

ESSENTIAL PRINCIPLES
OF ACCOUNTING AND
FINANCE FOR BUSINESS
LITIG.
GEORGE BROWN

Week One

How to Find Me

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Course Overview

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- Week 1: Accounting 101/ Intro to Valuation
- Week 2: Revenue Recognition
- Week 3: Expenses/Matching Principle
- Week 4: Loan Loss Reserves/ Loss Contingencies
- Week 5: Valuation Principles/ Stock Prices
- Week 6: Materiality Concepts and Rules

Course Overview

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- Week 7 Fair Value Accounting (TBD)
- Week 8 Damages in Securities Class Actions
- Week 9 Trading Models
- Week 10 Loss Causation
- Week 11 Stock Options and the Backdating Debacle
- Week 12 Internal Controls
- Week 13 Capital Accounts
- Week 14 Auditor Liability

Accounting Fundamentals

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- Foundation of Business
- Information key to managers:
 - ▣ Overall profits or losses
 - ▣ Division or Group performance
 - ▣ Resources management: cash/inventory/debt
- Information key to investors:
 - ▣ Overall profits or losses
 - ▣ Comparison to other companies
 - ▣ Details about the business

Accounting Fundamentals

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$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Assets

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- All of the property owned by a company
- Tangible and Intangible
- Examples:
 - ▣ Cash
 - ▣ Accounts Receivable
 - ▣ Office Building
 - ▣ Equipment
 - ▣ Patents
 - ▣ Inventory

Liabilities

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- Claims on assets by creditors:
 - Trade Accounts
 - Notes
 - Secured borrowings
 - Bonds
 - Subordinated Debentures
 - Future obligations
- Usually a preference over equity holders

Equity

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- Owners' claim to the net assets
- Residual claimants
- Concept is the same/ Business form may differ:
 - ▣ shareholders in a corporation
 - ▣ limited partners in an LLP
 - ▣ Members in an LLC

Balance Sheet

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- Financial condition of the company as of a specific date
- Captures and reflects the effects of all of the company's business activity
- The assets must equal the claims by creditors and owners against those assets
- Classified into categories current vs. long-term

Income Statement

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- Report on the economics of the business operations for a given time period
- Revenue: amounts realized or realizable as a result of the completion of the earnings process
- Expenses: amounts incurred to operate the business and earn the revenue

Income Statement

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- Cost of sales
- Gross profit
- Net income from operations
- Net Income (includes other; taxes)
- Extraordinary items
- Earnings per share

Statement of Cash Flows

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- Informs reader of sources and uses of cash during the reporting period
- Starts with reported net income
- Reverses the effect of non-cash accounting impacts on net income
- An alternative way of understanding how the company is performing

A Few Terms

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- Generally Accepted Accounting Principles (GAAP)
- Financial Accounting Standards Board (FASB)
- Statement of Financial Accounting Standard (SFAS)
- Accounting Codification Project
- SEC Staff Accounting Bulletin (SAB)

Accounting Concepts

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- Accrual vs. Cash Basis
- Cost Principle
- Matching Principle
- Consistency
- Materiality
- Lower of Cost or Market
- Recognition principle

Apple Inc. 10-Q

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- Review of financial statements
 - ▣ Consolidated Statements of Operations
 - ▣ Consolidated Balance Sheets
 - ▣ Consolidated Statements of Cash Flows
- Notes to financial statements
 - ▣ Note 1 (significant accounting policies)
 - ▣ Note 2 (financial instruments – cash, etc.)
 - ▣ Note 3 (details of condensed f/s)

Valuation

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- Investors/Owners are interested in maximizing the value of their investments
- Need to understand the value of the company in order to evaluate the status of the investment
- Need to compare investment opportunities and make choices
- Accounting is necessary but insufficient

Valuation Concepts

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- Inherent philosophical assumptions about human behavior
- Cash is king
- \$1 today is better than \$1 tomorrow
- Investor goals:
 - ▣ maximize present value
 - ▣ choose only positive NPV projects

Valuation Concepts

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- Fundamental tool is discounted cash flow methodology
- Identify series of cash flows
 - ▣ (problem of uncertainty)
- Identify appropriate rate of return required based on risk
- Compute the net present value of the estimated cash flows
- Compare investment opportunities using same methods

Valuation Concepts

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- DCF methodology can be used to value:
 - entire company
 - stock price
 - notes and bonds
 - divisions within a company (value of Youtube?)
 - projects within a company (Tesla sedan?)
 - real estate projects
 - apartment buildings

Don't Use DCF on These

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- Art
- Personal residence
- Super Bowl Tickets
- Vacation
- Pets
- Etc.

THE END