



Introduction of Financial Statement Analysis[©]

The Balance Sheet, Income Statement & Cash Flow Statement

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Background – Chaka Patterson



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- 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

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Introduction

Purpose of Financial Statement Analysis for Lawyers:

- **Legal Insight:** Helps identify client's or opposing party's financial health, revealing risks, hidden values, and liabilities.
- **Applicability:** Useful across corporate litigation, fraud, contract disputes, and M&A cases.
- **Decision-Making:** Guides on settlements, debt restructuring, shareholder disputes, and M&A.

Components of Financial Statements:

- **Balance Sheet:** Snapshot of assets, liabilities, and equity.
- **Income Statement:** Summarizes profitability and growth
- **Cash Flow Statement:** Tracks cash flows, showing liquidity and operational health.

Assets	2024	2023
Current assets:		
Cash and cash equivalents	\$219,306.00	\$272,194.00
Restricted cash	\$1,896.00	\$2,881.00
Accounts and financing receivables, net	\$126,833.00	\$102,749.00
Prepaid expenses and other current assets	\$70,050.00	\$102,473.00
Total current assets	\$418,085.00	\$480,297.00
Noncurrent assets:		
Property and equipment, net	\$248,524.00	\$244,649.00
Operating lease assets	\$176,755.00	\$174,677.00
Deferred income taxes	\$49,088.00	\$56,694.00
Intangible assets, net	\$776,694.00	\$812,338.00
Goodwill	\$961,262.00	\$961,262.00
Other assets, net		
Assets held for sale		
Total noncurrent assets		
Total assets		
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable		
Accrued payroll and benefits		
Accrued liabilities		
Deferred revenue		
Current operating lease liabilities		
Total current liabilities		
Noncurrent liabilities:		
Long-term debt		
Long-term operating lease liabilities		
Deferred income taxes	\$29,526.00	\$26,068.00
Other liabilities	\$38,675.00	\$37,416.00
Total noncurrent liabilities	\$884,625.00	\$922,002.00
Total liabilities	\$1,372,282.00	\$1,353,205.00

Commitments and contingencies

Shareholders' equity:		
Common stock, \$0.01 par value per share, 200,000 shares authorized; 37,681 and 42,310 shares outstanding as of June 30, 2024 and June 30, 2023, respectively	\$832.00	\$822.00
Additional paid-in capital	\$611,949.00	\$568,761.00
Retained earnings	\$2,540,509.00	\$2,403,750.00
Accumulated other comprehensive loss	-\$2,227.00	-\$2,227.00
Treasury stock, at cost, 45,513 and 39,922 shares as of June 30, 2024 and June 30, 2023, respectively	-\$1,781,928.00	-\$1,513,770.00
Total shareholders' equity	\$1,369,135.00	\$1,457,336.00
Total liabilities and shareholders' equity	\$2,741,417.00	\$2,810,541.00

What Is the Balance Sheet?

— Understanding the Balance Sheet

Assets Section:

Understanding Asset Value and Ownership

Liabilities Section:

Debt and Financial Obligations

Shareholders' Equity Section:

Understanding Ownership Structure

Analyzing the Balance Sheet

Key Balance Sheet Ratios:

- **Net Working Capital:** Current assets less current liabilities.
- **Current Ratio:** Current assets/current liabilities. Shows liquidity.
- **Debt-to-Equity Ratio:** Long-term debt/Equity.
- **Quick Ratio:** Cash+marketable securities+receivables/current liabilities.
- **Leverage Ratio:** Assets/Equity.

— Analyzing the Balance Sheet

Application for Lawyers:

- Bankruptcy and Insolvency
- Mergers & Acquisitions (M&A)
- Contract Disputes and Breaches
- Litigation Involving Financial Representations

What Is the Income Statement?

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Sample Income Statement

Consolidated Statements of Income
(in thousands, except per share data)

Revenue	
Revenue	\$1,584,652
Operating Costs and Expenses	
Cost of Goods Sold (COGS)	-\$698,548
Gross Profit	\$886,104
Operating Expenses:	
Administrative Expense	-\$632,965
Restructuring Expense	\$1,870
Business Acquisition and Integration Expense	\$34,215
Gain on Sale of Assets	\$0
Total Operating Costs and Expenses	-\$1,367,598
Operating Income	\$217,054
Other Income (Expenses)	
Depreciation and Amortization	-\$75,320
Interest Expense	-\$63,659
Interest Income	
Income from Continuing Operations Before Income Taxes	\$163,937
Provision for Income Taxes	-\$26,224
Income from Continuing Operations	\$137,713
Discontinued Operations	
Loss from Discontinued Operations Before Income Taxes	-\$762
Loss on Disposal of Discontinued Operations	\$0
Before Income Taxes	
Provision for Income Taxes: \$(174)	-\$174
Loss from Discontinued Operations	-\$936
Net Income	
Net Income	\$136,777

Earnings (Loss) Per Share

Basic:	
Continuing Operations	\$3.49
Discontinued Operations	-\$0.02
Total Basic Earnings Per Share	\$3.47
Diluted:	
Continuing Operations	\$3.42
Discontinued Operations	-\$0.02
Total Diluted Earnings Per Share	\$3.39

Weighted-Average Shares Outstanding

Basic Shares	39,413
Diluted Shares	40,307

Understanding the Income Statement

Revenue Section

Revenue Recognition &
Accuracy

Cost of Goods Sold (COGS)

Direct Costs of Production

Gross Profit and Gross Margin

Profitability of Core
Operations

Operating Expenses (SG&A)

Sales, General, and
Administrative Expenses
(SG&A)

Operating Income (EBIT)

Earnings Before Interest
and Taxes (EBIT)

Interest Expense and Income

Debt Servicing Costs

Pre-Tax Income and Tax Expense

Income Before Taxes (EBT)

Net Income and Net Profit Margin

Net Income

— Analyzing the Income Statement

Key Income Statement Ratios:

Gross Profit Margin: $\text{Gross Profit} / \text{Revenue}$. Efficiency in controlling production costs.

Operating Profit Margin: $\text{Operating Profit} / \text{Revenue}$. Measures core operations profitability.

Net Profit Margin: $\text{Net Income} / \text{Revenue}$. Indicates overall profitability after costs.

Interest Coverage Ratio: $\frac{\text{Net Income} + \text{Interest Expense} + \text{Tax Expense}}{\text{Interest Expense}}$. Measures a company's ability to pay its interest expenses on outstanding debt using its operating income.

Earnings Per Share: $\frac{\text{Net Income}}{\text{Common Shares Outstanding}}$. Tells common shareholders how much profit can be ascribed to each share purchased.

— Analyzing the Income Statement

Application for Lawyers:

- Valuation in Mergers & Acquisitions (M&A)
- Contractual Disputes and Performance-Based Agreements
- Financial Misrepresentation or Fraud Cases
- Tax Compliance and Disputes

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Sample Cash Flow Statement
Consolidated Cash Flows
(in thousands)

Operating activities:

Net income	\$136,777
Loss (income) from discontinued operations	\$936
Income (loss) from continuing operations	\$137,713

Adjustments to reconcile net income to net cash provided by operating activities:

Stock-based compensation	\$25,947
Amortization and impairments to operating lease assets	\$32,641
Depreciation	\$39,676
Amortization of acquired intangible assets	\$35,644
Amortization and write-off of debt discount and issuance costs	\$5,663

costs

Provision for bad debts	
Deferred income taxes	
Loss on disposals, accelerated depreciation	
Impairments to property and equipment	
Gain on extinguishment of debt	
(Gain) loss on investments	
Gain on sale of assets	
Unrealized loss on assets held for sale	

Changes in assets and liabilities:

Accounts and financing receivables	
Prepaid expenses and other current assets	
Cloud computing implementation assets	
Accounts payable	
Accrued payroll and benefits	
Accrued liabilities	
Deferred revenue	
Operating lease liabilities	
Other assets and liabilities	

Net cash provided by operating activities-operations

Net cash provided by (used in) operating activities-discontinued operations

Net cash provided by operating activities

Investing activities:

Capital expenditures	-\$48,893.00
Proceeds from sales of marketable securities	\$1,732.00
Purchases of marketable securities	-\$689.00
Proceeds from note receivable related to property sold	\$0.00
Payment for purchase of business, net of cash and restricted cash acquired	\$0.00
Cash received on loan	\$0.00
Net cash (used in) provided by investing activities-continuing operations	-\$47,850.00
Net cash used in investing activities-discontinued operations	\$0.00
Proceeds from sale of business, net of cash transferred	\$0.00
Payment for working capital adjustment for sale of business	\$0.00
Net cash (used in) provided by investing activities	-\$47,850.00

Financing activities:

Proceeds from exercise of stock options	\$17,089.00
Employee taxes paid on withholding shares	-\$7,731.00
Proceeds from stock issued under Employee Stock Purchase Plan	\$810.00
Repurchases of common stock for treasury	-\$261,966.00
Payment on equity forward contract	\$0.00
Proceeds from issuance of long-term debt	\$1,896.00
Repayments of long-term debt	-\$51,896.00
Payment of debt discount and issuance costs	\$0.00
Payment for purchase of redeemable noncontrolling interest of subsidiary	\$0.00
Net cash used in financing activities	-\$301,798.00
Net decrease in cash, cash equivalents and restricted cash	-\$53,873.00
Cash, cash equivalents and restricted cash at beginning of period	\$275,075.00
Cash, cash equivalents and restricted cash at end of period	\$221,202.00

What Is the Cash Flow Statement?

Understanding the Cash Flow Statement

Operating Cash Flow:

Reflects cash generated or used by the company's core business operations

Investing Cash Flow:

Reflects cash used for or generated from investments in or sales of assets

Financing Cash Flow:

Reflects cash transactions between a company and its creditors or shareholders

Cash Flow Reconciliation and Net Cash Position:

Shows the net increase or decrease in cash during the period

— Analyzing the Cash Flow Statement

Key Cash Flow Ratios:

Operating Cash Flow Ratio: Operating cash flow/current liabilities.

Free Cash Flow (FCF): Operating cash flow less capital expenditures.

Cash Flow to Revenue Ratio: Operating cash flow/revenue.

Current Liability Coverage Ratio: Operating cash flow/average current liabilities.

Cash Flow to Total Debt Ratio: Operating cash flow/total debt.

Capital Expenditure Ratio (Reinvestment Ratio): Operating cash flow/capital expenditures.

— Analyzing the Cash Flow Statement

Application for Lawyers:

- Bankruptcy and Insolvency Cases
- Contract Disputes and Debt Covenants
- Mergers & Acquisitions (M&A)
- Financial Misrepresentation and Fraud Investigations
- Shareholder Disputes and Equity Distributions

Common Red Flags in Financial Statements

High or Fluctuating Debt Levels: Unexplained increase in debt or debt-to-equity ratio that's unusually high.

High-Value Intangible Assets: A large portion of total assets comprised of intangible assets.

Abnormal Gross or Operating Margins: Margins significantly different from industry peers or the company's historical average.

Unusual Changes in Inventory or Accounts Receivable: Inventory or receivables growing faster than sales.

Inconsistent Cash Flow and Net Income: High net income but low or negative cash flow from operations.

Unusual Revenue Growth or Decline: Revenue growth is significantly higher or lower than industry trends or the company's historical performance.

Financial Statement Analysis in Legal Contexts

Applications in Litigation and Disputes

- Contract Breaches and Damage Quantification
- Fraud Investigation
- Forensic Accounting in Divorce and Estate Cases

Applications in Mergers & Acquisitions (M&A)

- Due Diligence:
- Valuation and Purchase Price Adjustment

Common Mistakes in Financial Statement Analysis

Pitfalls to Avoid in Financial Analysis:

- Over-reliance on Single Ratios or Statements
- Ignoring Industry or Economic Context
- Neglecting Qualitative Data

— Best Practices in Financial Statement Analysis

Comprehensive Approach:

Review all three main statements (Balance Sheet, Income Statement, Cash Flow Statement) together to get a holistic view.

Use Benchmarks for Comparison:

Compare ratios and performance metrics with industry peers and historical data for context.

Consider Qualitative Insights

Management changes, pending lawsuits, or industry disruptions can significantly impact financial performance and should be part of the analysis.

Key Takeaways



Importance of Financial
Analysis for Legal Insights



Applications in Various Legal
Contexts



Key Ratios and Adjustments for
Accurate Financial Assessment



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