Board agreed that it was in the best interest of the organization and the community to separate VLI into two entities: (1) a non-profit law firm for providing pro bono legal services, keeping the legacy name "Veterans Legal Institute"; and (2) a think tank, spun off into its own organization, named the "Center for Law and Military Policy". VLI and the Board had assumed, for purposes of the IOLTA Grant and VLI's 990 Form, that the costs associated with the spin-off of the think tank would be considered to be a general pass through, given its one-time exceptional nature.

The original audit was reviewed by the entire Board and was discussed briefly and was agreed upon. The Board Minutes do not reflect the general adoption because the Board was in agreement of how to proceed, and there was no dissent, so we did not think that a formal adoption motion would be necessary. Therefore, while approval of the Board Members did exist, no formal Motion was reflected in the Board Minutes. To ensure that there is no question later, on December 2, 2019, the Board adopted the original

audit retroactively to May 14, 2019, for purposes of recordkeeping by a vote of 17 to 0, with two abstentions.

When VLI was told by State Bar representatives that the spin-off allocation of funds raised from a special fundraiser would not be permitted as a one-time pass through, we immediately had to take action with our auditor to revise the audit to comply with the State Bar requirements. The independent auditor advised VLI to amortize the one-time exceptional spending of funds over the next 20 years because that would be anticipated length of time for the benefit of separating the two organizations. This was discussed in advance of an Executive Committee Session by me with the Executive Director, Deputy Executive Director, Secretary, and auditor. The Executive Committee all agreed that the audit should be revised, especially given the acceptable and regular nature of amortization of these types of expenses. With permission of the Executive Committee of the VLI Board, I informed the Executive Director to go through with the revised audit and submit it to the Bar as part of our Application for the IOLTA Grant. This information was forwarded to the auditor and made known that it needed to be done on an urgent basis for timely submission to the State Bar.

The information was reported at the next Board Meeting with a general consensus that was not the subject of a formal Motion. For purposes of recordkeeping, on December 2, 2019, a special retroactive Motion was made to adopt the amended audit retroactively effective as of August 13, 2019 by a vote of 17 to 0, with two abstentions.

We greatly appreciate the Committee's time and dedication to supporting legal aid, and especially those like VLI who support the veteran community. If the Committee has any further questions, and/or needs any additional information, please let me know. Thank you very much.

Sincerely,

**HANKIN PATENT LAW, APC**

*/Marc E. Hankin/*

Marc E. Hankin, Esq.  
Chair of the Board of Directors  
Veterans Legal Institute

## **TAB 2**

**Tab 2 – Percentages of Expenditures Attributable to Indigent Clients**  
*Re: Supplemental Information In Support of VLI's Reconsideration Request*

**Quarters 1, 2, and 3 of 2019**

**State Bar Rule 3.672(A)** – defining “indigent person” as a person either (1) whose income is 125% or less of the current poverty threshold; or (2) who is eligible for Supplemental Security Income Act or free services under the Older Americans Act or the Developmentally Disabled Assistance Act

Total unduplicated indigent clients	739
Total unduplicated clients	1152
Attributable to Indigent Clients	$739/1152 = 64\%$
Approximate Percentage of Out-of-State Clients <sup>1</sup>	4%
<b>Percentage Attributable to Indigent California Clients</b>	<b>60%</b>

**Business & Professions Code § 6213(d)** – defining an “indigent person” as a person whose income is 75% or less of the maximum levels of income for lower income households as cited at Health & Safety Code § 50079.5

Total unduplicated indigent clients	924
Total unduplicated clients	1152
Attributable to Indigent Clients	$924/1152 = 80\%$
Approximate Percentage of Out-of-State Clients	4%
<b>Percentage Attributable to Indigent California Clients</b>	<b>76%</b>

**Projected for Quarter 4, 2019 and 2020**

VLI expects the numbers of indigent clients for the fourth quarter of 2019 and 2020 to be at or greater than the numbers for the first three quarters of 2019.

<sup>1</sup> VLI's out-of-state clients are survivors of military sexual trauma that have no other recourse for justice.

**TAB 3**



**Tab 3 – September 2018 Fundraiser for Center for Law and Military Policy**  
*Re: Supplemental Information In Support of VLI's Reconsideration Request*

<b>Income</b>	
Sponsorships	\$110,500
Underwriting	\$6,000
Individual Tickets	\$21,250
Donations	\$6,450
Auction, Opportunity, Fund a Need	\$64,921
Rothenbuehler Foundation	\$80,000
<b>TOTAL INCOME</b>	<b>\$289,121</b>
<b>Expenses</b>	
Venue, Food and Beverage	\$39,473
Printing and Postage	\$1,149
AV, Video, Photography	\$7,465
Auction Fees and Supplies	\$2,912
Band	\$1,000
Credit Card Fees	\$2,469
Insurance	\$190
<b>TOTAL EXPENSES</b>	<b>\$54,658</b>
<b>TOTAL NET</b>	<b>\$234,463</b>

VLI Supplemental Documents Part 1 (pages 1-141)

# SAVE THE DATE

The Veterans Legal Institute Inaugural Gala

## *The American Patriots Ball*

Celebrating and Empowering Our Nation's Heroes

**SATURDAY**  
**September 22**  
**5:30 PM**

**The**  
**Fashion Island Hotel**  
Newport Beach, CA

### **Honorees:**

**Philip V. Brozenick**, Deloitte - Veteran of the Year  
**Rochelle Karr**, O'Melveny & Myers - Veteran Advocate of the Year  
**OC Women2Women** - Community Partner of the Year

For volunteer and sponsorship opportunities, please contact  
Antoinette Balta at 949.290.5733 or email at [abalta@vetslegal.com](mailto:abalta@vetslegal.com).

## COMMITTEE

**Yemi Adeyanju**, Providence St. Joseph Health  
**Merit Albaiady**, CoreLogic  
**Antoinette Balta**, Veterans Legal Institute  
**Sherry Bragg**, Weintraub Tobin  
**Mike Brewer**, The Brewer Law Firm  
**Debra Ann Buttacavoli**, SYSPRO USA  
**Matthew S. Buttacavoli**, Minyard Morris Law  
**Lanan M. Clark**, Merrill Lynch  
**Mario Ekiert**, Advanced Depositions  
**Sheila-Marie Finkelstein**,  
Holstrom Block & Parke, APLC  
**Kristin Godeke**, Wells Fargo  
**Kevin Gramling**, Kleindinst, PC  
**Lauren Grochow**, Troutman Sanders  
**Ursula Guzman**, CoreLogic  
**Marc E. Hankin**, Hankin Patent Law APC  
**Sahar Hanna**, Interior and Event Design  
**Sarah Hardin**, Deloitte  
**Michelle Highberg**, Veterans Legal Institute  
**Wendy Hooper**, Coastal Village Real Estate  
**Jennifer Johnson**, Jennifer Johnson Law  
**Rita Kallas**, US Veterans Magazine  
**Rochelle Karr**, O'Melveny & Myers

**Deirdre Kelly**, Chapman University  
**Ariana Mangum-Miramontes**,  
Miramontes Capital  
**Jeff Manley**, Savills Studley  
**Mischa Martineau**, Martineau Systems  
**Adrianne Marshack**, Manatt & Phelps  
**Bobby McDonald**, Black Chamber of OC  
**Andrew Nelson**,  
Friedman Stroffe & Gerard  
**Michael A. Ocasio**, Small Business  
Development Corporation  
**Jon Olsen**, Advanced Depositions  
**Randall Parker**, Savills Studley  
**Briana Richmond**, Rutan & Tucker  
**Michele Rivituso**, O'Melveny & Myers  
**KellyAnn Romanych**, Veterans Legal Institute  
**Johnny Tai**, Pacific Coast Exchange Club  
**Blas Villalobos**, Chapman University  
**Jennifer Unger**, Advanced Depositions  
**Kevin Snyder**, Snyder Law  
**Alessandra Whipple**, OPUS Bank  
**Natalie Wang**, Alorica  
**Nanci Vella**, Vella & Associates,  
Landscape Architects



Dear Veteran Supporter,

Because of dedicated advocates like you, Veterans Legal Institute has empowered thousands of homeless, disabled, at-risk, and low-income veterans across Southern California. Our local heroes have overcome barriers and restarted their civilian lives with the support of generous partners making pro bono legal services possible. Truly, your compassion will continue to drive VLI's mission to increase access to housing, employment, education, and healthcare – one veteran and military family at a time.

To continue honoring and empowering our veterans and service members, we invite you to our inaugural charity gala, **The American Patriots Ball**, on **September 22, 2018** at 5:30 pm at **The Fashion Island Hotel in Newport Beach**.

This inspirational evening will welcome hundreds of community and business leaders for dancing, dining, and an exciting live auction. We will be honoring these long-term partners who are perfect reflections of VLI's mission:

**Philip V. Brozenick, Deloitte - Veteran of the Year**

**Rochelle Karr, O'Melveny & Myers - Veteran Advocate of the Year**

**OC Women2Women - Community Partner of the Year**

How can you be part of this special evening?

- Sponsor or underwrite the event
- Purchase a ticket
- Support our live or silent auction with a unique experience, gift basket, or gift card
- [Donate](#)

To sponsor, donate, or volunteer, please contact me directly at 949-290-5733 or by email at [abalta@vetslegal.com](mailto:abalta@vetslegal.com). You may also contact KellyAnn Romanych, Director of Development, at 818-219-1916 or [kromanych@vetslegal.com](mailto:kromanych@vetslegal.com). We are happy to arrange a volunteer to pick up live and silent auction items. A mail in form is attached for your convenience. We appreciate your consideration and look forward to you joining us to increase veteran well-being.

With gratitude,

Antoinette Balta, President and Co-Founder

*All proceeds from the evening will go to ensuring high quality, free legal care so our deserving veterans and service members live with dignity, hope, and promise.*





The Veterans Legal Institute Presents an Inaugural Gala

# *The American Patriots Ball*

Celebrating and Empowering Our Nation's Heroes

Saturday, September 22, 2018  
Fashion Island Hotel, Newport Beach  
5:30 PM



## MISSION

Veterans Legal Institute (VLI) is a 501(c)(3) that provides pro bono legal assistance to homeless, at-risk, disabled, and low income current and former service members to eradicate barriers to housing, healthcare, education, and employment, and to foster self-sufficiency. VLI also advocates on behalf of its clients by providing community education and policy advocacy in an effort to increase awareness, resources, and overall protections to current and former members of the US military.

## IMPACT

### Since 2014

- ★ Opened over 3,600 individual cases
- ★ Restored over \$1.5 million in veteran benefits
- ★ Provided a value of over \$13.5 million of pro bono legal services

### 2017 Highlights

- ★ 1,647 individual cases (83% male; 17% female; 38% older Veterans)
- ★ 32 mobile outreach clinics at veteran hotspots
- ★ 36% of cases in veteran benefits and discharge upgrades; an increase of 16% from 2016

## NONPROFIT RECOGNITION

### Local

- ★ 85 pro bono attorneys from solo and top law firms
- ★ Local, state, and national corporate support
- ★ Newsletter to 7,000+ business, veteran, and government professionals

### National

- ★ Platinum Seal in Guidestar
- ★ The Patriots Initiative Accreditation
- ★ Multi-year inclusion in US Veterans magazine with national distribution

***"I wouldn't have been able to go from homeless shelter to homeowner without VLI's help."***  
***~ Linda, Army Veteran***

Linda is an Army Veteran who made her military career in flight operations. She came to VLI because she was facing a court action by a major national bank for a loan she had already paid. As a result, she was blocked from buying property. "You take a big step owning your own home," Linda shared. "The bank attorney would not respond to my phone calls. It was crazy." VLI accepted Linda's case, contacted the bank's attorney, and successfully filed an Acknowledgement of Satisfaction of Judgement. With the case dismissed, Linda has been able to buy and sell property three times and looks forward to an even brighter future.

## EMPOWER VETERANS AND MILITARY FAMILIES TO SELF-SUFFICIENCY

Veterans Legal Institute is accepting donations of gift cards, gift baskets, art, jewelry, services, and other exciting items for the Live and Silent Auctions. If you wish to be a sponsor, donor or volunteer, please contact Antoinette Balta at phone 949.290.5733 or email at [abalta@vetslegal.com](mailto:abalta@vetslegal.com); or KellyAnn Romanych at phone 818.219.1916 or email at [kromanych@vetslegal.com](mailto:kromanych@vetslegal.com).

The Veterans Legal Institute Presents an Inaugural Gala

# The American Patriots Ball

Celebrating and Empowering Our Nation's Heroes

Saturday, September 22, 2018  
Fashion Island Hotel, Newport Beach  
5:30 PM



## SPONSORSHIP LEVELS

BENEFITS	PRESENTING \$20,000	PLATINUM \$10,000	GOLD \$7,500	SILVER \$5,000	BRONZE \$3,000	PEARL \$1,000
<b>Print Advertising</b>						
Stewardship Ad in Chosen Trade Magazine	★	★	★			
Ad in Program Book	Prominent Full	Full	Half	Quarter	Name	Name
Corporate Logo on Step and Repeat	★	★				
Ability to Distribute Marketing Materials	★	★	★	★	★	
Corporate Logo on Photo Booth Pictures	★	★				
Corporate Logo on Event Photos	★	★				
Presence in Event Collateral	Prominent Logo	Logo	Logo	Logo	Name	Name
<b>Social Media Advertising</b>						
Presence on VLI Website	Prominent Logo and Sponsor Link	Prominent Logo	Logo	Logo	Name	Name
Live Streaming During Event with Guests	★	★				
Post Event Metrics for SM Forums	★					
<b>Event Extras</b>						
Pre-Event VIP Reception	★	★	★	★		
Event Table for Ten	★	★	★	★	★	2 Tickets
Recognition by MC	★	★	★	★		
Prime Table Seating	★	★	★			
Opportunity to Speak on Stage	★					

## EXCLUSIVE UNDERWRITING OPPORTUNITIES

All underwriting opportunities receive prominent signage at the event, presence on VLI website, listing in the event program book, and an opportunity to distribute marketing materials in the event swag bag.

**\$5,000**

Wine  
Audio Visual  
Bar Services

**\$3,000**

VIP Reception

**\$2,500**

Print Collateral

~~Swag~~ **SOLD**

**\$1,500**

Decor & Centerpieces  
Photography

**\$1,000**

Live & Silent Auctions  
Entertainment

Veterans Legal Institute is accepting donations of gift cards, gift baskets, art, jewelry, services, and other exciting items for the Live and Silent Auctions. If you wish to be a sponsor, donor or volunteer, please contact Antoinette Balta at phone 949.290.5733 or email at [abalta@vetslegal.com](mailto:abalta@vetslegal.com); or KellyAnn Romanych at phone 818.219.1916 or email at [kromanych@vetslegal.com](mailto:kromanych@vetslegal.com).



## The American Patriots Ball

### Ticket/Sponsorship Purchase Form

Name \_\_\_\_\_ Company Name \_\_\_\_\_

Billing Address \_\_\_\_\_

City \_\_\_\_\_ State \_\_\_\_\_ Zip Code \_\_\_\_\_

Telephone \_\_\_\_\_ Fax \_\_\_\_\_ Email \_\_\_\_\_

- ☐ I would like to purchase \_\_\_\_\_ tickets at \$250 each
- ☐ I would like to sponsor at the following level \_\_\_\_\_
- ☐ Check is enclosed (Please make payable to Veterans Legal Institute)
- ☐ I would like to make a donation of \$\_\_\_\_\_
- ☐ I would like to donate the following item(s) to the silent/live auction: \_\_\_\_\_
- ☐ Please charge my credit card (we accept AMEX, M/C, Visa, Discover)
- ☐ Invoice my company

Card # \_\_\_\_\_ Exp. Date: \_\_\_\_\_ Code: \_\_\_\_\_

Name on Card: \_\_\_\_\_

Name of Company: \_\_\_\_\_

Authorizing Signature: \_\_\_\_\_

Date: \_\_\_\_\_

EIN 47-1608069

Please return completed form to:

Antoinette Balta  
c/o Veterans Legal Institute  
2100 N. Broadway Ave., Ste 209  
Santa Ana, CA 92706

\*Donations are tax deductible to the extent the law allows



INTERNAL REVENUE SERVICE  
P. O. BOX 2508  
CINCINNATI, OH 45201

DEPARTMENT OF THE TREASURY

Date: **SEP 08 2014**

VETERANS LEGAL INSTITUTE  
16842 PACIFIC COAST HWY UNIT 105  
HUNTINGTON BEACH, CA 92649-0000

Employer Identification Number:  
47-1608069  
DLN:  
26053633002164  
Contact Person:  
CUSTOMER SERVICE ID# 31954  
Contact Telephone Number:  
(877) 829-5500  
Accounting Period Ending:  
December 31  
Public Charity Status:  
170(b)(1)(A)(vi)  
Form 990/990-EZ/990-N Required:  
Yes  
Effective Date of Exemption:  
August 11, 2014  
Contribution Deductibility:  
Yes  
Addendum Applies:  
No

Dear Applicant:

We're pleased to tell you we determined you're exempt from federal income tax under Internal Revenue Code (IRC) Section 501(c)(3). Donors can deduct contributions they make to you under IRC Section 170. You're also qualified to receive tax deductible bequests, devises, transfers or gifts under Section 2055, 2106, or 2522. This letter could help resolve questions on your exempt status. Please keep it for your records.

Organizations exempt under IRC Section 501(c)(3) are further classified as either public charities or private foundations. We determined you're a public charity under the IRC Section listed at the top of this letter.

If we indicated at the top of this letter that you're required to file Form 990/990-EZ/990-N, our records show you're required to file an annual information return (Form 990 or Form 990-EZ) or electronic notice (Form 990-N, the e-Postcard). If you don't file a required return or notice for three consecutive years, your exempt status will be automatically revoked.

If we indicated at the top of this letter that an addendum applies, the enclosed addendum is an integral part of this letter.

For important information about your responsibilities as a tax-exempt organization, go to [www.irs.gov/charities](http://www.irs.gov/charities). Enter "4221-PC" in the search bar to view Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities, which describes your recordkeeping, reporting, and disclosure requirements.

Letter 5436

-2-

VETERANS LEGAL INSTITUTE

Sincerely,

A handwritten signature in black ink, reading "Tamera Rippanda". The signature is written in a cursive, flowing style.

Director, Exempt Organizations

Letter 5436



**TAB 4**

3:02



## Transaction Details

Veterans Legal Institute 2100 N. Broadway, Suite 209 Santa Ana, CA 92706 714-852-3492		4063 16-49/1220	
		12/21/18 Date	
Pay to the Order of		Center for Law and Military Policy   \$ 70,000 <sup>00</sup> / <sub>100</sub>	
Seventy thousand dollars		<sup>00</sup> / <sub>100</sub> Dollars	
Union Bank Tustin 0033 P.O. Box 512380 Los Angeles, CA 90051		Security Features Details on Back	
For		per agent dated 7/24/18	
		St. Balta	
⑆ 122000496⑆ 0041470477⑈ 4063			

Name

Check # 4063

Amount

- \$70,000.00

Posted Date

12.28.2018

Withdrawn From

Business Extra  
Checking · 0477

Reference ID

#000007568740

3:06



## Transaction Details

<b>Veterans Legal Institute</b> 09-14 2100 N. Broadway, Suite 209 Santa Ana, CA 92706 (714) 862-3492		<b>3116</b> 16-48/1220	
		<u>6/21/19</u> Date	
Pay to the Order of <u>Center for Law and Military Policy</u>		\$ <u>70,000.00</u>	
<u>Seventy thousand dollars</u>		dollars	
<b>Union Bank</b> Tustin 0033 P.O. Box 512380 Los Angeles, CA 90051		<u>ABeltz</u> NP	
<u>full and final pmt of stmt</u>			
⑆ 122000496⑆ 0041470477⑆		3116	

Name

Check # 3116

Amount

- \$70,000.00

Posted Date

6.19.2019

Withdrawn From

Business Extra  
Checking · 0477

Reference ID

#000007531426

**TAB 4a**

## Deposited Checks

VLI Supplemental Documents Part 1 (pages 1-141)

THE ROTHENBUEHLER FOUNDATION

840 NEWPORT CENTER DR STE 750

NEWPORT BEACH, CA 92660

1101

16-24/1220 4417  
8098589685

21 Sep 18

Date

Pay to the  
Order of VETERANS LEGAL INSTITUTE

\$80,000.00

Eighty THOUSAND AND 00/100

Dollars

Phone  
Bank  
Information  
Locally or TollWells Fargo Bank, N.A.  
California  
wellsfargo.com

For \_\_\_\_\_

⑆ 122000247⑆ 8098589685⑆ 01101

Page 23 of 141

Check #0

6 of 6

Amount: \$80,000.00

**TAB 4b**



INTERNAL REVENUE SERVICE  
P. O. BOX 2508  
CINCINNATI, OH 45201

DEPARTMENT OF THE TREASURY

Date: DEC 14 2018

CENTER FOR LAW AND MILITARY POLICY  
4952 WARNER AVE STE 230  
HUNTINGTON BEACH, CA 92649

Employer Identification Number:  
83-1587085  
DLN:  
17053240369008  
Contact Person:  
MRS. HEIN ID# 31072  
Contact Telephone Number:  
(877) 829-5500  
Accounting Period Ending:  
December 31  
Public Charity Status:  
170(b)(1)(A)(vi)  
Form 990/990-EZ/990-N Required:  
Yes  
Effective Date of Exemption:  
August 7, 2018  
Contribution Deductibility:  
Yes  
Addendum Applies:  
No

Dear Applicant:

We're pleased to tell you we determined you're exempt from federal income tax under Internal Revenue Code (IRC) Section 501(c)(3). Donors can deduct contributions they make to you under IRC Section 170. You're also qualified to receive tax deductible bequests, devises, transfers or gifts under Section 2055, 2106, or 2522. This letter could help resolve questions on your exempt status. Please keep it for your records.

Organizations exempt under IRC Section 501(c)(3) are further classified as either public charities or private foundations. We determined you're a public charity under the IRC Section listed at the top of this letter.

If we indicated at the top of this letter that you're required to file Form 990/990-EZ/990-N, our records show you're required to file an annual information return (Form 990 or Form 990-EZ) or electronic notice (Form 990-N, the e-Postcard). If you don't file a required return or notice for three consecutive years, your exempt status will be automatically revoked.

If we indicated at the top of this letter that an addendum applies, the enclosed addendum is an integral part of this letter.

For important information about your responsibilities as a tax-exempt organization, go to [www.irs.gov/charities](http://www.irs.gov/charities). Enter "4221-PC" in the search bar to view Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities, which describes your recordkeeping, reporting, and disclosure requirements.

Letter 947



-2-

CENTER FOR LAW AND MILITARY POLICY

Sincerely,

*Stephen A. Martin*

Director, Exempt Organizations  
Rulings and Agreements

Letter 947



**TAB 5**



STEPHEN H. PENMAN

## Accounting for Intangible Assets: There is Also an Income Statement

Accounting is often criticized for omitting intangible assets from the balance sheet. This paper points out that the omission is not necessarily a deficiency. There is also an income statement, and the value of intangible (and other) assets can be ascertained from the income statement. Thus, calls for the recognition of 'intangible assets' on the balance sheet may be misconceived. The paper lays out the property whereby the income statement corrects for deficiencies in the balance sheet. It then explores the case where the income statement perfectly corrects for a deficient balance sheet and the case where it does so imperfectly. In the latter case, the paper then asks whether accounting in the balance sheet—by capitalization and amortization of intangible assets or carrying them at fair value—could remedy the deficiency in the income statement (or makes it worse). The investigation involves an analysis and valuation of Microsoft Corporation and Dell Inc., two companies presumed to possess a good deal of 'intangible assets'. The paper is instructive, not only to those concerned with accounting issues but also to analysts attempting to value firms, like Microsoft and Dell, with assets missing from the balance sheet.

**Key words:** Clean surplus; Fair value; Historical cost; Intangibles.

Many commentators view the omission of 'intangible assets' from balance sheets as a glaring deficiency. They ask: How can accountants report a balance sheet that omits important assets like brands, distribution and supply chains, knowledge, human capital, and organization capital, particularly when value in modern firms comes more from these assets than from the tangible assets on the balance sheet? The complaint reached a crescendo during the 1990s as technology and internet firms identified with these types of 'assets' came to the market with high price-to-book ratios. While diminishing as the perceived intangible assets for many of these firms seemingly evaporated, the accounting for intangible assets continues as a significant research area. Indeed, the current trend towards booking more value to the balance sheet with fair value accounting involves many of the same issues.

This paper provides a perspective that I hope is not only helpful to researchers grappling with accounting issues, but also to analysts who use financial statements to value firms with so-called intangible assets. The main point of the paper simply reminds us that accounting reports not only a balance sheet but also an income statement. The value of assets can be ascertained from the income statement as well

---

STEPHEN H. PENMAN (Shp38@columbia.edu) is Professor of Accounting at the Columbia Business School, Columbia University.

as a balance sheet, so the issue of accounting for intangible assets is not necessarily a balance sheet problem. Indeed, there is no accounting problem if the income statement informs about the value. If it does so imperfectly, the research question involves asking if and how accounting for intangible assets in the balance sheet can ameliorate the problem. Calls for recognition of intangible assets on balance sheets may be misconceived; they fail to understand the structure of accounting under which articulated income statements and balance sheets work together to indicate firm value, and each statement can correct for the deficiencies in the other.

Before expanding on this theme, we make a number of preliminary points that bear on how accounting might handle intangible assets.

### PRELIMINARY POINTS

#### *'Intangible Asset' Is a Speculative Notion*

Intangible assets differ from tangible assets not just because they lack physical appearance but also because they are not identifiable such that contracts can be written on them for delivery. Explicit legal rights like patents and copyrights, and possibly brands, are exceptions (and these are booked to the balance sheet if purchased, as with any other asset), but 'customer relationships', 'organization capital', 'knowledge assets', 'human capital' and the like are not specific enough for a market price *ever* to be observed for them. A conjectured value of a conjectured asset that can never be validated with a market price is inherently speculative; value is in the mind of the beholder. This was so for the 'intangible assets' conjectured in the 1990s bubble for which there was no subsequent manifestation. Accounting runs into trouble when speculative, conjectured values enter the financial statements, more so when the asset's existence itself is conjectural. Indeed, the term intangible asset can just be a cover for speculation or even fantasy; the existence of assets can be promoted simply by developing attractive language.

In the speculative 1920s, accountants wrote up asset values in balance sheets for perceived value, but woke to the crash of 1929 accused of 'putting water in the balance sheet'. The subsequent advent of the Securities and Exchange Commission in the United States led to a sixty-year regime where such accounting was a no-no. This outlook was reinforced by fundamental analysts of the time, Benjamin Graham and his adherents. Graham followed a dictum in investing: Separate what you know from speculation and anchor on what you know. To the accountants: Don't put speculation into the financial statements; tell me what you know—what I can anchor on—but leave the speculation to me, the analyst. The accountant reports what he or she knows from transactions: If an (intangible) asset is identified in a transaction, book it, but do not book it in response to speculation about its existence.

History repeats. In the speculative 1990s, accounting 'for the industrial age' (where value was said to have come from tangible assets) came under challenge, accused of failing to adapt to the 'information age' (where value is said to come from intangible assets). But this time accounting authorities largely stood firm against water in the balance sheet. With the bursting of the 1990s bubble and the erosion of market value attributed to intangible assets, 'industrial age accounting' now looks sensible; waiting

until a firm makes a sale to add value to the balance sheet is not such a bad idea after all. It's what we know, as evidence of value. (The point should be considered by those advocating more fair value accounting in the balance sheet.)

Those who advocated intangible asset accounting in the 1990s often referred to the high price-to-book ratios as justification. Graham, I think, would turn in his grave. For the fundamentalist, accounting serves to inform about the prices of firms. It should be developed independently of prices, not inferred from prices. Only then can accounting challenge prices. In the fundamentalists' view, accounting should challenge entrepreneurs, management, and analysts who claim that firms possess intangible assets.

### *'Intangible Assets' Involve Using Assets Jointly*

Most intangible assets are not stand-alone assets that can be valued on a balance sheet independently of other assets; rather, their value comes from producing cash flow streams jointly with other assets. Brands, distribution networks, and customer relationships work together to produce value at the Coca-Cola Company, and they cannot work without tangible assets such as delivery trucks and bottling plants. 'Knowledge capital' is employed with productive processes, marketing, and management, and cannot work without tangible assets. 'Organization capital' involves the organization of assets to be used jointly. Indeed, it is the firm that is the asset; the firm is an organization of assets designed to gain competitive advantage, and the entrepreneurial idea that translates to a business plan for organizing the assets is the source of value. Listing an intangible asset on a balance sheet as separately identified is suspect, let alone putting a separate dollar number on it.

The point, of course, applies to all assets on the balance sheet apart from those (like cash and near-cash assets) with separable value (whose liquidation does not affect the value of the remaining assets). Totalling dollar numbers for assets separately listed ('total assets') cannot report joint value. The balance sheet is not a place to report the value of intangible assets or indeed tangible assets.<sup>1</sup> Recording intangible assets at historical cost, as with tangible assets, is an open issue to which we will return.

## MAIN POINT: THERE IS ALSO AN INCOME STATEMENT

If it is impossible to get a summary value number from the balance sheet, is accounting information useless for inferring the value of intangible assets? No; there is also an income statement. Even though intangible assets are missing from the balance sheet, earnings from intangible assets flow through the income statement. Value can be established by measuring the asset value directly but also by capitalizing the earnings from the asset. For example, the value of a stand-alone rental building can be ascertained from the market price of the building (a stock valuation) or from the

<sup>1</sup> The statement implicitly criticizes fair value accounting for non-separable individual assets and liabilities used jointly. But it also provides an explanation of why separable assets, like marketable securities, could be fair valued. See Nissim and Penman (2008) for elaboration.

rents that the business yields (a flow valuation). When one cannot determine a stock valuation (a balance sheet valuation), one turns to the flow (an income statement valuation). The value of Coca-Cola's brand is not on the income statement, but earnings from the brand are in the income statement. Even with a price-to-book of about 6 because of the missing brand asset in the balance sheet, the Coca-Cola Company is readily valued from its income statement.<sup>2</sup>

There is another important point in turning to the income statement. While the balance sheet cannot yield a summary number that reports the value of using assets jointly, the income statement does (at least in principle): Earnings is the accounting measure of value added from employing tangible assets along with entrepreneurship, brands, knowledge, organizational capital, and so on. This is the brilliance of accounting: rendering a performance measure from organizing assets under a business plan. With this summary measure, there is no need to identify intangible assets (or even to ask if they exist); one just observes earnings generated by the business plan.

The point that earnings give the value of intangible assets is implicitly acknowledged in statements of those who claim the existence of intangible assets. Speculators in the 1990s pointed to price-to-book ratios, but writers on intangible assets often point to earnings performance to infer those assets. The paper on 'Organization Capital' by Lev *et al.* in this issue is an example. Organization capital at Wal-Mart, Microsoft, Southwest Airlines, Intel and Dell is recognized because these firms have had very good earnings performance. Indeed, the paper proceeds to estimate the value of organization capital from sales and expenses in the income statement. One of course seeks to understand the source of good performance, but attributing earnings performance to organization capital is by fiat (without cause and effect demonstrated); one is simply observing firm performance as reported in earnings, whatever the cause, and calling it something else.

One thinks usefully of identifying assets with *ex ante* value, capable of producing future earnings, not something after the fact that restates *ex post* performance as an asset. One would be reluctant to claim that intangible assets existed when Wal-Mart, Dell and so on were start-ups or if they had proceeded to make losses. Indeed, while commentators in the 1990s assailed 'industrial age accounting' for ignoring the intangible assets of internet stocks, the derided accounting reported serial losses for these firms that turned out to predict their demise. These firms failed; negative earnings were an indication of the absence of intangible assets. The accounting played its role of challenging the speculators.

Some formality follows to crystallize these ideas.

### THE INCOME STATEMENT MITIGATES POOR BALANCE SHEETS

In what follows, the analyst is viewed as valuing equity, but the ideas apply to any asset, in particular the firm (enterprise) with so-called intangible assets. (Value of the firm = Equity value + Value of net debt.)

<sup>2</sup> See Penman (2010, p. 500) and the Appendix B to Nissim and Penman (2008) for a demonstration.

The balance sheet approach to valuation infers value from book value on the balance sheet:

$$Value_t = Book\ value_t. \quad (1)$$

Accordingly, balance sheet accounting attempts to construct balance sheets that are indicative of value. Such accounting and valuation typically works for cash equivalents but not for business assets and equity value, for reasons above. However, if one expects no subsequent earnings growth, value can also be inferred by capitalizing forward earnings:

$$Value_t = \frac{Expected\ earnings_{t+1}}{r}$$

Here  $r$  is the required return.<sup>3</sup> If current earnings are a sufficient indicator of forward earnings (because there is no expected earnings growth),

$$Value_t = \frac{Earnings_t}{r}. \quad (2)$$

A core accounting concept takes the balance sheet out of the picture: the cancelling error property. Provided that earnings are comprehensive (clean-surplus) earnings, it is always true that

$$Stock\ return_{t+1} = P_{t+1} + d_{t+1} - P_t = Earnings_{t+1} + (P_{t+1} - B_{t+1}) - (P_t - B_t), \quad (3)$$

where  $P$  is equity price,  $B$  is the book value of equity, and  $d$  is dividends, but the equation applies to any asset.<sup>4</sup>

This equation relating stock returns to earnings says that omission of value from the balance sheet does not matter if the error on the balance sheet,  $P - B$ , at the end of an accounting period is the same as that in the beginning; the errors cancel. In this case, the expected stock return equals expected earnings and, as value is always equal to the expected stock return capitalized at the rate,  $r$  (under the no-arbitrage condition), value is also equal to capitalized expected earnings. Valuation tolerates accounting error in the balance sheet if that error is constant.

We teach the cancelling error property in introductory accounting courses by pointing out that it does not matter whether one capitalizes R&D expenditure (and subsequently amortizes it) or expenses it immediately, provided there is no growth

<sup>3</sup> Balance sheet valuation and income statement valuation are modeled in Ohlson and Zhang (1998). The Ohlson (1995) valuation model is a weighted average of the two.

<sup>4</sup> This equation first appears in Easton *et al.* (1992), but textbooks of old used to discuss the cancelling error property. The equation is derived as follows. The 'clean-surplus' equation forces the articulation of earnings, book value, and net dividends:

$$B_{t+1} = B_t + Earnings_{t+1} - d_{t+1}$$

Substituting  $d_{t+1} = Earnings_{t+1} - (B_{t+1} - B_t)$  into the stock return,  $P_{t+1} + d_{t+1} - P_t$ ,

$$Stock\ return_{t+1} = Earnings_{t+1} + (P_{t+1} - B_{t+1}) - (P_t - B_t).$$

in R&D expenditure.<sup>5</sup> Even though it is perceived to be ‘wrong’ to leave R&D investment off the balance sheet, the balance sheet errors from expensing immediately cancel, leaving earnings unaffected. More generally, the omission of assets from the balance sheet is mitigated by the income statement and cancelling errors.

### CAN THE BALANCE SHEET MITIGATE POOR INCOME STATEMENTS?

Having understood that putting an intangible asset on the balance sheet adds nothing when there is no growth in that asset, it follows that recognizing an intangible asset on the balance sheet can only be helpful if there is growth. Again we know from our introductory accounting that, while expensing R&D does not affect earnings relative to R&D capitalization when there is no growth, growth in R&D depresses earnings if the R&D is expensed. The stock return-earnings equation (3) says that this introduces a change in premium; that is, errors in the balance sheet do not cancel (the premium over book value widens). The accounting produces error in both book value and earnings; the task of correcting these errors is left to the analyst.

If intangible asset research is to focus on the balance sheet, the question is whether correction of the balance sheet error (by booking intangible assets) mitigates the error in earnings as a basis for valuation. Can accounting resolve the problem, or must it be left to the analyst to add value for intangibles? Below are some issues to consider in pursuing this research question:

1: For the reasons in the preamble, booking the value of intangible assets on the balance sheet is quite doubtful if value comes from using assets jointly. Even if identifiable, any valuation is likely to be speculative.

2: Reporting speculative, fuzzy numbers on the balance sheet can damage earnings as an indicator of value rather than ameliorating the error in earnings. By the clean-surplus relation, earnings is the difference in book value (adjusted for net dividends), so errors in measurement of book value (net assets) is magnified in earnings; the error in earnings is affected by the random errors in both the beginning and ending book value.<sup>6</sup> (One would strictly be worse off in the no-growth case, by adding error to beginning and ending book values that would otherwise cancel.)

3: If one rules out intangible assets on the balance sheet at estimated (speculative) value, one is left with the question of whether they should be booked at historical cost and then amortized. This is more familiar ground to the accountant and well worth further research. As capitalization makes no difference in the no-growth case, the issue is whether earnings in the growth case is more informative with capitalization. Here are some considerations:

<sup>5</sup> The reader can demonstrate this by working through the accounting from investing \$100 in R&D each year that generates sales of \$150 in each of the subsequent three years (say), with the R&D amortized over three years under the capitalization regime. Once steady state is reached in the balance sheet (constant sales and book values), earnings are the same for both regimes. Penman (2010, Chapter 16) provides an example, and extends the example to the case where there is growth.

<sup>6</sup> Peasnell (2006) makes this point with respect to fair value accounting.



First, isolating the cost of intangible assets that are hard to identify (like organizational capital, knowledge capital and the like) is likely to be difficult. Not only are current earnings affected by any imprecision (as expenses capitalized would otherwise be in earnings), but future earnings will be affected by the amortization of fuzzy numbers. The spectre of earnings management—shifting expenses to the balance sheet from the income statement—arises. Capitalization of observable expenditures on R&D and brand building through advertising is more straightforward. Resolving when and how expenditures on non-tangible assets might be capitalized is a promising area of research.

Second, even if historical cost can be identified with integrity, establishing an amortization schedule would typically be quite speculative. Unlike purchased patents and copyrights that have definite lives and tangible assets with estimable lives, the life of more sublime intangible assets is very uncertain, as is the pattern of economic benefits for matching costs against revenue over time. Fuzzy amortization expense may well destroy earnings as a basis for valuation and thus make accounting less informative about value. The experience with amortizing purchased goodwill (before the new accounting that requires impairment) speaks to the issue. Analysts routinely added back amortization expense, seen as arbitrary, implicitly rejecting accountants' attempts to deal with intangible valuation in this way. The analysts said: Leave the speculation to us. Solving the amortization issue with impairment testing (as with the new requirements for goodwill) is fraught with difficulties. Ascertaining the impaired value of an intangible is problematic, though one could look to triggering events like failure to get government approval for a drug. In general, the experience with one-time charges has been unsatisfactory; they are seen as obscuring the profitability picture and subject to abuse with earnings management. It is an open research question as to whether they improve the ability of earnings to indicate value.

These points aside, the issues around capitalization and amortizing are the most encouraging for accounting research. It is on this point that Lev *et al.* (2009) are most interesting: Their analysis involves capitalizing and amortizing selling, general and administrative expenses (SG&A) and also an abnormal profit measure.<sup>7</sup> For identifiable expenditures, research might focus on developing amortization schedules (for R&D, for example) that capture the economics. That might be feasible in the case of an established firm with a long history of payoffs to R&D. However, the established firm is likely to report earnings that are quite informative (with canceling errors) under an immediate expensing rule, so changing the accounting may not be effective. For a start-up R&D firm, where earnings are less informative, the specification of an amortization schedule (and even the assessment of any future benefits at all) is much trickier.

As benefits to intangible assets are so speculative, the accountant might well fall back on the advice of the fundamentalist: Don't put speculation in the financial statements; tell me what you know, but leave the speculation to me, the analyst. The

<sup>7</sup> Kovacs (2004) also finds that treating SG&A as an asset indicates future benefits.



advice says that the accountant has no comparative advantage in handling speculation. That division of labour is assigned to the analyst with his or her deep knowledge of the business and the industry.

Accounting is utilitarian, so the accounting research question is one of developing accounting that handles intangible assets in a way that helps rather than hinders the analyst who wishes to value the firm. The standard residual earnings model, expressed in its short form here, explains how an analyst estimates value from book value and earnings. With  $Earnings_{t+1}$  set equal to  $Earnings_t$ ,

$$Value_t = Book\ value_t + \frac{Earnings_t - (r \cdot Book\ value_t)}{r - g}. \quad (4)$$

The growth rate here,  $g$ , is the expected growth rate for residual earnings (in the numerator) which, in turn, comes from the growth in the book value (net assets) and the earnings they generate. Penman (1997) shows that the growth rate,  $g$ , is determined (solely) by the errors in the book value and earnings relative to their benchmarks in equations (1) and (2). That is, growth in residual earnings is actually an accounting phenomenon produced by earnings and book value that differ from those which directly indicate value. If the accounting has balance sheet errors (such that value  $\neq$  book value) but those errors cancel, as in the stock return equation (3),  $g = 0$ , and the valuation is based solely on earnings.<sup>8</sup> If in addition to balance sheet errors there are errors in the earnings such that equation (2) does not hold,  $g \neq 0$  and the amount of  $g$  is determined by the size of the two errors.<sup>9</sup>

Significantly, we observe that analysts in practice forecast earnings and earnings growth. Forecasting is speculation and analysts step in to add speculative growth to the accounting when the accounting is incomplete. The picture is quite consistent with the view of the fundamentalists. Benjamin Graham saw expected growth as the most speculative part of a valuation. As an investor he was most careful in handling growth, but he saw it as something to be handled by the analyst, not the accountant.<sup>10</sup>

This picture focuses the research question: Can accounting be utilized or modified to supply the  $g$  (perhaps through reporting line items that aid additional financial

<sup>8</sup> In this case, equation (4) is equivalent to equation (2). Restating equation (4) for  $g = 0$ ,

$$\begin{aligned} Value_t &= Book\ value_t + \frac{[Earnings_t - (r \times Book\ value_t)]}{r} \\ &= Book\ value_t + \frac{Earnings_t}{r} - \frac{r \times Book\ value_t}{r} \\ &= \frac{Earnings_t}{r}. \end{aligned}$$

As this valuation holds in the case of balance sheet errors that cancel, one sees that the introduction of  $g$  in equation (4) is due to errors in earnings as well as errors in the balance sheet.

<sup>9</sup> Feltham and Ohlson (1995) show how conservative accounting (that keeps assets off the balance sheet) induces growth in residual earnings. Penman (2010, Chapter 16) has examples showing how growth in investment produces growth in residual earnings when assets are not booked to the balance sheet.

<sup>10</sup> See Graham (1973, pp. 315–16) and Penman (2006).

statement analysis) or is the determination of the growth rate for residual earnings best left to the analyst?

What follows are two cases which show how an analyst handles the valuation of firms with intangible assets. The first is Microsoft Corporation, to which commentators attribute intangible assets in large doses. The second is Dell Inc., a firm to which a significant organization capital asset is attributed by Lev *et al.* (2009).

## HANDLING INTANGIBLE ASSETS WITH ACCOUNTING INFORMATION

### *Microsoft Corporation*

After publishing its annual report for fiscal year ending June 2008, Microsoft traded at \$25 per share or \$228,775 million. With book value of \$36,286 million, the market saw considerable value, \$192,489 million, missing from the balance sheet (the price-to-book ratio is 6.3). The book value of \$36,286 million was made up of \$12,624 million of net operating assets (enterprise book value) and \$23,662 million of cash and near-cash investments (and no financing debt). The latter are separable, marked to market, and are typically considered to be carried at their value. The income statement for 2008 reported interest income on the cash and near-cash assets of \$846 million (after an allocation of tax) and after-tax income from the business of \$16,835 million, for total net income of \$17,681 million.

These accounting numbers are summary numbers from the financial statements and presumably one would gather more information with a full financial statement analysis. But how far can we go towards a valuation with just these few numbers? Applying residual earnings valuation as if there were no expected growth (no errors in earnings),

$$\begin{aligned} \text{Value of equity} &= \text{Enterprise value} + \text{Value of cash} \\ &= \text{Enterprise book value}_{2008} + \frac{\text{Expected enterprise residual income}_{2009}}{r} + \text{Cash}_{2008}. \end{aligned}$$

The risk-free rate at the time was about 4 per cent and finance web sites were giving Microsoft a beta of about 1.0. With a typical risk premium for a beta of 1.0 of 5 per cent, a reasonable required return for the enterprise (the weighted-average cost of capital, WACC) is 9 per cent. The equity value, calculated from the summary income statement and balance sheet numbers is (in millions of dollars),

$$\begin{aligned} \text{Value of equity} &= 12,624 + \frac{16,835 - (0.09 \times 12,624)}{0.09} + 23,662 \\ &= 210,718 \text{ or } \$23.03 \text{ per share.} \end{aligned}$$

Note that the valuation forecasts 2009 enterprise income as being the same as that reported for 2008 and the capitalization at 9 per cent forecasts a perpetuity at that level. Thus we are only using information in the financial statements, strictly. One can quibble about the appropriate required return, but the point is clear: While considerable value is missing in the balance sheet, the accounting that includes earnings explains almost all the value that the market sees. Of course, this is not to dismiss the

research question: Can accounting be designed to do an even better job? But it does serve to say that accounting, as practised, does not do as poor a job as those who insist on intangible asset accounting imply.

Of course, the market price could be a misprice, so the validation is not emphatic. But history would suggest that the accounting numbers would have provided a strong challenge to mispricing: In the bubble years when Microsoft was trading at up to \$60 (on a post-split basis) and very high multiples, the accounting valuation was much lower than the market price. Rather than the market price suggesting that the accounting was ignoring intangible assets, the accounting (which reflected the value of intangible assets through earnings) would have suggested that the market was mispricing those assets. While after-the-fact observations are dangerous, subsequent experience suggests that investors who shunned intangible asset stocks such as Microsoft, Cisco Systems, Intel, Dell and the like in the 1990s fared considerably better than those who purchased the stocks because they had 'intangible assets'.

The valuation above can be criticized because it does not incorporate the expected growth rate in equation (4). But the core question is whether better accounting can supply this or whether it is best left to the analyst. It is a fascinating question, because (as noted) growth is an accounting phenomenon due to errors in earnings and book value. Note, however, that financial reports do not report just earnings and book values; they also report more detailed financial information in line items and, over time, historical sales, earnings and book value growth rates. This information can be exploited with financial statement analysis.<sup>11</sup> For a market price of \$25 for Microsoft, the growth rate implied (that reverse engineers the residual earnings model) is 0.84 per cent. The analyst challenges this implied growth rate using further financial statement analysis and other information.

### *Dell Inc.*

Dell, the computer manufacturer, is said to have valuable organization capital. Are its financial statements deficient because this nominated asset is not on the balance sheet?

Table 1 shows the balance sheet for Dell for fiscal year 2008, reformulated to separate assets in the business from the net financial assets consisting of cash and near-cash assets less financing debt.

Trading at \$20 per share or an equity market capitalization of \$41,200 million at the time, the market attributed considerable value to Dell over the book value of \$3,735 million (a price-to-book of 11). The missing balance sheet value could readily be attributed to the enterprising way Dell organizes its business (direct-to-customer delivery, just-in-time inventory, outsourcing of production, and innovative supply chains). But putting an organization capital asset on the balance sheet could be redundant: The balance sheet, presented in the form here, actually highlights these features. Relative to \$61.1 billion in sales, accounts receivable is low (direct-to-

<sup>11</sup> See Penman (2010, Chapter 14) for financial statement analysis that elicits growth rates for valuation. An example there (and in Appendix B of Nissim and Penman, 2008) shows how the historical sales growth rate for Coca-Cola Company yields a valuation close to the market price.

*ABACUS*

TABLE 1

DELL INC., COMPARATIVE BALANCE SHEET, 2008, REFORMULATED  
(in millions of dollars)

	2008	2007
Enterprise book value		
<i>Enterprise assets</i>		
Working cash	40	40
Accounts receivables	5,961	4,622
Financing receivables	2,139	1,853
Inventories	1,180	660
Property, plant and equipment	2,668	2,409
Goodwill	1,648	110
Intangible assets	780	45
Other assets	<u>3,653</u>	<u>3,491</u>
	18,069	13,230
<i>Enterprise liabilities</i>		
Accounts payable	11,492	10,430
Accrued liabilities	4,323	5,141
Deferred service revenue	5,260	4,221
Other liabilities	<u>2,070</u>	<u>647</u>
	<u>23,145</u>	<u>20,439</u>
Net enterprise assets	(5,076)	(7,209)
Net financial assets		
Cash equivalents	7,724	9,506
Short-term investments	208	752
Long-term investments	<u>1,560</u>	<u>2,147</u>
	9,492	12,405
Short-term borrowing	(225)	(188)
Long-term debt	(362)	(569)
Redeemable stock	<u>(94)</u>	<u>(111)</u>
	<u>8,811</u>	<u>11,537</u>
Common shareholders' equity	<u>3,735</u>	<u>4,328</u>

customers yields cash in advance), inventory is low (just-in-time), and property, plant and equipment is low (outsourcing). The low enterprise asset values mean that shareholders need invest less to get value. But the big feature of the balance sheet is the negative net enterprise assets—\$5,076 million in 2008. This negative number is due, not only to the low investment in assets but to the large enterprise liabilities. In managing its supply chain, Dell is able to get suppliers to accept deferred payment (such that accounts payable and accrued expenses are high) and attracts customers to pay in advance (producing deferred revenues).

The negative net enterprise assets means that there is even more value (from the business) missing from the balance sheet than the 11 price-to-book ratio would

# ACCOUNTING FOR INTANGIBLE ASSETS

suggest; the shareholders' equity is positive only because Dell holds \$8,811 million in net financial assets. Does this make the accounting even more deficient? No, because there is also an income statement. That statement reports enterprise income (after tax) of \$2,618 million. Calculating residual income from the enterprise (value added over book value at the beginning of the year) using a required return on 10 per cent,

$$\begin{aligned}\text{Residual income} &= 2,618 - (0.10 \times -7,209) \\ &= 3,338.9\end{aligned}$$

(in millions of dollars). Dell's residual income is actually larger than its income. This is because Dell adds value with earnings of \$2,618 million, but also from organizing its business with negative net enterprise assets. The value of the organization asset is reflected in the accounting. That organization means that Dell effectively runs a float and that float means that shareholders, rather than investing in the business, can withdraw from the business and invest elsewhere: Rather than investment being charged at the required return to reduce residual income, the component of the residual income calculation, \$720.9 = -(0.10 \times -7,209) million, is the value that shareholders add from investing the float at 10 per cent. (Dell's large, yearly stock repurchases are in part the flow to shareholders out of this float.)

Incorporating the residual income into a valuation with no growth,

$$\text{Value of equity} = 8,811 - 5,076 + \frac{3,338.9}{0.10} = 37,124 \text{ million}$$

or \$18.02 per share. This is lower than the market price of \$20, but the point is that much of the value of organization capital in the market price is in the accounting. The missing value in the accounting must come from expected growth, and that growth (in residual income) must come from growth in enterprise income or growth in the float from the way the business is organized. The challenge for research into the accounting for intangibles is to ask whether the extra \$2 in value can be elicited by better accounting or whether it should be left to the analysts to speculate about.

## CONCLUSION

This paper challenges both the perception that accounting ignores the value of intangible assets and the prescribed remedy of booking intangible assets to the balance sheet. The paper explains how rich accounting can be, even with the omission of intangible assets from the balance sheet. The reason is that there is also an income statement that remedies deficiencies in the balance sheet. The examples with Microsoft and Dell, two companies to whom intangible assets are often attributed, demonstrate that accounting, handled appropriately, is not backward looking, but reports forward looking information from which value can be estimated.

Of course, income statements may not always be as rich as those for seasoned firms like Microsoft and Dell. Indeed, for a start-up reporting losses, the accounting can be quite uninformative. But one has to ask whether there is an accounting solution that solves the problem. A start-up is the most speculative of firms, possibly

with no product developed yet from its R&D, no government approval for its drug, and no sales. Guessing the likely outcome for these firms and putting it into the balance sheet (or even capitalizing expenditures) would be very speculative accounting. I tell my students who ask how to value a start-up biotech: Go and get a PhD in biochemistry; it is not an issue that accounting can solve.

The paper aims not to discourage research into accounting for intangible assets, but to put it in perspective. As with any accounting research, the researcher needs to start with an understanding of how accounting works to indicate value, and focus on the balance sheet alone is misconceived. The issue of capitalization and amortization of expenditures on intangible assets is very much alive, but developing amortization schedules that improve rather than damage earnings is a challenge.

Research might also focus on financial statement analysis—the analysis of balance sheet and income statement line items—and combining that analysis with other non-accounting information to forecast earnings growth. In so doing, research helps the analyst to whom the task of speculation falls. The Lev *et al.* (2009) paper is really a financial statement analysis utilizing sales, expenses, and property, plant and equipment, along with other information on employees and peer performance to forecast future sales and operating income growth. The financial statement analysis looks promising. However, placing a label ‘organization capital’ on the financial statement analysis measure extracted adds little, for no cause and effect is documented.

Intriguingly, though, the Lev *et al.* (2009) measure involves some capitalization and amortization (of SG&A expense). Capitalizing and amortizing is an accounting issue, not an analysis issue. Isolating the contribution of this accounting to the forecast of growth (from financial statement analysis components of the measure) would be very helpful to those involved in research into accounting for intangibles.

As most of the research on intangibles focuses on the valuation of intangible assets, this note takes a valuation approach for evaluating the accounting issues. There may well be other issues (stewardship of assets, control and planning) where the accounting for intangibles should be approached differently.

#### REFERENCES

- Easton, P., T. Harris and J. Ohlson, ‘Accounting Earnings Can Explain Most of Security Returns: The Case of Long-Event Windows’, *Journal of Accounting and Economics*, Vol. 15, Nos 2/3, 1992.
- Feltham, G., and J. Ohlson, ‘Valuation and Clean Surplus Accounting for Operating and Financial Activities’, *Contemporary Accounting Research*, Vol. 11, No. 2, 2005.
- Graham, B., *The Intelligent Investor*, 4th rev. ed., Harper & Row, 1973.
- Kovacs, E., *The Future Benefits in Selling, General and Administrative Expenses*, unpublished PhD dissertation, Columbia University, 2004.
- Lev, B., S. Radhakrishnan and W. Zhang, ‘Organization Capital’, *Abacus*, Vol. 45, No. 2, 2009.
- Nissim, D., and S. Penman, *Principles for the Application of Fair Value Accounting*, White Paper No. 2, Center for Excellence in Accounting and Security Analysis, Columbia Business School, 2008, at [http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file\\_id=3822](http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file_id=3822).
- Ohlson, J., ‘Earnings, Book Values, and Dividends in Equity Valuation’, *Contemporary Accounting Research*, Vol. 11, No. 2, 1995.
- Ohlson, J., and X. Zhang, ‘Accrual Accounting and Equity Valuation’, *Journal of Accounting Research*, Vol. 36 (Supplement), 1998.

*ACCOUNTING FOR INTANGIBLE ASSETS*

Peasnell, K., *Institution-Specific Value*, BIS Working Paper No. 210, 2006.

Penman, S., 'A Synthesis of Equity Valuation Techniques and the Terminal Value Calculation for the Dividend Discount Model', *Review of Accounting Studies*, Vol. 2, No. 4, 1997.

——, 'Handling Valuation Models', *Journal of Applied Corporate Finance*, Vol. 18, No. 2, 2006.

——, *Financial Statement Analysis and Security Valuation*, 4th ed., McGraw-Hill, 2010.



---

Valuation and Amortization

Author(s): Gabriel A. D. Preinreich

Source: *The Accounting Review*, Vol. 12, No. 3 (Sep., 1937), pp. 209-226

Published by: American Accounting Association

Stable URL: <https://www.jstor.org/stable/239096>

Accessed: 02-12-2019 17:15 UTC

---

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact [support@jstor.org](mailto:support@jstor.org).

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <https://about.jstor.org/terms>



JSTOR

*American Accounting Association* is collaborating with JSTOR to digitize, preserve and extend access to *The Accounting Review*



# The Accounting Review

VOL. XII

SEPTEMBER, 1937

No. 3

## VALUATION AND AMORTIZATION

GABRIEL A. D. PREINREICH

### WHAT IS A BALANCE SHEET?

**M**ANY accountants appear to have no very definite notion of what a balance sheet is. Fortright opinions on the subject are rare; by inference, however, two main trends of thought may be distinguished, one of which is based on the capital-value or property concept and the other on the investment or amount-of-money-advanced concept.

The former is exemplified by the so-called fundamental equation: Assets minus liabilities equal net worth. Numerous remarks on the subject of accounting valuations clearly show that their authors were guided at least temporarily by the idea that a balance sheet is or ought to be a statement of the worth of the business. This comment applies to all who would write up good will not purchased or who hold that, if purchased, it need not be amortized until it is actually worth less than it cost. That patents need not be amortized, because they are, in time, supplanted by good will, and that if a company's stock is quoted at a discount, its balance sheet must be inflated, are further samples of the same trend of thought. Inconsistencies are the rule, rather than the exception. For instance, many who subscribe to these views when discussing so-called intangibles would not uphold them with respect to what they consider tangible assets. On the other hand, those who by no means endorse the capital-value concept, sometimes make statements which sound as if they did. *Leake*, among others, says that "unfortunately it cannot be assumed as a matter of course that the assets or the liabilities of a joint stock company are stated in the balance sheet at their full and

fair values" and refers to the "more or less common knowledge that the value of the assets is either greater or less than stated in the balance sheet."<sup>1</sup>

The fallacies of the value idea are discussed by *May*: "... accounting is not essentially a process of valuation, as some writers on accounting and some economists conceive it to be. Primarily, accounting is historical in approach, with valuation entering into it at times as a safeguard. The emphasis is on cost, though where an asset is intended for sale and its selling value is known to be less than cost, the lower figure may be substituted for cost . . . The fact is that the word 'value' has come to be used to describe what is a mere figure—'book figure' would be more accurate than 'book value' . . . A balance sheet in which one asset is stated at book value, another at replacement value, a third at liquidation value and a fourth at going concern value, does not yield a figure that can be described as net worth . . . This does not mean that the balance sheet is valueless, but only that it is a highly technical production, the significance of which is severely limited and has in the past often been greatly overrated."<sup>2</sup>

The foregoing excerpts and the rest of the article from which they were taken may explain fully what a balance sheet is *not*, but they certainly remain silent on what it *is*. *Yang* also devotes a great deal of space to the theory of accounting valuations without reaching more than a negative conclusion.

<sup>1</sup> Cf. P. D. Leake: *Commercial Goodwill*, Sir Isaac Pitman & Sons, Ltd., London, 1921.

<sup>2</sup> G. O. May: "The influence of accounting on the development of an economy," *Journal of Accountancy*, Jan., 1936, pp. 15-21.

According to him, "a balance sheet is an expression of opinion, a hypothetical magnitude arrived at through a series of complicated and arbitrary computations."<sup>5</sup> Better are the definitions he quotes: "We may look upon annual balance sheets as statements that apportion in a *reasonable* way all payments, whatever their nature, over the whole period during which an undertaking continues to derive advantage from them."<sup>6</sup> "A display to those, such as creditors or proprietors, who have advanced values to a business, showing what has been done by that business with the values so advanced."<sup>6</sup>

The last two descriptions express the investment or amount-advanced concept of the balance sheet, but even they emphasize merely what has been done, not what the result is or ought to be. Modern accounting methods still adhere to the plan followed by Columbus, when he started out by dead reckoning in a "reasonable," *i.e.*, general westerly direction, knowing only whence he came, with perhaps some notion of how far he had come, but without ever being aware of where he was. Since a reasonable westerly direction may lie anywhere between northwest and southwest, it is essential to mention that the accountant's real goal is the liquidating value of the business, to be reached upon the unknown date of liquidation. In other words, *the task is to connect original cost with liquidating value in a way which will give due consideration to both risk and time.* Cost is an advance concept and liquidating value a value concept, each of which is paramount on its date. Between the two dates, both share in determining the course to be followed, the relative importance of the former declining and that of the latter increasing gradually. Only if bearings are continuously taken, not only backward, but also forward, will the course steered come near the true direction. In that case the balance sheet will measure, not the worth or capital value of a business, but the amount of money invested

in it at a given stage of the transition. And that is the highest purpose which it can serve, although it may also be adapted to simpler and more generally useful ends.

For certain assets independent methods of taking bearings forward have been developed to a remarkable degree, especially by statisticians and engineers. Many accountants could undoubtedly profit by a study of these methods, even though they are familiar with the general principle that "the accounting function in relation to capital assets is to measure and record, not the fluctuations in their value, but the extent to which their usefulness is exhausted through age or use and to make proper charges against income in respect of such exhaustion, based on the cost of the property exhausted, with the intent that the property shall stand on the books at its salvage value when the term of its usefulness is ended."<sup>6</sup> Uncoordinated methods, however, can lead to no satisfactory result, no matter how great their individual merits may be. What is still lacking is a bird's-eye view of the problem as a whole. Not only must each asset stand on the books at its salvage value when its usefulness is ended, but all assets taken together must be written down to their liquidating value by the time the company's life is ended. This period of life is an uncertainty, which the market regards in terms of the "horizon" (that future point of time beyond which the investor is unable or unwilling to look). Any asset's expectancy of usefulness is, therefore, limited by the horizon. Beyond that limit only its exchange value may be considered.

#### TANGIBLE AND INTANGIBLE ASSETS

As Hatfield has pointed out, "the phrase is not particularly appropriate and, except by enumeration, the separation between tangible and intangible assets is not easily made. There is no real difference between them as regards tangibility, materiality or realness."<sup>7</sup> That is to say, the term "asset" does not

<sup>5</sup> J. M. Yang: *Goodwill and Other Intangibles*, Ronald Press Co., New York, 1927.

<sup>6</sup> E. M. Carter: "What is an annual balance sheet?" *Accountant*, Oct. 22, 1910, p. 566.

<sup>6</sup> C. B. Couchman: *The Balance Sheet*, Journal of Accountancy, Inc., New York, 1924.

<sup>6</sup> May, *op. cit.*

<sup>7</sup> Cf. H. R. Hatfield: *Modern Accounting*, D. Appleton Co., New York, 1916, pp. 107-118; and *Accounting, Its Principles and Problems*, D. Appleton Co., 1932, pp. 111-129.

refer to all the inherent or acquired characteristics of material or immaterial property, but only to their aspects as investments. Assets are valued only for their services and this valuation is necessarily governed by two fundamental economic phenomena: risk and interest. So far the attention given by accountants to these basic factors has been quite inadequate and inconsistent, the result being that dubious mixture of conservatism and recklessness, which is commonly called "accounting theory," although it is truly a mere collection of partly obsolete and contradictory conventions or working rules, re-copied and reexpounded faithfully year after year.

In theory, differences between assets are limited to differences in the services expected from them either in use or in exchange. The principal criteria are total quantity, intensity, and time-shape of the stream, together with the degree to which each is capable of modification. In practice, there is another important difference: The specific services of some assets can be readily identified and measured, while those of others can not—especially if they are combined into a single productive unit. Valuation of the former is accordingly possible by the direct method, *i.e.*, by the discounting process, whereas the best that can be done for the latter is to value them indirectly, *i.e.*, to maintain a record of what their future services have cost.

Canning has done valuable work in defining direct and indirect valuation,<sup>8</sup> but his thoughts are not always carried to their logical conclusion. With respect to accounts receivable, for instance, he points out that they ought to be discounted for the period of their turnover. He overlooks that cash on hand or a demand deposit bearing no interest is likewise worth its face value only at the moment when its service is rendered, *i.e.*, when it is spent. Cash being thus subject to discount for its own turnover, it follows that accounts receivable must be discounted for the sum of both periods. Rapidly moving merchandise or finished goods can also be valued by the direct method, but it again

follows that the discount deducted from "selling price less selling expenses" must cover not only the turnover of the inventory, but the sum of all three turnovers. The suggestion that liabilities should also be discounted for the delay in payment is entirely in order.

In general, accountants give adequate attention to risk in valuing current assets, so that the main question there concerns interest alone. As will appear later, it is proper to omit interest for certain purposes. In any event the treatment of current assets and liabilities could be responsible for only a small fraction of the discrepancies which have rendered the typical balance sheet so meaningless that no one cares to define it. The principal problem is the treatment of the so-called capital assets and the various forms of deferred charges. Examples are illustrated and discussed in subsequent paragraphs.

#### DEPRECIATION

Leake describes depreciation, in part, as "fall in the exchangeable value of . . . assets."<sup>9</sup> If he had stopped there, he would not only have conformed to etymology, but would also have defined one of the essential bases of accounting valuation. To say that depreciation is the "fall in the exchangeable value of wasting assets, computed on the basis of cost expired during the period of their use in seeking profits"<sup>9</sup> is contradictory, because original cost less cost expired gives, not exchange value, but merely use value, which may, and usually does, differ from exchange value. By his insistence that "'expired capital outlay' is an exact definition of depreciation",<sup>10</sup> the concept of exchange value is definitely abandoned. Depreciation in this generally accepted sense has nothing to do with exchange value, but is merely concerned with the gradual extinguishment of cost; a task better described as amortization. Whether wasting assets be called tangible or intangible, the same thing, *viz.*, the cost of services not yet rendered, must remain on the books, so that it is il-

<sup>8</sup> J. B. Canning: *The Economics of Accountancy*, Ronald Press Co., New York, 1929.

<sup>9</sup> P. D. Leake: *Depreciation and Wasting Assets*, Sir Isaac Pitman & Sons, Ltd., London, 1917, p. 1.

<sup>10</sup> *Ibid.*, p. 5.

logical to describe the extinguishment of certain assets as depreciation and that of others as amortization.

#### THE METHOD OF AMORTIZATION

The cost of any capital asset may be analyzed into the present worth of its ultimate selling price plus the present worth of an annuity, each item of which consists of the

investment. If it is not essential that the balance sheet should record the true investment, interest may be omitted in the distribution.

The foundation for amortization is a curve showing the decline in the exchange value of an asset during the course of its useful life. By marking on this curve the point at which its usefulness is expected to come to an end,

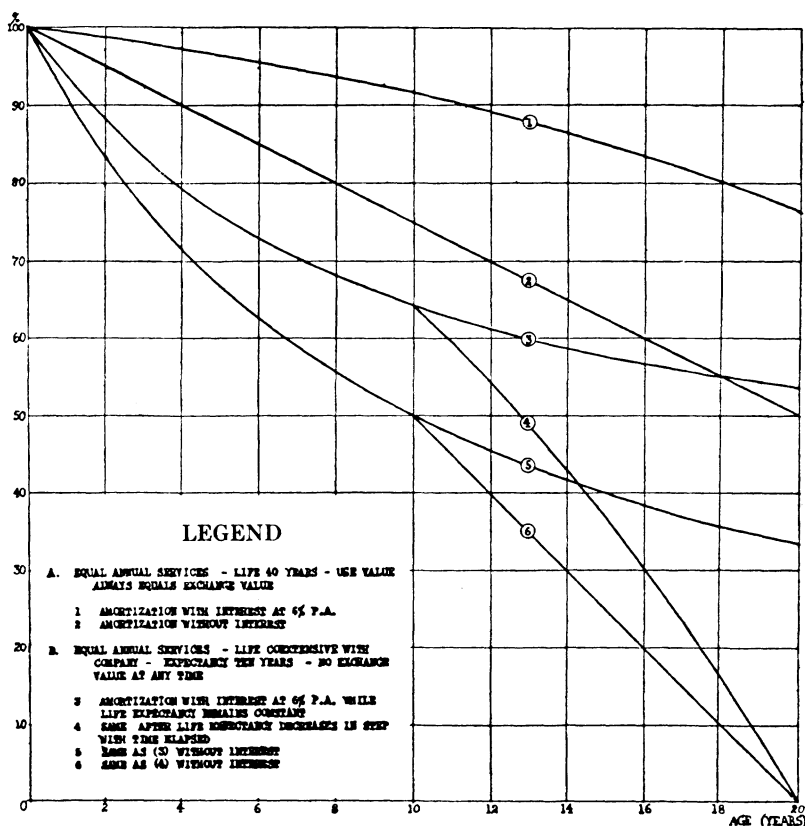


FIG. 1

cost of that unit of service to be rendered. The proper figure at which the asset should be stated in successive balance sheets is therefore obtained by discounting both the remaining service-costs and the ultimate selling price down to the successive dates. The difference between two consecutive summations is the net amortization, which may readily be separated into a charge for services rendered and a credit for interest on the

the allocation of cost to services and liquidating value is determined. The form of this real depreciation curve differs widely for different assets. In some cases, exchange value practically equals use value, while in others it drops immediately to zero. Between these extremes lie all other cases, where exchange value declines more or less rapidly to a salvage value or to zero, sometimes long before the asset has outlived its usefulness

This behavior of exchange values is explained by the more or less specialized utility of assets. Some are equally useful to anyone, whereas others can serve only their original owner. In general, second-hand equipment commands only a restricted market controlled by the buyer, so that the entire remaining use value can seldom be realized upon sale. Amortization must be computed with due regard for these variations.

#### EXAMPLES OF AMORTIZATION

A leasehold which has been subleased for its entire term may be taken as a fairly good sample of an asset commanding an exchange value practically equal to its use value to the sublessor. Curve (1) in Fig. 1 shows the amortization line connecting its original value with a final exchange value of zero forty years later. The ordinates of this curve were obtained by finding that forty-year annuity which \$1 will purchase at 6% *per annum* and plotting the worth of the decreasing number of payments still due on the successive dates. The amortization of such an asset will be entirely independent of the life expectancy of the business itself, since the curve of depreciation (exchange value) and the curve of amortization (investment or use value) follow the same law. The ordinate of the curve will represent either cost or fair market value, depending upon whether the asset is being valued indirectly or directly.

The opposite extreme is illustrated by organization or preliminary expenses, which have no salvage value. In such a case, amortization will depend entirely upon the life expectancy of the company. Assuming it to be ten years, the first year's amortization will be the difference between an eleven-year annuity worth cost and the present worth of its ten remaining payments. If at the end of the second year the life expectancy of the company is still ten years, the original cost must be reapportioned over twelve years and ten such payments discounted. Continuing from year to year, the investment level drops with decreasing speed as shown by curve (3) in Fig. 1.<sup>11</sup> When liquidation becomes a

definite future event, instead of merely a risk to be provided for, no revision of the apportionment will be made and the amortization curve (3) will bend toward zero ten years hence, as indicated in Fig. 1 at the ten-year point (curve 4).

As the third example, an item of equipment may be selected which has a long life and is subject only to comparatively slow depreciation. The exchange value, for instance, may not reach scrap value for forty years, although it will always be lower than use value. Statistical research shows that the mortality of physical property is subject to the same laws which govern human lives, except that the correspondence between the theory of probability and practical experience is closer because the phenomenon of high infant mortality arises only in the case of human beings.<sup>12</sup>

The mortality curve shown in Fig. 2 (1) is a cumulative frequency distribution of a special kind,<sup>13</sup> which appears better adapted to the problem than the cumulative normal curve of error. The ordinates show the chance of survival *per centum* at the various ages marked on the axis of abscissa. By summing up the entire area below the mortality curve, the average life (3) of the asset is obtained, which is in this case twenty years. When the asset is new, that is its life expectancy. As it grows older, the expectancy remaining at successive ages is found by

value, but a life coextensive with that of the company and if the annual services are equal in magnitude, the figure  $C_t$  at which it ought to be stated in the balance sheet, is:

$$C_t = C_0 \frac{1 - \frac{1}{(1+i)^n}}{1 - \frac{1}{(1+i)^{n+t}}}$$

In this formula  $i$  is the money rate,  $n$  the life expectancy or horizon of the company, and  $t$  the number of times (years) the expectancy was revised, *i.e.*, extended, since acquisition of the asset. Applying the theory of limits to the special case  $i=0$ , the same formula without interest becomes  $C_t = C_0 n / (n+t)$ . This formula is applied in Fig. 1 for the construction of curve (5).

<sup>12</sup> Cf. E. B. Kurtz: *Life Expectancy of Physical Property*, Ronald Press Co., New York, 1930.

<sup>13</sup> The cumulative curve VII (a form of the Pearsonian curve I) used by Kurtz. *Ibid.*, p. 90 and table 50, p. 170.

<sup>11</sup> If  $C_0$  be the cost of an asset having no exchange

computing the area of the mortality curve to the right of each age. The result, *per centum* of the total area, is plotted horizontally by adding it to the age on the level of the corresponding chance of survival. This gives the probable life curve (2). For instance, if the asset has reached the age of

on the right. The next step is to compute the remaining cost (6) at all ages. It is done by multiplying the remaining services (4) by the difference between 100% and the exchange value *per centum* (5) and then adding the latter again. If the investment is desired, interest must be considered in the computa-

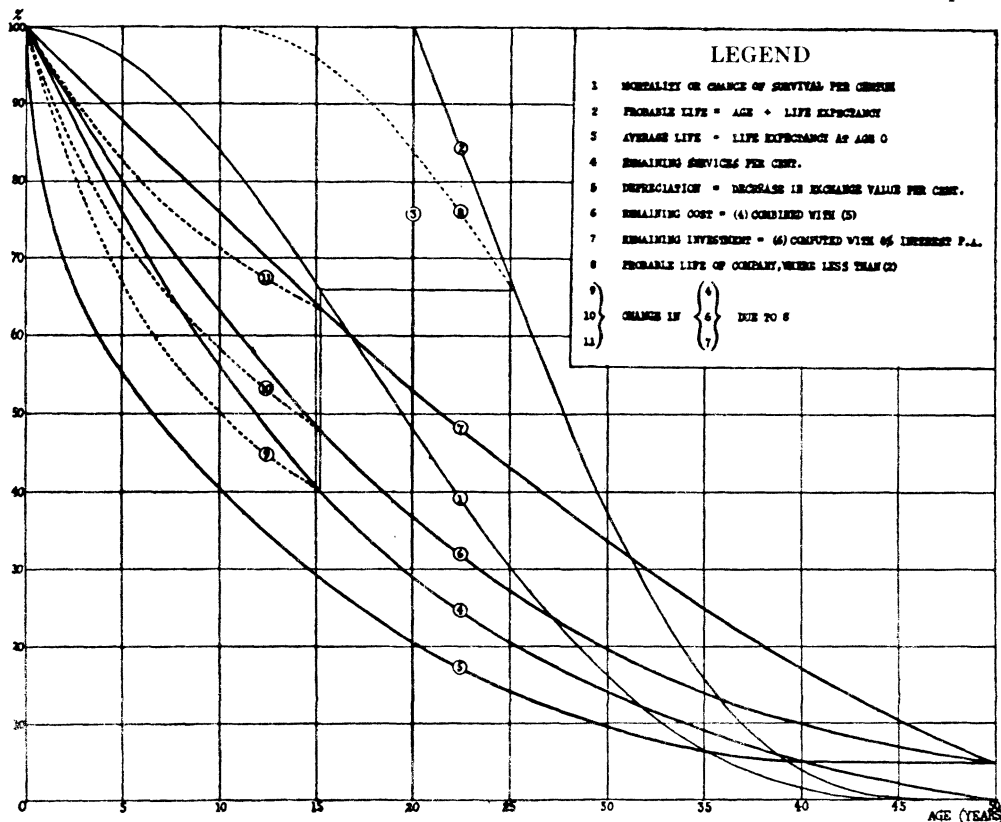


FIG. 2

ten years, it may be expected to live 12½ years longer; if it has survived twenty years, its expectancy is eight years more; and so on until the maximal age is reached. The sum of expectancy and age is the probable life. Terminology and method are the same as those used in human mortality studies.

The life expectancy at successive ages divided by the corresponding probable life gives the remaining services of the asset in terms of a total of 100%. This information is plotted vertically in Fig. 2 (4), descending from the upper left hand corner toward zero

tion. This phase of the problem does not appear to have received as much attention from engineers, perhaps because they are not primarily interested in investment valuations. The theory has been outlined in the preceding section entitled, "The Method of Amortization," but may be illustrated by concrete data. At the age of twenty years, for instance, the asset is expected to last eight years longer. Presumably, therefore, it will be sold at the age of 28 years when, according to the depreciation curve (5), it will be worth 11.2% of its original cost. Dis-

counting this figure at 6% for 28 years gives 2.09%, which means that 97.91% of the total cost must be allocated to 28 years of service. One payment of a 28-year annuity which 97.91 will purchase is 7.3 and the present worth of eight such payments is 45.5. Adding the present value of 11.2 due eight years hence, *viz.*, 7.0, results in the answer required, namely, that the investment in the asset at the end of the twentieth year is 52.5% of its original cost. Upon repeating the computation at suitable intervals, the investment or amortization curve (7) can be plotted.

If the life expectancy of the company is more than twenty years, there will be no interference with the independent calculation of amortization. Assuming, however, for the sake of illustration, that it is only ten years, the expectancy of the asset must be reduced to that figure, wherever it is greater. The upper portion of the mortality curve has accordingly been recopied ten years to the right (8) to supplant the corresponding portion of the probable life curve. The resultant indentions of the remaining service, cost, and investment curves are shown as dotted lines, which extend to about the fifteenth year.<sup>14</sup> Beyond that age the life expectancy of the asset is below ten years, so that the company's life has no further effect, unless its expectancy has also decreased in the meantime.

#### COMPOSITE AMORTIZATION

In Fig. 2 only a single and slowly wasting item of equipment was considered. It might have dropped out of service at any time, the probability of such an event being expressed by the mortality curve. What has been done there was to make only that provision for amortization which is "probably" sufficient, but not necessarily so. In the case of a large plant, consisting of many similar items of machinery, the problem is somewhat different. The more numerous the items are, the closer will the number of those actually dropping out of service correspond to the number called for by the mortality

curve. For locomotives, rolling stock, pumps, telegraph poles, *etc.*, a most remarkable correspondence between theory and practice has been observed.<sup>15</sup>

The amortization of a composite plant is illustrated in Fig. 3. Individual units are continuously discarded and replaced. Upon disposal all units have only a scrap value of 20% regardless of their age; the depreciation curve (5), therefore, is a horizontal line. The mortality (1) and probable life (2) curves are similar to those of Fig 2, except that the average life is only ten years. The rate at which units drop out of service is shown at the bottom of the chart; the replacements of the original units form the basic frequency distribution (8) the summation of which is the mortality curve. In addition to original units, replacements must also be replaced, so that the replacement rate (9) gradually stabilizes itself around the 10% level, corresponding to the average life of ten years.

The remaining service (4) remaining cost (6) and amortization (7) curves have been plotted as outlined for Fig. 2. Each block of annual replacements will have reached a different stage in this respect. At the end of the tenth year, for instance, the plant will be composed of about 48% of original units, plus 52% of the first year's replacements, plus 59% of the second, plus 67% of the third, and so on, the weighted total being always 100%. Correspondingly, the original units will represent a remaining service of 29%, a cost of 43%, and an investment of 50%; the first year's replacements, a remaining service of 31%, a cost of 45%, and an investment of 51%; and so on. The averages of all these data, weighted by the size of the respective blocks, give the composite service, cost, and investment remaining in the entire plant. The composite services without scrap value have not been plotted; the two other curves (10) and (11) start in the upper left hand corner of the chart, reach their lowest points at the end of the tenth year and become gradually stabilized at a slightly higher level, corresponding to an average age of 5.1 years and an average

<sup>14</sup> In strict mathematical theory this method is not entirely correct, but will serve as a satisfactory approximation.

<sup>15</sup> Cf. Charts and tables of actual experience presented by Kurtz, *op. cit.*

life expectancy of 6.2 years. These figures are obtained by tracing the level of the composite remaining cost from the infinitely distant future back to the remaining cost curve of a unit, proceeding from there along the 5.1 year ordinate to the mortality curve and drawing the horizontal line of probable life at that point. The same result will be ob-

pany's life expectancy into the problem will not reduce the plant to its scrap value, but will merely maintain it at the proper number of years' distance from scrap. The drop of the level is not proportionate, because the original cost had to be distributed over a shorter probable life, and in the case of the investment curve the scrap value was also

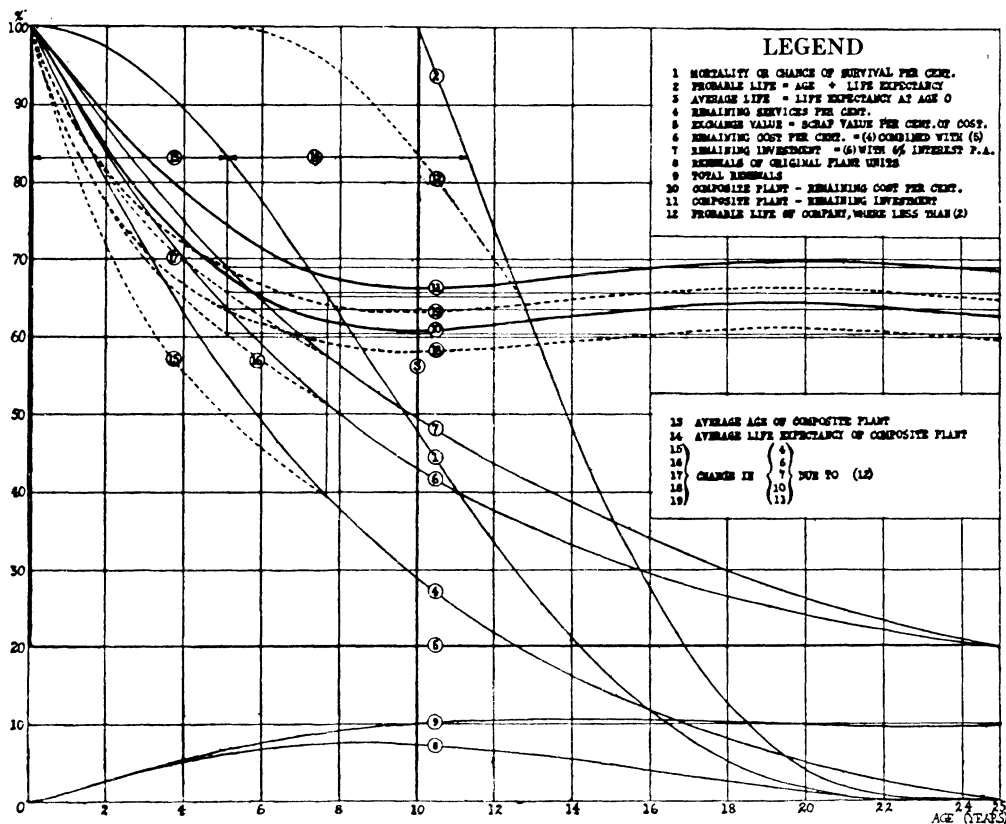


FIG. 3

tained by tracing the level of the composite investment curve to the unit investment curve. The intersection lies on the same 5.1 year ordinate.

Ordinarily the company's horizon is not apt to be less than ten years; nevertheless, to show what would happen if it were less, say five years, the cost and investment curves have been computed for this assumption also. It may be seen that their trend is again horizontal; introduction of the com-

discounted for a shorter period. The result is a higher present worth for both services and scrap which partly offsets the reduction in the length of the annuity discounted. The scrap value assumed in Fig. 3 has a great influence in this respect, because it is unusually high. If the plant is expanding, the compound amount of expansion must be added to the replacements. This will give an ascending trend to both the replacement and the cost or investment curves.



AMORTIZATION OF INVESTMENTS  
IN GOODWILL

If goodwill has been purchased on the basis of a careful and unbiased calculation, the data so obtained may be used for purposes of amortization. All that is necessary is to sum up the area below the discounted mortality curve to the right of each age and plot vertically the result *per centum* plus compound interest for those ages. Goodwill conceivably behaves like a large number of small original plant units taken together. Individual units will drop out of service in accordance with the mortality curve. The only difference is that good will has no scrap value. The plotting of the probable life curve and the computation from it of the curves of remaining services (cost) and investment per unit at successive ages are similar to the principles explained above. Multiplying the last curve by the number of units still in service, *i.e.*, by the ordinates of the mortality curve, produces the total investment curve.

Reference to the composite plant charted in Fig. 3 inevitably leads to the question of whether or not it is possible to replace goodwill in the same manner in which plant units are replaced. Theoretically it ought to be possible; in practice, however, the successive items added will seldom be sufficiently numerous or uniform. It seems preferable, therefore, to let each item of purchased or created good will and other deferred charge stand separately on its own merits, subject to corresponding amortization. The limitations imposed by the company's own life expectancy must be observed in all cases.

When purchased good will is not *bona fide*, but represents mere overcapitalization, there is a great deal to be said for Canning's insistence that "there is no possible excuse for perpetuating a gross blunder or the results of a misdeed in asset valuations."<sup>16</sup> That is particularly true in the public utility field, where the misdeed becomes a permanent source of revenue. In competitive business, accuracy is a goal equally worth striving for, but even if corporation laws were drastically revised, there would always remain a range

of reasonable doubt within which the valuations made might be suspected, but not upset. For this reason I do not agree that to distribute overvaluation over a future period is a statistical error for which no valid excuse can be presented.<sup>16</sup> On the contrary, the knowledge that amortization is as certain as the proverbial death and taxes, will itself restrict opportunities for abuse. To the investor, on to whom the organizers have unloaded the stock, the fictitious valuation is an actual investment. All he must understand is that the cake of excess profits has been eaten and that only the crumbs were left for him. It is the omission of adequate amortization from prospectuses forecasting future profits, which magnifies these crumbs into a semblance of the cake which he will never enjoy.

Until allegedly *bona fide* computations of good will can be checked by reference to statistical data and until abuses in reorganization can be effectively stopped, it may perhaps be best to treat all such deferred charges as if they were organization expenses having a life coextensive with that of the company. Uniformity will at least be gained in this manner.

## TIME-SHAPE OF SERVICES

To simplify the presentation of the actuarial theory of life expectancy in Figs. 2 and 3, the services of various assets were regarded as evenly distributed over their useful lives. In practice, that is seldom the case. Two main types of behavior may be distinguished in this respect. Certain assets have a more or less limited total capacity for rendering service, the average of which is known from experience. If the intensity of their use or exploitation varies greatly from time to time, it will be better to base the mortality study upon units of production in terms of the total expected. That is done in several industries. The considerations which tip the scales in favor of one method or the other can not be discussed here. Suffice it to say that if the abscissa of the mortality curve measures production units instead of time, a scale of time distorted in accordance with expected variations in productive intensity

<sup>16</sup> *Op. cit.*, p. 248.

must, nevertheless, be superimposed upon it to permit the computation of the investment remaining in the services not yet rendered.

Another class of assets has a capacity for service which is limited only by the opportunities for rendering it. Those commonly described as "intangibles" are in this group, *viz.*, patents, trade marks, copyrights, preliminary expenses, *etc.* As the recorded cost of such assets is frequently not *bona fide*, the inclination to refer to their services as "burdens" may be difficult to resist, but the change in name does not invalidate the general principle of amortization, intent upon insuring the stockholder's recorded equity against loss from liquidation. These services or burdens must be distributed in accordance with the opportunities to render them or the ability to bear them, whichever terminology be preferred. In other words, if the company is growing, the rate of growth should be considered. For this purpose the single horizon may no longer be an acceptable indicator of risk, because expansion has its own horizon. The distribution may accordingly be governed by a two-horizon method. Until research sheds more light upon the risk involved, the expansion horizon can only be estimated, but a careful estimate will give a more accurate result than mere scorn for all theory.<sup>17</sup>

The two main types of assets and their subdivisions deserve a great deal more attention than can be given them here. Assets with a limited total capacity for service often show a gradual decline in efficiency, so that their successive annual services may not be considered equal, even if opportunities for rendering them do not vary. The rate of decline will then influence the distribution.<sup>18</sup>

<sup>17</sup> The recognition of expansion ( $x$ ) will change the formula of note 11 into the following, wherein  $h$  = horizon of excess earnings and  $k$  = horizon of expansion:

$$C_t = C_0(1+x)^t \left[ \frac{x}{i} \left( \frac{1+x}{1+i} \right)^k + \left( 1 - \frac{x}{i} \right) \frac{(1+x)^k}{(1+i)^k} - 1 \right] + \frac{x}{i} \left( \frac{1+x}{1+i} \right)^{k+t} + \left( 1 - \frac{x}{i} \right) \frac{(1+x)^{k+t}}{(1+i)^{k+t}} - 1$$

This expression may be suitably reduced.

<sup>18</sup> Maintenance and repair charges as well as taxes and insurance may properly be considered in the computation of the net services rendered in successive

periods. Patents and copyrights expire within certain legal limits, but their true expectancy of service may justify a distribution over a shorter period. On the other hand, if the life expectancy of the business is shorter than that period, the residual exchange values on the horizon enter into the problem. The life expectancy of trade marks and trade names is limited by that of the company and there is no scrap value wherever the legal rule prevails that assignments in gross are void.<sup>19</sup> The illustrations given in preceding paragraphs indicate the general approach, which must be suitably modified for special cases.

#### APPRECIATION

Exchange values need be considered only as of the future dates when exchange is expected to take place either in the normal course of business or by way of insurance against the risk of liquidation. General hints have already been given about the valuation of current assets and liabilities. From them it is possible to deduce the rules governing other cases; for instance, when demand deposits earn a low rate of interest or when accounts, notes, and bonds receivable or payable call for a higher or lower rate than the one used in their valuation.

The exchange value of machinery, equipment, *etc.*, on the date when their sale is contemplated is ordinarily so small a portion of the original cost that normal fluctuations of exchange values will have only a negligible influence upon the apportionment of cost to services. It will seldom be necessary to revise the original estimate of scrap value for a composite plant. Gains or losses are, instead, absorbed currently, as they arise. The

periods. See Harold Hotelling: "A General Mathematical Theory of Depreciation," *Journal of The American Statistical Association*, Sept., 1925, pp. 340-353. For the sake of giving a plausible illustration, Hotelling assumes that repairs depend upon age, and taxes and insurance upon residual value. This does not justify Canning's criticism (*op. cit.*, p. 298) that the integral equation presented by Hotelling will work only in the assumed case. The equation states the general problem in terms of symbols representing the variables as unknown functions of time. If anyone does not like the known functions tentatively substituted, he may readily substitute others acceptable to him. The solution will fit the case he has in mind.

<sup>19</sup> Cf. my article on "The Law of Goodwill," *Accounting Review*, Dec., 1936, pp. 317-329.

greater the number of units in service, the less significant the distortion of earnings arising from this source.

More attention must be given to single large and slowly wasting items of investment. The extreme example is land, the cost of which often represents the present worth of perpetual service. Even then, however, the technique of apportionment is the same as for other assets. Under the investment-concept of the balance sheet the difference between cost and the net selling price looming upon the receding horizon must be distributed over the services rendered between the date of purchase and the horizon. So long as the trend of land values is horizontal, the charge for each annual service equals the credit to interest on investment and the land remains recorded at cost. If the trend is rising, the cost of each service is less than the credit to interest on investment, and the difference may be added to the cost of land. Should the slope of the trend equal the combined rate of interest and taxes, the services will cost nothing.

For cost accounting purposes appreciation may be disregarded, but it constitutes nevertheless a gain connected with manufacturing, until the point is reached where the selling price upon the horizon would pay for a comparable location plus the expense of tearing down the plant and moving the equipment. If no such action is taken, the company will thereafter be engaged in two separate ventures: one manufacturing and the other a real estate speculation, each of which calls for separate records. In the manufacturing division the book value of the land must be kept at the balancing point, which will change with changing opportunities for removal.

The real estate venture may be recorded by either the direct or the indirect method; preferably by both, supplemented further by copious explanation.<sup>20</sup> The direct method will consist of tracing the changing present

worth of the selling price and deducting the value recorded in the manufacturing division. As for the indirect method, it will be limited to capitalizing taxes and assessments not chargeable to manufacturing and to compounding interest on these expenditures. Or interest may be omitted in both instances. In an extreme case the facts will generally be easier to understand than the method of their recording. This should be borne in mind because any method is valuable only in proportion to its ability to simplify facts, and to permit conclusions to be drawn from them.

The date of sale which will yield the greatest profit is located at the point where the declining rate of appreciation becomes equal to the combined rate of interest and taxes on the value estimated by the direct method. This date is the logical horizon for manufacturing purposes, unless it is so far distant that the risk of manufacturing calls for a shorter period.

When the purchasing power of money shows a definite trend of change or fluctuates too widely, it may become necessary to adjust accounts by reference to some general price index.<sup>21</sup> The true appreciation or depreciation of a specific asset can then be measured more accurately.

A different form of appreciation occurs when exploration is rewarded by a valuable discovery. The same technique of apportionment could again be applied and would furnish a mathematically correct presentation, but such a method of gradual negative amortization would, nevertheless, look highly artificial and contrary to common sense. It is far more reasonable to adopt the position that exploration is one kind of business activity and the exploitation of discoveries quite another. Reorganizations have been effected for less weighty reasons. And even if the legal corporate entity happens to remain unchanged,<sup>22</sup> there can be no valid ob-

<sup>21</sup> Cf. H. W. Sweeney: *Stabilized Accounting*, Harper & Bros., New York, 1936.

<sup>22</sup> I again have in mind a case within my experience, where an oil well was discovered and appraised at forty times the cost of the land and its exploration. A share was quoted in the market at forty-three times the capital paid in and the first years profits equalled twice the recorded book equity.

<sup>20</sup> In discussing this subject, I have in mind an extreme case within my own experience, where the land rose about a hundredfold in value while the company continued manufacturing operations at a declining profit. In the end practically the entire value of the stock was attributable to the land.

jection to a careful allocation of the rewards to their respective sources. For this reason I do not quite understand why *May* calls discovery values "perhaps the most phantastic of all,"<sup>23</sup> unless he means merely that there is too much room for fancy in the appraisal.<sup>24</sup> All appraisals, of course, are "for experts of good character only,"<sup>25</sup> but the play of fancy will be greatly restricted by well-defined and enforced principles of amortization fully understood in advance.

#### INTEREST AND ITS LIMITATIONS

It is a curious phenomenon that many writers, in discussing the place of interest in valuation, devote more space to witty, but misleading remarks than to an exposition of its limitations. Interest can not be disposed of merely by saying that "it is as absurd as trying to correct for the earth's rotation in a snowball fight" or that "all we should have to do to earn rate  $i$  forever would be to abandon the plant." And when the "muddy pool of interest" is mentioned, it is difficult to resist the temptation of retorting that the appearance of muddiness may be due to the condition of the eye rather than to that of the pool.

expired life, the discounted excess profits plus the recorded value will always give the true fair market value, even though both the investment and the excess profits are measured incorrectly. This statement is a simple theorem of arithmetic.

Risk being disregarded for the time being, the only basic facts are the life of the asset and the proceeds of its services. Let us place the life at four years and let us assume that the proceeds are \$500, \$600, \$900 and \$700 for the successive years. Valuing now the asset at any random figure and filling in annual amortization (cost) likewise at random, a table may be completed as follows:

TABLE 1

Principal	Services		Profit		
	Cost	Proceeds	Total	Normal	Excess
\$1,000	\$ 300	\$ 500	\$ 200	\$ 50	\$ 150
700	100	600	500	35	465
600	200	900	700	30	670
400	400	700	300	20	280
—	\$1,000	\$2,700	\$1,700	\$135	\$1,565

Or, if preferred—

TABLE 2

Principal	Services		Profit		
	Cost	Proceeds	Total	Normal	Excess
\$200,000	\$ 20,000	\$ 500	\$— 19,500	\$10,000	\$— 29,500
180,000	80,000	600	— 79,400	9,000	— 88,400
100,000	30,000	900	— 29,100	5,000	— 34,100
70,000	70,000	700	— 69,300	3,500	— 72,800
—	\$200,000	\$2,700	\$— 197,300	\$27,500	\$— 224,800

The opponents of interest really have an argument stronger than any of those which they have mentioned so far, to my knowledge. A fundamental truth about accounting is that, given perfect and unlimited foresight, no matter at what value an asset is placed on the books and no matter in what haphazard way it is amortized over its un-

The random figures of amortization may be taken to represent more or less profound theories of distribution. Irrespective of their merit, the fair market value of the asset can be computed correctly from either table. It is \$2,373.75. If interest were used in the distribution of cost, the answer would still be the same. It follows that interest may be disregarded in the process of preparing accounting statements which have only the limited purpose of permitting a correct appraisal of the fair market value.

<sup>22</sup> *Op. cit.*, p. 17.

<sup>24</sup> See the recognition and measurement of discovery value under successive revenue acts and treasury regulations.

<sup>25</sup> Canning, *op. cit.*, p. 305.

The inclusion of interest has only one primary advantage: The true investment and the true goodwill can be separated only by allocating both cost and interest to future services. When used jointly with a measure of risk, interest will, therefore, partly remedy the complaint that "book figures may be reasonably satisfactory for current assets, but the recorded data of fixed property are usually inadequate for the purpose of a qualitative analysis of earning power."<sup>26</sup> But if risk can be omitted from consideration and if only the sum of investment and goodwill is desired, almost any method will give the correct primary result.

The rate of interest to be used is evidently the riskless rate which the market itself uses in valuing common stocks. The average level of that rate can be determined with sufficient accuracy<sup>27</sup> to preclude any wide di-

## THE GENERAL BUSINESS RISK

To introduce the concept of risk into the valuation problem means to limit perfect foresight to a short future period. This is merely a way of averaging unlimited, but imperfect foresight. Typical examples have already been presented graphically, but a review by figures appears indicated. To save computation, a very simple example must be selected. A certain amount of harmless distortion will result, which may serve to emphasize the principle involved.

Let the unit to be valued consist of an asset having a fixed ten-year life and of another having a life coextensive with that of the company, whose expectancy is limited to five years. Each asset cost \$1,000. Under accounting methods now in vogue the table of amortization would be as follows:

TABLE 3

Year	Book Value	Services		Profit			Apparent Market Value
		Cost	Proceeds	Total	Normal	Excess	
1	\$2,000.00	\$ 100.00	\$ 250.00	\$ 150.00	\$100.00	\$ 50.00	\$2,041.09
2	1,900.00	100.00	220.00	120.00	95.00	25.00	1,912.09
3	1,800.00	100.00	180.00	80.00	90.00	— 10.00	1,827.55
4	1,700.00	100.00	160.00	60.00	85.00	— 25.00	1,797.67
5	1,600.00	100.00	180.00	80.00	80.00	—	1,805.92
6	1,500.00	100.00	200.00	100.00	75.00	25.00	983.62
7	1,400.00	100.00	220.00	120.00	70.00	50.00	832.80
8	1,300.00	100.00	240.00	140.00	65.00	75.00	654.44
9	1,200.00	100.00	260.00	160.00	60.00	100.00	447.17
10	1,100.00	1,100.00	220.00	— 880.00	55.00	— 935.00	209.52
	—	\$2,000.00	\$2,130.00	\$ 130.00	\$775.00	\$— 645.00	—

vergence of opinion. And if the rate and amount of interest included in asset figures are disclosed, adjustment by interpolation is an easy task for anyone who prefers a slightly different rate. The requirement of full disclosure will also eliminate temptation.

<sup>26</sup> W. A. Paton: "The valuation of the business enterprise," *Accounting Review*, March, 1936, pp. 29-30. That portion of the complaint which refers to the change in the purchasing power of money will, of course, remain in force and calls for separate correction. (*Cf.* note 21.)

<sup>27</sup> For instance, by analyzing well known seasoned stocks which have long been earning less than the money rate. The horizon can there be considered infinite, and, therefore, their yield must equal the money rate, subject only to minor disturbing factors, which can be eliminated if a sufficient number of observations is analyzed.

The computation of the apparent fair market value is based, in accordance with the assumption, upon the next five years' excess profits ahead at each successive date. It may be seen that this method of book-keeping grossly overstates the market value until the end is in sight. Thereafter the figures are correct. When books are kept in this manner, the market will sooner or later learn to disregard them. Appraisal on the basis of rumors and "tips" is the natural consequence.

If risk is now considered, but interest is still omitted, the following figures will be obtained:

TABLE 4

Year	Book Value	Services		Profit			Correct Market Value
		Cost	Proceeds	Total	Normal	Excess	
1	\$2,000.00	\$ 333.33	\$ 250.00	\$- 83.33	\$100.00	\$-183.33	\$865.79
2	1,666.67	238.10	220.00	- 18.10	83.33	-101.43	815.80
3	1,428.57	178.57	180.00	1.43	71.43	- 70.00	808.96
4	1,250.00	138.89	160.00	21.11	62.50	- 41.39	857.45
5	1,111.11	111.11	180.00	68.89	55.56	13.33	944.05
6	1,000.00	200.00	200.00	—	50.00	- 50.00	983.62
7	800.00	200.00	220.00	20.00	40.00	- 20.00	832.80
8	600.00	200.00	240.00	40.00	30.00	10.00	654.44
9	400.00	200.00	260.00	60.00	20.00	40.00	447.17
10	200.00	200.00	220.00	20.00	10.00	10.00	209.52
	—	\$2,000.00	\$2,130.00	\$ 130.00	\$522.82	\$-392.82	—

Every line of this table is taken from corresponding primary tables prepared by using a different combination of foresight and hindsight for each. For instance, the second line of Table 4 is the second line of a six-year table combining one year of hindsight with five years of foresight. Similarly, the ninth line involves eight years of hindsight and two years of foresight. The fair market values now found are correct, but they must be calculated from the primary tables, not from Table 4 itself.

If it is desired to separate investment from goodwill, the ten primary tables must be computed by using interest in the distribution of cost. The result will be:

TABLE 5

Year	Book Value	Goodwill	Market Value
1	\$2,000.00	\$-1,134.21	\$865.79
2	1,705.97	- 890.17	815.80
3	1,496.44	- 687.48	808.96
4	1,339.74	- 482.29	857.45
5	1,218.23	- 274.18	944.05
6	1,121.38	- 137.76	983.62
7	918.43	- 85.63	832.80
8	705.34	- 50.90	654.44
9	481.60	- 34.43	447.17
10	246.67	- 37.15	209.52

For the purpose of the example, the horizon had to be assumed. Actually, it depends partly upon the nature of the business, partly upon special information relative to the future and partly upon the rate of return and the changes expected in it. A secondary advantage of including interest in the computation is that, by correctly stating the in-

vestment in the services expected, it will eliminate that part of the error in estimating the risk which is due to incorrectly computed rates of return.

The amortization enforced by the horizon of the business is a premium paid for insuring the book equity against loss upon liquidation. As in the case of natural persons, the company does not actually expect to die so soon; nevertheless, the horizon measures the risk that it might. The correctness of the premium charged in a given case may be checked roughly by using what appears to be an appropriate horizon for the computation of the market price from book figures. Until the legal phrase "suitable and proper"<sup>28</sup> can be made more definite by applying statistical methods, a range of doubt will remain open; in many instances, however, the discrepancy is so great that it can be immediately spotted.

#### THE FORMULA-REVERSAL TEST

To illustrate the application of the valuation formulae, let us select at random the unexpired portion of the primary table upon which line 3 of Table 5 is based (Table 6).

The negative good will at the beginning of the third year is \$687.48. The average excess profit for each year, therefore, is one payment of an annuity which that sum can purchase, *viz.*, \$-158.79. Subtracting normal profits gives an average net loss of \$83.97. Accordingly, the fair market value may be computed as follows:

<sup>28</sup> Cf. Note 19.

$$1 - \frac{1}{1.05^5} - 158.97 \frac{1}{.05} + 1,496.44 = 808.96$$

From this method, it is not proper to jump to the conclusion that the horizon refers to

all. If the asset will ultimately be reduced to salable scrap, only the present worth of that can receive consideration. The horizon-theory or liquidation insurance presented in this article rests ultimately upon the equivalence or interchangeability of the three formulae, or two viewpoints.

TABLE 6

Year	Book Value	Services			Profits		
		Amortization	Cost	Proceeds	Excess	Normal	Total
3	\$1,496.44	\$ 270.81	\$ 345.63	\$180.00	\$-165.63	\$ 74.82	\$- 90.81
4	1,225.63	284.36	345.64	160.00	-185.64	61.28	-124.36
5	941.27	298.58	345.64	180.00	-165.64	47.06	-118.58
6	642.69	313.51	345.64	200.00	-145.64	32.13	-113.51
7	329.18	329.18	345.64	220.00	-125.64	16.46	-109.18
	—	\$1,496.44	\$1,728.19	\$940.00	\$-788.19	\$231.75	\$-556.44

excess profits only and not to the life of the business itself. The computation can be readily converted into

$$1 - \frac{1}{1.05^5} - 83.97 \frac{1}{.05} + \frac{1,496.44}{1.05^5} = 808.96.$$

Now, the formula states clearly that the entire investment is repayable upon the horizon. Both varieties of the formula, of course, express a fiction obtained by substituting earnings, *i.e.*, "standard income," for the actual stream of services coming in.<sup>29</sup> The fiction was created for the purpose of permitting the investor to rely upon the recorded book equity and to compute the capital value from it. Figures closer to reality are used in the service formula preferred by economists. The average service in the example is \$345.64 - \$158.79 = \$186.85. Therefore—

$$186.85 \frac{1}{1.05^5} - 83.97 \frac{1}{.05} + 1,496.44 = 808.96.$$

Here the book equity is not mentioned at

<sup>29</sup> Irving Fisher defines standard income as "that income which capital can yield without alteration of value." Cf. *The Nature of Capital and Income*, p. 333.

When the annual volume of production is not constant, the averaging process is somewhat more complicated. If the increase is such that the fitting of a compound expansion curve is reasonable, the rate of expansion may be so found. A fairly accurate expansion rate can also be derived from the gross (undepreciated) book value of a composite plant, after it has been in operation long enough enough to have a stable renewal rate (see Fig. 3). By dividing an annuity growing at the expansion rate into the present worth of excess profits, adding the normal profit of the first year and dividing the result by the book equity at the beginning, the average earning rate is obtained. Alternatively, the net cash dividend rate (subscriptions, assessments, *etc.*, being considered negative dividends) may be computed and added to the expansion rate to find the earning rate. Choosing now an appropriate horizon, the appraisal can proceed.<sup>30</sup>

<sup>30</sup> The service formula is as follows, when  $r$  = earning rate,  $x$  = expansion rate,  $r - x$  = services,  $a$  = amortization and  $s$  = scrap value:

$$P = \frac{r - x + a}{x - i} \left[ \left( \frac{1+x}{1+i} \right)^n - 1 \right] + s \left( \frac{1+x}{1+i} \right)^n$$

The formula of amortization is:

$$a = (1-s) \frac{x-i}{1 - \left( \frac{1+i}{1+x} \right)^n}$$

The assumption here is that the horizon ( $n$ ) of earning and expansion rates is the same. If that is unlikely, the amortization can be obtained from a two-horizon formula.



Comparison of the appraisal so derived from past book figures with the trend of market prices for the same period makes it possible to estimate with a fair degree of accuracy, first, that portion of the book equity upon which redemption service has been maintained and, second, what the true return would have been under full redemption service.

#### SUMMARY OF THE INVESTMENT-CONCEPT

The investment-concept of the balance sheet may be restated briefly as follows:

1. Asset figures are obtained by either the direct or the indirect method of valuation. The difference between the two is that the former proceeds backward from the next future starting point of the operating cycle, whereas the latter moves forward from the last starting point. This point is the moment when cash is disbursed.

2. The dividing line between direct and indirect valuation is the line of realization. Above the line, assets are stated at their fair market or capital values, while below it merely unexpired past costs (including time-cost) are recorded for the purpose of submitting them to the market for appraisal on the basis of their earning power.

3. The exact point where the realization line ought to be drawn depends upon conditions prevailing in different industries; these conditions determine the degree of accuracy with which the value of future services can be foretold. The degree of accuracy, in turn, determines the choice of the method. In most cases, inventories will be found next to the line, on either or both sides of it.

4. It is not necessarily true that any asset capable of direct valuation should be so valued. Uniformity of classification will often be preferable. In many cases services in exchange are best valued by the direct method and services in use by the indirect method.

5. Each asset has its own horizon or life expectancy. The horizon of current assets is the sum of all turnover periods which separate them from the date when their proceeds are again disbursed (*cf.* page 211). The expectancy of the so-called fixed assets can be found from mortality studies.

6. Paramount over all horizons of individual assets is the life-expectancy of the company itself. Beyond the limit so set, an asset can not be expected to render services in use, but merely a final service in exchange.

The horizon of the business enterprise is the least definite element entering into the investment concept, but a very essential one, upon which research is sorely needed. Fortunately a high degree of correlation evidently exists between this horizon and the "average life"<sup>31</sup> of the principal items of equipment used in industry, because the more or less substantial nature of such equipment is determined chiefly by the prevailing business risk. For this reason the horizon of an enterprise is not apt to interfere with the independent amortization of plant assets so long as normal operating conditions exist. Its principal practical significance is probably limited to actually impending liquidation and to the amortization of assets or burdens having an indefinite life.

#### OTHER BALANCE SHEET CONCEPTS

The capital-value, property, or true-net-worth concept of the balance sheet is strenuously opposed on the ground that appraisal is not a function of accounting. This position is probably well taken although—wherever business risks are not adequately considered in selecting the type of equipment, *i.e.*, where the horizon of the business is shorter than the "average life"<sup>31</sup> of such equipment, the best way of disclosing how amortization was determined would be to compute annually *Canning's* "master valuation account."<sup>32</sup> In this manner it could easily be shown what the capital value of the business would have to be if the assumptions made in keeping the books were correct and if last year's profit were considered a correct average in the sense explained in the section entitled, "The Formula-Reversal Test." Indeed, if such a test were appended to every balance sheet which is nowadays blandly certified, the frequently ludicrous discrepancy between actual market quotations and the result of the test would forcibly call

<sup>31</sup> *Viz.* life expectancy at the age zero. *Cf.* the preceding section entitled "Examples of Amortization."

<sup>32</sup> *Op. cit.*, p. 42.

attention to the fact that something is radically wrong either with the market or with the books and the methods by which they are kept. A single test might not be conclusive; within a few years, however, it would inevitably appear who is right and who is not.

Quite apart from this suggestion it must be admitted that the investment concept can render valuable service in the public utility field by placing regulation on an unequivocal basis. That seems true especially because in the general case the horizon of earnings could be considered infinite, so that only the minor problem of the expansion horizon would remain. Furthermore, public utilities are entitled to a stated fair return, so that deviations from it are really assets or liabilities, as the case may be.

In all cases where it is not essential to measure the exact investment and the exact rate of return from year to year, interest may immediately be omitted. This will cause only a small conservative bias in estimating the horizon. The main problem of the horizon still remains, however, because when foresight does not extend beyond the "average life"<sup>31</sup> of the most durable asset, the shifting of the horizon from one set of services to the next makes it impossible to compute the fair market value from successive reports. This was pointed out with reference to Tables 4 and 5. Assets or deferred charges having an indefinite life always create this error, and this is the true, although perhaps not generally realized reason for the rule often preached, but seldom practised, that purchased goodwill, etc., ought to be separately stated on the balance sheet.

The mere segregation of such items will do no good, however, unless every reader of a balance sheet fully understands what that form of disclosure means. Another horizontal line has in effect been drawn, separating self-liquidating assets from those which are excluded from gradual redemption and are branded instead as ultimate deficits. If all assets having an "average life"<sup>31</sup> longer than the corporate horizon are placed below the line of redemption service and are thereby excluded from consideration in the valuation

process, the remainder of the book equity and the excess profits computed thereon in successive years will regain their faculty of giving the true fair market value, subject only to errors of foresight, but to no mechanical flaw of procedure.

The policy of banishing certain capital expenditures below the redemption line can be carried much further. A great deal, for instance, could be said in favor of the idea that items above the line shall present liquidating values only, *i.e.*, net selling prices of all assets looming either upon their own horizons or upon that of the company, whichever be shorter. Upon acquisition the cost of an asset could be apportioned immediately to both sides of the line. Depreciation tables, based upon market statistics of second-hand equipment—not upon any theory of use value to the present owner—would be needed for the annual adjustment of the figures above the line. The amount of the adjustment could be transferred below or written off altogether, since for valuation purposes what happens to it is irrelevant. The income account, in turn, would have to emphasize the net potential service, *i.e.*, sales less operating, selling, and administrative expenses, but excluding all depreciation or amortization. This requirement is observed in an old practice now frowned upon; that of stating depreciation at the end and not in cost of sales. For valuation purposes accounts would thus revert to the fundamental formula of capital value based upon services, for which the balance sheet would furnish the second term and the income account the first. For this purpose, however, reinvestments must also be deducted from the balance of the income account. Actually, therefore, only positive or negative cash dividends enter into the formula.

Above the redemption line, which now extends to the income account also, the fiction of standard income would thus be abandoned, but that does not mean that it can not be retained with respect to the entire balance sheet and the entire income account to whatever extent such a course may seem desirable. In accordance with this theory, accountants of the old school were

in the habit of gradually "rearing up" reserves against capital expenditures by appropriating profits. In so doing, they introduced no error into the valuation formula based upon services, since the transaction took place below the redemption line. Only an improvement in the method of disclosure could have been suggested to them, namely that of stating separately the future selling prices of all assets. How the remainder of cost is recorded is entirely optional.

When "during the 1920's, accountants fell from grace and took to readjusting capital values to an extent never before attempted,"<sup>33</sup> their cardinal sin was failure to disclose the redemption line and to call proper attention to its significance. This omission amounts to a warranty that such adjustments do have a bearing upon the capital value of an investment, although that is not true. So long as revaluation, however questionable, is limited to manipulating debits and credits

below the redemption line, the resultant harm is traceable directly to ignorance of its existence and ignorance of the economic law of capital value. On the other hand, when entries are passed between assets below the line and that portion of the income account which is above the line, the result is a misrepresentation or falsification of ascertainable facts.

Under the investment concept of the balance sheet the redemption line will disappear because full redemption service commensurate with risk becomes obligatory. That is a great advantage because there can be little doubt that the complications surrounding the line facilitate fishing in troubled waters. In the last analysis, however, no balance-sheet concept or other accounting principle can provide a safeguard unless it is applied in an intellectually, as well as legally, honest manner. That, incidentally, is a matter which might well receive a bit more attention from professional broadcasters on professional ethics.

<sup>33</sup> May, *op. cit.*, p. 16.

## COST ACCOUNTING IN THE SIXTEENTH CENTURY

THE BOOKS OF ACCOUNT OF CHRISTOPHER PLANTIN,  
ANTWERP, PRINTER AND PUBLISHER\*

FLORENCE EDLER

IT is a generally accepted belief that cost accounting originated in the nineteenth century and received its major impulse from the development of the factory system and the extensive use of machinery in industrial production. This common opinion is only partly true. A systematic technique of cost accounting was developed during the nineteenth century and has been greatly extended in recent decades,<sup>1</sup> but some elements of cost accounting are much older.

Existing medieval business records show that industrial accounts were used as early as the beginning of the fourteenth century.

This fact has been brought to light by recent research in old Italian account books, such as those of the Del Bene Company, Florentine importers and finishers of foreign woollen cloths in the first part of the fourteenth century;<sup>2</sup> Francesco Datini, Pratese merchant and manufacturer of woollen cloth at the end of that century;<sup>3</sup> the Medici, also

<sup>2</sup> For industrial accounts from the books of Francesco del Bene & Co., merchants of the Calimala Guild of Florence (importers and finishers of Flemish and French cloths), see Armando Saporì, *Una Compagnia di Calimala ai primi del Trecento*, Florence: Olshki, 1932, pp. 325-343.

<sup>3</sup> Some pages from manufacturing accounts that illustrate clearly the existence of industrial accounting in the Prato woollen industry of the first decade of the fifteenth century are given by Gaetano Corsani in his study of the Datini account books, *I fondaci e i banchi di un mercante pratese del Trecento: Contributo alla storia della ragioneria e del commercio*, Prato: Archivio Storico Pratese, Supplement n, 1922, pp. 161-165. For informa-

\* The material for this study was collected during the author's sojourn in Belgium, 1934-36, as a Fellow of the C.R.B. Educational Foundation, Inc.

<sup>1</sup> A. C. Littleton: *Accounting Evolution to 1900*, New York: American Institute Publishing Co., 1933, p. 320.

**TAB 6**

Content downloaded/printed from

[HeinOnline](#)

Sun Dec 1 13:37:37 2019

Citations:

Bluebook 20th ed.

Catherine L. Hammond, Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The , 27 Conn. L. Rev. 915 (1995).

ALWD 6th ed.

Catherine L. Hammond, Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The , 27 Conn. L. Rev. 915 (1995).

APA 6th ed.

Hammond, C. L. (1995). Amortization of intangible assets: 197 of the internal revenue code settles the confusion, the Connecticut Law Review, 27(3), 915-942.

Chicago 7th ed.

Catherine L. Hammond, "Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The ," Connecticut Law Review 27, no. 3 (Spring 1995): 915-942

McGill Guide 9th ed.

Catherine L Hammond, "Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The " (1995) 27:3 Conn L Rev 915.

MLA 8th ed.

Hammond, Catherine L. "Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The ." Connecticut Law Review, vol. 27, no. 3, Spring 1995, p. 915-942. HeinOnline.

OSCOLA 4th ed.

Catherine L Hammond, 'Amortization of Intangible Assets: 197 of the Internal Revenue Code Settles the Confusion, The ' (1995) 27 Conn L Rev 915

-- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at

<https://heinonline.org/HOL/License>

-- The search text of this PDF is generated from uncorrected OCR text.

-- To obtain permission to use this article beyond the scope of your license, please use:

[Copyright Information](#)

Use QR Code reader to send PDF to your smartphone or tablet device



## THE AMORTIZATION OF INTANGIBLE ASSETS: § 197 OF THE INTERNAL REVENUE CODE SETTLES THE CONFUSION

### I. INTRODUCTION

Since the beginning of the twentieth century, taxpayers and the Internal Revenue Service (IRS) have battled over whether customer-based intangibles<sup>1</sup> can be amortized<sup>2</sup> over the life of the asset. In interpreting the law, courts had tended to hold that an asset may not be amortized if it is inextricably linked to goodwill. In *Newark Morning Ledger Co. v. United States*,<sup>3</sup> however, the United States Supreme Court turned the tide when it concluded that a customer-based asset may be amortized regardless of its relationship with goodwill if the taxpayer can prove that the asset has an ascertainable value, a limited useful life the duration of which may be estimated with reasonable accuracy, and is not self-regenerating.<sup>4</sup> Motivated by the *Ledger* decision and other factors, Congress promulgated § 197 of the Internal Revenue Code<sup>5</sup> (the Code), which allows taxpayers automatically to amortize all intangible assets, with few exceptions, over a uniform fifteen year period.

Part II of this Note examines the case and statutory law on the amortization of intangible assets leading to the *Ledger* decision and the adoption of § 197. Part III recounts the facts and procedural history of *Ledger* and explores the majority and dissenting U.S. Supreme Court opinions. This Note then examines § 197 in Part IV. Next, Part V analyzes the changing role of the historic mass asset rule;<sup>6</sup> the factors that led to the enactment of § 197; the advantages, disadvantages and reper-

---

1. Customer-based intangibles include customer lists, subscription lists, prescription files, and other assets whose value is derived from the continued patronage of customers. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1676 (1993).

2. To amortize is to allocate and recover year by year the basis (the cost) of the intangible asset over its estimated useful life. For example, if X buys a patent for \$1000 and the patent is expected to be useful for ten years, X could deduct \$100 per year for ten years.

3. 113 S. Ct. 1670 (1993).

4. *Id.* at 1680.

5. 26 U.S.C. § 197 (Supp. 1994).

6. See *infra* text accompanying note 29.

cussions of § 197 to taxpayers; and § 197's implication on tax strategies. Finally, this Note concludes that despite a minor flaw, the Court properly decided *Ledger*, for the case spurred the adoption of § 197, a necessary addition to the tax code.

## II. BACKGROUND

### A. Legislation Leading to § 197

Prior to the enactment of § 197, the regulation controlling the amortization of intangible assets was Treasury Regulation Section 1.167(a)-3.<sup>7</sup> This regulation can be traced to Treasury Regulation 45, Article 163 which was promulgated in 1919.<sup>8</sup> Article 163 originally provided that if an intangible asset had a limited useful life in a trade or business as determined through experience, then the taxpayer could depreciate the asset. In addition, the article expressly disallowed the depreciation of goodwill, trade names, trademarks, trade brands, secret formulae or processes.

In response to pressures from liquor dealers at the onset of Prohibition in late 1919,<sup>9</sup> the Commissioner modified the law to no longer specifically prohibit the depreciation of goodwill.<sup>10</sup> An income tax ruling which followed this modification explained that if a liquor dealer chose not to continue a similar trade after the distribution and consumption of liquor became illegal, then the business' goodwill did, in fact, have a limited life and was subject to depreciation.<sup>11</sup> In other words, a deduction for obsolescence of goodwill was to be permitted in those rare cases in which a taxpayer could prove that the business'

---

7. See *infra* note 22.

8. Regulation 45, T.D. 2831, Art. 163 (1919) provides:

Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copy rights, licenses and franchises. Intangibles, the use of which in business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided that facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. There can be no such allowances in respect of good will, trade names, trademarks, trade brands, secret formulae or processes.

9. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1685 n.2 (1993) (Souter, J., dissenting).

10. T.D. 2929, 1 C.B. 133 (1919).

11. O.D. 818, 4 C.B. 178 (1921).



goodwill had no remaining value at the end of a set duration and that the business would subsequently be forced to discontinue operation.<sup>12</sup>

However, any hope business owners may have had of depreciating their goodwill was eliminated by the 1926 Court of Appeals decision in *Red Wing Malting Co. v. Willcuts*.<sup>13</sup> Determining that it had the authority to overrule tax rulings,<sup>14</sup> the Eighth Circuit Court of Appeals concluded that despite the fact that the value of goodwill constantly fluctuates, it cannot be exhausted in the operation of a business.<sup>15</sup> Therefore, the court held that goodwill is non-amortizable.<sup>16</sup>

In the following year, as a result of the *Red Wing* holding, the Treasury Department adjusted Article 163 to include the provision: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill."<sup>17</sup> The U.S. Supreme Court further clarified the law on this issue when it held that liquor distributors and breweries could not take depreciation deductions for loss of goodwill due to Prohibition, thus resolving a split in circuit authority.<sup>18</sup> The treatment of goodwill remained untouched thereafter until the adoption of the current depreciation/amortization code provision and regulation.<sup>19</sup>

### B. *Treasury Regulation Section 1.167(a)-3*

Under current law, § 167 of the Internal Revenue Code, which was adopted in 1954, provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . (1) of property used in the trade or business, or (2) of property held for the production of income."<sup>20</sup> In language similar to that of the original Article 163, Treasury Regulation Section 1.167(a)-3<sup>21</sup> more

12. O.D. 472, 2 C.B. 141 (1920).

13. 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). The plaintiff in this case manufactured barley malt and sold it to breweries. When the Eighteenth Amendment was enacted the plaintiff was forced out of the malt business and thus claimed that its goodwill no longer existed. *Id.* at 627.

14. *Id.* at 629.

15. *Id.* at 633.

16. *Id.*

17. T.D. 4055, VI-2 C.B. 63 (1927).

18. *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930).

19. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1685 n.2 (1993) (Souter, J., dissenting).

20. 26 U.S.C. § 167(a) (Supp. 1994).

21. As of the time of this Note's publication, Treas. Reg. § 1.167(a)-3 had not yet been adjusted to reflect the addition of § 197 to the Internal Revenue Code.

thoroughly interprets the meaning and application of § 167 with respect to intangible assets.<sup>22</sup>

Regulation section 1.167(a)-3, which was adopted in 1956 and amended in 1960, indicated that an intangible asset can be amortized if the asset can only be used for a limited period and if the length of that period can be estimated with reasonable certainty.<sup>23</sup> However, section 1.167(a)-3 specifically provides that goodwill was not subject to amortization. Presumably goodwill was excluded from those intangibles that can be amortized because its useful life was considered to be unlimited.<sup>24</sup> This regulation was the source of a considerable amount of litigation; the IRS continually challenged taxpayers' ability to distinguish an intangible asset from goodwill and to determine the useful life of such an asset.<sup>25</sup> Because the determination of whether an intangible can be amortized was a question of fact, the outcome of such litigation varied widely according to the circumstances of each particular case.<sup>26</sup> Additional confusion and litigation arose because the term "goodwill" is not defined in the Code or in the regulations.<sup>27</sup>

22. Treas. Reg. § 1.167(a)-3 states in relevant part:

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

26 C.F.R. § 1.167(a)-3 (1994).

23. *Id.*

24. See *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626, 633 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927) ("We are satisfied there can be no wear or tear of goodwill, or exhaustion thereof by use . . ."); see also Arthur A. Feder & Joel Scharfstein, *Intangibles: Past, Present, and Future*, 1 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 907, 910 (PLI Series No. J4-3666, 1993).

25. Glenn F. Mackles, *15-Year Amortization of Purchased Intangible Assets—Some Winners, Some Losers*, 79 J. TAX'N 332, 332 (1993).

26. *Id.*

27. In *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893), Justice Story defined goodwill to be:

the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.

*Id.* at 446. See also *Boc v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962) ("The essence of

### C. The Mass Asset Rule

Customer-based intangibles<sup>28</sup> is one group of intangible assets that has received a considerable amount of attention due to its close relationship with goodwill. With regard to the amortization of customer-based intangibles, until the early 1970s courts applied the mass asset rule, which was also known as the indivisible asset rule. This per se rule provides that "certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in value of the whole."<sup>29</sup> For example, although individual customers may cancel their subscriptions to a particular newspaper, other new customers constantly start new subscriptions. Therefore, taken as a whole, such an asset never experiences exhaustion but only a continual shifting of patronage.<sup>30</sup> Under the mass asset rule, the customer-based intangible is considered self-regenerating and non-wasting, and therefore, no amortization is permitted.<sup>31</sup>

The United States Court of Claims applied the mass asset rule in *Golden State Towel & Linen Service v. United States*<sup>32</sup> when it held that the plaintiff, a linen service corporation, could not deduct a loss when a customer, whose patronage was purchased during the acquisition of a competitor company, discontinued business with the plaintiff.<sup>33</sup> The court reasoned that "[t]he whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole."<sup>34</sup>

This legal fiction prevented taxpayers from amortizing the cost of customer-based intangibles despite their efforts to distinguish the asset

---

goodwill is the expectancy of continued patronage, for whatever reason.")

28. See *supra* note 1.

29. Marc D. Levy et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N 4, 5 (1993) (quoting *Danville Press, Inc.*, 1 B.T.A. 1171 (1925)).

30. See *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962) (A list of customer contracts is comprised of one interminable asset, not a composition of several short-term assets.).

31. Levy, *supra* note 29, at 5.

32. 373 F.2d 938 (Ct. Cl. 1967).

33. *Id.* at 941.

34. *Id.* at 944.

from goodwill and demonstrate the asset's limited useful life. However, in *Houston Chronicle Publishing Co. v. United States*,<sup>35</sup> the Fifth Circuit Court of Appeals marked a departure from the mass asset rule and a significant change in the treatment of the amortization of intangibles.

D. *Houston Chronicle Publishing Co. v. United States and the Subsequent Revenue Ruling 74-456*<sup>36</sup>

In *Houston Chronicle*, the taxpayer entered into a contract to acquire certain assets, including subscription lists, owned by the Houston Press Company.<sup>37</sup> Although the Houston Chronicle did not intend to continue to publish the Houston Press, it did intend to use the subscription lists to target prospective customers for its already operating publication.<sup>38</sup> Under the traditional view, the mass asset rule prevents the amortization of such lists as a matter of law. However, to the contrary, the court held that an intangible asset is not automatically non-amortizable simply because it is somehow related to goodwill.<sup>39</sup> Furthermore, the court determined that intangible assets, subscription lists in this case, may be amortized if the taxpayer meets its burden by proving that the assets "(1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy."<sup>40</sup>

The *Houston Chronicle* court reasoned that some intangible capital assets are nondeductible as a matter of law; for example, Treasury Regulation Section 1.167(a)-3 specifically prohibits the amortization of goodwill.<sup>41</sup> However, the court continued, there is no case history to suggest that subscription lists are non-amortizable as a matter of law, nor are all such lists inextricably linked to goodwill.<sup>42</sup> Therefore, if the taxpayer meets its "dual burden" which is based on a factual inquiry, then nothing prevents the subscription lists from being

---

35. 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

36. Rev. Rul. 74-456, 1974-2 C.B. 65.

37. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1243 (5th Cir. 1973).

38. *Id.* at 1243. See also Linda J. Pissott, *The Amortization of Customer-Based Intangibles: The 'Separate & Distinct From Goodwill' Requirement and H.R. 3035's Proposal For Change*, 45 TAX LAW. 1031, 1036-37 (1992).

39. *Houston Chronicle*, 481 F.2d at 1249. The court explained that it had previously defined goodwill as "the expectancy that the old customers will resort to the old place . . ." (quoting *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963)).

40. *Id.* at 1251.

41. *Id.* at 1247.

42. *Id.* at 1248, 1251.

amortized.<sup>43</sup>

In essence, *Houston Chronicle* rejected the traditional per se mass asset rule as it had been known. Since that decision, the rule has had little significance in cases involving customer-based intangibles; instead, courts have focused on the factual question of whether the asset has a limited useful life and a value separate from goodwill.<sup>44</sup> The *Houston Chronicle* decision is also significant because the court accepted evidence that was only "reasonably accurate," explaining that "[e]xtreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand."<sup>45</sup>

Following the *Houston Chronicle* decision, the IRS issued a revenue ruling<sup>46</sup> that states: "Customer and subscription lists, location contracts, insurance expirations,<sup>47</sup> etc. are not, as a matter of law, indistinguishable from goodwill possessing no determinable useful life."<sup>48</sup> The ruling further explains that in order to determine if an intangible asset may be amortized, the taxpayer must establish that the asset meets the

---

43. *Id.* at 1249. In sustaining the jury verdict that the taxpayer had met its burden by proving that the subscription lists had a value distinct from goodwill and had a limited useful life of five years, the court in *Houston Chronicle* took the following evidence into consideration: first, testimony of taxpayer's employees, based on their experience, regarding the cost of obtaining new subscriptions and the anticipated useful life of a subscription list of a newspaper in the Houston area, second, corroborative testimony from valuation engineers on the same topics, and finally, the results of a survey of the current subscribers of the *Houston Chronicle* regarding the length of the average subscription. *Id.* at 1253.

44. See *Levy, supra* note 29, at 6. See, e.g., *Donrey, Inc. v. United States*, 809 F.2d 534, 535 (8th Cir. 1987) (taxpayer was permitted to depreciate a newspaper subscription list because the list had a life of 23 years with an ascertainable value separate from goodwill); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Cl. Ct. 1976) (taxpayer was entitled to depreciate insurance expirations, which are customer lists of insurance policies indicating the type of policy, the coverage, and the termination date of each policy, because the assets were separate from goodwill and had a limited useful life, the duration of which could be established with reasonable accuracy).

45. *Houston Chronicle*, 481 F.2d at 1253-54. See John B. Palmer III, *Recent Developments in Tax Accounting*, in 4 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, FINANCINGS, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS 115, 174 (PLI Series No. J4-3652, 1991).

46. The National Office of the IRS writes revenue rulings as interpretations of tax law; however, revenue rulings tend to be less persuasive than regulations because they do not carry as much legal force. They are, instead, intended to lend guidance to taxpayers and IRS personnel when dealing in ordinary tax matters. LAWRENCE C. PHILLIPS & WILLIAM H. HOFFMAN, JR., WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES 41 (1979).

47. An insurance expiration is a copy of an insurance policy whose main purpose is to indicate which policies are in need of renewal. *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 450 (Cl. Ct. 1976).

48. Rev. Rul. 74-456, 1974-2 C.B. 65, 66.

two prong test defined in *Houston Chronicle*.<sup>49</sup> The IRS also notes, however, that only in “an unusual case” will the taxpayer be able to meet its burden; a customer-based intangible will generally be considered goodwill and thus non-amortizable.<sup>50</sup>

Generally, courts have employed two different methods of applying the first prong of the *Houston Chronicle* test, which asks whether the asset has an ascertainable value separate and distinct from goodwill. One approach requires the taxpayer to prove that the asset has both an ascertainable value *and* that it is separate from goodwill.<sup>51</sup> Under this interpretation, goodwill is generally defined as the “expectancy of continued patronage.”<sup>52</sup> With regard to customer-based intangibles, the burden is very difficult to meet because most assets of this sort are linked with the expectancy of continued patronage.

The other interpretation of the first prong requires only that the taxpayer prove the ascertainable value of the asset; if that can be proven, the “distinguishable from goodwill” requirement is automatically met.<sup>53</sup> Courts have reasoned that the value of goodwill is merely the remaining purchase price which exceeds the identifiable accounted for assets.<sup>54</sup> Therefore, if a definite value, not just the residual value, may be placed on an asset, the asset automatically must not be goodwill.<sup>55</sup>

Although *Houston Chronicle* signaled a changing attitude toward the amortization of intangibles, it did not clear the path completely. Under the facts of the case, because the taxpayer had purchased Houston Press intending to discontinue operation of that newspaper, and continued patronage was not a consideration, the acquired subscription lists looked more clearly distinguishable from goodwill. In contrast, customer lists purchased as part of a going-concern that will continue to function are

---

49. *Id.*

50. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1677 (1993). *See* *Sunset Fuel Co. v. United States*, 519 F.2d 781, 784 (9th Cir. 1975) (customer list was not amortizable because the taxpayer could not sufficiently prove that the value of the list was distinguishable from goodwill).

51. *Pissott*, *supra* note 38, at 1032 (citing *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 560 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993)).

52. *See, e.g., Houston Chronicle Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973).

53. *Pissott*, *supra* note 38, at 1032. *See also* *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 454 (Ct. Cl. 1976) (intangible asset is separate and distinct from goodwill if it can be shown to have an ascertainable value and a limited useful life); *Colorado Nat'l Bankshares v. Commissioner*, 60 T.C.M. (CCH) 771 (1990).

54. This method of valuing goodwill is known as “the residual method.” *See, e.g., Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 789 (goodwill is valued using the residual method).

55. *Id.*

not as clearly separable from goodwill.<sup>56</sup> Subsequently however, courts have gradually lowered the burden of proof threshold that taxpayers must sustain before customer-based intangible assets can be amortized.

*E. A Shift Toward Greater Acceptance of the Amortization of Customer-Based Intangibles*

After the *Houston Chronicle* court held that the possibility of amortization is a question of fact, taxpayers increasingly attempted to amortize a large number of customer-based intangible assets. Although courts rarely cited the mass asset rule as a rationale for preventing an allowance of amortization, discussion of the rule did not cease completely. In *Richard S. Miller & Sons, Inc. v. United States*,<sup>57</sup> the court held that the useful life of 1,383 insurance expirations purchased with an insurance business should be determined from facts pertaining to the single mass asset, rather than facts relative to each individual policy.<sup>58</sup> However, if the taxpayer could demonstrate that the grouped asset had a limited useful life, in other words it was a wasting asset, then the court would permit an amortization deduction.<sup>59</sup>

Utilizing statistical evidence, the court found that the group of expirations was due to lapse within five years from the date of purchase, and any renewals after that period would be credited to the efforts of the taxpayer, not to the goodwill of the prior owner.<sup>60</sup> The assets were considered distinct from goodwill and, therefore, amortizable because they were deemed to have a limited useful life and an ascertainable value.<sup>61</sup> In this case, despite the fact that the court chose to view the expirations as a single, mass entity, under Revenue Ruling 74-456 the court was forced to determine whether the asset was amortizable as a matter of fact, not as a matter of law.

*Citizens & Southern Corp. v. Commissioner*<sup>62</sup> is another significant case in the evolution of amortization deduction with respect to customer-based intangible assets. In *Citizens & Southern*, the taxpayer who had acquired nine banks attempted to amortize the deposit base of the

---

56. Palmer, *supra* note 45, at 174.

57. 537 F.2d 446 (Ct. Cl. 1976).

58. *Id.* at 454.

59. *Id.* at 452 (citing *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667, 668 (3d Cir. 1969)).

60. *Id.* at 455.

61. *Id.* at 457.

62. 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

purchased banks.<sup>63</sup> Several courts had previously refused to allow amortization of deposit bases reasoning that such bases serve as a foundation for the customer/bank relationship by which the bank offers services to the customer, and therefore are indistinguishable from goodwill.<sup>64</sup> However, the *Citizens & Southern* court chose to divert its attention from "the separate and distinct from goodwill" requirement and instead focused on the question of whether the asset had an ascertainable value and a limited useful life.<sup>65</sup> The taxpayer made an elaborate demonstration of the analytical methods used to establish the asset's value and limited useful life. Essentially, the value allocated to the core deposits was presented as the difference in cost between the maintenance of the acquired core deposits and the maintenance of alternative sources of funding for loans and other investments.<sup>66</sup> The court accepted the proof presented by Citizens & Southern and thus held the deposit base to be amortizable.<sup>67</sup>

Although this case was a victory for the taxpayer, some worried that the extensive evidence supplied by the Citizens & Southern Corporation may have established a particularly high standard of proof that must be met before amortization of an intangible asset would be permitted.<sup>68</sup> However, this concern was dispelled in *Colorado National Bankshares, Inc. v. Commissioner*<sup>69</sup> when the court permitted the amortization of a deposit base with less than exceptional proof.

In *Colorado National Bankshares*, the facts closely paralleled those of *Citizens & Southern*. The court also explained that because the taxpayer was able to establish the asset's value and limited useful life, it was separable from goodwill.<sup>70</sup> "The most significant indication that an

---

63. *Id.* at 473. The term "deposit base" refers to "the intangible asset that arises in a purchase transaction representing the present value of the future stream of income to be derived from employing the purchased core deposits[transaction accounts, regular savings accounts, and time deposit open accounts] of a bank." *Id.* at 465.

64. *See, e.g.,* AmSouth Bancorporation & Subsidiaries v. United States, 681 F. Supp. 698 (N.D. Ala. 1988); *see also* Southern Bancorporation, Inc. v. Commissioner, 847 F.2d 131 (4th Cir. 1988) (asset was not amortizable because the taxpayer failed to prove the useful life of the deposit base because it relied on account data from years subsequent to the years in question as its evidence).

65. John L. Cleary II, Comment, *Core Deposit Base: Goodwill or Not Goodwill—Is That the Question?*, 39 CATH. U. L. REV. 795, 797 (1990).

66. *Citizens & Southern Corp.*, 91 T.C. at 510.

67. *Id.* at 498, 512.

68. Palmer, *supra* note 45, at 175.

69. 60 T.C.M. (CCH) 771 (1990).

70. *Id.* at 789-90.



intangible asset is separate and distinct from goodwill is that its useful life can be shown with reasonable accuracy to be of limited duration."<sup>71</sup> Thus, because the taxpayer's studies and method of establishing the deposit base's useful life satisfied the court, the asset was considered amortizable.<sup>72</sup> Because the court determined that extraordinary proof like that delivered in *Citizens & Southern* was not necessary, the path toward greater allowance of amortizing intangible assets was once again broadened. This case set the stage for the landmark decision of *Newark Morning Ledger Co.*

### III. *NEWARK MORNING LEDGER CO. v. UNITED STATES*<sup>73</sup>

#### A. *Facts and Procedural History*

In 1976 The Herald Company (Herald) bought most of the outstanding stock of Booth Newspapers, Inc. (Booth).<sup>74</sup> Booth had published daily and Sunday newspapers for eight Michigan locations with a total of approximately 460,000 customer subscriptions.<sup>75</sup> On May 31, 1977 Herald and Booth merged, and Herald took over the responsibility of publishing the eight newspapers.<sup>76</sup> Approximately \$328 million was determined to be Herald's adjusted basis<sup>77</sup> in the Booth shares prior to the merger.<sup>78</sup> Herald allocated the adjusted basis among financial assets, tangible assets, goodwill, and paid subscribers.<sup>79</sup> Specifically, \$67.8 million was allocated to the value of the "paid subscribers."<sup>80</sup> This asset was described as the estimated future earnings that would be produced by the 460,000 subscribers who

---

71. *Id.* at 790 (citing *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Ct. Cl. 1976)).

72. *Id.* at 792.

73. 113 S. Ct. 1670 (1993).

74. *Id.* at 1672.

75. *Id.*

76. *Id.* The Michigan newspapers were as follows: The Ann Arbor News, The Bay City Times, The Flint Journal, The Grand Rapids Press, The Jackson Citizen Patriot, The Kalamazoo Gazette, The Muskegon Chronicle, and The Saginaw News. *Id.* at 1672 n.2.

77. The cost of an asset is known as the basis of that asset. The adjusted basis is said to equal the unadjusted basis plus the capital improvements made minus depreciation or amortization allowed. For example, if X bought a piece of equipment for \$1000 (the unadjusted basis) with a useful life of 10 years and then depreciated the asset \$100 per year and made a capital improvement to the asset worth \$500, after two years the adjusted basis of the asset would be \$1300. See 26 U.S.C. §§ 1011-12 (1986).

78. *Newark Morning Ledger Co.*, 113 S. Ct. at 1672.

79. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 556 (3rd Cir. 1991).

80. *Newark Morning Ledger Co.*, 113 S. Ct. at 1673.

would speculatively continue their patronage after the merger with Herald.<sup>81</sup> Additionally, \$26.2 million was allocated to goodwill and going-concern as an asset separate from the paid subscribers.<sup>82</sup> From 1977 through 1980, Herald claimed an amortization deduction for the \$67.8 million figure which had been allocated to the customer list asset; however, the IRS denied this deduction, reasoning that the value of the paid subscribers is inextricably linked with goodwill and therefore is per se non-amortizable.<sup>83</sup> Accordingly, Herald paid in full the additional taxes that the IRS determined it owed.<sup>84</sup>

In 1987, Newark Morning Ledger Co. (Ledger), a newspaper publisher whose principal place of business is in Newark, New Jersey, merged with Herald and subsequently became its successor.<sup>85</sup> Ledger then filed for a refund with the IRS alleging that Herald should have been allowed a deduction for the amortization of the 460,000 paid subscribers.<sup>86</sup> When the IRS failed to respond, Ledger filed suit in federal district court for a tax refund.<sup>87</sup>

Facing a bench trial, Ledger argued that the subscription list is amortizable because it has both an ascertainable value separate from goodwill and a limited useful life the duration of which may be determined with reasonable accuracy.<sup>88</sup> Using statistical techniques to calculate factors such as "death, relocation, lack of reader time, and changing life-styles," experts for Ledger estimated the duration of an average subscription for each of the eight newspapers.<sup>89</sup> Other factors such as competition with other newspapers and media sources were also named as determinants of subscription duration.<sup>90</sup>

Using the "income approach,"<sup>91</sup> Ledger attempted to support its claim that the paid subscribers assets were valued at \$67.8 million.<sup>92</sup> Ledger's experts testified that buyers and sellers would determine the extra price to be paid for the subscription list by subtracting the cost of

---

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* at 1672.

86. *Id.* at 1672-73.

87. *Id.* at 1673.

88. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 180 (1990).

89. *Id.*

90. *Id.*

91. The "income approach" is the method of valuing an asset by determining what price would be put on that asset in the market. *Id.* at 182.

92. *Id.* at 183.

revenue collection from the subscription revenue itself.<sup>93</sup> Using this method, Ledger argued, the fair market value of the subscription list was determined with reasonable accuracy.<sup>94</sup>

In response, the Government did not focus its argument on challenging Ledger's evidence; in fact, it "stipulated" to the estimated length of the useful lives of the paid subscriptions,<sup>95</sup> a litigation strategy which later proved to be unwise. With respect to the value of the customer lists, the Government did not challenge Ledger's actual calculation; instead, the Government claimed that the cost approach,<sup>96</sup> rather than the income approach, should have been used to value the asset.<sup>97</sup> To illustrate the cost approach, the Government argued that the value attributable to the customer list is equal to the cost of creating a new list.<sup>98</sup> The government presented expert testimony estimating the cost of creating such a list to be \$3 million.<sup>99</sup>

In essence, the Government relied on the argument that the asset was not separable from goodwill and consequently was non-amortizable.<sup>100</sup> The future revenue of the subscriptions acquired from Booth was a product of customers' continued patronage to the publication, and this, the Government argued, was the essence of goodwill.<sup>101</sup>

#### B. *The District Court Decision*

At the district court level, Judge H. Lee Sarokin ruled in favor of Ledger. The court did not question Ledger's estimation of the useful life of the paid subscriptions because the Government stipulated to those figures.<sup>102</sup> Furthermore, in light of the fact that the Government did not offer sufficient evidence to challenge Ledger's method of valuation of the asset, the court accepted both the methodology and valua-

---

93. *Id.* at 182. The subscription revenue was determined by calculating the present value of the gross income stream produced over the estimated lifetime of the subscription list. *Id.*

94. *Id.*

95. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1673 (1993).

96. The "cost approach" is the method of valuing an asset by determining the actual cost of generating the asset—in these circumstances—the cost of generating 460,000 new subscribers. *Id.*

97. *Id.* at 1682.

98. *Id.*

99. Respondent's Brief, *Newark Morning Ledger Co. v. United States*, 1992 WL 541266 (Nov. 10, 1992).

100. *Newark Morning Ledger Co.*, 113 S. Ct. at 1673.

101. *Id.*

102. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 181 (1990).

tion presented by Ledger.<sup>103</sup>

The court was also satisfied that the asset in question was distinguishable from goodwill. It reasoned that, by definition, goodwill has an unlimited useful life and can only be valued by means of the residual method.<sup>104</sup> Accordingly, the court determined that because the duration of the asset's limited life and its value had been determined with reasonable accuracy, the asset is separate from goodwill.<sup>105</sup> In furtherance of its determinations, the court held that Ledger could amortize the value of the subscription list in question over the stipulated life span of each newspaper.<sup>106</sup>

### C. *The Appellate Court Decision*

On appeal, the Third Circuit reversed the district court decision, explaining that the wrong definition of "goodwill" had been applied.<sup>107</sup> It rejected the lower court's determination that any asset which possesses an ascertainable useful life and value is automatically not linked to goodwill.<sup>108</sup> The Third Circuit explained that while some courts have chosen to adopt that approach, the true test of amortization is whether the asset is "separate and distinct from goodwill."<sup>109</sup> To establish that an asset is "separate and distinct from goodwill," its value must be distinguishable from the "expectation of continued patronage."<sup>110</sup> Because Ledger failed to satisfy its burden of demonstrating that the customer list had a value separate from the expectation of continued patronage, the court concluded that the asset was linked with goodwill and thus was non-amortizable.<sup>111</sup>

### D. *The United States Supreme Court Decision*

Newark Morning Ledger appealed the circuit court opinion and the United States Supreme Court granted certiorari.<sup>112</sup>

---

103. *Id.* at 182.

104. *Id.* See *supra* text accompanying note 54.

105. *Id.* at 183.

106. *Id.* at 184.

107. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 568 (1991).

108. *Id.* at 567.

109. *Id.* at 568.

110. *Id.* at 567.

111. *Id.* at 568.

112. *Newark Morning Ledger Co. v. United States*, 112 S. Ct. 1583 (1992).

# 1. The Majority Decision

In a 5-4 decision, Justices Stevens, O'Connor, Kennedy, and Thomas joined Justice Blackmun holding in favor of Ledger, the Petitioner.<sup>113</sup> Justice Blackmun first pointed out that questions of amortization of intangible assets have arisen because "goodwill" has not been defined by the Code or the Treasury Department Regulations.<sup>114</sup> Although a generally accepted definition of goodwill is the expectation of continued patronage, the Court explained that almost all intangible assets are somehow linked to future patronage, and therefore that definition is of little use.<sup>115</sup>

Examining the role of goodwill, the Court addressed *Red Wing Malting Co. v. Willcuts*,<sup>116</sup> in which the Eighth Circuit Court of Appeals held that goodwill is non-amortizable because it has an unlimited useful life.<sup>117</sup> The Government agreed with *Red Wing* and stated in its brief, "[t]he premise of the regulatory prohibition against the depreciation of goodwill is that, like stock in a corporation, a work of art, or raw land, goodwill has no determinate useful life of specific duration."<sup>118</sup> Accordingly, when an intangible asset is shown to waste over an ascertainable period, the asset may not be deemed goodwill and its amortization must be permitted.<sup>119</sup> Justice Blackmun noted that this approach is "more faithful to the purposes of the Code," for the Code attempts to accurately measure net income by matching revenues and expenses in a particular tax period.<sup>120</sup>

Specifically, the Court articulated a three prong test, similar to the *Houston Chronicle* test, that must be met before an intangible asset may be amortized. First, the asset must have an ascertainable value; second, it must have a limited useful life, the duration of which can be determined with reasonable certainty; and third, the asset cannot be self-regenerating.<sup>121</sup> Therefore, if a taxpayer can meet its burden and satisfy this test, the asset is amortizable regardless of the asset's relationship

---

113. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1671 (1993).

114. *Id.* at 1675.

115. *Id.*

116. 15 F.2d 626 (8th Cir. 1926).

117. *Newark Morning Ledger Co.*, 113 S. Ct. at 1680.

118. *Id.* at 1680 (quoting Respondent's Brief, *supra* note 99, at \*13).

119. *Id.* at 1680.

120. *Id.* (quoting *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992)).

121. *Id.* at 1680-81.

to the expectation of continued patronage.<sup>122</sup>

The Court acknowledged under this test a taxpayer's burden of proof is a significant one: "[T]hat burden will often prove too great to bear."<sup>123</sup> The circumstances of the *Ledger* case, however, were unique. Because the Government had offered little evidence challenging Ledger's valuation of the asset and had stipulated to the duration of the customer list's useful life, Ledger had an easier time meeting its burden of proof with regard to the first two prongs of the test.<sup>124</sup> The Court did, however, address the Government's miscalculation of the value of the list. It rejected the Government's contention and the court of appeals' finding that the value of the asset was equal to the cost of locating 460,000 new subscribers.<sup>125</sup> The Court determined that the customer list's value was attributable to the fact that those subscribers had provided long-term, reliable patronage in the past and would be more likely than new customers to continue to be a source of revenue in the future.<sup>126</sup> Therefore, Justice Blackmun reasoned, a list of new subscribers would not be nearly as valuable as a list of "seasoned" customers. Accordingly, the Court held that the value of the asset was equal to the price that would be exchanged between a buyer and seller for that asset.

With respect to the third prong of the test, the Court was satisfied that the 460,000 paid customers consisted of a finite number of subscriptions, and each subscription would not automatically be replaced when another one terminated.<sup>127</sup> Therefore, the list was not self-regenerating.<sup>128</sup> Because the Court determined that the mass asset rule only applied when the individual assets within the mass are self-regenerating, it found that the mass asset rule<sup>129</sup> does not apply to customer-based intangibles.<sup>130</sup> However, it did conclude that the mass asset rule is not completely outdated and may be applied to some assets such as an assembled workforce under certain circumstances.<sup>131</sup>

---

122. *Id.* at 1681.

123. *Id.*

124. *Id.*

125. *Id.* at 1682.

126. *Id.*

127. *Id.* at 1681.

128. *Id.*

129. *See supra* part II.C.

130. *Newark Morning Ledger Co.*, 113 S. Ct. at 1681.

131. *Id.* at 1677 (citing *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253, 267 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994)).

The Court reversed the Third Circuit opinion, concluding that the customer list's relationship to the expectation of continued patronage was irrelevant because the taxpayer had proved that the list had an ascertainable, non-self-regenerating value and a limited life, the duration of which could be determined with reasonable accuracy.<sup>132</sup>

## 2. Justice Souter's Dissenting Opinion

In dissent, Justice Souter, joined by Chief Justice Rehnquist, Justice White, and Justice Scalia, explained that goodwill has historically and legally been understood to be "the prospect that 'old customers will resort to the old place.'"<sup>133</sup> He argued that under this accepted definition, the customer list acquired from Booth was undoubtedly linked to goodwill.<sup>134</sup> Justice Souter argued that this asset should then be deemed non-amortizable since Treasury Regulation Section 1.167(a)-3 specifically prohibits amortization of goodwill as a matter of law.<sup>135</sup> Justice Souter pointed out that Ledger had attempted to maneuver around this obstacle by claiming that the Court should adopt a new definition of goodwill which would focus on the life span and value of the asset.<sup>136</sup> When the Court accepted this postulate, Justice Souter argued, it deserted an accepted interpretation of Treasury Regulation 1.167(a)-3 that courts had relied upon for 65 years.<sup>137</sup> He further stated, "[t]he consequences, therefore, of acceding to Ledger's argument are at once a rejection of statutory interpretation settled by Congress itself through reenactment of the tax code and a further invasion of the political domain to rewrite a Treasury regulation."<sup>138</sup>

Justice Souter went on to explain that even if Ledger's approach to defining goodwill had been justly adopted, the Petitioner had failed to meet its evidentiary burden of proving that the customer list had a limited useful life, the duration of which could be determined with reasonable certainty.<sup>139</sup> He suggested that if goodwill is to be amortized, only the goodwill existing at the purchase date may be amortized,

---

132. *Id.* at 1683.

133. *Id.* at 1684 (Souter, J., dissenting) (quoting *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (1971)).

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 1685.

138. *Id.*

139. *Id.* at 1686.

not goodwill acquired after the merger.<sup>140</sup> According to the dissenting opinion, Ledger's expert improperly assumed that the customers on the subscription list would be just as satisfied with the newspaper after Herald took over as when Booth owned the publication.<sup>141</sup> "Since, however, only the date-of-sale probability of faithfulness could be entitled to depreciation as a purchased asset, Ledger's expert on his own terms has not even claimed to make the showing of definite duration necessary to depreciate an asset under § 167(a)."<sup>142</sup>

Justice Souter argued, therefore, that regardless of which definition of goodwill was used, Newark Morning Ledger should have lost the suit.

#### IV. SECTION 197

In response to the growing amount of litigation over the amortization of intangible assets, Congress proposed numerous pieces of legislation in the early 1990s that would clarify the Code on this issue. The proposals were crafted to explain and simplify an area of the law that has received recent attention from the courts but scant attention from the legislature.<sup>143</sup>

One bill, H.R. 1456,<sup>144</sup> proposed specifically to prohibit the amortization of goodwill or going-concern,<sup>145</sup> but to permit the amortization of customer-based intangibles that are proven to have both an ascertainable value and a limited life span that can be reasonably estimated.<sup>146</sup> This bill also granted the Treasury Department the authority to set methods for valuing certain intangible assets and to define life spans for certain intangible assets.<sup>147</sup>

Another proposed bill, H.R. 563,<sup>148</sup> suggested the specific preclusion of the amortization of customer-based or market share intangible

---

140. *Id.*

141. *Id.* at 1688.

142. *Id.* at 1688-89.

143. Blake D. Rubin & Samuel Olchik, *1993 Tax Act Provisions Affecting Business*, in ALI-ABA COURSE OF STUDY MATERIALS: 1993 TAX ACT PROVISIONS AFFECTING BUSINESS 149, 149 (Oct. 21, 1993).

144. H.R. 1456, 102nd Cong., 1st Sess. (1991) was sponsored by Representatives Guy Vander Jagt (R-Mich.), Beryl F. Anthony, Jr. (D-Ark.), and Barbara B. Kennelly (D-Conn.).

145. *See infra* note 157.

146. Pissott, *supra* note 38, at 1040.

147. *Id.*

148. H.R. 563, 102nd Cong., 1st Sess. (1991) was sponsored by Representative Donnelly.



assets, including goodwill and going-concern value.<sup>149</sup>

However, neither of these bills was enacted; instead H.R. 3035<sup>150</sup> was adopted by Congress in the Omnibus Budget Reconciliation Act of 1993 and promulgated as § 197<sup>151</sup> of the Code.<sup>152</sup> This legislation became effective on the date of its enactment, August 2, 1993; however, a taxpayer could elect to apply § 197 to any assets purchased after July 25, 1991.<sup>153</sup>

Section 197 allows for the straight line method of amortization for almost all intangible assets over a fifteen year period.<sup>154</sup> This rule applies to § 197 intangibles that were acquired in connection with a trade or business or in a separate transaction, but it does not apply to self-created intangible assets, such as the cost of creating a customer relationship through advertising.<sup>155</sup> Those intangible assets that are included in the definition of § 197 intangibles are: goodwill,<sup>156</sup> going-concern value,<sup>157</sup> work force, information base assets,<sup>158</sup> know-how,<sup>159</sup> customer-based intangibles, supplier-based intangibles, other similar intangibles,<sup>160</sup> government licenses and permits, covenants not to compete, franchises, trademarks, and tradenames.<sup>161</sup> Certain other

---

149. Pissott, *supra* note 38, at 1040.

150. H.R. 3035, 102nd Cong., 1st Sess. (1991) was sponsored by Ways and Means Chairperson Dan Rostenkowski (D-Ill.).

151. 26 U.S.C. § 197 (Supp. 1994).

152. Section 197 was passed by a narrow margin of 218 to 216 in the House and 51 to 50 in the Senate. George Brode, Jr., *Structuring Taxable Acquisitions of Intangibles Under Section 197*, 60 TAX NOTES 1011, 1012 (1993).

153. STAFF OF HOUSE COMM. ON WAYS & MEANS, 103D CONG., 1ST SESS., REPORT ON FISCAL YEAR 1994 BUDGET RECONCILIATION 11, at 340 (Comm. Print 1993) [hereinafter Committee Report].

154. Annette Nellen, *RRA '93 Simplifies Rules on Acquired Intangible Assets*, 51 TAX'N FOR ACCT. 268 (1993).

155. *Id.*

156. Goodwill, for purposes of § 197, is defined as "the value of a trade or business that is attributable to the expectancy of continued patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor." Committee Report, *supra* note 153, at 324.

157. "Going-concern value" is "the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern." *Id.*

158. "Information base assets" include, but are not limited to, business records, books, and operating systems. *Id.* at 325.

159. "Know-how" includes, but is not limited to, any patent, copyright, formula, process, design, pattern, or format. *Id.*

160. "Any similar intangible" refers to any asset that is similar to work force, information base, know-how, customer-based intangibles, or supplier-based intangibles but does not succinctly fit into one of those categories. *Id.* at 326.

161. 26 U.S.C. § 197 (Supp. 1994).

intangible assets are excluded from the definition of § 197 intangibles regardless of whether the asset was acquired as part of a trade or business, or in a separate transaction. Depending upon the asset, it may be excluded because it has been determined to be non-amortizable or to have an amortization period of less than fifteen years.<sup>162</sup> These excluded assets are: interests in land, computer software, financial interests,<sup>163</sup> leases of tangible property, indebtedness, professional sport franchises, transaction costs,<sup>164</sup> and mortgage servicing rights.<sup>165</sup> Other intangible assets are also excluded from the definition of § 197 intangibles, but only if they were acquired in a transaction separate from the acquisition of a trade or business. These excluded assets are: any interest in a film, sound recording, or book; any right to receive tangible property under a contract, patents or copyrights; and any right under a government contract with a fixed duration of less than fifteen years.<sup>166</sup>

## V. ANALYSIS

### A. *A Debate Over the Changing Role of the Mass Asset Rule*

Since the Fifth Circuit decision in *Houston Chronicle Co. v. United States*, there has been an on-going debate between taxation scholars over the changing role of the mass asset rule. The mass asset rule<sup>167</sup> provides that certain intangible assets are grouped together as one asset. Although the separate components of the mass asset may fluctuate, the asset as a whole does not waste and therefore is non-amortizable.

One proponent of the mass asset rule, Calvin Johnson, argues that *Houston Chronicle*, which made the mass asset rule insignificant, was decided incorrectly and therefore should have had no influence on the *Ledger* decision.<sup>168</sup> He analogizes a customer-based asset to a leaky bucket that is continually being refilled.<sup>169</sup> Although water is always

---

162. Nellen, *supra* note 154, at 270.

163. "Financial interests" include, but are not limited to, stock, interests in future contracts, partnership interests, and interests in trusts or estates. 26 U.S.C. § 197(e)(1).

164. "Transactions costs" include but are not limited to any fees for professional services. 26 U.S.C. § 197(e)(8).

165. 26 U.S.C. § 197.

166. *Id.*

167. *See supra* part II.C.

168. Calvin H. Johnson, *Newark Morning Ledger: Intangibles Are Not Amortizable*, 57 TAX NOTES 691, 692 (1992).

169. Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56

dripping out of the bucket, new water is constantly replacing it to the same level.<sup>170</sup> Similarly, in Johnson's view, the level of customer subscriptions, or any other customer based intangible, is constantly being maintained with the replenishment of new assets, and thus the asset is non-wasting and non-amortizable.<sup>171</sup>

If amortization of a customer-based intangible is permitted, Johnson argues, the *effective* tax rate paid by the purchaser would drop below the corporate statutory rate set by Congress, for the taxpayer is able to amortize an asset that has not decreased in value.<sup>172</sup> Under this system, taxpayers who acquire customer-based intangibles through corporate buyouts receive an undeserved tax benefit, leaving the IRS in a revenue losing situation. Because the Supreme Court decision in *Ledger* provides that the mass asset rule may not be applied to a customer-based asset, Johnson claims the "decision is an embarrassment to the law and it needs to be narrowly construed."<sup>173</sup>

On the other hand, opponents of the mass asset rule, such as Stephan C. Gerard, argue that the leaky bucket analogy is flawed. First, the addition of new customers to a list is not necessarily intended to replace old customers in order to maintain a constant level.<sup>174</sup> Although the number of customers leaving an operation may have some effect on the number of incoming customers, there is no certain and direct correlation between the two to justify the application of the mass asset rule.<sup>175</sup>

Second, Gerard claims that if the mass asset rule were applied, taxpayers would not be permitted either to expense the cost of soliciting new customers or amortize that cost ratably over the life of the new customers.<sup>176</sup> Therefore, a taxpayer would be unable to take any deduction for its expenditure for attracting new customers.<sup>177</sup> Congress did not intend for the government to be the recipient of such a wind-

---

TAX NOTES 629, 631 (1992).

170. *Id.*

171. *Id.*

172. See Calvin H. Johnson, *Amortization of Intangibles: Impact of Seller Tax*, 59 TAX NOTES 285, 286 (1993).

173. Calvin H. Johnson, *Texas Law Professor Believes IRS Can Settle Intangible Cases*, 94 TAX NOTES TODAY 23-105, 23-110 (1994).

174. Stephen C. Gerard, *Mass Asset Rule = Mass Confusion*, 57 TAX NOTES 805, 806 (1992).

175. *Id.* at 807.

176. Stephen C. Gerard, *The Continuing Controversy Over Moring Ledger and the Mass Asset Rule*, 93 TAX NOTES TODAY 4-65, 4-67 (1993).

177. *Id.*

fall.<sup>178</sup>

Those who oppose the mass asset rule also tend to disagree with the *Ledger* decision with regard to the application of the rule. Although the Court held that the mass asset rule does not apply to customer-based intangibles,<sup>179</sup> it did find it could be applicable to an assembled work force.<sup>180</sup> The *Ledger* majority held that the taxpayer had proven that the mass asset rule did not apply to the purchased lists because "[t]he asset was not composed of constantly fluctuating components; rather, it consisted of identifiable subscriptions each of which had a limited useful life that could be estimated with reasonable accuracy according to generally accepted statistical principles."<sup>181</sup>

Under this holding, it would seem that the mass asset rule should not be applicable to any intangible, including an assembled work force, because a work force could be deemed to be a finite set of employees at the date of the acquisition, each having a limited useful life, the duration of which could be ascertained with reasonable accuracy.<sup>182</sup> If § 197 had not been enacted, dissolving the issue of the mass asset rule, the *Ledger* opinion may have left confusion and questions unanswered regarding the application of the rule.

#### B. *Implications of the Supreme Court Decision in Ledger On the Enactment of § 197*

The Supreme Court decision in *Newark Morning Ledger* was the final step toward permitting the amortization of intangible assets before the enactment of § 197. *Ledger* had a substantial impact on taxpayers' ability to obtain amortization deductions when they purchased customer-based intangibles prior to the adoption of this legislation. By declaring that an intangible asset may be amortized if the taxpayer has met the three prong test,<sup>183</sup> regardless of the asset's connection to the expectation of continued patronage, the Court effectively eliminated the IRS's main argument against amortization. The *Ledger* decision precluded the IRS from arguing that goodwill-related assets may not be amortized as

---

178. See Gerard, *supra* note 174, at 808.

179. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1681 (1993).

180. *Id.* at 1677 (citing *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994)).

181. *Id.* at 1681.

182. George L. Middleton, Jr. & Christian M. McBurney, *The Morning After Newark Morning Ledger: What Should Taxpayers Do Now?*, 93 TAX NOTES TODAY 103-82 (1993).

183. See *supra* text accompanying note 121.

a matter of law; instead, it was forced to concentrate on factual inquiries regarding the method of valuing the asset, the asset's claimed limited life, and the period over which the asset should be amortized.<sup>184</sup> In other words, the thrust of the Government's new approach to prevent the amortization of customer-based intangibles must be an aggressive attack on the taxpayer's evidence used to satisfy it.<sup>185</sup> Accordingly, it became necessary for the taxpayer to develop extensive, well-reasoned evidence through documentation and use of appraisers, accountants, and other financial experts in order to meet their significant burden.<sup>186</sup>

Despite the clarification of the law as it applies to intangible assets in *Ledger*, the decision left many questions unanswered and disputes between the IRS and taxpayers continued. Under the fact-based approach, purchasers of small, less profitable businesses were greatly disadvantaged, because they would be unable to hire high priced experts needed to meet their significant burden of proof; only those taxpayers with substantial financial resources could afford to obtain the tax benefit of amortization.<sup>187</sup> The fact-based approach also encouraged large acquisitions because the tax benefit that could be gained from amortizing a substantial amount of goodwill, which is usually involved with such acquisitions, almost always justifies the amount of money that would be spent on experts and litigation.<sup>188</sup> By logical extension, acquisitions of small enterprises were discouraged.

By allowing the cost of almost all intangible assets to be amortized over a fifteen-year period, § 197 balances the playing field between large and small business owners and resolves questions *Ledger* left unanswered. Congress promulgated this piece of legislation to simplify the law regarding the tax treatment of intangibles and to end controversies over whether particular intangible assets are amortizable; what portion of the purchase price in the acquisition of a trade or business can be allocated to an amortizable intangible asset; what is the proper method of amortization; and over what period should the asset be amor-

---

184. Mark Wertlieb et al., *The Amortization of Purchased Intangible Assets*, 24 TAX ADVISER 583, 589 (1993).

185. David G. Jaeger, *Supreme Court Decides Newark Morning Ledger Co.*, 71 TAXES 406, 413 (1993).

186. See *Newark Morning Ledger Co. v. United States*, 113 S. Ct. at 1681. See also Brian R. Greenstein, *The Depreciation of Customer-Based Intangible Assets After Newark Morning Ledger*, 20 J. CORP. TAX'N 315, 324 (1994).

187. Middleton, *supra* note 182.

188. *Id.*

tized.<sup>189</sup> As the legislative history explains, "much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets by treating acquired goodwill and going-concern value as amortizable intangible assets."<sup>190</sup>

Under § 197 there are no longer controversies over which assets may be amortized, for the statute specifically lists which are subject to amortization and which are excluded. Nor are there controversies over the useful life of intangibles, for all § 197 intangibles are amortized over fifteen years. However, these benefits did not come without a cost.

### *C. Advantages, Disadvantages, and Repercussions of § 197 to the Taxpayer*

Taxpayers may face one disadvantage of § 197 if they wish to amortize an intangible with a useful life less than fifteen years. For example, under former law, covenants not to compete could normally be written off over a three year period; however, under this new legislation taxpayers are forced to amortize their non-competition covenants over fifteen years regardless of the length of the covenant.<sup>191</sup> The acquisition of a trade or business which includes such a covenant is no longer as valuable to a purchaser as it may have been prior to § 197. Therefore, some taxpayers think that they could have gained a better tax advantage under the fact-based approach of *Ledger* than the § 197 approach.<sup>192</sup>

However, under *Ledger* an immense amount of money and preparation time often had to be invested in litigation against the IRS before the amortization of an intangible asset was authorized. Furthermore, taxpayers would have extreme difficulty proving that certain intangibles, goodwill for example, have met the *Ledger* test.<sup>193</sup> Although the Supreme Court explained in *Ledger* that even assets that are linked to the expectation of continued patronage may be amortized if the three prong test has been met,<sup>194</sup> the burden of proof is so high that few such assets could satisfy the burden. Therefore, because goodwill and

---

189. Committee Report, *supra* note 153, at 322.

190. *Id.*

191. See Brode, *supra* note 152, at 1019.

192. See Middleton, *supra* note 182.

193. *Id.*

194. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1681 (1993).

goodwill-related intangibles are now automatically amortizable over the statutory period of fifteen years with few exceptions, many taxpayers are receiving a significant advantage under § 197.

Additionally, for taxpayers who are in the market to buy or sell a trade or business, § 197 is a welcome addition to the Code. Businesses with a large amount of goodwill will find their after-tax value enriched due to the ability to amortize intangible assets.<sup>195</sup> This phenomenon is likely to make acquisitions more appealing, especially with regard to large businesses. For example, Philip Morris bought Kraft for \$13 billion; 90% of the purchase price was allocated to goodwill.<sup>196</sup> Similarly, Warner paid \$14 billion for Time Inc., 80% of which was allocated to goodwill.<sup>197</sup> Although these acquisitions occurred prior to the adoption of § 197, this tax provision will encourage similar buyouts involving the allocation of millions or billions of dollars to goodwill.

Some tax analysts have expressed adversity toward a uniform amortization period for intangible assets. Calvin Johnson argues that although the goodwill value of Kraft and Time Inc. may have fluctuated since their acquisitions, their goodwill value has not been reduced because of the mass asset rule.<sup>198</sup> He explains that allowing a uniform fourteen year amortization period<sup>199</sup> for intangible assets in essence lowers the general 34% corporate tax rate.<sup>200</sup> According to Johnson, a trillion dollars was spent on corporate acquisitions in the United States between 1986 and 1991.<sup>201</sup> A study by the General Accounting Office suggests that, on average, at least 10% of an acquisition's purchase price can be allocated to customer or supply based intangibles; this amounts to approximately \$7.8 billion per year.<sup>202</sup> Permitting assets worth \$7.8 billion to be amortized while the asset has preserved its value will cause the IRS to lose millions of dollars in revenue per

---

195. Feder & Scharfstein, *supra* note 24.

196. Calvin H. Johnson, *Effective Tax Rates on High-Goodwill Takeovers Under House and Senate Bills*, 60 TAX NOTES 531, 531 (1993).

197. *Id.*

198. *Id.* at 531.

199. Some of the early House Bills on the amortization of intangible assets proposed that intangibles be amortized over 14 years; this period was increased to 15 years when § 197 was adopted.

200. Johnson, *supra* note 196, at 531. See *supra* text accompanying note 163. Johnson suggests that the appropriate period over which intangibles should be amortized is between 85 and 99 years. Calvin H. Johnson, *Texas Law Professor Believes IRS Can Settle Intangible Cases*, 94 TAX NOTES TODAY 23-105, 23-108 (1994).

201. Johnson, *supra* note 169, at 629-30.

202. *Id.* at 630.

year.<sup>203</sup>

#### D. *Allocation As a Tax Strategy*

Prior to the enactment of § 197, buyers preferred to allocate the purchase price of a business or trade to a non-competition covenant which was usually amortized over a three to five year period, or to other amortizable intangibles that tended to have recovery periods shorter than tangible assets.<sup>204</sup>

After the adoption of § 197, buyers no longer have an incentive to shift the value of their purchase to an intangible asset that must be amortized over fifteen years. Instead, the buyer would rather allocate the price of the business toward tangible assets such as machinery or equipment that tend to have useful lives of about seven years and therefore depreciate rapidly.<sup>205</sup> If unable to allocate toward machinery and equipment, buyers are encouraged to shift the value of the purchase to § 197 intangibles rather than to land with a 31.5 year depreciation period.<sup>206</sup> Sellers also have an incentive to allocate the purchase price in a way that is similar to the buyer, for if the after-tax value of the asset increases, then the buyer will be willing to pay more for the asset.

The IRS, on the other hand, is likely to argue that a taxpayer should allocate a purchase price in the direction of intangible assets or real estate in order to create a long amortization period. To a certain extent, the roles of the IRS and the taxpayer have been reversed.<sup>207</sup> Prior to the enactment of § 197, the IRS favored allocation toward tangible assets to slow the amortization process while taxpayers favored allocation toward amortizable intangibles with a shorter recovery period. Now, it is the taxpayer who prefers allocation toward tangible assets and the IRS who prefers the allocation toward intangibles. The way in which taxpayers allocate the purchase price of a trade or business will be monitored by the IRS according to fair market value, and therefore taxpayers will not be free to maximize their tax advantage through

---

203. See Johnson, *supra* note 169, at 630 (amortizing \$7.8 billion over 8.8 years will cost the government \$1.66 billion in revenue annually).

204. Jack S. Levin & Donald E. Rocap, *A Transactional Guide to New Code Section 197*, 61 TAX NOTES 461, 472 (1993).

205. See Feder & Scharfstein, *supra* note 24, at 911.

206. James A. Doering, *The Amortization of Intangibles: Before and After Section 197*, 71 TAXES 621, 630 (1993).

207. Brode, *supra* note 152, at 1019.



absurd allocations.<sup>208</sup> Because of this, taxpayers should be sure to obtain fair market appraisals that are consistent with their allocations.

## VI. CONCLUSION

If the Supreme Court had not held in favor of the taxpayer in *Ledger*, it is likely that § 197 would not have been enacted. Therefore, because § 197 was necessary to simplify and clarify the Code, *Ledger* was properly decided, despite a minor flaw in the majority opinion.

The flawed aspect of the majority decision involves the Court's discussion of the mass asset rule. Case law indicates that in deciding if this rule should apply, a court should focus only on the characteristics of the mass asset itself, for the characteristics of the component assets are irrelevant. By focusing on the characteristics of the component assets, the *Ledger* Court has, in effect, dissolved the rule without intending to do so, and therefore created a potential for great confusion over the application of that rule.

Fortunately, such confusion did not have the opportunity to materialize, because any debate over the mass asset rule became moot with the adoption of § 197. This legislation resolved the controversy regarding which intangibles are amortizable, what method of amortization should be used, and over what period an asset should be amortized. Although § 197 has spurred additional debates, such as how the purchase price of an acquisition should be amortized, the benefits of saving taxpayers and courts the time and expense of litigating amortization issues outweigh any new controversies that have arisen.

CATHERINE L. HAMMOND

---

208. Doering, *supra* note 206, at 630.



**TAB 7**



VLI Board Meeting  
January 17, 2017

Call to Order

- Roll Call Review
- Approval of Minutes Past Minutes
- New Board Members

Antoinette Balta's Report

- Financial Report- balance as of today is \$282,903.01
- Grants
  - *Approved*
    - Charles Brewer Fiscus Foundation \$1,500
    - City of Mission Viejo \$3,500
    - Cox Communications \$5,000
    - Crean Foundation \$5,000
    - Sunwest Bank \$5,000
    - Wells Fargo \$5,000
    - OCCF EJW Shortfall \$25,000
    - Nicholas Endowment, UCI Legal Fellow \$65,000
    - As of TODAY, OCBACF \$22,000
    - **Total \$137,000**
  - *Declined*
    - Pacific Life (too many demands for charitable giving), Satterberg (Veterans considered too narrow a population), Nationwide (too many demands for charitable giving), OL Haskell (too many demands for charitable giving), MVAT (choosing to use funding to support internal programs), Western Digital (too many demands for charitable giving and employee connectedness is a high priority)
  - OMM selected VLI for its United Way fundraiser
- Past and Upcoming Events
  - *Lawyers for Warriors- April 30, 2018*
    - An event celebrating pro bono that is largely attended by attorneys, military personnel, and other professionals. This event typically sells out and is capped at 200 people. It is a networking and fundraising event with 2 hours of networking, passed appetizers, and unlimited wine pour, and then 20 minutes of program. In 2018 we will be honoring Marc E. Hankin, a leader of Provisers and IP attorney, for all of his pro bono efforts and the award will be presented by founding board member and new judge, Hon. Bradley Erdosi. Sponsorships in 2018 will start at \$500 and title sponsor is \$5000. All sponsorships include tickets and other benefits to the event. Flyer and sponsorship information is attached. You can also register

here: <http://events.r20.constantcontact.com/register/event?oeidk=a07eev2hll4d8e1adf4&llr=54bdezrab> **We are seeking to put together a committee to support this event.**

○ *The American Patriot Ball- September 22, 2018*

- The American Patriot Gala at the Island Hotel. No less than 300 people are expected at this black tie optional affair which will honor an attorney of the year, veteran team of the year, and community partner of the year. Officially announced to date is the community partner of the year will be OC Women2Women. Sponsorships that include 10 tickets will start at \$3k and the title sponsorship is available. **We are forming a gala dinner committee which will meet January 25 from 11:30am to 1pm at O'Melveny & Myers. Please let me know if you are interested in joining the committee. Special thanks to board member Briana Richmond who is one of the members of the committee!** At present, we have over 12 members including in-house counsel from Wells Fargo, CoreLogic, and OPUS. See committee member expectations in your handouts.

▪

Dwight Stirling's Report

New Business

Old Business

Good of the Order

*Future board meetings will be held on the following dates:*

- Date: March 21

Host Name: James Maine

Location: Orrick Herrington, 2050 Main St., Ste 1100, Irvine

- Date: May 16

Host Name: Matt Rabin

Location: TBD

- Date: July 18

Host Name: Jon Guerena

Location: Deliotte

- Date: September 12

Host Name: Briana Richmond

Location: Rutan & Tucker

- Date: November 19

Host Name: Rosanna Fristed

Location: Miller Morton

Adjournment



**VLI BOARD OF DIRECTORS MEETING**

**Regular Meeting**

**Troutman Sanders**

**5 Park Plaza, Suite 1400**

**Irvine, CA 92614**

**Wednesday, January 17, 2018**

**5:00 P.M.**

***CALL TO ORDER (5:40 p.m.)***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at Troutman Sanders, located at 5 Park Plaza, Suite 1400, Irvine, CA 92614.

With a quorum present, Bobby McDonald, Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta  
Peter Pitchess  
Briana Richmond  
Andrew Nelson  
Rosanna E. Fristed

Sheila Marie Finkelstein  
Marc Hankin  
Bobby McDonald  
Pete Seitz

Dwight Stirling  
Jeff Hallin  
Chris Bernabe (by phone)  
Matthew Murphey

The following Directors were not present:

Peter Park  
Jack Williams  
Martin Ellison  
Marco Arcadia

Jon Guerena  
Fernando Lopez  
James Maune  
Matthew Rabin

Laura Riley  
Richard Wilner

***APPROVAL OF MINUTES***

The minutes for the last regular meeting held on September 27, 2017 were circulated to the Board on October 2, 2017 and again on January 17, 2018. Sheila-Marie Finkelstein and Marc Hankin noted an error in the minutes concerning the date listed for the next regular meeting, which was subsequently corrected. Upon motion by Jeff Hallin, seconded by Sheila-Marie Finkelstein, a majority of the Directors present at the meeting voted to approve the minutes as amended from the September 2017 meeting. The amended minutes were emailed to the Board on January 30, 2018.

### ***VOTE ON BYLAWS AMENDMENT***

During the January 2018 meeting, Marc Hankin pointed out an issue with the minutes at page 2 that was not discussed by the entire Board. On page 2 of the September 27, 2017 minutes, there is a sentence that reads: "This vote will occur on or before the date of the annual VLI volunteer reception, held in December." This sentence was intended to memorialize the Board's decision to vote on approval of the amended bylaws by email, with that vote to occur on or before the date of the December 7, 2017 volunteer reception. That vote in fact took place and was completed timely. The vote was as follows:

In favor	Arcadia, Balta, Bernabe, Finkelstein, Ellison, Guerena, Hallin, Hankin, Lopez, Maune, McDonald, Fristed, Pitchess, Rabin, Richmond, Riley, Seitz, Stirling, Williams, Wilner, Murphey, and Nelson
Opposed	None
Abstention	Park

A copy of VLI's Bylaws is attached as **Exhibit A**.

### ***ADDITION OF NEW DIRECTOR; RESIGNATIONS***

Prospective board member Matthew Buttavocali attended the January 2018 meeting. Antoinette Balta nominated Mr. Buttavocali before the September 2017 regular meeting; however, Mr. Buttavocali was not able to attend that meeting to be voted in along with Messrs. Nelson and Murphey. The vote to add him as a Director was thus deferred until the next regular meeting.

After brief discussion concerning Mr. Buttavocali's qualifications and his support for VLI's mission, a quorum of the Board of Directors voted in favor of adding Mr. Buttavocali as a Director.

Dwight Stirling informed the Board that Director Peter Park tendered his resignation. Mr. Park's resignation took effect January 31, 2018.

With the addition of Mr. Buttavocali and the resignation of Mr. Park, the Board of Directors of VLI currently has 23 members.

### ***VLI OPERATING DOCUMENTS***

This action item was a carry-over from the September 2017 regular meeting. Sheila Marie Finkelstein voiced some concern with the Employee Handbook. The Board decided to defer its vote to approve the Employee Handbook until Ms. Finkelstein had an opportunity to review and revise the Employee Handbook, as necessary. Ms. Finkelstein reported that she has secured the assistance of an employment law firm to review the Employee Handbook on a *pro bono* basis. The Board deferred its vote on the handbook until the next regular meeting.

### ***CONFLICT OF INTEREST QUESTIONNAIRE***

There was a brief discussion concerning the Conflict of Interest Policy and Questionnaire. The Board decided that each Director must submit a new questionnaire for 2018. The Board further decided that its Directors should complete a new questionnaire on an annual basis.

### ***DWIGHT'S REPORT***

VLI's health could not be better on both the law firm side and the think tank side. On the law firm side, VLI hired a new employee who is a UCI School of Law graduate. His name is Ian Dede. He is progressing well and learning VLI's practice areas.

VLI is currently recruiting an employee for the position of Pro Bono Director.

VLI continues to receive a steady stream of applications from new clients. For example, over the past weekend, nine applications came in. The areas of law include landlord/tenant, family law, and applications for review of discharge from the Armed Forces ("discharge upgrades"). Dwight currently teaches a practicum at USC. He assigns each student two discharge upgrade applications.

VLI recently welcomed 21 law clerks for the spring term.

On the think tank side, VLI-sponsored podcast "A World Apart" will debut in the next month. Prominent Constitutional-law expert Erwin Chemerinski will appear on an episode.

Dwight will publish an article on the *Feres* Doctrine in the upcoming issue of the Journal of Law, Policy, and Military Affairs.

### ***ANTOINETTE'S REPORT***

#### Grants

- Approved
  - Charles Brewer Fiscus Foundation: \$1,500
  - City of Mission Viejo: \$3,500
  - Cox Communications: \$5,000
  - Crean Foundation: \$5,000
  - Sunwest Bank: \$5,000
  - Wells Fargo: \$5,000
  - OCCF EJW Shortfall: \$25,000
  - Nicholas Endowment, UCI Legal Fellow: \$65,000
  - OCBACF: \$22,000
  - **Total** **\$137,000**



- Declined
  - Pacific Life: too many demands for charitable giving
  - Satterberg: veterans considered too narrow a population
  - Nationwide: too many demands for charitable giving
  - OL Haskell: too many demands for charitable giving
  - MVAT: choosing to use funding to support internal programs
  - Western Digital: too many demands for charitable giving and employee connectedness is a high priority

#### Fundraiser Beneficiary Awards

OMM selected VLI for its United Way fundraiser

#### Past and Upcoming Events

##### **Lawyers for Warriors April 30, 2018**

An event celebrating pro bono that is largely attended by attorneys, military personnel, and other professionals. This event typically sells out and is capped at 200 people. It is a networking and fundraising event with 2 hours of networking, passed appetizers, and unlimited wine pour, and then 20 minutes of program. In 2018 we will be honoring Marc E. Hankin, a leader of Provisers and IP attorney, for all of his pro bono efforts and the award will be presented by founding board member and new judge, Hon. Bradley Erdosi. Sponsorships in 2018 will start at \$500 and title sponsor is \$5000. All sponsorships include tickets and other benefits to the event. Flyer and sponsorship information is attached. You can also register online.

We are seeking to put together a committee to support this event.

##### **The American Patriot Ball September 22, 2018**

The American Patriot Gala at the Island Hotel. No less than 300 people are expected at this black tie optional affair which will honor an attorney of the year, veteran team of the year, and community partner of the year. Officially announced to date is the community partner of the year will be OC Women2Women. Sponsorships that include 10 tickets will start at \$3k and the title sponsorship is available. We are forming a gala dinner committee which will meet January 25 from 11:30am to 1pm at O'Melveny & Myers. Please let me know if you are interested in joining the committee. Special thanks to board member Briana Richmond who is one of the members of

the committee! At present, we have over 15 members including in-house counsel from Wells Fargo, CoreLogic, and OPUS.

This event will feature a live and silent auction, a photo booth, and a cigar roller. VLI will also publish a hard cover book for this event featuring tributes or dedications to veterans. Pages in the book can be purchased for \$500.

Directors Matthew Buttavocali, Sheila-Marie Finkelstein, and Marc Hankin graciously volunteered to serve on the planning committee for this event. Committee member expectations were included in handouts distributed at the meeting.

### ***FINANCIAL REPORT***

VLI's bank balance is \$282,903.01

### ***NEW BUSINESS***

If anyone has an "in" at Western Digital, please contact Antoinette.

OCBA Women Lawyers Association honored VLI in December 2017. Special thanks to Sheila-Marie, who is a member of OCWLA's board.

VLI's Impact Report has been published. A copy was provided to each board member and is available on VLI's social media sites.

A need was expressed for board members who specialize in bankruptcy law and family law. Matthew Murphey indicated that he has a senior associate in mind.

Dwight intends to present Judge Gray to the Review Committee for its consideration .

### ***OLD BUSINESS***

The issue of the Employee Handbook was addressed above.

Review will take place this quarter or next to determine the terms of each Director so that the Board can set elections.

There was a fair amount of discussion concerning amending the bylaws to increase the maximum number of Directors permitted to serve on the Board. The current limit is 25. After hearing arguments "pro" and "con," the Board decided that Chair Bobby McDonald would solicit feedback by email from the Board. The results will be discussed at the next regular meeting.

### ***FUTURE MEETINGS***

Date:                March 21, 2018

Host: James Maune  
Location: Orrick Herrington  
2050 Main St., Ste 1100, Irvine

Date: May 16, 2018  
Host: Matt Rabin  
Location: TBD

Date: July 18, 2018  
Host Name: Jon Guerena  
Location: Deloitte

Date: September 12, 2018  
Host Name: Briana Richmond  
Location: Rutan & Tucker

Date: November 19, 2018  
Host Name: Rosanna Fristed  
Location: Miller, Morton, Caillat & Nevis, LLP,  
500 Newport Center Drive, Suite 580, Newport Beach, CA 92660

***All Board Members are encouraged to  
attend regular meetings in person.***

***GOOD OF THE ORDER***

Chair Bobby McDonald shared his experiences in Washington, D.C.

***ADJOURNMENT***

There being no further business, the meeting was adjourned at 6:53 p.m.

Ms. Rosanna E. Fristed  
Secretary

## ***Veterans Legal Institute***

### ***Meeting Agenda***

**Orrick's Orange County Office  
2050 Main Street, 11<sup>th</sup> Floor, Irvine 92614.**

***Board of Directors Meeting  
March 21, 2018 5:30pm-7:00pm***

Call In Information (641) 715-3580, access code 804621

#### **Call to Order**

#### **Roll Call**

#### **Review and Approval of Minutes**

Past Minutes

#### **Elections**

Board Members

#### **Special Report**

Bylaw BOD Amendment Update

Resignations/Additions

#### **Financial Report/Update**

#### **Upcoming VLI Events/Development**

VLI 2017 IMPACT Report

#### **New Business**

Update VLI Board Member Roster

Dwight Stirling Update

Antoinette Naddour Balta Update

#### **Old Business**

#### **Good of the Order**

#### **Next Meetings:**

May 16, July 18, Sept 19, Nov. 14

#### **Adjournment**



**Thank You To Our Host Jim Maune**



**VLI BOARD OF DIRECTORS MEETING**

**Regular Meeting**

**Orrick, Herrington & Sutcliffe, LLP**

**2050 Main Street, Suite 1100**

**Irvine, CA 92614**

**Wednesday, March 21, 2018**

**5:00 P.M.**

***CALL TO ORDER (5:13 p.m.)***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at Orrick, Herrington & Sutcliffe, LLP, located at 2050 Main Street, Suite 1100, Irvine, CA 92614.

With a quorum present, Bobby McDonald, Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta	Sheila Marie Finkelstein (arrived late)	Matthew Buttavocali
Peter Pitchess (arrived late)	Marc Hankin	Matt Rabin (by phone)
Briana Richmond	Bobby McDonald	Martin Ellison (by phone)
Rosanna E. Fristed	Pete Seitz	Jeff Hallin
Dwight Stirling	Fernando Lopez	James Maune
Jack Williams		

The following Directors were not present:

Andrew Nelson	Jon Guarena	Matt Murphey
Jack Williams	Laura Riley	
Marco Arcadia	Richard Wilner	

***APPROVAL OF MINUTES***

The minutes for the last regular meeting held on January 17, 2018 were circulated to the Board on February 8, 2018 by email. Upon motion by James Maune, seconded by Rosanna E. Fristed, a majority of the Directors present at the meeting voted to approve the minutes from the January 2018 meeting.

***VOTE ON BYLAWS AMENDMENT***

Before this meeting, there was a fair amount of discussion concerning amending the bylaws to increase the maximum number of Directors permitted to serve on the Board. The existing bylaws allow a maximum of 25 Directors. Chair Bobby McDonald dutifully attempted to solicit, and did solicit, feedback from various Directors. The feedback revealed that the Board was generally in favor of increasing the

maximum number of Directors from 25 to 35. Amendment of the bylaws in accordance with this general preference was therefore put to a vote. Upon motion by Vice-Chair Peter Seitz, seconded by Rosanna E. Fristed, the motion to amend the bylaws to increase the maximum number of Directors to 35 carried.

The issue of this particular bylaw amendment was further discussed in the context of the successful completion of Bobby McDonald's term as Chairman of the Board. Mr. McDonald advised the Board that he would not seek re-election as Chairman, but instead suggested that he transition to the role of Past Chair or Chair Emeritus. The Board accepted Mr. McDonald's surrender of the Chairmanship, which was passed on by vote to Director Marc Hankin. A majority of the Directors present further voted to elect Mr. McDonald to the position of Chair Emeritus. Mr. McDonald will continue to serve as a Director and will also be considered a member of the Board's Executive Committee. The bylaws were amended to reflect the addition of the role of Chair Emeritus.

#### ***ADDITION OF NEW DIRECTOR; RESIGNATIONS***

The Nominating/Review Committee vetted prospective Director Judge Jim Gray before the March 2018 meeting. Judge Gray was unanimously voted in as a Director.

The following Directors' terms expired before the March 2018 meeting: Jeff Hallin, Matt Rabin, and Laura Riley. Each of these Directors were re-elected by a unanimous vote of the Directors present at the meeting. Following the meeting, however, Director Jeff Hallin tendered his resignation from the Board. Mr. Hallin served as a Director from June 17, 2015 through March 21, 2018.

Director Chris Bernabe completed his entire term as a Director (June 17, 2015 to January 17, 2018) and decided not to seek re-election.

As indicated above, Chairman Bobby McDonald decided to step down from the role of Chair, having successfully completed his term and serving in this role since VLI's inception in November 2014. Mr. McDonald was formally confirmed as Chair on February 11, 2015. Director Marc Hankin was nominated to serve as the next Chair of VLI. Mr. Hankin expressed enthusiasm and willingness to serve in this role; he was unanimously elected as VLI's new Chairman by the Directors present at this meeting.

#### ***VLI OPERATING DOCUMENTS***

This action item was a carry-over from the September 2017 regular meeting. Director Sheila Marie Finkelstein graciously offered to solicit assistance from an employment firm in reviewing and editing VLI's Employee Handbook. Ms. Finkelstein reported at this meeting that this review is underway. A vote on approval of the Employee Handbook will be deferred until a review of it is complete.

#### ***CONFLICT OF INTEREST QUESTIONNAIRE***

At the January 2018 meeting, the Board decided that each Director must submit a new questionnaire for 2018. Some of the Directors present at the March 2018 meeting filled out a questionnaire in person. Those Directors who have yet to complete a conflict of interest questionnaire for 2018 should do so at their earliest convenience and forward the original to VLI.

### ***FINANCIAL REPORT/UPDATE***

Treasurer Jon Guerena has all of the current financial reports for VLI. As of the date of the meeting, VLI had approximately \$285,000 in its operating account. VLI hired Bill Tanner to serve as VLI's Pro Bono Director. Mr. Tanner will receive an annual salary of \$72,000.

### ***UPCOMING VLI EVENTS/DEVELOPMENT***

Antoinette discussed the upcoming VLI events:

- Lawyers for Warriors – April 30, 2018. Directors were asked to continue to solicit sponsorships for this event and secure silent auction items.
  - Special thanks to Director Jack Williams for securing a yacht trip as a “unique experience” to be auctioned at the event.
- American Patriots Ball. There was a lengthy report on the progress of the various sub-committees for this event. Sub-committees include the Military Honor Book, Underwriting & Sponsorships, Décor, Wine/Liquor, Silent and Live Auction, and Logistics & Entertainment.
  - The event needs an MC. If any Director knows a celebrity who is willing to MC this event, please contact Antoinette.
  - The Directors floated additional suggestions for the event (*e.g.*, a magician, a photo booth).
  - Special thanks to Vice Chair Peter Seitz for offering to provide a template budget for the event to help it stay within budget and meet goals.
  - Special thanks to Director Matthew Buttavocali for his efforts to make forward, positive progress with this event.

Attached as **Exhibit A** is a true and correct copy of the development notes for the March 2018 meeting.

### ***DWIGHT'S REPORT***

Dwight reiterated Judge Gray's qualifications to serve as a Director. Judge Gray actually approached VLI (rather than the other way around), and asked to become part of the Board.

VLI was featured in a news segment on local station Channel 7. Since that broadcast, Mr. Stirling reported an increase in interest from prospective clients and from volunteers. For example, on March 21, 2018, VLI received 48 applications.

Director Sheila Marie Finkelstein will be starting an estate planning clinic for VLI. As soon as demand increases, the EP clinic will become more like VLI's family law clinic. EP services will include wills, trusts, small estates, possibly some probate, and advanced directives.

VLI has 24 new volunteers in 2018 – *e.g.*, a colonel in Cal Guard who is retiring will be volunteering one day per week at VLI. Insurance defense attorney John Wallace has also agreed to volunteer to represent VLI clients.

On the think tank side, VLI-sponsored podcast “A World Apart” has debuted with great success. The Journal of Law, Policy, and Military Affairs has also been published.

### ***ANTOINETTE’S REPORT***

Refer to **Exhibit A**, incorporated herein by reference, for the report on VLI grants. Additional notes are as follows.

VLI received a grant from the State Bar. With big grants, however, come big audits. VLI complied with the State Bar’s audit.

Antoinette and KellyAnn are working on re-applying for a county grant from CalVet. This is a \$36,000 grant. Antoinette will be going to Sacramento to present at CalVet’s conference with Larisa Owen and Lori Pack.

VLI is at a disadvantage because of the lack of an employee dedicated to finance auditing.

Nicolas Endowment grant – difficult to get for a second year. We want University of California at Irvine to make VLI a grantee.

Chapman University wants to start a fellowship program, but lacks funding. They’re seeking funding of \$70,000, \$60,000 of which will go to VLI with the remaining \$10,000 going to Chapman for administrative charges associated with the fellowship.

There will be a 2-page spread in US Veterans Magazine for various VLI honorees including Karen Butera and Rochelle Carr. There will also be another 2-page spread in this magazine at the end of 2018.

Wine Night. The Original Wine Club is sponsoring an event on June 6, 2018. Directors are encouraged to attend.

Poker Tournament. VLI is a beneficiary of an upcoming poker tournament, which promises to be “easy money” for VLI.

Impact Report. A copy of VLI’s 2017 Impact Report is attached to these minutes as **Exhibit B**, and is incorporated in full by this reference.

### ***NEW BUSINESS***

None.



***OLD BUSINESS***

The issue of the Employee Handbook was addressed above.

***FUTURE MEETINGS***

Date: May 16, 2018

Host: Matt Rabin

Location: TBD

Date: July 18, 2018

Host Name: Jon Guerena

Location: Deloitte

Date: September 12, 2018

Host Name: Briana Richmond

Location: Rutan & Tucker

Date: November 19, 2018

Host Name: Rosanna Fristed

Location: Miller, Morton, Caillat & Nevis, LLP,  
500 Newport Center Drive, Suite 580, Newport Beach, CA 92660

***All Board Members are encouraged to  
attend regular meetings in person.***

***GOOD OF THE ORDER***

The Association of the United States Army will honor VLI at an upcoming golf tournament.

Director Sheila Marie Finkelstein passed the State Bar's estate planning specialist examination.

All Directors are encouraged to set up their Amazon.com accounts to make VLI the recipient of Amazon Smile donations.

***ADJOURNMENT***

There being no further business, the meeting was adjourned at 6:18 p.m.

Ms. Rosanna E. Fristed  
Secretary

# **EXHIBIT A**

**Rosanna E. Fristed**

---

**From:** Antoinette Balta <abalta@vetslegal.com>  
**Sent:** Wednesday, March 21, 2018 5:45 PM  
**To:** Rosanna E. Fristed  
**Subject:** Fwd: Development Notes for March Board Meeting

For your notes about what I said...

Warmest Regards,

Antoinette Balta, Esq., LLM  
President and Co-Founder  
Veterans Legal Institute  
2100 N. Broadway, Ste. 209  
Santa Ana, CA 92706  
Ph: [714-852-3492](tel:714-852-3492)

*VLI featured on cover of the OC Register here:* <http://www.ocregister.com/articles/veterans-716783-military-year.html>

*View our client testimonials here:*

<https://www.youtube.com/watch?v=i-0tBBMe1IM>

[https://www.youtube.com/watch?v=GmV\\_xHGF60Q](https://www.youtube.com/watch?v=GmV_xHGF60Q)

<https://www.youtube.com/watch?v=dexA9a0lkCE>

<https://www.youtube.com/watch?v=585ipPK4d5o>

Begin forwarded message:

**From:** <[kromanych@vetslegal.com](mailto:kromanych@vetslegal.com)>  
**Date:** March 20, 2018 at 7:46:15 PM PDT  
**To:** [abalta@vetslegal.com](mailto:abalta@vetslegal.com)  
**Subject:** Development Notes for March Board Meeting

<b>Grants</b>		
<b>Awarded</b>		
California Scottish Rite Foundation	\$3,000	
The Michael & Patricia Smith Foundation	\$1,500	
Jeanette Berteia Hennings Foundation	\$5,000	
<b>Total</b>	<b>\$9,500</b>	

## VLI Supplemental Documents Part 1 (pages 1-141)

<b>Submitted</b>		
Cal Vet Prop 63 FY 18/19	\$36,000	
OCWLA	\$5,000	
MAXIMUS Foundation	\$7,500	
Santa Ana CDBG	\$30,000	
The Mentor Foundation	\$5,000	
Tustin Community Foundation		(they decide)
Tustin CDBG	\$5,000	(Requested 10K but all orgs were reduced to 5k level)
Combined Federal Giving		
Our Promise (CA State Employees)		
Bank of America	\$10,000	
<b>Total</b>	<b>\$98,500</b>	
<b>In Progress</b>		
VSF		
Cal Bar FY 19		
Lockheed		
Union Pacific		
OneOC - I Heart Giving Day Collaboration		
<b>Lawyers for Warriors</b>		
Pledged	\$31,000	
Paid Tickets	108	
Silent Auction	\$9,100	(some items still need FMV; sail and lunches priceless)
# ind items	43	
<b>Gala</b>		
Next meeting March 29 at Savills Studley 12 noon to 1:30 pm		
Gala and honorees submitted for US Vets Magazine spread in May		
Collateral nearly final		
Honor book details nearly final; price \$125		
<b>Mission Viejo</b>		
Casino fundraiser Saturday, April 14; we receive a portion of fees and full value of additional silent auction items		
we provide.		

<b>Audit</b>		
FY 2017 will be ready and submitted to Cal Bar by March 31 as required.		

Kind regards,

KellyAnn Romanych  
Director of Development  
Veterans Legal Institute  
2100 N. Broadway, Ste. 209  
Santa Ana, CA 92706  
C: 818-219-1916  
EIN: 47-1608069  
[www.vetslegal.com](http://www.vetslegal.com)

VLI featured on cover of the OC Register [here](#).

View our client testimonials in:

[Estate Planning](#)

[Employment, Housing, Immigration & Veterans Benefits](#)

[Employment](#)

[Family Law](#)

# **EXHIBIT B**



# IMPACT REPORT 2017

*Providing a future of hope and dignity for our veterans and their families*

## MISSION

Veterans Legal Institute (VLI) is a 501(c)(3) organization that provides pro bono legal assistance to homeless, at risk, disabled and low income current and former service members to eradicate barriers to housing, healthcare, education, and employment and foster self-sufficiency. VLI also advocates on behalf of its clients by providing community education and policy advocacy in an effort to increase awareness, resources, and overall protections to current and former members of the US military.

### Legal Services are **Critical** to Empowerment

1647 individual cases opened, of which 83% were male, 17% were female, & 38% were older veterans

32 mobile clinics at the VA Hospital Long Beach, Starbucks Coffee, Saddleback College, OC Veterans Service Office, & the City of Mission Viejo

36% of cases addressed veterans benefits and discharge upgrades-- an increase of 16% over 2016

60 individual cases were dedicated to keeping veterans in their homes

### Homeless & Low Income Veterans & Their Families Face **Significant & Diverse** Challenges

19 - 99 is the age range of our veterans served with an average age of 47

892 children were supported through empowering veteran parent(s)

\$1,500 or less is our client's average income

\$1,600 is the median rent in Southern California

### Increasing Legal Advocacy Requires **Creative** Commitment

48 outreach events tailored to connecting veterans with specialized resources

33 pro bono attorneys & volunteers assisted on women's cases

40 pro bono cases in military sexual trauma

200+ volunteers & summer law clerks provided 6,000+ hours of service

2100 N. Broadway, Suite 209, Santa Ana, CA 92706  
www.vetslegal.com ★ info@vetslegal.com ★ 714.852.3492

Tax ID No. 47-1608069



**VLI BOARD OF DIRECTORS**  
**Regular Meeting**  
**VLI Headquarters**  
**2100 N. Broadway #209, Santa Ana 92706**  
**Wednesday May 16, 2018**  
**5:00 p.m.**

***CALL TO ORDER***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”) a California nonprofit public benefit corporation, was held at VLI Headquarters, located at 2100 N. Broadway #209, Santa Ana 92706, on Wednesday May 16, 2018.

With a quorum present, Col. Pete Seitz (R.), Vice Chair of the Board, called the meeting to order:

The following Directors were present:

Col. Pete Seitz	Dwight Stirling	Matt Rabin
Briana Richmond	Jon Guerena	Marc Hankin (by phone)
Martin Ellison (by phone)	Antoinette Balta (by phone)	Andy Nelson (by phone)
Jack Williams (by phone)	Richard Wilner (by phone)	Sheila-Marie Finkelstein (by phone)
Peter Pitchess (by phone)	Matt Murphey (by phone)	

The following Directors were not present:

Rosanna Fristed	Marco Arcadia	Jim Maune
Bobby McDonald	Fernando Lopez	

***APPROVAL OF MINUTES***

The minutes for the March 2018 meeting were provided to the Board for review and consideration before the meeting. Upon motion by Matt Murphey, seconded by Jon Guerena, and with a quorum present, the minutes for the March 2018 meeting were approved. No discussion ensued.



### ***AMEND BYLAWS***

Upon motion by Dwight Stirling, seconded by Matt Murphey, and with a quorum present, the Bylaws were recommended for approval. No discussion ensued. The Board unanimously voted to amend the bylaws.

### ***INTRODUCTION OF BILL TANNER, VLI'S NEW DIRECTOR OF PRO BONO AND CLINICS***

Dwight Stirling introduced Bill Tanner, the recently-hired Director of Pro Bono and Clinics at VLI. Bill Tanner has significant experience from his work at the Legal Aid/Public Law Center.

### ***ANTOINETTE'S REPORT***

#### VLI Gala

Antoinette Balta advised that the VLI Gala Planning Committee was behind in sponsorships for the upcoming gala. The Planning Committee is looking for sponsors that can purchase entire tables. The minimum sponsorship for a table is \$3,500. The Planning Committee was also considering postponing the Gala until next year due to "sponsor fatigue."

Pete Seitz asked what the financial commitment was for the Gala. Antoinette Balta advised that the cost is approximately \$125/person. Antoinette Balta further advised that the venue required a \$2,000 deposit, which would be lost if the event was postponed. The VLI Gala Planning Committee will review and make the ultimate decision as to whether the event should be postponed.

#### Grants

Antoinette Balta advised that VLI is financially healthy. VLI received an extension to file its Form 990 with the IRS. VLI had over \$570,000 in revenue from 2017.

The Lawyers for Warriors event netted \$64,000 for VLI. Marc Hankin advised that KellyAnn Romanych was instrumental in holding a successful Lawyers for Warriors event. Marc Hankin proposed giving Ms. Romanych a raise of approximately \$500/month. Pete Seitz asked what Ms. Romanych's current salary is and Marc Hankin advised that her current salary is \$60,000/year. Dwight Stirling advised that the Board had raised her salary at the beginning of the year. Antoinette reported that there was a concern about Ms. Romanych leaving because she was being solicited by other organizations. Dwight Stirling advised that the staff attorneys at VLI earn between \$2,000 and \$6,000 a month. Jon Guerena proposed that VLI put together an annual review process to avoid ad hoc raises. The Board agreed with Jon Guerena's recommendation.

### ***DWIGHT'S REPORT***

Dwight Stirling reported that VLI continues to grow and is currently receiving approximately 10 applications a day. He also advised that Bill Tanner is directing calls made to the Public Law Center from Veterans to VLI.

Dwight advised that VLI's summer interns would be working from May 21, 2018 to July 27, 2018. The interns ranged from high school students to law school students. Dwight also reported that during the spring and fall semesters, VLI had approximately 17-19 law student interns.

Dwight reported that VLI's Think Tank is holding a symposium on the Feres Doctrine at Chapman Law School on October 12. The Think Tank has also started two new publications: VLI On Point, an op-ed for policy issues, and Journal of Law, Policy, and Affairs, a traditional academic journal.

### ***CLOSING COMMENTS***

Marc Hankin advised that the VLI Gala is on September 22, 2018 and more people and sponsorships will be needed to support the Gala.

Pete Seitz reported that the Greater Los Angeles Association of the United States Army will be hosting a golf tournament the Monday after the VLI Gala at the Alta Vista Country Club. 50% of the proceeds from the golf tournament will be going to VLI.

The next regular meeting will be held on July 18, 2018.

### ***ADJOURNMENT***

There being no further business, the meeting was adjourned at 6:01 p.m.



---

Rosanna E. Fristed, Secretary,  
By: Briana Richmond, Director



**VLI BOARD OF DIRECTORS MEETING**  
**Special Meeting**  
**Orange County Black Chamber of Commerce/OC One Stop**  
**17891 Cartwright Road, Suite 100,**  
**Irvine, CA 92614**  
**Wednesday, July 18, 2018**  
**4:00 P.M.**

***CALL TO ORDER (4:14 p.m.)***

A special meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at the Orange County Black Chamber of Commerce, located at 17891 Cartwright Road, Suite 100, Irvine, CA 92614.

Chair Marc Hankin called the Special Meeting. Notice of the meeting was provided in accordance with VLI Bylaw IV.f., by email, on July 15, 2018 at 10:26 a.m.

With a quorum present, Marc Hankin, Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta	Sheila Marie Finkelstein	Matt Rabin (by phone)
Peter Pitchess	Marc Hankin	Laura Riley
Briana Richmond	Bobby McDonald	Martin Ellison (by phone) <sup>1</sup>
Rosanna E. Fristed	Pete Seitz	James Maune
Dwight Stirling	Fernando Lopez	Richard Wilner
Jack Williams	Marco Arcadia	Andrew Nelson
Jon Guerena (by phone)	Jim Gray (by phone)	

---

<sup>1</sup>At 5:12 p.m., Director Martin Ellison e-mailed the Board, as follows:

Marc and Fellow Board Members,

I am resigning from the Board effective immediately, as of the time and date of the sending of this email. To be clear, I am resigning during the course of the July 18, 2018 special meeting, and prior to any action taken by the Board of Directors at the July 18, 2018 special meeting. I will of course retain all confidential information in confidence going forward.

The resignation complies with Bylaw IV.i.4.

The following Directors were not present:

Matthew Murphey

### ***PURPOSE OF MEETING***

Chair Marc Hankin began the meeting by explaining his rationale for calling the special meeting, as well as the primary agenda item, which arose out of the recently-decided fact that “Dwight Stirling and Antoinette Balta have decided to go their separate ways.” Before the meeting, Marc, Dwight, and Antoinette met with Hon. Judge Jim Gray (Ret.), Director, to memorialize the terms of their separation. Jim Gray served as the mediator through this exercise.

The gist of the separation is as follows. In light of an investigation, Dwight will resign from VLI to start his own 501(c)(3) organization in the model of the Think Tank. This Think Tank will continue to publish a law journal, conduct symposia, and work on various policy initiatives. VLI will remain intact. Bill Tanner will be elevated to Managing Partner of VLI, with Kellyann Romanych staying on as well as the head of development. Antoinette will remain the President of VLI.

The complete terms of this separation are memorialized in a document entitled “Restructuring of Veterans Legal Institute,” a fully-executed copy of which is attached to these minutes as **Exhibit A** and incorporated in full by this reference.

Before the Board voted to approve the “Restructuring of Veterans Legal Institute,” a great deal of discussion took place. Bullet points of the discussion follow.

- Jim Gray shared his opinion that it is logical to form a separate entity for the Think Tank and expressed that he was in favor of what Dwight and Antoinette had agreed to.
- Laura Riley asked if the restructuring essentially means that Directors must “choose between Antoinette and Dwight.” Marc Hankin explained that, no, the choice is between VLI and the Think Tank, both of which have important goals and objectives.
- A great deal of discussion ensued over a request from Dwight to amend the restructuring agreement to include a provision obligating all Directors to (1) delete the HR report prepared by Linda Duffy, which was circulated by email to the Board on July 15, 2018, and (2) send an email to Marc Hankin confirming that he/she has done so.
  - Following are the discussion points:
    - Dwight explained his concern with the report being disseminated or otherwise published to third parties. He indicated that in the event this happened, he may have to sue VLI.
    - Antoinette responded that she needed assurances that she and VLI would be protected from suit in the event the HR report somehow gets disseminated or published.

- Several other Directors were heard on the various issues implicated by Dwight's request: Jim Gray agreed that everyone should delete the HR report, as did Pete Seitz and Richard Wilner; Briana Richmond explained her concerns about the enforceability of any release of future claims arising out of the potential dissemination or publication of the report; Andrew Nelson offered the suggestion of including a covenant not to sue in lieu of a release; Marc Hankin expressed concern that it may be not as simple an issue of deleting the email, as the email and its attachment may be recoverable if saved to a server; Marc Hankin further agreed that "VLI should not be responsible if someone disseminates" the report.

**Vote No. 1: Deletion of the HR Report and All Related Documents**

- Jim Maune moved to require each Director to sign a statement that he/she has deleted the report. The motion was seconded by Peter Seitz; however, the vote was postponed because lengthy, further discussion ensued.
  - Marc Hankin drafted and proposed to the Board language to be added to the restructuring agreement, the final version of which is recited below as part of the motion that eventually carried.
  - Marc Hankin invited comment and input from the Board as to the content of the additional language. It was ultimately decided that it was better to create a separate agreement, rather than add the language to the restructuring agreement.

Whereupon, the motion by Jim Maune, seconded by Pete Seitz, was renewed, as modified, and was called for a vote. The motion is as follows. Shall VLI create a separate agreement which reads:

It has been agreed by and between Veterans Legal Institute and Dwight Stirling that the HR Report that was prepared by Linda Duffy on behalf of VLI, dated June 30, 2018, will be deleted by each and every Member of the Board of Directors (with the sole exceptions of Marc E. Hankin and Antoinette Balta, each of whom are permitted to keep their copies), each of whom will send an email to Chair Hankin to confirm that they have deleted their copy of the HR Report and any related emails and/or attachments. Hankin and Antoinette agree not to disseminate the HR Report except in defense of any lawsuit brought by Dwight against VLI and/or Antoinette. Dwight agrees not to disseminate the HR Report and/or to speak to anyone else about the HR Report going forward. Based on those representations and those representations by the individual Board Members, Dwight hereby covenants not to sue VLI and/or Antoinette for any possible (and unlikely) dissemination of the HR Report in the future.

The vote is recorded below:

<b>Ayes</b>	<b>Nays</b>	<b>Abstentions</b>
Marco Arcadia, Antoinette Balta, Shelia Marie Finkelstein, Jim Gray, Jon Guerena, Marc Hankin, Fernando Lopez, James Maune, Bobby McDonald, Andrew Nelson, Peter Pitchess, Matt Rabin, Briana Richmond, Laura Riley, Pete Seitz, Dwight Stirling, Jack Williams, and Richard Wilner	Rosanna Fristed	<i>Due to Non-Attendance</i> Matthew Murphey

*The motion carried.*

**Vote No. 2: Should the Board Approve Payment of \$15,000 to the Venue Hosting the Gala?**

The September gala is proceeding, which requires at this time payment of \$15,000. The amount in question (\$15,000) requires Board approval. No other discussion ensued.

Upon motion by Sheila-Marie Finkelstein to approve the \$15,000 check, seconded by Rosanna E. Fristed, the Board voted as follows:

<b>Ayes</b>	<b>Nays</b>	<b>Abstentions</b>
Marco Arcadia Shelia Marie Finkelstein Rosanna Fristed Jim Gray Jon Guerena Marc Hankin Fernando Lopez James Maune Bobby McDonald Andrew Nelson Peter Pitchess Matt Rabin Briana Richmond, Laura Riley Pete Seitz Dwight Stirling	None	Antoinette Balta Jon Guerena  <i>Due to Non-Attendance</i> Matthew Murphey

Ayes	Nays	Abstentions
Jack Williams Richard Wilner		

*The motion carried.*

**Vote No. 3: Should the Board Approve the Agreement to Restructure VLI?**

The Board returned its attention to the primary agenda item, which was approval of the restructuring agreement. Marc Hankin invited questions about the content of the agreement, which are memorialized as follows:

- Jim Maune and Briana Richmond questioned why the amount to be granted from VLI to the Think Tank is not included in the restructuring agreement. The amount of the grant was disclosed to be \$140,000. It was emphasized that VLI is not paying Dwight, it is granting the money to the Think Tank. The terms of the payment are memorialized in a confidential separation agreement referenced at paragraph 6 of the agreement.
- Rosanna E. Fristed questioned the payment to be made to Johannes Marler. Specifically, the agreement indicates that he will remain a paid employee of VLI for the month of August 2018 notwithstanding his resignation on July 20, 2018. It was explained that, in exchange for payment, Mr. Marler is providing VLI a release of claims as well as a waiver of Civil Code section 1542.
- Laura Riley expressed concern that the vote on the restructuring seemed rushed.
- All of the assets of VLI will remain with VLI, except for Dwight's personal furniture, artwork, and computer equipment.

Director and Chair Emeritus Bobby McDonald moved to approve and ratify the restructuring agreement. The motion was seconded by Jim Maune.

The vote is recorded below:

Ayes	Nays	Abstentions
Marco Arcadia Shelia Marie Finkelstein Rosanna Fristed Jim Gray Jon Guerena Marc Hankin Fernando Lopez James Maune Bobby McDonald Andrew Nelson Peter Pitchess Matt Rabin	None	Antoinette Balta Laura Riley Dwight Stirling  <i>Due to Non-Attendance</i> Matthew Murphey

Ayes	Nays	Abstentions
Briana Richmond Pete Seitz Jack Williams Richard Wilner		

***The motion carried.***

***FUTURE MEETINGS***

There was a regularly-scheduled and duly-noticed general meeting on calendar for July 18, 2018 at 5:30 p.m. Upon motion by Marc Hankin, seconded by Rosanna E. Fristed, a quorum of the Board voted to postpone this meeting and table all future business. Director Sheila-Marie Finkelstein abstained from the vote.

***ADJOURNMENT***

There being no further business, the meeting was adjourned at 5:40 p.m.



---

Ms. Rosanna E. Fristed  
Secretary





**VLI BOARD OF DIRECTORS MEETING**

**Regular Meeting**

**Rutan & Tucker**

**611 Anton Blvd., Ste. 1400**

**Costa Mesa, CA**

**Wednesday, September 12, 2018**

**5:00 P.M.**

***CALL TO ORDER (5:30 p.m.)***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at Rutan & Tucker, located at 611 Anton Blvd., Costa Mesa, CA 92626.

With a quorum present, Peter Seitz, Vice-Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta	Sheila Marie Finkelstein	Richard Wilner (by phone)
Jim Gray (arrived late; left early)	Marc Hankin (by phone)	
Briana Richmond	Jon Guerena (by phone)	
Rosanna E. Fristed	Pete Seitz	
Matt Rabin	Fernando Lopez (by phone)	
Jack Williams (by phone)	Marco Arcadia	

The following Directors were not present:

Andrew Nelson	Jim Maune
Bobby McDonald	
Peter Pitchess	

***APPROVAL OF MINUTES***

The minutes for the special meeting held on July 17, 2018 were circulated to the Board on July 19, 2018 and again on September 12, 2018 by email. Upon motion by Matt Rabin, seconded by Marco Arcadia, a majority of the Directors present at the meeting voted to approve the minutes.

***BYLAWS***

Given the recent changes with VLI, the organization’s bylaws will need to be amended. Marc Hankin and Rosanna Fristed will take the lead on revising the bylaws. The revised bylaws will thereafter be circulated to the entire Board for review and comment. The goal is to have the bylaws amended and voted on before the end of 2018.

## ***BOARD MEMBERS***

The Board currently has 17 Directors. Several people have approached Antoinette asking to join. We have politely declined several. VLI's goal, however, is to recruit several Directors. We'd like to maintain diversity and encourage, but not require, military service.

Toward to the goal of bringing on new Directors, VLI must revise its "Board Member Expectations." This document describes the minimum qualifications for Directors and also the requirements that each one must meet as part of his/her service to VLI. This document has not been revised since 2015. A recommendation was made that it be revised before the next regular meeting. Vice-Chair Pete Seitz and Director Matt Rabin offered to work on the revisions.

Each Director is encouraged to think of candidates from his/her network. The Review Committee will vet each candidate and provide recommendations to the Board. Directors Briana Richmond and Peter Pitchess will remain members of the Review Committee; Director Marco Arcadia offered to join as well.

A proposal was put forward to encourage or require participation in a Board retreat to focus on ways for Directors to become more effective, to bond, to engage in team building exercises, and to achieve cultural realignment and single-mindedness of purpose. Chair Marc Hankin explained that the retreat will probably take place on a weekend day and that he has someone capable in mind to lead the retreat. This person is a VLI supporter who has donated money; she is willing to provide a reduced rate to VLI for the retreat. The Board will vote in new Directors before we schedule the retreat.

Potential Directors/candidates include: Michael Barone, Michael Kibbe, Ron Penland, and Monica (last name not recorded – she's a member of OCWLA).

Antoinette brought up the subject of Non-Disclosure Agreements, which she explained a lot of non-profit organizations require board members to sign. The NDAs are used, for example, for fundraising. Some discussion ensued, with the Board ultimately deciding not to require Directors to sign an NDA.

The Board must agree on 2019 meeting dates now. We are still undecided on the days, times, etc. to hold the meetings. Chair Marc Hankin will send out a "Doodle" survey to the Board. We will decide the day of the month and time to meet (e.g., first Wednesday of the month at 5:30 p.m.) and the frequency of the meetings.

Finally, the Board's Executive Committee has had a vacancy created by the promotion of Marc Hankin to Chair. The bylaws currently require that the Committee consist of the Officers of VLI and at least two Directors. Marc Hankin served as the latter until he was promoted to Chair. Director Briana Richmond was asked to join the Executive Committee. She agreed to do so.

## ***VLI OFFICE***

Antoinette updated the Board on VLI's office. Dwight Stirling's departure has meant that VLI was required to obtain "new" furniture, which Antoinette was able to secure for a reasonable price. Antoinette also secured a new copy machine for VLI for \$90/month for five years from a VLI supporter.

VLI staff now meets once per month and Antoinette reported that there is a positive atmosphere in the office, with staff members feeling excited and empowered to make decisions. Tish Leon continues to work at the Office Administrator, with a primary focus on VLI's office software.

On the IT side, the transitions have been relatively smooth but there is a lot of work to be done. The goal is to be running "cleaner" by December 31. VLI's office has gone paperless and is moving toward more secure online platforms.

Bill Tanner has embraced his role as VLI's Managing Attorney and has taken ownership of the job. He is also a good mentor to the junior attorneys. VLI was able to hire a full-time assistant for Bill.

Scot Douglas is a VLI staff attorney for whom VLI was awarded a six-month stipend from the Rothenbuehler Foundation. VLI will also be getting a sizeable grant from this foundation in the near future.

One-Stop/Working Wardrobes has previously provided administrative staff to VLI. Two of the VLI admins recently got jobs. Antoinette will be interviewing new candidates sent by One-Stop.

Bill Tanner asked Antoinette to discuss several items with the Board:

- Some of VLI's cases carry a statutory right to fees. Mr. Tanner asked whether VLI should be pursuing these fees and the answer was yes.
- Referrals. VLI refers cases it cannot handle (because the clients do not income-qualify) to a network of private attorneys. The question arose as to whether VLI can and should accept referral fees. The decision was made at this time to forego collecting such fees. There was also some discussion concerning VLI itself acting as a referral service like the OCBA's LRIS.
- Bankruptcy Clinics. VLI's clinics continue to experience good attendance, with attendees needing helping with a variety of legal (and non-legal) issues. One area where there is a "gap" in legal services is bankruptcy. VLI needs to work on securing volunteer attorneys whose practice areas include bankruptcy.

#### ***UPCOMING VLI EVENTS/DEVELOPMENT***

Upcoming events:

- American Patriots Ball. This event is on September 22, 2018. Volunteers are needed between 1:30 p.m. and 10:30 p.m. All Directors are invited to a VIP reception. Please pre-register for the silent auction. Antoinette is accepting donations of gift wrap (cellophane), which she needs to wrap gift baskets to be auctioned.
- AUSA Golf Tournament. This tournament is on September 24, 2018. Half of the proceeds of this event go to VLI. AUSA provides financial assistance to military families on an expedited basis. Directors are encouraged to golf or to refer golfers they know to this event. Foursomes are \$760 and include lunch, dinner, and swag.
- Annual Charity Fall Wine & Spirit Festival. To be held October 20, 2018. All are welcome. Tickets are \$25, \$15 of which goes to VLI provided that you select VLI as the recipient when you register online. All silent auction proceeds go to VLI.

- Fletcher Jones Motorcars Patriots Promise going forward November 13, 2018. Tickets to this event cost \$100 with all ticket sale proceeds going to VLI. Volunteers are needed for this event. Check the Fletcher Jones website for event marketing and details.
- Lawyers for Warriors 2019. Scheduled for September 23, 2019. This will be VLI's only major fundraising event next year. Planning must start now. Directors are encouraged to submit requests for donations and sponsorships now. VLI is hoping to net \$100,000 from this event. Please submit nominees for the event honoree to Antoinette and please also provide feedback on the number of awardees, whether we should honor a community partner, etc. The committee for this event will include Antoinette, Sheila-Marie, Marc, and Rosanna; others are encouraged to join.

Update on grants:

- Shady Canyon granted money to 5-6 charities, including VLI. Thank you to Rutan & Tucker and Kelly Galligan.
- Rutan & Tucker's annual holiday gift will go to VLI this year. \$5,000.
- Equal Justice Works extended Allison Higley's fellowship for a third and final year.

### ***NEW BUSINESS***

All Directors are required to sign a statement affirming they have destroyed any and all copies of the investigation and HR report by Linda Duffy dated June 30, 2018.

### ***OLD BUSINESS***

See above.

### ***FUTURE MEETINGS***

Date: November 19, 2018  
Host Name: Rosanna Fristed  
Location: Miller, Morton, Caillat & Nevis, LLP,  
500 Newport Center Drive, Suite 580, Newport Beach, CA 92660

### ***GOOD OF THE ORDER***

Director Sheila-Marie Finkelstein has opened up her own firm, Ahava Law. Gratitude was extended to all Directors who elected to stick with VLI.

### ***ADJOURNMENT***

There being no further business, the meeting was adjourned at 6:47p.m.

Ms. Rosanna E. Fristed  
Secretary



**VLI BOARD OF DIRECTORS MEETING**

**Regular Meeting**

**Miller, Morton, Caillat & Nevis, LLP**

**500 Newport Beach, Suite 580**

**Newport Beach, CA 92660**

**Wednesday, November 14, 2018**

**5:30 P.M.**

***CALL TO ORDER (5:47 p.m.)***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at Miller, Morton, Caillat & Nevis, LLP, located at 500 Newport Center Drive, Suite 580, Newport Beach, CA 92660.

With a quorum present, Marc Hankin, Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta  
Briana Richmond  
Pete Seitz  
Jim Maune (by phone)

Sheila Marie Finkelstein  
Marc Hankin  
Matt Rabin  
Andrew Nelson

Bobby McDonald  
Rosanna E. Fristed  
Marco Arcadia (by phone)

The following Directors were not present:

Richard Wilner  
Jack Williams

Jon Guerena  
Peter Pitchess

Jim Gray  
Fernando Lopez

***APPROVAL OF MINUTES***

The minutes for the September 12, 2018 regular meeting were circulated to the Board on September 18, 2018. Upon motion by (not recorded), seconded by (not recorded), a majority of the Directors present at the meeting voted to approve the minutes.

***BYLAWS***

The bylaws remain under review and subject to revision. Marc Hankin will make preliminary revisions to the bylaws, and the Board agreed that the bylaws should be finalized by the January 8, 2019 meeting, at which time the Board will vote on the revised bylaws.

## ***BOARD MEMBERS***

Following the September 2018 meeting, Antoinette Balta revised VLI's "Board Member Expectations." This document describes the minimum qualifications for Directors and also the requirements that each one must meet as part of his/her service to VLI. Concurrently, Vice-Chair Pete Seitz and Director Matt Rabin also worked on revisions to this document.

A great deal of discussion ensued concerning the "give or get" requirement that each Director is encouraged to meet as part of his or her commitment to VLI. Emphasis was also placed on Director attendance at VLI events (e.g., Lawyers for Warriors, Patriots Promise).

There are nine candidates under consideration for membership on the Board of Directors. Four of these candidates were present at the meeting:

- Sean Twomey – attorney and pro bono advocate in the area of veterans benefits.
- Michael Kibbe – attorney. Mr. Kibbe's bio is attached and incorporated by reference.
- Carol Marzouk. Ms. Marzouk will be presiding over the February 2019 Board Retreat.
- Andrea Ruth Bird – attorney. Ms. Bird's resume is attached and incorporated by reference.

Additional Directors under consideration include Sherry Bragg (partner at Weintraub Tobin), Kathy Dawson (ProVisors member and owner of an employment agency), David Price (attorney and Vietnam War Veteran), Dr. Sunny Jha (renowned anesthesiologist), and Jennifer Johnson (attorney).

Each Director is encouraged to think of candidates from his/her network. The Review Committee will vet each of the above candidates and provide recommendations to the Board. Directors Briana Richmond and Peter Pitchess will remain members of the Review Committee; Director Marco Arcadia offered to join as well.

The Board Retreat will go forward on February 9, 2019. The location is TBD. Ms. Marzouk indicated that ideally the space will have both indoor and outdoor components. Directors are asked to seek sponsors for food for this event.

## ***2019 MEETING DATES***

Regular meetings of the Board of Directors will go forward on the following dates in 2019:

- January 8;
- March 12;
- April 9;
- May 14;
- June 11;
- August 13;
- September 10; and,
- October 8.

The November 2019 regular meeting will not go forward because it is scheduled for the same date as Patriots Promise, and VLI is expected to be the event honoree again in 2019. Even if the dates do not conflict, the Board will be dark in November 2019.

### ***VLI OFFICE & OPERATIONS UPDATE***

Antoinette updated the Board on VLI's office. VLI staff continue to meet once per month and Antoinette reported that there is a positive atmosphere in the office, with staff members feeling excited and empowered to make decisions.

Antoinette provided the following staff update:

- Suzy Kieu. Ms. Kieu, who is learning-disabled, volunteers at VLI up to 16 hours/week. She has proven to be extremely useful, and Antoinette expressed an interest in hiring Ms. Kieu as a part-time employee at minimum wage.
  - Vice-Chair Pete Seitz moved to hire Ms. Kieu at the applicable minimum wage on a part-time basis, effective immediately. Director Sheila-Marie Finkelstein seconded the motion, which motion carried ("ayes" by all Directors present except for Antoinette Balta, who abstained.).
- Jim Nyenhuis. Mr. Nyenhuis is an AmeriCorps fellow. He helps with volunteers.
- Tish Leon. Ms. Leon has been VLI's Office Administrator for quite some time. Ms. Leon is currently a paid employee but has asked to cut back on her hours and to transition to a volunteer position.
- Danny Duffield and VEAP program. Will start next week.
- Leonard Schlanger. Mr. Schlanger will be VLI's Office Administrator. He has expressed a desire to attend law school and was described as one of VLI's "better hires."
- Teresa Kraske. Ms. Kraske comes to VLI via OC's One-Stop/Working Wardrobes Program.

On the IT side, VLI's transition to "paperless" is complete. The original estimate was woefully inadequate compared to the actual cost to complete the transition. The invoice has not yet been processed and will not be paid until Chair Marc Hankin has an opportunity to review it.

Antoinette circulated a draft budget, which Treasurer Jon Guerena must review. Antoinette has asked that the Board have a serious discussion about the 2019 budget and indicated that VLI needs to hire more staff attorneys. Chair Marc Hankin asked that Antoinette secure three years of financial reports to provide to the Board.

The Board was asked to ratify a \$17,500 expenditure for "One OC – Jim." Upon motion by Secretary Rosanna Fristed, seconded by Vice-Chair Pete Seitz, each Director present at the meeting voted to approve this expenditure, with the exception of Antoinette, who abstained from the vote.

Antoinette provided the Board with a litigation report prepared by attorney Bill Tanner, which is attached and incorporated herein by reference.

***UPCOMING VLI EVENTS/DEVELOPMENT***

Past Events:

- American Patriots Ball. September 22, 2018. This event was a success and the net to VLI is approximately \$140,000.
- AUSA Golf Tournament. September 24, 2018. The net of this event was approximately \$15,000, half of which will go to VLI.
- Annual Charity Fall Wine & Spirit Festival. October 20, 2018. Net proceeds of this event of \$435 go to VLI.
- Upper Newport Halloween Party. October 28, 2018. Two VLI volunteers attended and had fun.
- AISS Bowl-A-Thon. November 10, 2018. This event, sponsored and organized by high school students, netted \$200 for VLI.
- Fletcher Jones Motorcars Patriots Promise. November 13, 2018. This event was a success and the expected proceeds to VLI amount to \$13,000.

Upcoming Events:

- OC Black Chamber of Commerce Golf Tournament. November 19, 2018.
- VLI Volunteer Recognition Event. December 12, 2018 at Advanced Depositions in Irvine.
- Lawyers for Warriors Committee Meeting. December 18, 2018.
- Lawyers for Warriors 2019. Scheduled for September 23, 2019 at the Center Club in Costa Mesa. This will be VLI's only major fundraising event next year. Planning must start now. Directors are encouraged to submit requests for donations and sponsorships now. VLI is hoping to net \$100,000 from this event. Please submit nominees for the event honoree to Antoinette and please also provide feedback on the number of awardees, whether we should honor a community partner, etc.

Grants Update:

- See attached update prepared by Antoinette and KellyAnn, which is incorporated by reference.

***NEW BUSINESS***

None.

***OLD BUSINESS***

All Directors are required to sign a statement affirming they have destroyed any and all copies of the investigation and HR report by Linda Duffy dated June 30, 2018. Fernando Lopez is the only Director who has not yet signed.



***FUTURE MEETINGS***

See above.

***GOOD OF THE ORDER***

None.

***ADJOURNMENT***

There being no further business, the meeting was adjourned at 7:10 p.m.



---

Ms. Rosanna E. Fristed  
Secretary

717261\_1.docx



## **Board Meeting**

January 8, 2019 from 5:30pm-7:00pm

Hosted by: Andy Nelson and Matt Rabin of Fortis Law LLP

650 Town Center Dr., Ste 1530, Costa Mesa

Conference call participants, use this dial-in:

US Toll free: (714) 659-6448 / Passcode: 805031

Welcome, Introduction, and Roll Call

Old Business

- Minutes
- Bylaws

Board Members

- Board member expectations and revisions
- Election of existing board members whose terms are expiring:
  - Marco Arcadia
  - Sheila-Marie Finkelstein
  - Fernando Lopez
  - Jack Williams
  - Briana Richmond
- Board member terms up/resigned:
  - Peter Pitchess
  - Richard Wilner
- Potential New Board Members to be voted on
  - Sean Twomey, Associate, Gibson Dunn
  - Michael Kibbe, Littler Mendelson, USMC Veteran
  - Sherry Bragg, Partner, Weintraub Tobin
  - Andrea Ruth Bird, Bird Law Group, USMC Veteran
- Potential New Board Members Observing
  - Dr. Sunny Jha, USC
- Board Retreat, Saturday, February 9
  - Location
  - Roll call
- Remaining 2019 Board Meeting Dates
  - February 9, 2019 (board retreat)
  - March 12, 2019
  - April 9, 2019
  - May 14, 2019

- June 11, 2019,
- JULY DARK
- August 13, 2019
- September 10, 2019
- **October 8, 2019- MUST BE RESCHEDULED**
- November 12, 2019
- DECEMBER DARK

VLI Office and Operations Update (also see attached)

- Staff Update
  - Former paralegal Eric Desmond
  - Cham “Suzi” Kieu
  - Jim Nyenhuis, AmeriCorps
  - Danny Duffield and VEAP program
  - One-Stop/ Working Wardrobes Program
- Building
  - Parking
  - Paint, art, and flooring
- Finances
  - CLMP first installment paid
  - Treasurer Review

Development (see report attached)

- Volunteer report attached
- Past events
  - 2018 Black Chamber Golf Tournament
  - December 12, 2018: VLI Volunteer Recognition Event
    - Hon. Lon Hurwitz and Justice Eileen Moore present
    - \$1000 donation by Mark Wilson
- Upcoming events
  - January 17, 2019 from 11:45am to 1:00pm: Lawyers for Warriors Committee Meeting at Rutan & Tucker. February host needed (date flexible).
  - February 23, 2019 at 7:30am: OSO Fit Marathon through City of Mission Viejo. All preregistrations where VLI is designated awards us 100% of fees. Register here: <http://osofit5k.org>
  - September 23, 2019: Lawyers for Warriors
    - We need to submit requests to firms from now
    - Committee (Discusses who we are seeking nomination for our awardee(s), How many awardees, logistics, etc.)
  - November 12, 2019: Patriots Promise Fundraiser at Fletcher Jones
  - Golf tournament?
- Shirts
- Grants Update (attached)

Miscellaneous  
Adjournment



**VLI BOARD OF DIRECTORS MEETING**

**Regular Meeting**

**Fortis Law, LLP**

**650 Town Center Drive, Suite 1530**

**Costa Mesa, CA 92626**

**Tuesday, January 8, 2019**

**5:30 P.M.**

***CALL TO ORDER (5:40 p.m.)***

A regular meeting of the Board of Directors of Veterans Legal Institute (“VLI”), a California nonprofit public benefit corporation, was held at Fortis Law, LLP, located at 650 Town Center Drive, Suite 1530, Costa Mesa, CA 92626.

With a quorum present, Marc Hankin, Chair of the Board, called the meeting to order:

The following Directors were present:

Antoinette Balta  
Briana Richmond  
Pete Seitz (left early)  
Jim Maune (by phone)

Sheila Marie Finkelstein  
Marc Hankin  
Matt Rabin  
Andrew Nelson

Jack Williams  
Rosanna E. Fristed  
Marco Arcadia

The following Directors were not present:

Jon Guarena  
Jim Gray

Fernando Lopez  
Bobby McDonald

The following prospective Directors were present:

Andrea Ruth Bird (by phone)  
Sean Twomey

Michael Kibbe  
Sherry Bragg

Dr. Sunny Jha

***APPROVAL OF MINUTES***

The minutes for the November 14, 2018 regular meeting were circulated to the Board on November 16, 2018 and again on January 7, 2019. Upon motion by Sheila-Marie Finkelstein, seconded by Matt Rabin, a majority of the Directors present at the meeting voted to approve the minutes.

***BYLAWS***

The bylaws remain under review and subject to revision. Marc Hankin reported that the bylaws require significant revisions, which are underway.

### **BOARD MEMBERS**

VLI's revised "Board Member Expectations" were provided to the Board. This document describes the minimum qualifications for Directors and also the requirements that each one must meet as part of his/her service to VLI. Upon motion by Peter Seitz, seconded by Matt Rabin, a majority of the Directors present at the meeting voted to approve this document.

The terms of the following Directors completed in January 2019: Richmond, Williams, Arcadia, Lopez, and Wilner. Before the meeting, Richard Wilner resigned from the Board. Director Peter Pitchess also tendered his written resignation before this meeting. Except for Richard Wilner, the Directors with expiring terms all expressed the desire to continue as a Director. Upon motion by Antoinette Balta, seconded by Pete Seitz, Directors Richmond, Williams, Arcadia, and Lopez were re-elected to a second, two-year term. Each of these Directors, however, formally abstained from voting on his/her own re-election.

There were four new candidates under consideration for membership on the Board of Directors: Sean Twomey, Michael Kibbe, Sherry Bragg, and Andrea Ruth Bird. Upon motion by Rosanna Fristed, seconded by Briana Richmond, Mr. Twomey, Mr. Kibbe, Ms. Bragg, and Ms. Bird were unanimously voted in as Directors.

Dr. Sunny Jha attended this meeting. His election to the Board will take place at the March 12, 2019 meeting.

The Board Retreat will go forward on February 9, 2019 at Treasurer Jon Guarena's office, located at 695 Town Center Drive, Costa Mesa, CA 92626. Carol Marzouk will facilitate the retreat and will be contacting each Director to conduct a one-hour interview. Sherry Bragg volunteered to bring breakfast for the retreat, while Chair Marc Hankin offered to bring wine. The Board still needs sponsors for lunch and dinner.

### **2019 MEETING DATES**

A sign-up sheet for 2019 regular meeting dates was circulated. Antoinette asked that Directors also sign up to bring three bottles of wine to each meeting. Any wine that is not consumed during the meetings will be used at VLI events throughout the year.

<u>Date</u>	<u>Sponsor/ Location</u>	<u>Wine Sponsor</u>
March 12	Mike Kibbe Littler Mendelson	
April 9		
May 14	Pete Seitz VLI	
June 11	Briana Richmond Rutan & Tucker	
August 13	Sean Twomey Gibson Dunn	
September 10	Jack Williams	Sheila-Marie Finkelstein

	Jones Day	
October (TBD)	Rosanna Fristed Miller Morton	

The October 2018 meeting must be rescheduled because several Directors observe Yom Kippur, which begins on the date currently set for the October meeting.

### ***VLI OFFICE & OPERATIONS UPDATE***

Antoinette updated the Board on VLI's office. She provided the following staff update:

- A brief discussion took place about Eric Desmond.
- Cham "Suzi" Kieu. VLI hired Ms. Kieu two days per week.
- Jim Nyenhuis. Mr. Nyenhuis is an AmeriCorps fellow. He helps with volunteers. He requires a lot of attention and his AmeriCorps supervisor is helping out with him.
- Danny Duffield and VEAP program. Will start next week and must serve 500 hours for VLI.
- One-Stop/Working Wardrobes. Will provide VLI with two adults to work 18 hours/week.

Some problems have arisen with the parking at VLI. VLI may need to consider moving offices. Alison Higley's partner and his friends re-painted the entire office suite and they've offered to install new floors. VLI also has new art work.

On the financial side, Antoinette reported that VLI made its first installment payment to CLMP. Antoinette will be meeting with Treasurer Jon Guarena to review VLI's budget vis-à-vis the outstanding requests to add staff attorneys.

Antoinette provided the Board with a litigation report prepared by attorney Bill Tanner, which is attached and incorporated herein by reference.

### ***UPCOMING VLI EVENTS/DEVELOPMENT***

The development report, prepared by Antoinette and KellyAnn, is attached and incorporated in full by this reference. The volunteer report, prepared by Jim Nyenhuis, is also attached and incorporated in full by this reference.

#### **Past Events:**

- 2018 Black Chamber Golf Tournament.
- December 12, 2018 VLI Volunteer Recognition Event. Hon. Judge Lon Hurwitz and Justice Eileen Moore were present. Mark Wilson made a \$1000 donation to VLI.

#### **Upcoming Events:**

- January 17, 2019 from 11:45 a.m. to 1:00 p.m.: Lawyers for Warriors Committee meeting at Rutan & Tucker.

- February 23, 2019 at 7:30 a.m. OSO Fit 5k through City of Mission Viejo. All pre-registrations where VLI is designated nets 100% proceeds.
- Lawyers for Warriors 2019. Scheduled for September 23, 2019 at the Center Club in Costa Mesa. This will be VLI's only major fundraising event next year. Planning must start now. Directors are encouraged to submit requests for donations and sponsorships now. VLI is hoping to net \$100,000 from this event. Please submit nominees for the event honoree to Antoinette and please also provide feedback on the number of awardees, whether we should honor a community partner, etc.
- November 12, 2019: Patriots Promise at Fletcher Jones.
- Golf tournament. If any Director would like to organize a golf tournament to benefit VLI, please contact Antoinette.

Grants Update:

- See attached update prepared by Antoinette and KellyAnn, which is incorporated by reference.

***NEW BUSINESS***

None.

***OLD BUSINESS***

None.

***FUTURE MEETINGS***

See above.

***GOOD OF THE ORDER***

Sheila-Marie Finkelstein has written an article on how to become a VA accredited attorney and has been nominated for an award.

Jamboree Housing had its groundbreaking for the new Veterans Village.

***ADJOURNMENT***

There being no further business, the meeting was adjourned at 7:03 p.m.



---

Ms. Rosanna E. Fristed  
Secretary

Litigation Report to Board - January 2019

**Intake, Clinics, and Litigation**

As you can see by the year end numbers the requests for assistance have increased this year. The staff is working to maintain the quality of service despite the growing number of cases. We are meeting in January to evaluate our delivery system to see if there are any modifications that can make us more efficient.

We have finalized dates for our in-house clinic - Family Law, VA Benefits, Women's, Estate Planning

We have also finalized our outreach clinic dates for OCVSO, Saddleback, Starbucks, and VA Long Beach. We are still waiting on confirmation for City of Mission Viejo and North County Vet Center.

During the holidays the clinic schedule slows down. So we only have the OCVSO clinic and VA Benefits Clinic. The OCVSO has been referring veterans to our office directly and not having them wait for the monthly clinic so the number of clinic attendees has gone down but the overall referrals have increased. Two clients received news during the VA Benefits Clinic that their claims were granted - one received back pay of \$12,000, and a surviving spouse will be receiving aid and attendance to cover her in home care with back pay yet to be determined.

**Case summaries:**

Johnanthony is assisting a veteran with a child custody case. The veteran and their estranged spouse live on completely opposite sides of the country. The veteran lives in Massachusetts while the spouse lives in California with their three year old daughter. The veteran is seeking to be as involved as possible in the life of their daughter and cement a strong bond between the two. Thus, the veteran is requesting visitation for two weeks every other month, though the spouse is contesting the proposed visitation plan. Johnanthony went in ex parte on a request for visitation or order shortening time. Mediation will be attempted before the case is heard on January 14, though it is unlikely the two will come to an agreement. The veteran is simply seeking an equitable solution to a cross-country problem.

Ian is assisting a son (an Afghanistan veteran) and father (a Vietnam veteran) in a conservatorship matter. In that case, an attorney from Los Angeles filed a petition to become the conservator of the father without any warning to the father and against the father's wishes. The son is very involved in his father's life and the two had arranged for the father to sell his home and go and live with the son and his family before that petition was ever filed. Ian is representing the son in his opposition to the conservatorship petition and is working closely with the father's court-appointed attorney to prepare legal documents allowing the son to manage his father's affairs as he ages, and to make sure that the petitioning attorney does not succeed in becoming conservator. Ian believes strongly that this is in the best interests of both the father and son.

Allison is helping a 70 year old Marine Corps veteran that came to our office for assistance with being sued for rental arrears. The veteran and his wife lived at a property, while his wife was the property manager. She worked for them for 20 years until she was diagnosed with cancer and became very ill. She eventually passed in 2016, and the veteran fell behind on rent trying to pay off the medical bills. He spoke with the owner about the situation when he was 3-4 months



behind, she understood and was willing to give him more time to come up with the money; he was planning on refinancing an old home in Louisiana to get a loan to pay everything off. 5 months later, she changed her mind and served him with a 60 day notice. He moved out in September 2018 and was served with a civil suit in November for \$32,000, costs of suit and prejudgment interest on rent arrears. He acknowledges that he owes the money and wanted help negotiating - he has family that can help him with \$5,000 at the beginning of this year, is working on refinancing the Louisiana property, but right now he only has \$1,700 in social security and \$1,900 in VA benefits. Allison assisted him with filing a response to the suit, and we are now working on responding to discovery requests - preparing responses to Requests for Admissions and Responses to Form Interrogatories. If the client is able to come up with money, we believe it is in the landlord interest to negotiation because if she gets a judgment, it will be useless - 1) he won't be able to refinance to get her her money, 2) he can file bankruptcy and discharge the judgment, and 3) she won't be able to garnish as long as he doesn't have more than 60 days of his social security and benefits in his account. He is still working on coming up with some amount of cash so that we may negotiate a settlement with the landlord and their attorney.

### **Other Activities/Volunteer-**

The volunteer recognition event was well attended. Volunteer attorneys, paralegals, law school partners, even Supervising Judge Hurwitz was present. A highlight of the event was Justice Moore swearing in Johnanthony. Johnanthony has already made several appearances including an ex parte the week he was sworn in.

Newly admitted Daniel Duffield has joined VLI. He was volunteering and now has a stipend for 500 hours. He appeared in family court on December 24, 2018 for an RFO to obtain custody and visitation orders for a veteran.

The spring semester interns have started helping us this week. We are all attending events the next couple of months recruiting summer and fall interns.

We have several new pro bono attorneys who have offered their time to help veterans. There is one who has taken and case and attended the VA Hospital clinic who works for Virgin Orbit and even one who is licensed in Brazil and taking the California attorney bar in July.

### **Training/Evaluation**

We are about halfway through the staff evaluations. The next step will be for Bill to meet with each attorney and come up with an individualized training plan.



### **Expectations of the Board as a Whole**

The mission of Veterans Legal Institute is to provide pro bono legal assistance to homeless, at risk, disabled and low income current and former service members to eradicate barriers to housing, healthcare, education, and employment and foster self-sufficiency.

As the highest leadership body of the organization and to satisfy its fiduciary duties, the board is responsible for:

- determining the mission and purposes of the organization;
- selecting and evaluating the performance of the President;
- strategic and organizational planning;
- ensuring strong fiduciary oversight and financial management;
- fundraising and resource development;
- enhancing the organization's public image; and
- assessing its own performance as the governing body of the organization.

### **Individual Board Member Responsibilities**

- Know and effectively articulate the mission, vision, core values, goals, policies, and program areas of Veterans Legal Institute ("VLI").
- Serve as a VLI ambassador in the community. This includes in person, at events, and on social media, if applicable.
- Shape and uphold the mission and ensure that decisions reflect core values.
- Prepare for, attend, and conscientiously participate in at least 75% of Board of Directors meetings, in person (preferred) or via conference call.
- Be present at VLI events and encourage your networks to attend.
- Participate in VLI resource development activities (e.g., identifying, cultivating, soliciting, and thanking donors).
- If able, make or solicit a meaningful financial contribution annually to VLI of no less than \$2500.
- Identify and support connections — individuals, corporate leaders, foundations, etc. — that can benefit the organization's fundraising and reputational standing.
- Assist in locating working board members that will make meaningful contributions.
- Participate in annual board retreat, if scheduled.
- Be part of at least one board committee each year.
- If requested, participate in regular board self-assessments.
- Host location, food, or beverage (or a combination of all three) of at least one board meeting or other VLI event every 15 months.

### **Competencies & Qualifications**

- Meaningful-experience in-leadership, with accomplishments in law, business, military, government, non-profit and/or philanthropy.
- Savvy diplomatic skills and a natural affinity for cultivating relationships and persuading, convening, facilitating, and building consensus among diverse individuals.
- Ability to listen, analyze, and think strategically.

**VLI Supplemental Documents Part 1 (pages 1-141)**  
**DEVELOPMENT NOTES – For Board Meeting January 8, 2019**

**2018 AWARDED**

	<b>Dollars</b>	<b>In-Kind Value</b>
Google for NonProfit		\$120,000
Cal Vet Prop 63 FY 18/19	\$32,000	
California Scottish Rite Foundation	\$3,000	
The Michael & Patricia Smith Foundation	\$1,500	
Jeanette Berteau Hennings Foundation	\$5,000	
Bank of America	\$5,000	
Shady Canyon Golf Course Charitable Foundation	\$8,000	
Subcontract to SFSC (to be received 2019)	\$15,000	
Sunwest Bank	\$5,000	
IOLTA EAF Application for 2019	\$70,510	
EJW VLC Year 3	\$24,930	
UCI School of Law/Nicholas Endowment (Year 2)	\$65,000	
MHSA 1 Extension	\$2,000	
Hoag Community Benefit	\$18,000	
Rothenbuehler Foundation	\$15,000	
Edison (Invited)	\$5,000	
Volunteers of America Los Angeles	\$40,000	
Rothenbuehler Foundation	\$65,000	
NAVSO	\$5,000	\$5,000
Craig Newmark Philanthropies	\$15,000	
Judicate West (applied Dec 2017; received 2018)	\$10,000	
OCBA Charitable Fund (applied 2017; received 2018)	\$22,000	
<b>TOTAL</b>	<b>\$431,940</b>	<b>\$125,000</b>

**2018 PENDING**

Starbucks	
Kaiser Community Giving	\$2,500
The Mentor Foundation	\$5,000
Land of the Free Foundation	
Santa Ana POA	
Pajadoro Family Foundation	\$5,000
Lockheed Martin	\$5,000
Union Pacific	\$5,000
Mazda Foundation	\$10,000
Stanley Ekstrom	\$65,000
EJW 2 Year Fellowship	\$100,000
Satterberg	\$300,000
JM and Milbank Foundations	\$25,000
ABE Opportunity Grant	\$25,000
JB Hunt	\$10,000
OCBA Charitable Fund	\$34,000
Kaiser Community Giving	\$2,500
Kaiser Community Giving	\$1,500
Kaiser Community Giving	\$5,000
Kaiser Community Giving	\$5,000
Kaiser Community Giving	\$2,500
Judicate West	\$15,000
Sidney Stern Memorial Trust	\$7,500
Kaiser Community Giving	\$2,500
Kaiser Community Giving	\$5,000
<b>TOTAL</b>	<b>\$638,000</b>

**2018 Declines**

OCWLA  
MAXIMUS Foundation  
Santa Ana CDBG  
Tustin Community Foundation  
The Knight Foundation - LBCF