CHAKA™ STRATEGY

Essentials of Accounting & Finance for Lawyers©

The Language of Business

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Background – Chaka Patterson

- Partner at Alston & Bird (and former Partner at Jenner & Block and Jones Day)
- Professor at University of Chicago Law School
- Former General Counsel of a Fortune 1000 Global Education Company
- Former Treasurer & VP for Investor Relations of a Fortune 100 Energy Company
- JD from Harvard Law School
- MBA from University of Chicago Booth School of Business

HARVARD LAW SCHOOL

CHICAGO BOOTH The University of Chicago Booth School of Business

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Why Do Lawyers Need to Know Accounting & Finance?

- Enables you to speak fluent business language to your business clients.
- Equips you to provide more effective legal advice.
- Encourages you to find ways to deliver greater value to clients by understanding their business.
- Educates you on how to conduct due diligence on counterparties and litigation adversaries
- Expands your negotiation skills.

Key Financial Statements

The Key Financial Statements Every Lawyer Should Know

- **Income Statement**: details how a company made and spent money for a given reporting period.
- **Balance Sheet**: provides information about a company's “book” value and tally of an organization’s assets, liabilities, and owners’ equity at a single point in time.
- **Cash Flow Statement**: offers a look into a company’s cash flow from operating, investing, and financing activities.

What is the Income Statement

- One of the most common, and critical, of the financial statements.
- Also known as profit and loss (P&L) statements, summarizes all income and expenses over a given period.
- Often shared as quarterly and annual reports, showing financial trends and comparisons over time.
- Includes a detailed breakdown of income and expenses over the course of a reporting period.
- This is where the “topline” (revenue) and the “bottom line” (profit) can be found.
- The income statement is similar to a paycheck. The topline is your gross pay. The bottom line is your take home pay after all expenses have been deducted.

What Information is Found in the Income Statement

- **Revenue**: The amount of money a business takes in during a reporting period.
- **Costs of goods sold (COGS)**: The cost of component parts of what it takes to make whatever it is a business sells.
- **Gross profit**: Total revenue less COGS.
- **Expenses**: The amount of money a business spends during a reporting period.
- **Operating income**: Gross profit less operating expenses.
- **EBITDA**: Earnings before interest, depreciation, taxes, and amortization.
- **Depreciation (and amortization)**: The extent to which tangible assets (like equipment) or intangible assets (like intellectual property) have lost value over time (carried over from the assets section of the balance sheet).
- **Tax Expense**: What a company owes in taxes.
- **Interest Expense**: The interest a company pays on its debt. Debt can be found in the long-term liabilities section of the balance sheet.
- **Net income**: Income after taxes.
- **Earnings per share (EPS)**: Division of net income by the total number of outstanding shares.

Key Takeaways from the Income Statement

- Recognize how legal matters (transactions, litigation, government investigations, settlements, etc.) will impact the top and bottom lines.
    - Determine whether the revenue generated in the reporting period is "real revenue."
    - Be on the look out for fake revenue like
        - Channel stuffing
        - Roundtrip revenue
- Determine whether all costs incurred in the reporting period have been accurately categorized as either an expense or capitalized.
- Gather financial intelligence on competitors and contractual or litigation counterparties.

What is the Balance Sheet?

- A financial document designed to communicate exactly how much a company or organization is worth—its so-called "book value."
- Achieves this by listing out and tallying up all of a company's assets, liabilities, and owners' equity as of a particular date.
- Typically prepared and distributed on a quarterly basis.
- Provides a summary of a business at a given point in time.
- It's a snapshot of a company's financial position, as broken down into assets, liabilities, and equity.
- The Balance Sheet Equation: Assets = Liabilities + Owners' Equity.
- A balance sheet MUST always balance.
- Assets must always equal liabilities plus owners' equity. Owners' equity must always equal assets minus liabilities. Liabilities must always equal assets minus owners' equity.

What Information is Found in the Balance Sheet

- **Assets**: An asset is defined as anything that is owned by a company and holds inherent, quantifiable value. Assets are typically tallied as positives (+) in a balance sheet and broken down into two further categories: current assets and noncurrent assets.

- **Liabilities**: A liability is the opposite of an asset. While an asset is something a company owns, a liability is something it owes. Liabilities are financial and legal obligations to pay an amount of money to a debtor, which is why they're typically tallied as negatives (–) in a balance sheet.

- **Owners' Equity**: Owners' equity, also known as shareholders' equity, typically refers to anything that belongs to the owners of a business after any liabilities are accounted for.

- If you were to add up all of the resources a business owns (the assets) and subtract all of the claims from third parties (the liabilities), the residual leftover is the owners' equity.

Key Takeaways for the Balance Sheet

- **Generating Revenue and Increasing Cash flow by using contracts to:**
  - Reduce Accounts Receivable (thereby increasing cash collected by the business).
  - Reduce bad debt expense (thereby increasing cash to the business).
  - Increase Accounts Payable (thereby allowing third parties to finance the business for longer periods).
    - All of this additional cash generates revenue for the business because it is invested by the Finance team and any interest or dividend income shows up on the income statement.

- **Providing increased protection to the business by:**
  - Ensuring that the company is in compliance with all debt covenants.
  - Assessing whether business is consistently using same accounting methods for depreciation and amortization or has complied with GAAP in making any changes to those accounting methods.
  - Verifying that the company is testing its good will for any impairments.
  - Confirming that when the company buys back shares those shares show up in the treasury stock account in the equity section of the balance sheet.

What is the Cash Flow Statement

- The purpose of a cash flow statement is to provide a detailed picture of what happened to a business's cash during a specified period, known as the accounting period.
- It demonstrates an organization's ability to operate in the short and long term, based on how much cash is flowing into and out of the business.
- The cash flow statement is typically broken into three sections:
  - Operating activities
  - Investing activities
  - Financing activities

What Information is Found in the Cash Flow Statement

- **Operating Activities**: details cash flow that's generated once the company delivers its regular goods or services, and includes both revenue and expenses.
- **Investing Activities**: includes cash flow from purchasing or selling assets—think physical property, such as real estate or vehicles, and non-physical property, like patents—using free cash, not debt.
- **Financing activities**: details cash flow from both debt and equity financing. Dividends paid and shares repurchased are found here.

Key Takeaways from the Cash Flow Statement

- You can see how much cash different types of activities generate.
- Ideally, a company's cash from operating income should routinely exceed its net income, because a positive cash flow speaks to a company's ability to remain solvent and grow its operations.
- It's important to note that cash is different from profit, which is why a cash flow statement is often interpreted together with other financial documents, such as a balance sheet and income statement.
  - The key difference between cash flow and profit is while profit indicates the amount of money left over after all expenses have been paid, cash flow indicates the net flow of cash into and out of a business.
- The cash flow statement provides information on a company's financial health by helping you analyze the following:
  - The liquidity situation of the company
  - The company's sources of cash
  - The free cash flow the company generates to further invest in assets or operations
  - Whether overall cash has increased or decreased
- On December 4, 2023, Paul Munter, Chief Accountant at the SEC, announced SEC will focus on the Cash Flow Statement specifically on classifications among Operating, Investing, and Financing and whether misclassifications require restatement of the Financials

Appendix: Key Financial Terms Every Lawyer Should Know

Amortization: Amortization is a method of spreading an intangible asset's cost over the course of its useful life. Intangible assets are non-physical assets that are essential to a company, such as a trademark, patent, copyright, or franchise agreement.

Assets: Assets are items you own that can provide future benefit to your business, such as cash, inventory, real estate, office equipment, or accounts receivable, which are payments due to a company by its customers.
There are different types of assets, including:

- **Current Assets**: Current assets can be converted to cash within a year.
- **Fixed Assets**: Fixed assets can't immediately be turned into cash, but are tangible items that a company owns and uses to generate long-term income.

Asset Allocation: Asset allocation refers to how you choose to spread your money across different investment types, also known as asset classes. These include:

- **Bonds**: Bonds represent a form of borrowing. When you buy a bond, typically from the government or a corporation, you're essentially lending them money. You receive periodic interest payments and get back the loaned amount at the time of the bond's maturity—or the defined term at which the bond can be redeemed.
- **Stocks**: A stock is a share of ownership in a public or private company. When you buy stock in a company, you become a shareholder and can receive dividends—the company's profits—if and when they are distributed.

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Balance Sheet: A balance sheet is an important financial statement that communicates an organization's worth, or "book value." The balance sheet includes a tally of the organization's assets, liabilities, and shareholders' equity for a given reporting period.

- **The Balance Sheet Equation:** Balance sheets are arranged according to the following equation: Assets = Liabilities + Owners' Equity.

Capital Gain: A capital gain is an increase in the value of an asset or investment above the price you initially paid for it. If you sell the asset for less than the original purchase price, that would be considered a capital loss.

Capital Market: This is a market where buyers and sellers engage in the trade of financial assets, including stocks and bonds.

Cash Flow: Cash flow refers to the net balance of cash moving in and out of a business at a specific point in time. Cash flow is commonly broken into three categories, including:

- **Operating Cash Flow**: The net cash generated from normal business operations.
- **Investing Cash Flow**: The net cash generated from investing activities, such as securities investments and the purchase or sale of assets.
- **Financing Cash Flow**: The net cash generated financing a business, including debt payments, shareholders' equity, and dividend payments.

Appendix: Key Financial Terms Every Lawyer Should Know

Cash Flow Statement: A cash flow statement is a financial statement prepared to provide a detailed analysis of what happened to a company's cash during a given period of time. This document shows how the business generated and spent its cash by including an overview of cash flows from operating, investing, and financing activities during the reporting period.

Compound Interest: This refers to "interest on interest." Rather, when you're investing or saving, compound interest is earned on the amount you deposited, plus any interest you've accumulated over time. While it can grow your savings, it can also increase your debt; compound interest is charged on the initial amount you were loaned, as well as the expenses added to your outstanding balance over time.

Depreciation: Depreciation represents the decrease in an asset's value. It's a term commonly used in accounting and shows how much of an asset's value a business has used over a period of time.

EBITDA: An acronym standing for Earnings Before Interest, Taxes, Depreciation, and Amortization, EBITDA is a commonly used measure of a company's ability to generate cash flow. To get EBITDA, you would add net profit, interest, taxes, depreciation, and amortization together.

Equity: Equity, often called shareholders' equity or owners' equity on a balance sheet, represents the amount of money that belongs to the owners of a business after all assets and liabilities have been accounted for. Using the accounting equation, shareholder's equity can be found by subtracting total liabilities from total assets.

Income Statement: An income statement is a financial statement that summarizes a business's income and expenses during a given period of time. An income statement is also sometimes referred to as a profit and loss (P&L) statement.

Appendix: Key Financial Terms Every Lawyer Should Know

Liabilities: The opposite of assets, liabilities are what you owe other parties, such as bank debt, wages, and money due to suppliers, also known as accounts payable. There are different types of liabilities, including:

- **Current Liabilities**: Also known as short-term liabilities, these are what's due in the next year.
- **Long-Term Liabilities**: These are financial obligations not due over a year that can be paid off over a longer period of time.

Liquidity: Liquidity describes how quickly your assets can be converted into cash. Because of that, cash is the most liquid asset. The least liquid assets are items like real estate or land, because they can take weeks or months to sell.

Net Worth: You can calculate net worth by subtracting what you own, your assets, with what you owe, your liabilities. The remaining number can help you determine the overall state of your financial health.

Profit Margin: Profit margin is a measure of profitability that's calculated by dividing the net income by revenue or the net profit by sales. Companies often analyze two types of profit margins:

- **Gross Profit Margin**: Which typically applies to a specific product or line item rather than an entire business.
- **Net Profit Margin**: Which typically represents the profitability of an entire company.

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Return on Investment (ROI): Return on Investment is a simple calculation used to determine the expected return of a project or activity in comparison to the cost of the investment, typically shown as a percentage. This measure is often used to evaluate whether a project will be worthwhile for a business to pursue. ROI is calculated using the following equation: ROI = [(Income – Cost) / Cost] * 100.

Valuation: Valuation is the process of determining the current worth of an asset, company, or liability. There are a variety of ways you can value a business, but regularly repeating the process is helpful, because you're then ready if ever faced with an opportunity to merge or sell your company, or are trying to seek funding from outside investors.

Working Capital: Also known as net working capital, this is the difference between a company's current assets and current liabilities. Working capital—the money available for daily operations—can help determine an organization's operational efficiency and short-term financial health.

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