Contents

Preface xxiii

OVERVIEW OF ACCOUNTING 1

- A. Introduction 1
- **B.** Brief History of Accounting 1
- C. Accounting Scandals 4
 - 1. Waste Management, Inc. 5
 - 2. Enron Corp. 6
 - 3. WorldCom, Lehman Brothers, and More 7
- D. Importance of Accounting and Finance Literacy for Lawyers 9

UNDERSTANDING THE BASICS OF FINANCIAL STATEMENTS 11

- A. Introduction 11
- **B.** Primary Financial Statements 11
 - 1. Balance Sheet 12
 - a. Components of the Balance Sheet 14
 - i. Assets 14
 - (a) Current Assets 15
 - (b) Long-Term Assets 15
 - ii. Liabilities 16
 - (a) Current Liabilities 17
 - (b) Long-Term Liabilities 18
 - iii. Equity 18
 - (a) Sole Proprietorship 19
 - (b) Partnership 19
 - (c) Limited Liability Company 19
 - (d) Corporation 20
 - b. Application to Practice 21
 - 2. Income Statement 23
 - a. Revenues 23

- **XII** Contents
 - b. Expenses 24
 - i. Cost of Goods Sold 24
 - ii. Operating Expenses 25
 - c. Other Income or Gains and Other Expenses or Losses 26
 - d. Income Tax Expense 27
 - e. Application to Practice 28
 - 3. Statement of Cash Flows 29
 - a. Operating Activities 30
 - i. Direct Method 30
 - ii. Indirect Method 31
 - b. Investing Activities 33
 - c. Financing Activities 34
 - d. Net Increase or Decrease in Cash 35
 - e. Application to Practice 36
 - 4. Statement of Changes in Stockholders' Equity 37
 - 5. Interconnections Between the Financial Statements 38
 - a. Balance Sheet and Income Statement 38
 - b. Balance Sheet and Statement of Changes in Stockholders' Equity 39
 - c. Balance Sheet and Statement of Cash Flows 39

OVERVIEW OF ACCOUNTING AND AUDITING PRINCIPLES 41

A. Introduction 41

B. Accounting Bodies 41

- 1. Generally Accepted Accounting Principles 43
 - a. FASB Accounting Standards Codification 43

C. Accounting Assumptions, Principles, and Constraints 44

- 1. General Assumptions 44
 - a. Business Entity Assumption 44
 - b. Going Concern Assumption 45
 - c. Monetary Unit Assumption 45
 - d. Time Period Assumption 45
- 2. General Principles 45
 - a. Historical Cost Principle 46
 - b. Revenue Recognition Principle 46
 - c. Matching Principle 46
 - d. Full Disclosure Principle 47
- 3. General Constraints 47
 - a. Materiality Constraint 47
 - b. Conservatism Constraint 47
 - c. Industry Practices Constraint 48
 - d. Consistency Constraint 48

- e. Cost Constraint 48
- f. Objectivity Constraint 48
- D. American Institute of Certified Public Accountants 49
 1. Generally Accepted Auditing Standards 49
- E. Public Company Accounting Oversight Board 491. PCAOB Auditing Standards 50

F. Auditing Process 50

- 1. Planning the Audit 51
- 2. Audit Risk 52
 - a. Risk of a Material Misstatement 52
 - b. Detection Risk 52

G. Audit Procedures 53

- 1. Test of Controls 53
- 2. Substantive Procedures 54
 - a. Audit Evidence 54
- 3. Management's Representations 55
- 4. Audit Inquiry Letters 56
 - a. Attorney Responses to Audit Inquiry Letters 58
- 5. Audit Documentation 59
- 6. Audit Report and Opinion 60
 - a. Audit Report 60
 - i. Unqualified Opinion 61
 - ii. Unqualified Opinion with Explanatory Language 61
 - iii. Qualified Opinion 61
 - iv. Adverse Opinion 62
 - v. Disclaimer of Opinion 62

H. Auditor's Liability 63

- 1. Liability to Clients 63
- 2. Liability to Third Parties 64
- 3. Statutory Liability 65
- 4. Criminal Liability 66

I. Audit Alternatives 67

- 1. Compilation Engagement 67
- 2. Review Engagement 68

J. Cost of an Audit 68

K. International Accounting Standards Board 69

1. International Financial Reporting Standards 70

L. Accountant and Attorney Interactions 70

- 1. General Business Matters 71
 - a. Entity Selection 71
 - b. Entering into a Legal Relationship 71

- c. Contracts 71
- d. Owner Disputes 72
- 2. Forensic Matters 72

FINANCIAL STATEMENT PREPARATION 75

A. Introduction 75

- B. Bookkeeping 75
 - 1. Double-Entry Bookkeeping 76
 - 2. Debits and Credits 77
 - 3. Accounts 77

C. Balance Sheet Entries and Preparation 78

- 1. Preparing Journal Entries 80
- 2. Posting Journal Entries to T-Accounts 81

D. Income Statement Entries and Preparation 91

- 1. Cash versus Accrual Accounting Methodology 92
 - a. Cash Basis Accounting 92
 - b. Accrual Basis Accounting 93
 - i. Revenue and Gain Recognition 94
 - ii. Expense and Loss Allocation 95
 - c. Basic Accrual Concepts at Work 96
 - d. Basic Deferral Concepts at Work 97
 - e. Accrual and Deferral in More Detail 98
 - i. Prepaid Expenses 98
 - ii. Deferred or Unearned Revenue 99
 - iii. Advanced Accrual and Deferral Concepts at Work 100
 - f. Bad Debt Expense 104
 - i. Estimating Bad Debt Expense 104
 - (a) Percentage of Credit Sales Method 104
 - (b) Aging of Accounts Receivable Method 105
 - ii. Accounts Receivable Write-Offs 106
 - g. Posting Adjusting Entries 107
 - h. Closing the Income Statement Accounts 107
 - i. Income Tax Calculations and Entries 108
 - ii. Closing Profit and Loss Account 110

E. Accounting for Inventory 122

- 1. A Merchandise Business 122
- 2. A Manufacturing Business 123
- 3. Ownership of Inventory 123
 - a. Items in Transit 124
 - b. Items Governed by a Consignment Arrangement 124

- c. Items Subject to a Financing Arrangement 124
- d. Items Eligible for Return 125
- 4. Inventory Accounting Methods 125
 - a. Perpetual Inventory System 126
 - b. Periodic Inventory System 127
- 5. Valuation of Inventory 131
 - a. Specific Identification 131
 - b. Cost Flow Assumptions 132
 - i. First-In, First-Out (FIFO) 132
 - ii. Last-In, First-Out (LIFO) 133
 - iii. Weighted Average 135
 - iv. Comparison of Cost Flow Assumption Methods 136
- 6. Lower of Cost or Market for Inventory 140
- 7. Estimating the Value of Inventory 142
 - a. Gross Profit Method 142
 - b. Retail Method 143

F. Fixed Assets and Depreciation 143

- 1. Accounting for the Initial Acquisition of the Asset 143
- 2. Depreciation Accounting 145
 - a. Determining Depreciation Expense 147
 - i. Useful Life 147
 - ii. Salvage Value 148
 - iii. Method of Depreciation 148
 - (a) Straight-Line Method 149
 - (b) Declining Balance Method 149
 - (c) Sum-of-the-Years' Digits Method 150
 - (1) Prorating Depreciation 152
 - (d) Units of Production Method 153
- 3. Post-Acquisition Costs 154
- 4. Sale or Disposal of a Fixed Asset 155
- 5. Impairment of a Fixed Asset 157
- 6. Other Long-Lived Assets 158
 - a. Intangible Assets and Amortization 158 i. Goodwill 159
 - b. Natural Resources and Depletion 159



DIVIDEND DISTRIBUTIONS 165

- A. Introduction 165
- B. Dividend Distribution Overview 165
- C. Understanding the Components of the Balance Sheet's Equity Section 166

XVI Contents

D. Types of Dividend Distributions 169

- 1. Cash Dividends 169
- 2. Property Dividends 170
- 3. Stock Dividends 171
- 4. Stock Splits 173

E. Legal Restrictions on Distributions 174

- 1. Statutory Restrictions 175
 - a. Traditional Legal Capital Tests 175
 - b. Modern Legal Capital Tests 177
 - i. Balance Sheet Insolvency 178
 - (a) Valuation of Assets: *Randall v. Bailey* and Introduction of Fair Market Value 179
 - (b) Modern Statutes and Fair Market Value 180
 - ii. Equity Insolvency 181
 - iii. Combination of Equity and Balance Sheet Insolvency 182
 - iv. Earned Surplus Test 182
 - c. Other Dividend Distribution Tests 183
- 2. Other Restrictions 183
 - a. Shareholders' Agreement Restrictions 183
 - b. Loan Agreement Covenants 185

F. Creditors' Rights 185

- 1. Fraudulent Conveyance Laws 186
- 2. Federal Bankruptcy Code 187

ANALYSIS OF FINANCIAL STATEMENTS 191

A. Introduction 191

B. Annual Report on Form 10-K 192

- 1. Risk Factors 192
- 2. Selected Financial Data 193
- 3. Management's Discussion and Analysis 193
- 4. Financial Statements and Supplementary Data 194
- 5. Audit Report 194
- C. Horizontal Trend Analysis 195

D. Common-Size Analysis 197

E. Ratio Analysis 199

- 1. Liquidity Ratios 199
 - a. Current Ratio 199
 - b. Quick Ratio or Acid Test 200

Contents XVII

- 2. Profitability Ratios 201
 - a. Gross Profit Margin 201
 - b. Net Profit Margin 202
 - c. Return on Assets 203
 - d. Return on Equity 203
 - e. Earnings per Share 204
 - f. Price-to-Earnings Ratio 205
- 3. Leverage Ratios 206
 - a. Debt-to-Equity Ratio 206
 - b. Debt-to-Assets Ratio 207
- 4. Coverage Ratios 207
 - a. Interest Coverage Ratio 207
 - b. Other Coverage Ratios 208
- 5. Efficiency or Activity Ratios 208
 - a. Asset Turnover 209
 - b. Accounts Receivable Turnover 209
 - c. Inventory Turnover 210
- F. Overview of Analyst's Reports 211

COMMITMENTS AND CONTINGENCIES 215

- A. Introduction 215
- B. Commitments 215
- C. Contingencies 217
 - 1. Loss Contingencies 218
 - a. Probability Determination 219
 - b. Timing Determination 219
 - c. Reasonably Estimable Determination 222
 - 2. Type of Disclosures 223
 - a. Loss Contingency Is Probable and Timing Is Met 223
 - b. Loss Contingency Is Reasonably Possible and Timing Is Met 223
 - c. Loss Contingency Is Remote and Timing Is Met 224
 - d. Loss Contingency Is Unasserted 224
 - i. Disclosure Generally 224
 - 3. Types of Potential Loss Contingencies 224
 - a. Litigation 225
 - i. Probability Assessment in Litigation Context 225
 - b. Guarantees 228
 - c. Product Warranties 229
 - d. Environmental Liabilities 231

INTEREST AND TIME VALUE OF MONEY PRINCIPLES 235

A. Introduction 235

- B. Overview of the U.S. Federal Reserve System and Interest Rates 235
 - 1. The Federal Reserve 236
 - 2. Prime Rate and SOFR 236
 - 3. Interest 237

C. Calculating Interest 238

- 1. Simple Interest 238
- 2. Compound Interest 239

D. Overview of the Time Value of Money 243

- 1. Future Value of a Lump Sum 243
- 2. Present Value of a Lump Sum 246
- 3. Annuities 247
 - a. Future Value of an Annuity 248
 - i. Future Value of an Ordinary Annuity 249
 - ii. Future Value of an Annuity Due 250
 - b. Present Value of an Annuity 252
 - i. Present Value of an Ordinary Annuity 252
 - ii. Present Value of an Annuity Due 253
 - c. Amount of an Annuity Payment 255
 - d. Perpetual Annuity 256
- 4. Rules of 72 and 110 257
- 5. Time Value of Money Limitations 257

E. Bonds and Bond Valuation 258

- 1. Increased Market Interest Rates 260
- 2. Decreased Market Interest Rates 260
- 3. Other Bond Features 261
- 4. Bond Ratings 262

9

FINANCIAL TERMS AND COVENANTS IN CONTRACTS 265

A. Introduction 265

B. Commercial Loan Agreement 265

- 1. Financial Covenants 266
 - a. Incurrence Covenants 266
 - b. Maintenance Covenants 267
 - i. Balance Sheet Covenants 267

Contents **XiX**

- (a) Minimum Net Worth 267
- (b) Debt-to-Equity or Debt-to-Total-Capital 268
- ii. Cash Flow Covenants 268
 - (a) Minimum EBITDA 269
 - (b) Debt-to-EBITDA 269
 - (c) Interest Coverage 269
 - (d) Fixed Charge Coverage 270

C. Indentures, Bonds, and Notes 270

- 1. Financial Covenants 271
 - a. Limitation on Incurrence of Indebtedness 271
 - b. Limitation on Restricted Payments 272
 - c. Limitation on Liens 272
 - d. Limitation on the Sale of Assets 273
 - e. Limitation on Transactions with Affiliates 273
 - f. Limitation on Sale and Leaseback Transactions 274
 - g. Limitation on Dividends 274

D. Merger and Acquisition Agreement 274

- 1. Purchase Price Adjustments 275
- 2. Earn-Outs 276

BUSINESS VALUATION 281

A. Introduction 281

B. Business Valuation Methods 281

- 1. Income Approach 282
 - a. Determining Cash Flows 282
 - i. Capitalized Cash Flow Method 283
 - ii. Discounted Cash Flow Method 284
- 2. Market Approach 285
 - a. Guideline Method 286
 - b. Transaction Method 287
- 3. Asset Approach 288
 - a. Book Value Method 288
 - b. Adjusted Book Value Method 289
 - c. Liquidation Value Method 290
 - d. Cost to Create Method 291

C. Valuation Report 291

D. Valuation in Practice 292

OTHER ACCOUNTING AND CORPORATE FINANCE CONCEPTS 295

A. Introduction 295

B. Leases 295

- 1. Capital Leases from the Lessee's Perspective 296
 - a. Transfer of Ownership 296
 - b. Bargain Purchase Option 297
 - c. Lease Term 297
 - d. Present Value of Minimum Lease Payments 298
- 2. Accounting for Capital Leases by the Lessee 299
- 3. Operating Leases from the Lessee's Perspective 300
- 4. Leases from the Lessor's Perspective 301
 - a. Operating Lease 302
 - b. Sales-Type Lease 302
 - c. Direct Financing Lease 302
 - d. Leveraged Lease 303

C. Financial Markets 304

- 1. Capital Markets 304
- 2. Money Market 305

D. Methods of Raising Capital 305

- 1. Equity 306
- 2. Debt 306

E. Types of Equity Financing 307

- 1. Common Stock 307
- 2. Preferred Stock 308
- 3. Convertible Securities 309

F. Types of Debt Financing 310

- 1. Commercial Loans 310
 - a. Term Loan Facility 310
 - b. Revolving Credit Facility 311
 - c. Swingline Loan Facility 312
 - d. Letter of Credit Facility 312
- 2. Debt Securities 312
 - a. Bonds and Debentures 313
 - b. Notes and Commercial Paper 313

G. Cost of Capital 314

H. Derivative Instruments 315

- 1. Options 316
- 2. Forward Contract 318
- 3. Futures Contract 319
- 4. Swaps 320

- Exhibit A Retailers, Inc. Sample Financial Statements 321
- Exhibit B Sample Audit Inquiry Letter for Fictitious Company 325
- Exhibit C Audit Response Letter for Fictitious Company 327
- Exhibit D Unqualified Audit Opinion for Fictitious Company 329
- Exhibit E Unqualified Audit Opinion with Explanatory Language for Fictitious Company (Elective Change in Accounting Principle) 331
- Exhibit F Qualified Audit Opinion for Fictitious Company 333
- Exhibit G Adverse Audit Opinion for Fictitious Company 335
- Exhibit H Disclaimer of Opinion for Fictitious Company 337
- Exhibit I Future Value of a Lump Sum Table 339
- Exhibit J Present Value of a Lump Sum Table 345
- Exhibit K Future Value of an Ordinary Annuity Table 349
- Exhibit L Present Value of an Ordinary Annuity Table 353
- Exhibit M Present Value of an Annuity Due Table 357
- Exhibit N Net Working Capital Adjustment Example 361
- Exhibit O Earn-Out Example 363

Glossary 365 Index 383