Accounting and Auditing 101 for Lawyers

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Acknowledgement: Written by Jeffrey A. Cone, CPA, Cone Consulting Group, Ltd.

Objectives

- Provide basic accounting information so you are better able to identify, search and review financial and accounting data in your e-discovery cases.
- Understand the general principles of accounting.
- Learn why accounting information can be important in litigation.
- Learn about basic financial reporting, including balance sheets and income statements.
- Become familiar with Generally Accepted Accounting Principles (GAAP).
- Understand specialized accounting terms such as debits, credits, double-entry bookkeeping and materiality.
- Understand the degrees of accuracy to be expected in accounting records.
- Understand basic auditing principles (principles, opinions, estimates, focus of audits).
- Become familiar with the kinds of accounting records that support financial reports.
- Understand what consolidated financial statements are.
- Understand what "related" entities are.

Introduction to Accounting for Lawyers

Accounting is the system by which **entities** (companies, non-profits, governments, and even individuals) monitor their financial health and performance.

> TIP: In cases requiring e-discovery, it is important to have a basic understanding of accounting and auditing practices and principles when financial data are at issue, or when such data are used to prove damages. This chapter will serve as an introduction of accounting and auditing to prepare you for Chapter _____ "Working With Accounting Data."

Accounting systems are usually either **cash-based** or **accrual-based**. Cash-based accounting systems, as you would expect, keep track of only cash transactions. Personal tax returns are a typical example of cash-based accounting. Income is generally only reported on a tax return for cash actually received. Deductions are generally only reported against cash actually spent. Cash-based systems are generally simple and are widely used not only for tax returns, but are also how many small businesses keep their books.

> Warning: Cash-basis accounting systems can be easily manipulated to make an entity look flusher than it is by either accelerating or delaying the date cash will either be received or disbursed. Further, cash-based accounting systems are not designed to capture the full economic realities behind an entity's financial health based on the agreements and transactions that the entity has entered into.

Accrual-based accounting systems, on the other hand, are designed to capture the economic reality of what an entity is doing. Hence, on the date you receive a shipment of "Widgits" from your supplier, you **accrue a liability for** the amount of the Widgits that you owe to your supplier and add a similar amount to inventory. Similarly, when you ship the assembled "Widgets" to your customer you **accrue revenue** and record a **receivable** for the amount that your customer now owes you.

An entity's economic performance is then measured by comparing accrued revenues and accrued expenses. Recording the timing of when cash is actually dispersed to vendors and suppliers, or cash is received from customers, does not provide as accurate an accounting of the economic performance of an entity as does an **accrual-based** accounting system. A company may have

little cash in the bank and yet millions of dollars in product orders that it can show a bank as collateral for a loan to finance producing those products. Only an **accrual-based** accounting would reflect the true state of such a company's economic health.

Similarly, economic health is initially measured by comparing assets, including such items as what customers owe you (receivables) as opposed to what you owe other entities (liabilities). Normally, a healthy entity's assets exceed its liabilities. However, when assessing the economic health of an organization, the quality and kinds of assets and liabilities must be evaluated. For example, will enough cash come in from receivables in the next month to be able to pay the amounts owed to suppliers in the next month?

The financial community (e.g., banks, stock exchanges, investors) is vitally concerned about the economic health and performance of the companies they deal with. They generally insist on companies' reporting financial information using accrual-based accounting.

As will be further discussed, an accrual accounting system is a mix of raw facts (e.g., how much cash there is) and estimates of the ultimate economic effect of transactions and agreements (e.g., what accounts receivable might not be ultimately collectible). Therefore the financial reports that are derived from accounting records tell a **story** of an entity's financial health at distinct points in time and its economic performance over periods of time. An extensive body of principles and rules has been developed which provide standards for entities to follow when preparing accrual-based financial statements.

Auditors (outside independent accountants) are often hired to examine an entity's financial statements and issue a report on the financial statements attesting whether they believe management has presented them fairly.

Importance to Litigation

In your e-discovery data collections, you will may come across financial statements and accounting data. This chapter provides definitions of technical terms and accounting jargon to help you better understand what financial statements (e.g. balance sheets) are and for what purposes they are used.

TIP:	Armed with the general overview of accounting information gained from this chapter, you will be better able to identify, search and review financial and accounting data in your e-discovery efforts, or, in complex accounting matters, to ask informed questions of forensic accountant experts.

Financial statements are, of course, important and sometimes critical parts to negotiating agreements and entering into transactions with other entities. Consequently, when issues arise about a company's financial practices or accounts, a frequent issue is whether the **story** that the entity's financial reports communicated did so **fairly,** and whether or not all **material** facts and information about the company were disclosed.

TIP:	"**Fairly**" is a term that accountants and auditors use to indicate whether the financial statements reflect all known **material** (see next tip) facts about an entity, and whether the statements' estimates are reasonable. Thus litigation often centers on whether the entity's financial statements are, in fact, presented "fairly".

TIP:	"**Material"** is a term that accountants and auditors use to indicate that they are only concerned about facts and information that would affect or influence users of the financial information. For example, assume a company has $1,000,000 of accounts receivable and $5,000,000 of total assets. They have identified one account that totals $1,000 that is likely to be uncollectible. Most accountants and auditors would consider the $1,000 **immaterial** and would not be concerned whether it was recorded or not the company's accounts receivable include this account. By contrast, if the doubtful account totaled $100,000, then that amount is most likely now **material,** and most accountants and auditors would insist on it not being included in the accounts receivable owed to the company.

Because financial reports are both important and tell a **story** (and are not just a recitation of raw facts), management is often motivated to use them to manipulate financial reports to tell the story management wants to have told versus the economic realities of the entity's operations and financial health. This manipulation can, of course, range from using words to obscure or highlight the part of the story management wants to tell, to outright fraud to cover up poor management or theft.

For example, let's take the case where management wants to increase its income to impress its bank in the hopes of getting a new loan. Management knows that there are some accounts receivables that it will likely never collect, but it conceals this knowledge. Misleading financial reports are then issued on which the bank relies in making the new loan. The bad debt problem grows, and eventually the company defaults on its loan. Litigation is then initiated by the bank based on its reliance on the misleading financial statements.

TIP: The ways in which financial statements can be distorted or made misleading and/or fraudulent are only limited by the imagination of the unscrupulous. One great example of fraudulent financial reporting was the 1964 Salad Oil Swindle where inventories were grossly overstated or misrepresented (e.g., "assets" of storage tanks full of water, with just enough salad oil floating at the top to fool inspectors). Enron is a more recent example of fraudulent financial statement manipulation. Its financial statements omitted "related entities" where losses could be "dumped" that normally would and should have been included in consolidated financial reports (see additional information at the end of this chapter). By moving its losses off its books and into the accounts of affiliated or subsidiary companies, Enron made itself look more glamorous and profitable than it really was. When the truth came out, investors (including many Enron employees with 401k retirement accounts with big investments in Enron stock) suffered heavy losses, Enron went bankrupt, and some of its chief executives were convicted of crimes.

Financial Health

Accounting systems monitor a company's financial health by assembling and reporting information about an entity's **assets** and **liabilities** as of a specific date. Normally, in a healthy company the total assets exceed the total liabilities. The amount of this difference is called **equity** (see further description below). Assets, liabilities and equity are reported on what is called a **balance sheet**. A requirement for either the cash or accrual accounting system is that assets must always equal the sum of liabilities and equity, i.e. both sides of the ledger need to "balance out." A "balance sheet" is what accountants use as a format to demonstrate that balance in a snapshot of time.

A example of a simple balance sheet for a company is shown in Figure 1:

Example Company

Balance Sheet as of December 31, 2007 (in thousands)

Assets		Liabilities and Equity	
Current Assets		***Current Liabilities***	
Cash	$ 100	Accounts Payable	$ 2,300
Accounts Receivable	2,000	Accrued Payroll	300
Inventory	2,300	Other	200
Other	200	**Total Current Liabilities**	**2,800**
Total Current Assets	**4,600**		
		Mortgage Payable	1,300
Long-Term Assets		**Total Liabilities**	4,100
Property & Equipment	1,200	***Equity***	
Other	200	Contributed Captial	100
Total Long-Term Assets	1,400	Retained Earnings	1,800
		Total Equity	1,900
Assets	**$ 6,000**	**Liabilities & Equity**	**$ 6,000**

Figure 1. Company Balance Sheet.

Balance sheets are always a financial snapshot of a specific point in time. Frequently, balance sheets may show financial data for two points in time for easy comparison (e.g., last year and this year), in effect, "two snapshots."

A complete understanding of all the items on a balance sheet is essential to understanding the financial health of an entity.

The Example Company has some typical items on its balance sheet. Let's explore what each of these represents:

- **Current Asset**s - Cash or items that would be expected to be converted into cash within one year. These are also frequently referred to as **Short-Term Assets**.

    - **Cash** – An entity's checking accounts and short-term investments (such as money market accounts).

    - **Accounts receivable** – What an entity's customers owe it for products or services sold, but not yet paid for. In a typical scenario, an entity is legally owed $2,100 by its customers, but $100 of this amount is likely to be uncollectible due to customer financial difficulties. So the net amount of $2,000 is shown on the balance sheet.

    - **Inventory** – Products produced by the company or held by the company that will be sold to customers.

    - **Other** – This includes all of the other assets that are expected to be converted to cash or "consumed" in the next year, but are not significant enough in themselves to have separate line items on the financial statement. For example, if the company loaned $100 to a crucial supplier to help it with short-term cash flow problems, then this amount might be included in this category. Another example would be an insurance policy that has an annual cost of $200 that was paid for in 2007 and covered 7/1/2007 to 6/30/2008. Since only half ($100) of the $200 premium applies to 2007, only this $100 is included in 2007 expenses. The remaining $100 is related to 2008 and is included in this category as an asset that will be used up in the following year.

- **Long-Term Assets** – Generally, these are assets that provide value to the company over more than just the next year.

    - Property & Equipment (also known as Fixed Assets) are assets acquired as part of operations. In a typical scenario, a piece of equipment costing $1,000 has been purchased that will improve the company's operations for the next 5 years. Since the asset will be of benefit for multiple years, the $1,000 cost needs to be **depreciated** over this 5-year life. **Depreciation** is the process by which the $1,000 is reduced to $0 over the 5 year **useful** life of this particular asset. In each of the five years, $200 of its original cost is depreciated and included in expense. This depreciation is included in an "Accumulated Depreciation" account. The amount of Property and Equipment category is reduced by the accumulated depreciation. So at the end of the second year, the asset had accumulated depreciation of $400, and Property and Equipment reflects a **net book value** of $600.

- **Other** – Other assets that will not be converted to cash or consumed in the next year. A typical example might be a note receivable that is not due for 5 years. Another example might be where a company has paid a $100 license fee that gives it the right to use a particular manufacturing process for the next 5 years. Therefore, similar to purchasing a piece of equipment, this $100 must be **amortized** over the five year life of the license agreement. If December 31, 2007 is the end of the second year of the license, then the amount included in "Other Assets" would be $60 ($20 being charged to "Expense" for the last two years).

- **Current Liabilities** – Obligations of the company that it expects to pay within one year. These are also frequently referred to as **Short-Term Liabilities**.

  - **Accounts Payable** – Amounts owed to vendors and suppliers for goods and services received by the company but not yet paid for.

  - **Accrued Payroll** - Amounts owed to employees for work performed but not yet paid for.

  - **Other** - All other amounts that are expected to be paid within one year. Examples would include the amount of income tax that will be paid in the next year, or a short-term loan received from a customer to purchase special equipment.

- **Long-Term Liabilities** – Debts and other obligations that will not be paid during the next year.

  - **Mortgage Payable** – The principal amount owed on the building owned by the company.

- **Equity** - Amounts invested by the owners of the company. Theoretically, this is the amount that the owners (shareholders) would receive if all assets and liabilities were liquidated at the values shown.

  - **Contributed Capital** – Amounts paid directly to the company by owners. For example, the proceeds from an initial public offering (IPO) would go here. Only cash or value actually contributed by owners of the company is reflected in this account.

  - **Retained Earnings** – The sum of all income and losses since the inception of the company that have been retained by the entity and not distributed to its owners (usually as dividends).

Each item of a balance sheet is usually the combination of individual **accounts**. An account is where individual assets are tracked. For example, each checking account a company uses would have its own account on the

company's books. To completely understand an entity's balance sheet it is critical that you know which **accounts** are included in a particular dollar amount reported on the balance sheet.

TIP: Do not necessarily trust balance sheet descriptions. Just because a description for an amount appears self-explanatory does not mean that the title fully explains what is included in the item. Judgment and what "story" the entity wants to tell about itself can and does affect the way accounts are combined together in the balance sheet.

TIP: Estimates and judgments permeate balance sheets, and directly affect the **equity value** of the company. For example, an entity wants to look good at a point in time and uses $100,000 as the allowance for doubtful accounts, when in fact, $200,000 is more realistic. Consider the math! That $100,000 ends up increasing the equity value in the company by the $100,000.

TIP: Always confirm that a balance sheet in fact balances! Have someone add up the numbers and make sure it all does add up.

TIP: Sarbanes-Oxley, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 , was enacted in 2002 in response to Enron, Tyco International, Peregrine Systems, WorldCom and other financial scandals to codify what companies should have been doing before such legislation with regard to their financial statements. A good summary of Sarbanes-Oxley requirements can be found at http://en.wikipedia.org/wiki/Sarbanes-Oxley_Act

Financial Performance

Accounting systems monitor financial performance by assembling and reporting information about an entity's **revenues** and **expenses** for a given period of time in an **Income Statement** (also referred to as "Statement of Profit & Loss" or "Statement of Revenue and Expenses"). Time segments by months, quarters and years are the typical periods of time over which accumulated revenues and expenses are accounted for. The key purpose of an income statement is to **match** revenues and expenses. In other words, the income statement should capture all of the costs related to the revenue it generated during a given period.

A example of a simple P&L statement is shown in Figure 2:

Example Company
Income Statement
For the year ended December 31, 2007 (in thousands)

Revenues	
Sales	$ 5,200
Less returns and allowances	(100)
	5,100
Cost of Goods Sold	
Material	1,300
Labor	1,600
Overhead	600
Total Cost of Goods Sold	**3,500**
Administrative Expenses	
Office Expense	700
Other	200
Total Expenses	**900**
Operating Income (Loss)	**700**
Income taxes	400
Net Income	**$ 300**

Figure 2. Profit & Loss Statement.

The Example Company has some typical items on its Statement of Income. Most of them are self-explanatory. If you need further explanation or understanding of the details of an income statement, we suggest you consult a financial accounting expert.

TIP: Publicly traded companies must file their financial statements and various other documents with the Securities and Exchange Commission (SEC). The SEC, in turn, stores these in their "EDGAR" database. Additional information about the EDGAR database can be found at http://www.sec.gov/edgar.shtml. In certain e-discovery cases, these financial statements can be important evidence. The accompanying CD includes a PDF file of The Coca-Cola Company's 2006 financial statements filed with the SEC (Coca-Cola Form_10K_2006.pdf) as an example of what financial statements look like and the kinds of information they contain.

Generally Accepted Accounting Principles (GAAP)

Management and its accounting staff are responsible for determining the "fair" value of amounts reported in the financial statements (see above Importance to Litigation section) and how information is presented in the balance sheet and other financial reports.

As a matter of accepted practice, management is supposed to follow what is known as Generally Accepted Accounting Principles ("GAAP"). For example, GAAP requires that equipment be depreciated over the years of its useful life. However, it is up to management, with advice of the accountants, to determine the useful life of the various pieces of equipment it owns. Thus management's judgment plays an essential role in how costs are allocated to particular time periods and how much net income or loss is reported in a particular time period.

Warning:	Assigning unrealistic depreciation schedules for assets, either to enhance the company's "story" or as part of questionable tax-avoidance strategies, are other potential areas of abuse to be on the lookout for when you propound or respond to e-discovery requests, or in the context of Department of Justice "Second Requests" in its regulation of corporations' compliance with anti-trust laws, or when conducting due diligence investigations in mergers where e-discovery technologies can be utilized to good effect.

GAAP also provides a widely-accepted uniform standard on how companies account for information. This uniformity helps financial analysts consistently compare the financial health and performance of different companies. Further, GAAP specifies the minimum reporting requirements for financial reports meeting GAAP standards. The standard requirements are:

- Balance Sheet – Discussed above.
- Income Statement – Discussed above.
- Statement of changes in cash flow.
- Statement of changes in stockholder equity.
- Notes to financial statements. GAAP requires a variety of financial disclosures about an entity as part of its financial statements.

In the United States, GAAP for commercial and certain non-profit organizations is promulgated by an entity named the Financial Accounting Standards Board (FASB) which works closely with the Securities and Exchange Commission (SEC). FASB (www.fasb.org) has issued a number of pronouncements that give guidance on what GAAP is and how to account for various types of actions.

GAAP for other non-profit organizations and local governments (all except the federal government) is promulgated by the Governmental Accounting Standards Board (GASB www.GASB.org). GAAP for the federal government is promulgated by the Federal Accounting Standards Advisory Board (FASAB www.fasab.gov)

Other countries have equivalent GAAP standards that, while generally similar to those followed in the United States, have important differences that can significantly impact how financial information is reported. Be alert to what country's standards a company is using, especially if it is an international company.

Warning:	The results depending on which country's GAAP are used can be dramatic. For example, in order to be allowed to list its shares on the New York Stock Exchange, the German auto manufacturer, Daimler-Benz, had to agree to reconcile its accounting to American GAAP. After it did that, the company's reported 1993 net income went from 615,000,000 German Marks (DM) in the black, using German GAAP, to a *loss* of 1,839,000,000 German Marks (DM) under U.S. GAAP!

How "Accurate" are Financial Reports and the Underlying Accounting Records?

The "accounts" that accountants refer to (and which added together form the financial reports) have varying degrees of exactitude.

For example, the cash accounts are generally rather exact and reliable (as they are reconciled to bank statements prepared by a third party) and little judgment is required by management in deciding how cash is reported.

Similarly, the Accounts Receivable account (not the reserve account mentioned earlier) is usually accurate since it is based on historical transactions with the entity's customers (assuming no intentional misrepresentations by management). However, more analysis and judgment may be required to properly assign certain items to the Accounts Receivable account. For example, GAAP defines when revenue should be recognized and a receivable recorded. But consider the following situation. A company generally records sales when product is packaged and sitting on the dock waiting for the shipping company to pick it up. However, the actual agreements with customers call for ownership of the product to pass upon delivery to the customer. Further, the customer has 15 days to return it, and historically there has been a 10% return rate. In this situation, it becomes clear that management and its accountants have to carefully evaluate when and how much revenue should be recorded during an accounting period.

TIP:	If during the course of e-discovery your client is required to produce accounting and other financial data, make sure you and any experts you may hire understand the underlying assumptions and procedures used by management to arrive at the numbers stated in the financial documents. Even with the GAAP, there are usually unique aspects to every company's accounting practices that are not obvious when reading its financial reports.

Many other accounts that comprise the general ledger have similar types of issues. They represent a combination of historical transactions and facts and management's judgment. But all too often management has a story to tell which can warp how transactions are recorded and how estimates are determined.

So accounting records and financial statements are not normally talked of in terms of whether they are "accurate" or "factual." Instead, they are discussed in terms of whether they are **materially** correct or **fairly** reflect the financial results of the company as discussed earlier.

TIP: In cases where you suspect financial or other fraud has occurred with unwitting or intentional collusion of accountants and those in charge of a company's finances, useful discovery inquiries might include when and why an entity changed or discontinued its use of outside CPA firms, or when and why it changed its accounting practices. Mergers and acquisitions may also be events in an entity's life where a company with a solid reputation is taken over by less scrupulous management that employs entirely different, "creative" accounting to mask radical changes in the way the junior party to the new arrangement would have done business.

In a class action lawsuit, **In re DaimlerChrysler AG Securities Litigation**, U.S. District Court, Delaware, Master File No. 00-993 (JJF), the merger of Chrysler Corporation with Daimler-Benz was alleged to be fraudulent by shareholders who claimed to be victims of "creative accounting and profit smoothing" and other misrepresentations made in public statements. What was claimed to be a merger was in reality, the plaintiffs alleged, a takeover by the German auto manufacturer, which should have entitled plaintiffs to a "control premium" that is normally paid to investors in a takeover. In 1998, Daimler-Benz paid $36 billion for the merger with Chrysler, but as of early December 2000, perhaps reflecting different accounting methods and practices, the newly *merged* company was reported to be worth not more than $38 billion, an amount less than Daimler-Benz's value alone before the merger took place. In 2004, a $300 million settlement was approved as to all shareholders except the billionaire investor Kirk Kerkorian, who chose to continue pressing his claims in a separate lawsuit.

The Role of Outside Accountants (CPAs)

Outside accountants, which in the United States are called "Certified Public Accountants" (CPAs), provide a check and balance to make sure management is reasonable and consistent in its treatment of accounting and financial information. Further, they provide assurance to the financial community that an entity's financial reports can be relied upon.

CPAs, in this context, are those actually in the practice of public accounting. CPAs often leave the practice of public accounting and join management of company's. When they do this they are no longer considered to be a practicing CPA and even if they maintain their CPA license they should be considered part of management.

What services a CPA does depend on the size of the company, its financial reporting requirements and management's financial sophistication. For financial reporting, CPAs generally provide either **Audit**, Review or **Compilation** services with a formal report that must accompany the financial statements.

- **Independent audit reports** – Independent audit reports are generally required for publicly traded companies and often required by financial institutions that loan funds to companies. Companies can also sometimes just desire an independent audit to provide greater creditability in the financial markets. The financial statements are prepared in accordance with GAAP and are audited in conformance with **Generally Accepted Auditing Standards (GAAS)**. The financial statements include not only the required financial statements but **Notes to the Financial Statements** that disclose all other material pertinent financial information about the company. (See Coca-Cola's 2006 financial statements on the accompanying CD in the "Coca-Cola Form_10K_2006.pdf" file). **Independence**, in this context, means that the outside accounting firm or its staff has no direct or indirect financial interest in the company and there are no other circumstances that could impair their impartial judgment See below for additional discussion of audits.

- **Review reports** – Reviews are also performed by **independent** outside accountants. Reviews involve much less work than an audit. However, the amount of work done by the outside accountants is limited compared to an audit (which is not limited at all). Work done for a review involves the outside accountants asking pertinent questions about the accounting records and performing analytical procedures. The Outside Accountant also usually prepares the financial statements. The financial statements must be prepared in accordance with GAAP and include all of the notes (similar to what is required for audited financial statements).

- **Compilation reports** – Compilation reports are prepared based on the representations of management, and the Outside Accountant's role is limited to

preparing the financial statements in accordance with GAAP. There is also no requirement that the Outside Accountant to be independent and may, in fact, frequently be involved in advising the company on other financial and business issues. However, a lack of independence must be disclosed as part of the financial statements.

TIP:	Whenever working with financial reports, make sure to understand what level of involvement CPAs have had with their preparation. If financial reports do not include one of the above types of statements by a CPA, then the financial reports are solely the responsibility of management. See Chapter _____ for ideas on items to ask for in discovery if there is suspicion that the story management is not based on reality.

Accounting Records

As discussed above, financial statements are summaries of **accounts**. Accounts, in turn consist of various **accounting entries**. Accounting entries are part of the **double-entry bookkeeping** system.

Double-entry bookkeeping is the basis for modern accounting. The basic principal of double-entry bookkeeping is that every accounting entry is part of a **balanced** entry. So for every entry in one account there is an offsetting entry in another account.

So, for example, if on 1/5/07 Example Company sells $50 worth of product to a customer, it would be recorded with the first entry which has both a debit and a credit line as shown in Figure 3. Then, when Example Company receives the customer's check paying for the product on 2/10/07, the second entry is made with both debit and credit entries.

Date	Account	Account Name	Debit	Credit
1/5/07	1200	Accounts Receivable	$50.00	
1/5/07	4000	Sales		$50.00
	Record sale of products			
2/10/07	1000	Cash	$50.00	
2/10/07	1200	Accounts Receivable		$50.00
	Record cash received on account			

Figure 3. Double-entry.

As you can see each entry is balanced, the debits = credits forming a **balanced** entry. The terms **Debits** and **Credits** are just titles for the two sides of each accounting entry. After both entries have been recorded cash has been increased by $50, the accounts receivable entries net to $0, and Sales total $50.

Each account normally has either a debit or credit balance. For example, as can be discerned from the journal entries, the normal balance of the account where sales are recorded is a credit. Normal debit/credit balances are recorded in accordance with the following protocol as shown in Figure 4:

Account	Debits	Credits
Assets	Debit	
Liabilities		Credit
Equity		Credit
Revenue		Credit
Expenses	Debit	

Figure 4. Credits and Debits

As a common convention, debits are often treated as positive values and credits are treated as negative. The key is that at any point in time the debits always equal credits within an accounting system, and the total of the accounts with debit balances always equals the total of accounts with credit balances.

Account information for a period is often displayed in a **General Ledger (GL)** format. The GL format includes all of the accounting activity for each account for a given period.

If every check and cash receipt for a large company was entered in the company's general ledger it would quickly become very large and unwieldy. To solve this problem, individual entries are included in **Subsidiary Ledgers**. Then at the end of an accounting period, the totals for each account are included in the general ledger. Examples of subsidiary ledgers include:

- Cash Disbursements register, or sometimes know as a Check Register.
- Cash Receipts register
- Sales register
- Purchase register
- Payroll register

Subsidiary ledgers are typically used to record the vast bulk of the entries in a general ledger. Companies use **Journal Entries** to record miscellaneous entries that do not belong in any of the subsidiary registers. For example, recording adjustments or correcting errors is frequently a use of journal entries.

> TIP: General ledgers and subsidiary ledgers are essential parts of all sophisticated accounting systems. To understand them and the information they include generally requires financial expertise. If an understanding of them is required, you should consider asking a financial expert to assist you.

Try It Out!

Double-entry bookkeeping can quickly become complex and difficult to follow especially when dealing with a sequence of related transactions. Experienced accountants use "T-Account" analyses (because they look like a "T") to make sure they understand the accounting impact of complex transactions. T-Account analyses are often just scratched on a yellow-pad.

Let's use T-Accounts to analyze the effect on the general ledger accounts of the purchase of a building and related transactions. On December 1st, a company purchased a building for $1,000,000 with a 10% down payment. The Seller had already paid property taxes for the year ended December 31st and the amount paid the seller was increased by $500 for the property taxes attributable to December. The first mortgage payment of $1,000 was paid on December 31st.

The first step in dealing with complex accounting transactions is to break them down into individual transactions that are readily understandable by themselves. The next step is to create journal entries that reflect the individual transactions. The final step is to record the journal entries amounts in T-Accounts to see the overall effect of the transactions on the general ledger accounts.

For our building purchase, Figure 5 shows the journal entries to record the purchase, first mortgage payment and amortization of the "prepaid" taxes.

	Accounts	Debit	Credit
1	Fixed Assets	1,000,000	
	Prepaid Expenses	500	
	Cash		100,500
	Notes Payable		900,000
	Purchase building with a 10% downpayment and pre-paying $500 of property taxes for current year		
2	Notes Payable	50	
	Interest Expense	950	
	Cash		1,000
	Make first payment on note on December 31st		
3	Taxes	500	
	Prepaid Expense		500
	Amortize prepaid taxes		

Figure 5. Journal entries to record building purchase.

The first step in setting up T-Accounts is to create one for each account included in the journal entries. Then we will record the first journal entry of just the purchase of the building as shown in Figure 6.

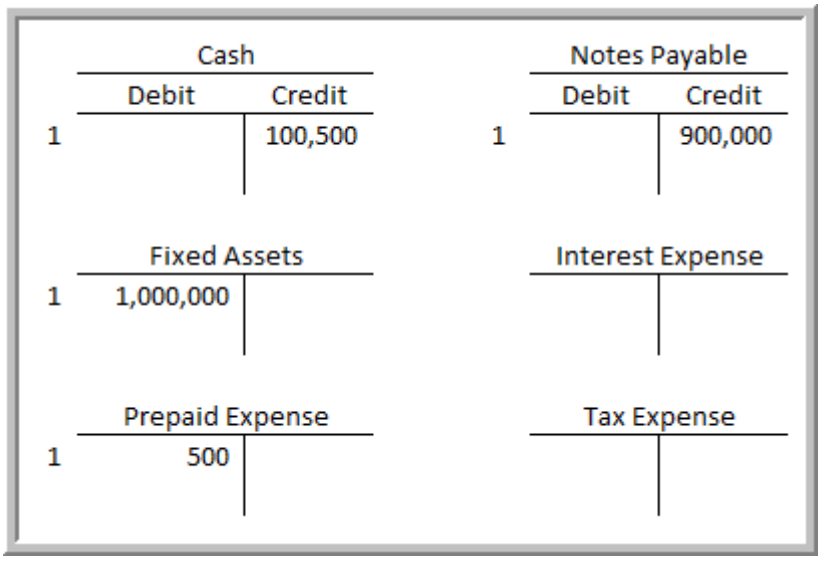

Figure 6. T-Accounts after recording purchase of building.

Each "T" represents an account in the general ledger. Debit amounts are entered on the left side of the "T" and credits on the right.

The number 1 is a reference to the first journal entry number in Figure 5. Then the respective debits and credits are recorded.

Now we can record the other entries and calculate the changes in account balances with the journal entry reference numbers helping us keep track of each entry.

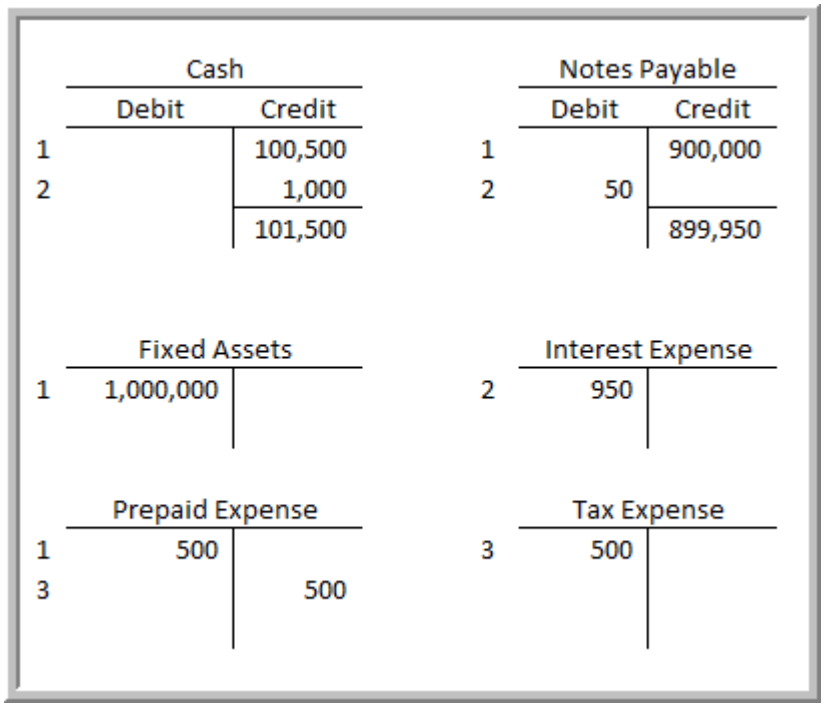

Figure 7. T-Accounts after all journal entries recorded

Now you can see the full effect of all the entries. The effect on cash is that it is goes down by $101,500. Notes payable increases by a net of $899,950. Prepaid expenses, consisting of property, taxes net to zero.

While this is a very simplified example, it demonstrates a common approach to understanding the accounting for complex transactions.

Financial Statements

The financial statements that we have discussed so far are for a single entity. However, what happens when one company owns one or more other companies and financial statements need to be presented as if they are one entity? To accomplish this, accountants prepare **consolidated financial statements**. Consolidated financial statements combine the accounting and financial information for two or more companies together.

However, you normally cannot just add them together! Take, for example, a situation where you have Company A and Company B that are both owned by Company C. Company C issues consolidated financial statements as it owns Company A and B. But there are transactions between the companies. Company A makes "Agits" and sells them both to regular customers but also sells them to Company B. Company B, in turn includes "Agits" into a "Bgits". Then Company B sells "Bgits" to both regular customers and to Company C.

Consolidated statements should only report on the transactions with third parties and must **eliminate** the transactions between the **related** companies. A consolidated financial statement is shown in Figure 4.

	A	B	C	Combined	Eliminated	Consolidated
	(Agits)	(Bgits)	(Cgits)			
Sales to customers	100	150	200	450		450
Intercompany sales	50	25	0	75	(75)	0
Total Sales	**150**	**175**	**200**	**525**	**(75)**	**450**
Purchases from vendors	125	90	100	315		315
Intercompany purchases	0	50	25	75	(75)	0
Purchases	125	140	125	390	(75)	315
Gross Income	25	35	75	135	-	135

Figure 5. Financial Statement.

This is a very simple example involving wholly owned subsidiaries. It can get much more complex, such as when consolidating partially owned subsidiaries.

Related Entities

The companies discussed in the prior consolidation example are known as **related** companies. Transactions with related parties are not necessarily at **arm's length**, i.e. the terms of transactions between them are not necessarily the same as they would be with an unrelated third party.

GAAP provides extensive guidance on when and what are **related** entities and when **related** companies should be consolidated. Management is responsible for disclosing all pertinent information about related transactions and agreements with related entities either in the financial statements themselves or in the accompanying Notes to the financial statements.

TIP:	Related entity transactions are particularly subject to abuse, and users of financial reports should always be alert to the possibility that transactions and relationships with related parties are not being accounted for or properly disclosed in the financial statements as required by GAAP.

Conclusion

Financial statements are often an important element in litigation. This chapter introduced basic accounting concepts to help litigators understand enough about accounting to know the right questions to ask and to recognize when it might be appropriate to consult with an expert. Financial accounting experts and forensic accountants that have expertise are able to sift through complex accounting records and grasp what really happened.

Fortunately, well prepared discovery requests can generate valuable accounting data in electronic form that allows for a thorough understanding of what makes up the accounting records and what estimates management used in preparing financial statements. Chapter __ - Working with Accounting Data discusses issues that should be considered when requesting accounting data or producing accounting data during discovery.

However, accounting data can be very voluminous and intimidating to those unfamiliar with accounting data. When accounting data is received during discovery it is important to marshal the appropriate resources and tools to organize and understand it. Chapter __ - Working with Accounting Data further discusses issues to consider what to do with accounting data after it has been received.