ACCOUNTING FOR LAWYERS:
The Energy Cooperative Assignment

Moe Hennessy is the president of The Energy Cooperative (TEC), a small tax-exempt organization established to provide inexpensive fuel to low- and moderate-income families in Massachusetts. TEC buys fuel on the wholesale markets and resells the fuel at favorable rates to qualified families. The organization has a small staff and rents office space in downtown Boston. Aside from its fuel inventories and a modest bank account, TEC's only substantive assets are computers on which it stores and analyzes information about the energy industry and consumption patterns of local communities. TEC finances its operations through the combination of a bank loan and an initial contribution from a charitable foundation run by Moe Hennessy's family.

TEC is in the process of preparing its financial statements for its current fiscal year, which ends on March 31, 2001. The organization's accountants have already prepared a projected balance sheet and income statement for TEC's current fiscal year based on the organization's existing accounting practices (reprinted on the next page). However, the accountants are proposing two changes that could, if implemented, affect some of the projected figures on these statements.

- First, the accountants are recommending that the enterprise change to a last-in-first-out (LIFO) system of accounting for the organization's fuel inventories. They believe this change is appropriate because, as the price of fuel has risen significantly in the past year, a LIFO system would more accurately reflect the organization's net income.
- Second, the accountants believe that roughly half (book value $20,000) of the enterprise's computer equipment, is now obsolete and therefore should be written off immediately.

Moe Hennessy has asked you – his outside counsel – to review these two changes. Moe wants to know whether these changes might have an impact on the terms of the organization's bank loan. Under the loan agreement, TEC will be in default (and therefore may have to repay the loan immediately) if its annual return on assets (ROA) falls beneath five percent, or if its Total Liabilities to Surplus ratio increases to above 200 percent. [These concepts are described on pages 4-48 through 4-51 of the readings.]

Please write a brief memorandum explaining whether the changes that TEC's accountants are proposing might cause the organization to fail to comply with either or both of these two terms of the organization's loan agreement. If you anticipate problems, could you suggest some plausible arguments (based on your knowledge of accounting) that might be used to persuade the bank that it should not penalize TEC for the impact of either or both of these two proposed accounting changes? [For purposes of this memorandum, assume that the date is early April 2001.]

The Energy Cooperative (TEC)						
Balance Sheet as of March 31, 2000 (actual) and March 31, 2001 (projected)						
Assets				**Total Liabilities & Surplus**		
	03/31/01	*03/31/00*			*03/31/01*	*03/31/00*
Cash	$30,000	$15,000		Accounts Payable	$10,000	$5,000
Fuel Inventory (FIFO)	$230,000	$135,000		Bank Loan	$190,000	$126,000
Computers	$40,000	$50,000		**Total Liabilities**	**$200,000**	**$131,000**
Total Assets	**$300,000**	**$200,000**		**Surplus**	**$100,000**	**$69,000**

The Energy Cooperative	
Income Statement for Year Ended March 31, 2001(projected)	
Sales Revenues	$800,000
Cost of Fuel Sold	($600,000)
Gross Margin	$200,000
Operating Expenses	($140,000)
Depreciation of Computers	($10,000)
Operating Earnings	$50,000
Interest Expense	($19,000)
Net Income	**$31,000**