
TABLE OF CONTENTS

PREFACE TO THE SIXTH EDITION	V
TABLE OF ACRONYMS	XLV
TABLE OF CASES	XLIX
TABLE OF STATUTES	LV
TABLE OF REGULATIONS	LVII
TABLE OF OFFICIAL ACCOUNTING AND AUDITING PROMULGATIONS	LIX

Chapter I. Introduction to Financial Statements, Bookkeeping, and Accrual Accounting	1
A. Importance to Lawyers	1
B. The Balance Sheet	3
1. Assets	7
2. Sources	9
a. Liabilities	10
b. Equity	11
3. The Fundamental Accounting Equation	13
4. The Classified Balance Sheet	14
C. Double-Entry Bookkeeping	17
Problems	27
D. The Income Statement	29
1. Revenues and Expenses	31
2. The Closing Process	35
Problems	39
3. The Trial Balance and Six-Column Worksheet	43
Problems	47
E. The Statement of Changes in Owner's Equity	49
1. The Sole Proprietorship	50
Problems	50
2. The Partnership	51
3. The Corporation	52
a. Contributed Capital	54
(1) Shares with Par Value	57
(2) No-Par Shares	61
b. Earned Capital	62
c. State of Incorporation	64
Problems	64
F. Accrual Accounting	65
1. Introduction	67
a. Assumptions	67
(1) Economic Entity Assumption	68
(2) Monetary Unit Assumption	68
(3) Periodicity Assumption	68
(4) Going Concern or Continuity Assumption	69

b.	Basic Principles	69
(1)	Historical Cost Principle	69
(2)	Objectivity or Verifiability Principle	70
(3)	Revenue Recognition Principle	70
(4)	Matching Principle	71
(5)	Consistency Principle	71
(6)	Full Disclosure Principle	71
(7)	An Emerging Fair Value or Relevance Principle	71
c.	Constraints or Modifying Conventions	72
(1)	Cost-Benefit	72
(2)	Materiality	73
(3)	Conservatism	73
(4)	Industry Practices	74
	Problems	74
2.	Deferral of Expenses and Income	74
a.	Expenses	75
(1)	In General	75
(2)	Depreciation Accounting	78
b.	Revenues	80
3.	Accrual of Expense and Income	83
a.	In General	83
(1)	Expenses	83
(2)	Revenues	86
	Problems	89
b.	Income Tax Accounting	90
4.	Practice Problem	91
	Problems	100
G.	Accounting for Merchandise Inventory	105
1.	Sales	106
2.	Cost of Goods Sold	107
3.	Gross Profit and the Multi-Step Income Statement	108
4.	Periodic Inventory System	110
5.	Summary of the Bookkeeping and Accrual Accounting Process	113
	Problems and Questions	115
H.	The Statement of Cash Flows	121
1.	History	123
2.	The Purpose of the Statement of Cash Flows	124
3.	Cash and Cash Equivalents	124
4.	Classification of the Statement of Cash Flows	126
5.	The Operating Section	127
6.	Noncash Investing and Financing Activities	131
7.	Disclosures	131
8.	Preparation of the Statement of Cash Flows	132
a.	Compute the Change in Cash	132
b.	Calculate the Net Cash Flow from Operating Activities	132
(1)	Direct Method	132
(2)	Indirect Method	135

c.	Determine Net Cash Flows from Investing Activities and Financing Activities	137
	Problems	139
I.	Consolidated Financial Statements.....	142
	Problems.....	149
J.	Illustrative Financial Statements.....	150

Chapter II. The Development of Accounting Principles and Auditing Standards.....	151	
A.	Importance to Lawyers	151
B.	The Need for Accounting Principles and Auditing Standards	156
C.	Generally Accepted Accounting Principles.....	160
1.	The Establishment of Accounting Principles	162
a.	The Securities and Exchange Commission.....	163
(1)	Statutory Ability to Designate Private Standard Setter	169
(2)	Statutory Ability to Establish Listing Standards for Securities Exchanges.....	170
(3)	Regulations, Releases, and Informal Guidance on Periodic Reporting	170
(4)	Review of Financial Statements and Periodic Filings.....	174
	Problems.....	175
(5)	Enforcement.....	176
(6)	International Accounting Principles	177
b.	The Private Sector.....	178
(1)	AICPA and the Past	179
(2)	FASB and the Present.....	181
a)	Emerging Issues Task Force.....	185
b)	Private Company Council	186
c)	Advisory Groups	188
(3)	Stock Exchanges, Listing Standards, and Quasi-Private Ordering.....	189
c.	Congress.....	190
d.	International Accounting Standards	194
2.	How Do Accounting Principles Become “Generally Accepted”?	198
a.	The FASB Accounting Standards Codification	199
b.	Before the Codification.....	201
c.	Regulatory Accounting Practices	202
3.	Who Selects Among Generally Accepted Accounting Principles?	204
4.	Critique	206
	Melvin A. Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants	207
	Notes	209
	Problems	216

D.	Sound Accounting Practices Necessary for Registrants Under the Federal Securities Laws	218
1.	The Foreign Corrupt Practices Act	220
a.	Accurate Books and Records	221
b.	Internal Accounting Controls	221
c.	1988 Amendments	222
2.	Sarbanes-Oxley, Dodd-Frank, and the JOBS Act	223
a.	Disclosure Controls and Procedures	223
b.	Internal Control over Financial Reporting	224
	(1) Management's Report on Internal Control over Financial Reporting	226
	(2) Auditor's Attestation Report	227
c.	Whistleblower Incentives and Protections	231
3.	Enforcement	234
	In re JPMorgan Chase & Co.	234
	Notes	253
	Problems	266
E.	Audits and Generally Accepted Auditing Standards	267
1.	The Establishment of Generally Accepted Auditing Standards	268
a.	Issuers	271
	(1) The Securities and Exchange Commission	272
	(2) Public Company Accounting Oversight Board	275
	a) Auditing and Related Standards	276
	b) Registration and Inspection	276
	c) Discipline	278
	d) International Issues	279
	(3) Congress	281
b.	Nonissuers	281
c.	International Auditing Standards	283
2.	Components	284
a.	Broad Principles	284
	(1) Personal Responsibilities	284
	(2) Performance Responsibilities	285
	(3) Reporting Responsibilities	285
b.	Auditing Procedures	285
3.	Who Selects the Auditing Procedures?	286
4.	Independence and the Audit Process	286
a.	Independence	287
	Notes on Auditor Independence	294
	Problems	307
b.	The Audit Process	308
	(1) Planning the Audit and Assessing Internal Control	310
	(2) Implementing the Audit Program	313

- (3) Reporting the Audit Results 314
 - a) Standard Report 315
 - (i) General Elements 324
 - (ii) Opinion Section 324
 - (iii) Basis for Opinion Section 324
 - (iv) Report on Internal Control over Financial Reporting 325
 - b) Other Reports 328
 - (i) Explanatory Language Added to an Unqualified Opinion 329
 - (ii) Qualified Opinion 329
 - (iii) Adverse Opinion 332
 - (iv) Disclaimer of Opinion 336
- 5. The Expectation Gap 339
 - a. “Present Fairly” 343
 - b. The Auditor’s Responsibility to Detect and Report Errors, Fraud, and Illegal Acts 347
 - Problems 349
- F. Alternatives to Audits 349
 - 1. Review 350
 - 2. Compilation 353
 - 3. Other Services 355
- G. Published Sources of GAAP, GAAS, and Other Financial Information 356
 - 1. GAAP 357
 - 2. GAAS 361
 - 3. Current Developments 362
 - 4. General Financial Information 362
 - Research Problems 363
- H. Accountants’ Legal Liability 364
 - Bily v. Arthur Young & Co. 370
 - Notes 390

Chapter III. The Time Value of Money 395

- A. Importance to Lawyers 395
- B. Interest 400
 - 1. Factors Determining Interest Rates 400
 - 2. Computations 409
- C. Future Value 411
 - 1. Single Amounts 411
 - a. Consequence of More Frequent Compounding 415
 - b. Rule of 72s: Doubling an Investment 416
 - c. Practical Advice Part I: Why You Should Start Saving for Your Retirement as Soon as Possible 417
 - 2. Annuities 420
 - a. Ordinary Annuity 420
 - b. Annuity Due 423

c.	Practical Advice Part II: Why You Should Start Saving for Your Retirement as Soon as Possible	426
D.	Present Value	426
1.	Single Amounts	426
2.	Annuities	430
a.	Ordinary Annuity	430
b.	Annuity Due	433
c.	Calculating the Amount of the Annuity Payment	437
E.	Perpetual Annuities	443
F.	Comprehensive Illustrations	444
1.	Choosing Among a Present Amount, a Future Sum, and an Annuity	444
2.	Calculating the Market Value of Bonds	446
3.	Retirement Planning	447
G.	Cautions About Time Value Analysis	448
	Problems	449

Chapter IV. Introduction to Financial Statement Analysis and

	Financial Ratios.....	453
A.	Importance to Lawyers	453
B.	Analytical Tools and Techniques	455
1.	General Comments About Reading Financial Statements	455
2.	Annual Reports	457
3.	Analytical Procedures	460
a.	Trend Analysis	461
b.	Common-Sized Analysis	461
c.	Financial Ratios	461
C.	The Balance Sheet	462
1.	Changes in Owners' Equity	462
2.	Analytical Terms and Ratios	465
a.	Working Capital	466
b.	Financial Ratios	467
(1)	Liquidity Ratios	467
a)	Current Ratio	467
b)	Acid Test or Quick Ratio	468
(2)	Leverage Ratios	468
a)	Debt to Equity	469
b)	Debt to Total Assets	470
c.	Net Book Value	471
d.	Cautions And Application	472
	Problems	475
D.	The Measurement of Income	477
1.	Results of Operations	477
a.	The Income Statement	479
(1)	Unusual or Nonrecurring Operating Items	481
(2)	Accounting Changes	482
a)	Changes in an Accounting Principle	483
b)	Changes in Accounting Estimates	485
(3)	Prior Period Adjustments	486

(4) Discontinued Operations.....	487
(5) Extraordinary Items.....	489
(6) Noncontrolling Interests	490
Problems.....	491
b. Non-GAAP Metrics.....	491
(1) Advantages.....	492
(2) The Pitfalls.....	493
(3) Regulation G	496
(4) Practical Tips for Lawyers	502
Problems.....	503
c. Comprehensive Income	505
Problems	507
2. Ratio Analysis	508
a. Coverage Ratios.....	509
(1) Times Interest Earned	509
(2) Debt Coverage.....	509
(3) Dividend Coverage, Dividend-Payout, and Dividend Yield.....	510
b. Profitability Ratios	511
(1) Earnings Per Share	512
(2) Price-Earnings Ratio	514
(3) Return on Sales or Net Profit Margin	515
(4) Gross Profit Percentage	515
(5) Operating Profit Margin	516
(6) Return on Assets	516
(7) Return on Equity	516
(8) Earnings Before Interest, Taxes, Depreciation and Amortization	517
c. Activity Ratios	518
(1) Receivables Turnover	518
(2) Inventory Turnover	518
(3) Asset Turnover	519
Problems.....	525
E. The Statement of Cash Flows	528
1. Patterns	528
2. Free Cash Flow and Cash Flow from Operations Compared to Net Income	530
3. Monthly Cash Flow Statements.....	530
4. Ratio Analysis	531
a. Liquidity and Coverage.....	531
b. Profitability.....	532
c. Quality of Income	532
Problems	536
F. Management's Discussion and Analysis.....	537
1. The Purpose of Required Disclosure in MD&A	538
Financial Reporting Release No. 36.....	539
Notes	540

2.	Compliance with GAAP Alone Does Not Satisfy MD&A Requirements	547
	In re Caterpillar Inc.	547
	Notes	552
3.	Enforcement Issues Arising from Liquidity Problems	557
	In re America West Airlines, Inc.	557
	Notes	561
	Problems	565
G.	The Future of Financial and Non-Financial Reporting.....	566

Chapter V. Shareholders' Equity and Legal Issues Involving

	the Balance Sheet.....	573
A.	Importance to Lawyers	573
B.	Limitations on the Issuance of Shares	575
	Hanewald v. Bryan's Inc.	576
	Notes	579
C.	Distributions and Legal Restrictions.....	579
1.	Dividends and Redemptions.....	580
2.	Stock Dividends and Stock Splits	584
a.	Accounting Treatment	588
b.	Treatment Under the Legal Capital System	590
3.	Restrictions on Corporate Distributions.....	592
a.	Statutory Restrictions.....	593
(1)	Corporate Law	593
a)	Surplus Statutes	594
(i)	Any Surplus.....	594
(ii)	Earned Surplus and Probably Capital Surplus	596
b)	Income Statement Tests.....	596
(i)	Retained Earnings	597
(ii)	Recent Earnings—"Nimble Dividends"	598
c)	Insolvency Tests.....	599
(i)	Equity Insolvency	600
(ii)	Balance Sheet Test	601
d)	Financial Ratios as Tests	602
e)	Combinations	602
(2)	Creditors' Rights Statutes	603
(3)	Other Regulatory Requirements	605
(4)	Relationship of GAAP to Statutory Restrictions	606
	Randall v. Bailey	607
	Resolution Trust Corp. v. Fleischer	609
	Notes.....	612
	Current Issues on the Legality of Dividends from a Law and Accounting Perspective: A Task Force Report	614
	Notes.....	616
b.	Contractual Restrictions.....	617
	Problems	622

D. Drafting and Negotiating Legal Documents Containing Accounting Terminology and Concepts	626
Terry Lloyd, Financial Language in Legal Documents	626
Notes	643
Problems	654
Questions	657
Questions	659
Questions	669

Chapter VI. Revenue Recognition and Issues Involving the

Income Statement	671
A. Importance to Lawyers	671
B. Contracts with Customers	676
1. ASC Topic 606	678
Problems	688
2. ASC Topic 605	688
a. A Bona Fide Exchange Transaction	689
(1) The Nature of the Exchange Transaction	689
a) Market Transaction	690
b) Shams	691
Lincoln Savings & Loan Association v. Wall	692
Notes	700
(2) Exceptions to the Exchange Transaction Requirement	713
b. Earnings Process Substantially Complete	714
(1) Delivery, Passage of Title, or Performance	714
Pacific Grape Products Co. v. Commissioner	715
Notes	718
(2) Right of Return and Buy-Back Arrangements	719
(3) Nonmonetary Transactions	721
(4) Long-Term Contracts	722
3. Common Financial Frauds	725
In re Kurzweil Applied Intelligence, Inc.	725
Notes	731
a. Premature Revenue Recognition	741
b. Round-Trip Transactions	742
c. Channel Stuffing	745
d. Income Smoothing	747
4. Rent, Interest, and Certain Services	747
a. Straight-Line Method	748
b. Effective Interest Method	748
c. Rule of 78s	749
d. Comparison of the Three Methods for Allocating Interest to Different Accounting Periods	751
5. Special Circumstances	751
a. Nonmonetary Exchanges	752
(1) Installment Method	753
(2) Cost Recovery Method	753

	(3) Illustration of the Effects of the Accrual, Installment, and Cost Recovery Methods.....	754
	b. Related Party Transactions.....	756
	6. Customer Deposits and Prepayments	759
C.	The Matching Principle for Expenses.....	760
	1. Deferral of Expenditures and Declines in Value	762
	a. Alternative Theories for Deferring Expenses for Financial Accounting Purposes	762
	(1) “Cause and Effect” Relationships	762
	(2) Systematic and Rational Allocation	763
	Problem	764
	b. Deferred Losses	765
	Problem.....	767
	2. Accrual of Expenses and Losses.....	768
	a. Alternative Theories for Accruing Expenses and Losses for Financial Accounting Purposes	772
	(1) “Cause and Effect” Relationships	772
	(2) Systematic and Rational Allocation	773
	(3) Lack or Loss of Future Benefit	774
	Problem	774
	b. Matching Expenses for Income Tax Purposes.....	775
	United States v. General Dynamics Corp.....	775
	Notes	778
	c. The Problem of Uncollectible Accounts.....	778
	Problem.....	783
	d. Stock Options.....	784
	e. Postretirement Benefits.....	785
	f. Income Taxes	787
	3. Other Issues Involving Accrual of Expense and Deferral of Income.....	788
	Problems	789
	4. “Earnings Management” and Other Financial Frauds	789
	a. Finite Insurance	795
	b. Vendor Rebates	797
D.	Fair Value Accounting.....	799
	1. In General.....	800
	2. Financial Instruments	804
	a. Investments in Securities	804
	(1) Passive Investments.....	805
	a) Debt Securities.....	806
	(i) Trading Securities	806
	(ii) Held-to-Maturity Debt Securities.....	806
	(iii) Available-for-Sale Securities.....	810
	(iv) Comparison of the Accounting Treatments for the Different Categories of Debt and Marketable Equity Securities Held as Passive Investments.....	813

b)	Equity Securities	814
(i)	Readily Determinable Market Value.....	814
(ii)	No Readily Determinable Market Value	815
(2)	Active Investments	816
a)	Consolidated Financial Statements	816
b)	Equity Method	818
c)	Consolidation of Variable Interest Entities	821
b.	Credit Impairment	825
c.	Hedge Accounting.....	828
3.	Fair Value Option for Other Assets and Liabilities.....	829
4.	Losses	831
5.	Personal Financial Statements	833
	Problems	834
E.	Drafting and Negotiating Legal Agreements and Documents Containing Terminology Implicating the Income Statement	835
	Terry Lloyd, Financial Language in Legal Documents	835
	Notes	842
	Problems	844
	Chapter VII. Contingencies	847
A.	Importance to Lawyers	847
B.	The Financial Accounting Rules	853
	Notes	870
C.	Securities Disclosure Issues	887
	Staff Accounting Bulletin No. 92	888
	Notes	893
D.	Audit Inquiries and Relevant Professional Standards.....	916
	Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information	916
	Notes	922
	Problems	925
E.	Discovery Issues	928
1.	Audit Inquiry Letters.....	929
	Tronitech, Inc. v. NCR Corp.	929
	United States v. Gulf Oil Corp.	931
	Notes	934
2.	Work Product Protection	940
	United States v. Deloitte LLP	940
	Notes	951
3.	Accountant-Client Privilege	955
	FMC Corp. v. Liberty Mutual Insurance Company	956
	United States v. Arthur Young & Company	959
	Notes	965
	Problems	980
	Questions	981

Chapter VIII. Inventory	983
A. Importance to Lawyers.....	983
B. Determining Ending Inventory.....	987
1. Which Costs and Goods to Include in Inventory.....	987
a. Includable Costs.....	987
Berkowitz v. Baron.....	988
Notes.....	991
(1) Merchandiser.....	992
(2) Manufacturer.....	993
Photo-Sonics, Inc. v. Commissioner.....	995
Notes.....	997
(3) Other Illustrations of “Cost Accounting”.....	998
United States v. R.W. Meyer, Inc.....	999
Notes.....	1003
b. Which Items to Count as Inventory.....	1006
Accountants’ Handbook, 6th ed.....	1007
Note on Inventory Fraud.....	1009
Problems.....	1012
2. How to Price Inventory.....	1014
a. Flow Assumptions.....	1014
(1) Alternatives.....	1014
a) Specific Identification.....	1015
b) Weighted Average Cost.....	1016
c) First-In, First-Out.....	1017
d) Last-In, First-Out.....	1017
e) Retail Method.....	1018
f) Standard Costs.....	1019
g) Combination.....	1020
(2) Critique and Basis for Selection.....	1020
a) Illustration of the Effects of FIFO, Average, and LIFO Costing Methods.....	1020
b) First-In, First-Out.....	1020
c) Last-In, First-Out.....	1021
(i) Advantages.....	1021
(ii) Disadvantages.....	1023
United States v. Ingredient Technology Corp.....	1030
Note.....	1036
d) Retail Method.....	1036
b. Lower of Cost or Market.....	1037
Branch v. Kaiser.....	1043
Notes.....	1044
Note on Tax Accounting.....	1046
Problems.....	1048
C. Consistency.....	1050
Chick v. Tomlinson.....	1050
Notes.....	1053
D. Financial Statement Presentation and Disclosure.....	1054

Chapter IX. Long-Lived Assets and Intangibles 1057

- A. Importance to Lawyers 1057
- B. Classification of Expenditures: Assets vs. Expenses 1061
 - In re Valley Systems, Inc. 1063
 - In re Star Technologies, Inc. 1065
 - Notes 1071
 - Problems 1074
- C. Allocation of Capitalized Costs 1075
 - 1. Costs to Acquire and Retire the Asset 1077
 - a. Specific Costs: Direct and Overhead Costs 1077
 - (1) Land and Buildings 1077
 - (2) Equipment 1078
 - b. Special Issues in Asset Acquisitions 1079
 - (1) Issuance of Ownership Interests 1079
 - (2) Deferred Payment Contracts 1079
 - (3) Lump-Sum Purchases 1079
 - (4) Acquisition by Gift 1080
 - c. Asset Retirement Obligations 1080
 - 2. Salvage Value 1081
 - 3. Useful Life 1081
 - 4. Depreciation Methods 1082
 - a. Units-of-Activity (or Units-of-Production) Method 1083
 - b. Straight-Line Method 1083
 - c. Accelerated Methods 1084
 - (1) Sum-of-the-Years'-Digits 1085
 - (2) Declining-Balance Methods 1086
 - Note on Changes in Accounting Principles and Estimates 1087
 - d. Illustration of the Effects of the Different Depreciation Methods on Depreciation Expense 1088
 - 5. Use During Accounting Period 1089
 - Note on Tax Depreciation and Deferred Income Taxes 1090
 - Problems 1093
 - 6. Group Method 1095
 - Problems 1097
- D. Depletion 1098
 - 1. Cost Collection Methods 1098
 - 2. Cost Allocation 1100
- E. Intangible Assets and Goodwill 1101
 - 1. Intangible Assets (Other than Goodwill) 1104
 - a. Finite-Lived 1104
 - (1) Impairment Review 1105
 - (2) Cash Flows Analysis 1106
 - (3) Impairment Loss 1107
 - b. Indefinite-Lived 1107
 - 2. Goodwill 1109
 - Dugan v. Dugan 1116
 - Notes 1123
 - Problems 1135

F. Lease Accounting	1137
1. ASC Topic 842	1137
a. Lessees	1139
b. Lessors	1145
2. ASC Topic 840	1146
a. Operating Leases.....	1147
b. Capital Leases	1149
Problems	1150
3. Synthetic Leases	1150
G. Write-Downs and the “Big Bath”	1151
1. The Problem	1151
2. The Current Rules	1154
a. General Rules on Impairments	1155
(1) Assets Held for Use	1155
(2) Assets Held for Disposal by Other than Sale	1156
(3) Assets Held for Disposal by Sale	1157
b. General Rules on Disposal Activities.....	1157
Appendix A. Illustrative Financial Reports and Statements	1161
Annual Letter to Shareholders of Starbucks Corporation for the Fiscal Year Ended September 29, 2019.....	1163
Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for Starbucks Corporation (for the fiscal year ended September 29, 2019)	1169
Proxy Statement for the 2020 Annual Meeting of Shareholders of Starbucks Corporation (dated January 24, 2020).....	1277
Starbucks Corporation Earnings Release Dated October 30, 2019 for Fourth Quarter and Fiscal 2019	1353
Appendix B. Present and Future Value Tables	1377
Table I: Future Value of \$1.00	1379
Table II: Future Value of Annuity of \$1.00	1380
Table III: Present Value of \$1.00.....	1381
Table IV: Present Value of Annuity of \$1.00 in Arrears	1382
INDEX	1383