

Basic Finance for In-House Lawyers

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ACC – Chicago Chapter

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Your Host

- In-House almost 25 years, three-time General Counsel
- Write “[Ten Things You Need to Know as In-House Counsel](#)” blog
- Published four books (fifth due out in 2021)
- CEO & Senior Counsel of Hilgers Graben PLLC
- Consult with legal departments/coach in-house lawyers
- Connect with me on [LinkedIn](#) and Twitter (@TenThingsLegal)



WHY
Introduction

ARE

WE

HERE

?

Introduction – Don't Be a Tourist

- When I got to law school, there was no math (unless you count student loans)
- Even at a law firm, there was some need for basic accounting and finance but certainly nothing I worried about on a day-to-day basis
- Then I went in-house and things changed. Accounting and finance are the language of business and if you don't speak the language then you're just another tourist in ill-fitting shorts, t-shirt, and White Sox baseball cap
- By “tourist” I mean that you're not likely to stay very long if you don't speak the language - and the language of business is numbers



Introduction – Know When to Up Your Game

After a few meetings where “EBITDA” and “CAGR” flew over my head, I knew I needed to buckle down and start figuring out what all this number stuff was about. Over time, I got to the point where I could at least follow along at meetings when the Finance folks pulled out the spreadsheets

Over the years I kept a notebook of key financial terms, formulas, resources, and other information I think are key to being a successful (and valuable) in-house attorney

Today we are going to discuss basic finance. None of this will make you an expert but, hopefully, you'll be able to recognize/navigate some of the most common issues



Mind the
GAAP

MIND THE GAAP

Mind the GAAP

- Everything starts here (at least in the U.S)
- GAAP stands for “Generally Accepted Accounting Principles” promulgated by the Financial Accounting Standards Board (“FASB”). These are the rules that the finance and accounting teams use to track, measure, and report the financial performance of the company. GAAP is especially important if your company is publicly-traded because the regulators want to ensure that investors have an accurate understanding of the financial condition of the company
 - GAAP financials are the subject of audits conducted by outside accounting firms (another way to ensure investors/shareholders have an accurate picture of the company’s financial health)
- The Sarbanes-Oxley legislation arose from companies, like Enron, “gaming” the GAAP rules to give a false picture of the company’s finances. Aside from this regulatory focus, use of GAAP also gives company management an accurate picture of the financial health of the business and, most importantly, its viability as a “going concern”

Mind the GAAP

- Outside of the U.S., companies use IFRS accounting standards promulgated by the International Accounting Standards Board (“IASB”). There are efforts between FASB and IASB to coordinate standards so they move closer to uniformity
- You often hear of companies using “non-GAAP” measures to report their finances. Basically, this means that the company’s management feels there are other metrics to report that better show the company’s true financial position. You will usually see such measures with the word “adjusted” in front to indicate deviation from GAAP.
 - For example, a company might exclude extraordinary one-time expenses because they are not part of the “normal” operations of the business.
- Companies that use non-GAAP measures must still include the applicable GAAP measures and if there are too many non-GAAP items in the financial statements, investors become very wary about the quality of the information and the health of the business

A word cloud of accounting terms. The central text reads "Accrual Accounting" in large, white, sans-serif font. Surrounding this central text are various accounting terms in different sizes and colors (yellow, orange, and green) on a dark blue background. The terms include: ACCOUNTS, ASSET, FLOW, SHAREHOLDERS, EQUITY, ACCRUAL, INCOME, LIABILITY, CASH, EXPENSE, REVENUE, PAYABLE, RECEIVABLE, BALANCE, SHEET, METHOD, BASIS, STATEMENT, and SHAREHOLDERS. The words are arranged in a circular pattern around the center, with some words appearing multiple times in different sizes.

Accrual Accounting

ACCOUNTS ASSET FLOW SHAREHOLDERS EQUITY ACCRUAL INCOME LIABILITY CASH EXPENSE REVENUE PAYABLE RECEIVABLE BALANCE SHEET METHOD BASIS STATEMENT SHAREHOLDERS

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Accrual Accounting

- There are two ways to keep track of money. The easiest is on a cash basis where you simply record money in when you get it and money out when you pay it
- For all but the smallest businesses, the cash method doesn't work well because it postpones recognition of revenue and it doesn't match the costs of generating revenues with those specific revenues
- The answer is to utilize an accrual basis method

Accrual Accounting

Under the accrual method revenues are recognized in the period when the goods or services are rendered and the costs/expenses are recognized in the period in which those expenses helped generate the revenue. In other words, they are “matched.”

Under the accrual method it is irrelevant when cash is paid out or received. Not only does GAAP require use of the accrual method, the method more accurately reflects expenses and revenue, and it gives management a better picture of sales activity in the relevant period.

This is all part of “double entry” accounting which has been around for about 500 years or so. In sum, for every accounting entry in the books, there is an equal and opposite entry made as well – this is how the accounts “balance.”



The Big Three

The Big Three

There are three core financial documents you need to know about:

- Balance Sheet
- Income Statement
- Cash Flow

BALANCE SHEET

The Balance Sheet

- The balance sheet is a “snapshot” in time that shows what the company owns (assets), what it owes (liabilities), and what’s left over (owner’s equity). The balance sheet is the product of the “accounting equation”

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- Assets are things like equipment, cash, buildings, accounts receivable, pre-paid services, and supplies. It also includes intangible assets like “goodwill” and intellectual property
- Liabilities are things like loans, salaries, interest, accounts payable, and deferred taxes
- Owner’s Equity is simply the difference between the two and constitutes the stockholders’ claim to the assets of the company, e.g., common and preferred stock. It also represents the net worth or “book value” of the company
 - The book value/net worth set out in the accounting equation is not the same thing as the “market value” of the company, which is typically much higher because everything is shown at cost in the equation vs. what a willing buyer would pay for the assets

BALANCE SHEET December 31, 2100

ASSETS

Current assets

Cash and cash equivalents	\$ 100,000
Accounts receivable	20,000
Inventory	15,000
Prepaid expense	4,000
Investments	10,000
Total current assets	149,000

Property and equipment

Land	24,300
Buildings and improvements	250,000
Equipment	50,000
Less accumulated depreciation	(5,000)

Other assets

Intangible assets	4,000
Less accumulated amortization	(200)

Total assets **\$ 472,100**

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities

Accounts payable	\$ 30,000
Notes payable	10,000
Accrued expenses	5,000
Deferred revenue	2,000
Total current liabilities	47,000

Long-term debt 200,000

Total liabilities **247,000**

Shareholders' Equity

Common stock	10,000
Additional paid-in capital	20,000
Retained earnings	197,100
Treasury stock	(2,000)

Total liabilities and shareholders' equity **\$ 472,100**

Income Statement

Revenue
Predict
Deduct
Estimates
Disposals
Operations
Financial performance
Assets
Top line
Gross
Taxes
Sources

Cost
Publish
Audit
Equity
Cash flow
Administrative
Amortization
Depreciation

Earnings
Profit
Loss
Assess
Single Step
Multi-Step
Cash outflows
Net income
Bottom line
Write-offs
Cash inflows
Period of time
Year

Expenses
Period

Income Statement

- The income statement (also called a profit and loss (P&L) statement) shows how profitable the company is over some measurement period, e.g., a year or a quarter. It shows two things: revenues (money in) and expenses (money out). The difference is called “net income.” It is expressed as follows:

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

- Revenues are earnings resulting from the activities of the company, e.g., sale of goods and services. Under the accrual method, revenues are recorded when earned and not when actually received (note: revenues are not the same thing as receipts)
- Expenses are the costs incurred to produce the company’s revenues, e.g., rent, salaries, costs of materials, advertising, depreciation, and utilities. Like revenues, expenses are accrued when incurred regardless of when the company actually pays for them

Income Statement

- Under the accrual method the expenses are matched to the revenues they generate. For example, Company X contracts to deliver 100 widgets in August for \$1,000. The revenue from the contract is recorded for August regardless of when the customer pays for the widgets. Company X also contracts to pay a vendor \$100 to deliver the widgets to the customer in August, with payment for the delivery services due in September. The expense is still recorded in August and is matched with the \$1,000 in revenue
- The difference between revenues and expenses is net income or net loss if the company loses money. It is also often referred to as the company's "bottom line"
- A multiple of net income is an established method to place a value on a business.
- For in-house lawyers, the business may assign the legal department its own P&L. This means the business watching closely how the department tracks expenses (money out) vs. the budget

HUNTER COMPANY

Income Statement

For the Year Ending December 31, 20X9

Revenues

Net sales		\$653,000
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Expenses and losses

Cost of goods sold	\$283,000	
Selling expenses	142,000	
General & administrative	170,000	
Loss on sale of land	2,000	
Interest expense	7,000	604,000

Income before tax

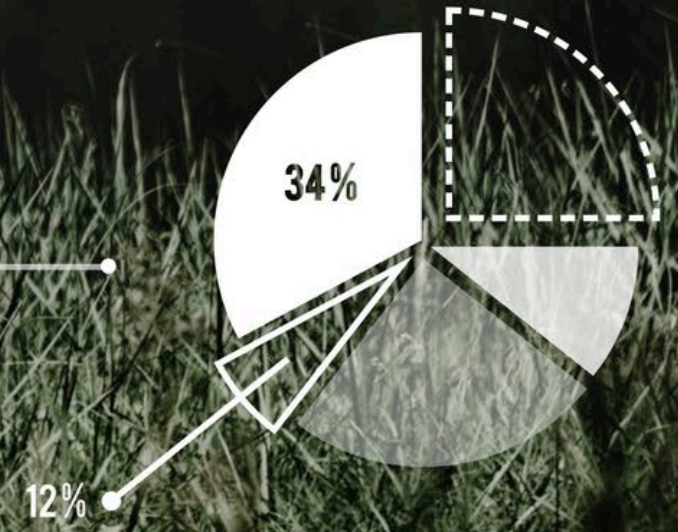
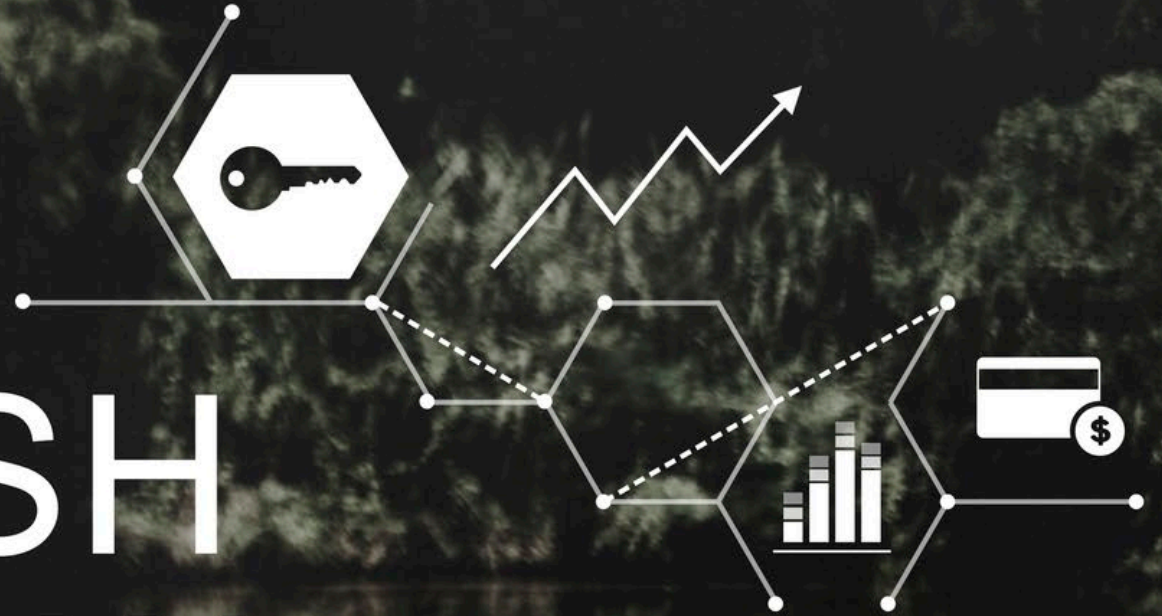
\$ 49,000

Income tax expense		10,000
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Net income

\$ 39,000

CASH FLOW



Cash Flow

The cash flow statement shows cash in and cash out over a certain period of time, e.g., a year, a quarter, etc. It is comprised of cash from: operating activities, investing returns, and financing (borrowing)

All companies need adequate cash flow to operate, e.g., pay bills, salaries, etc. Companies can be “doing well” from a sales standpoint but be cash-poor, meaning a lot of customers owe them money but haven’t paid yet (accounts receivable)

Since companies still need to pay their own debts, this sometimes requires short term loans from a bank or sale of bonds to generate cash (often called a "revolver" or line of credit)

Investors and potential buyers of the business are very interested in cash flow because “cash is king.” A discounted cash flow analysis is another to value how much a business is worth

Cash Flow Statement

[USD \$ millions]

	2014	2015	2016	2017	2018
Operating Cash Flow					
Net Earnings	2,474	11,791	21,075	26,713	28,227
Plus: Depreciation & Amortization	19,500	18,150	17,205	16,544	16,080
Less: Changes in Working Capital	9,003	1,702	775	903	827
Cash from Operations	12,971	28,239	37,505	42,354	43,480
Investing Cash Flow					
Investments in Property & Equipment	15,000	15,000	15,000	15,000	15,000
Cash from Investing	15,000	15,000	15,000	15,000	15,000
Financing Cash Flow					
Issuance (repayment) of debt	-	-	(20,000)	-	-
Issuance (repayment) of equity	170,000	-	-	-	-
Cash from Financing	170,000	-	(20,000)	-	-
Net Increase (decrease) in Cash	167,971	13,239	2,505	27,354	28,480
Opening Cash Balance	-	167,971	181,210	183,715	211,069
Closing Cash Balance	167,971	181,210	183,715	211,069	239,550

The General Ledger

The General Ledger

- Every company has a general ledger. This is the data base that contains all of the journal entries as a series of debits and credits
- In Accounting World: Credit is money out and Debit is money in (yes, weird)
- Journal entries are the record of each company transaction, e.g., sales, expenses, cash in, cash out, loans, salaries, and everything else discussed above. The journal entries feed into the Big Three financial documents
- Ensuring the integrity of the general ledger and journal entries is a big part of the job of the internal audit function (as well as part of the work of the company's external auditors)

The General Ledger

- The general ledger may have dozens and dozens, if not hundreds, of different accounts under which to make entries. It just depends on how much detail the company needs. Some examples include: cash, accounts receivable, notes payable, service revenue, wages, rent, and depreciation
- The legal department typically falls under a general category called “Selling, General & Administrative” expense (“SG&A”). SG&A represents most of the cost of operating the business. When times are tough and the business is looking to “cut costs,” SG&A is one of the first places they look
- This is why it’s so important to operate the legal department like part of the business, with attention to expenses and budgets. A free-spending legal department is not likely to escape the cost-cutting hatchet and will generate questions about its leadership and ability to operate efficiently

General Ledger Example Account

General Ledger Sheet				Sheet No: 21	
Account: Electricity Expense				Account No: 640	
Date	Details	Ref.	Debit	Credit	Balance
2018					
Mar 15	To Accounts Payable	J1	4,000		4,000
June 17	To Accounts Payable	J3	3,640		7,640
Sept 14	By Accounts Payable	J5		430	7,210

KEY TERMS!

Key Terms

There are way too many “finance terms” to discuss today. Get a good glossary and keep a copy on your desk for when you run across terms you do not know or need a quick refresher. For a good glossary, [click here](#). Here some finance terms I focused on early in my career that seemed to come up often:

- [EBITDA](#) – earnings before interest, taxes, depreciation, and amortization. It is a quick [proxy](#) for cash flow and profitability of the business
- [Depreciation/Amortization](#) – both are ways of showing the lessening of value of a company asset over time. For example, a truck or a computer will decrease in value over time, ultimately to zero. Depreciation is for tangible assets and amortization is for intangible assets (e.g., intellectual property). The portion of depreciation or amortization assigned for any one year, becomes an “expense” of the business

Key Terms

- CAGR – compounded annual growth rate. This shows the annual growth rate of an investment or line of business over some period of time. It can be backward or forward looking or a combination. It helps analyze an investment especially when year-over-year results are not consistent. It is calculated as follows:

$$\text{CAGR} = \left[\frac{\text{End value}}{\text{Beginning value}} \right]^{[1/\text{years}]} - 1$$

- Basis point – is 100th of 1% and is used to measure changes in rates, usually interest rates but it can be used for rate or return, etc. It seems small but it can add up to a lot of money over time. For example, if the interest your company must pay on a bond it issues goes from 6% to 6.05%, it rose five (5) basis points. Over time that .05% can mean a lot of money out the door

Key Terms

- Goodwill – generally, this represents the premium paid for a business over its book value (“owner’s equity”), usually because the business has created a favorable brand, has a large customer base, happy workers, patents or other IP, and so forth. Goodwill is an intangible asset of the company and sits on the balance sheet
- Pro-forma – In the finance world, pro-forma typically means financial statements generated based on assumptions, projections, and hypotheticals. For example, if your company is looking to acquire another company, the Finance team will create a pro-forma P&L to show what the combined operations would look like if the deal happens. They will make certain assumptions about costs, overhead, sales, and other factors to come with the “make believe” numbers

Key Terms

- The “Close Process.” – there are times when your friends in Finance cannot grab lunch or a beer, usually when they are in the “close process.” This means they are closing the books on the measurement period (the month, the quarter or the year) and preparing the appropriate financial statements for management or investors in the case of a publicly traded company
- In addition to simply balancing the books (the ledger) for all relevant transactions during the measure period, the Finance team and management are looking at different numbers and ratios to determine if anything is “out of whack” that either requires attention of management or, more problematic, some type of disclosure in the publicly released financial statements

Key Formulas

Key Formulas

In addition to getting a clear picture of the financial health of the company, the Big Three financial documents can give deeper insights into how the company is performing and where extra attention – good or bad – may be required. Management and outsiders will take data from the Big Three and plug them into dozens of formulas – each of which reveals some important fact or trend about the business. Here are a handful that I found most useful to know:

- Gross margin – this is the company's total sales revenue (minus) its cost of goods/services sold (divided by) total sales revenue. The resulting percentage shows the total amount of sales revenue retained by the company after backing out the direct costs of producing those sales. The higher the percentage, the more of each dollar sold the company keeps. If the percentage is dropping, then it usually means it's time to cut costs

Key Formulas

- Net present value (NPV) – NPV is way to evaluate the profitability of a future investment. It ties into the concept of the “time value of money,” i.e., a dollar in the future is worth less than a dollar in hand today because you have different opportunities to invest today’s dollar and make more money, e.g., collecting interest in the bank
 - There are several variables used to calculate the NPV of a project. A project with a positive NPV should be profitable and one with a negative NPV will likely lose money. Companies use NPV to compare and contrast different options to determine the best way for the company to spend its money on investments in new lines of business or products/services
- Contribution to margin – this formula allows you to calculate the profitability of a specific product or service by subtracting the variable costs (but not fixed costs like overhead) of producing a product/service from the price charged for that product/service
 - A high contribution margin means the product or service is a money maker for the company. A low or negative contribution margin means the product or service may be a drag on earnings and needs attention. And when times get lean, the company will put its resources behind products or services with a higher contribution

Key Formulas

- Earnings per share (EPS) – if your company is public or thinking of going public, this is an important formula. EPS shows how much profit the company delivers per share of stock in the company. It is calculated by subtracting any stock dividends paid out from the company's net revenue and then dividing that number by the number of outstanding shares of stock
 - One way management and investors check the “quality” of EPS is to focus on the cash flow generated by the company for each share of stock. This is a good indicator of the health of the business and is helpful when comparing companies with a similar EPS
- Debt/Equity ratio – this formula measures how much debt the company is using to finance its assets vs. using owner's equity. It is calculated by dividing the company's total liabilities by owner's equity (i.e., total assets – total liabilities). The higher the ratio/percentage the more debt the company is taking on to finance its operations
 - While using some debt (“leverage”) to operate the company is smart, a very high ratio can mean the company is having to borrow money to simply keep going – not a good sign

Setting Reserves

A close-up, macro photograph of a metal slide rule. The image shows multiple curved scales with numbers. The top scale has numbers 1.5, 2, 3, 10, 20 in yellow and white. Below it, a scale has 1.2, 2, 2.8, 4 in white. Further down, another scale has 1.2, 2, 2.8 in white. A textured, diamond-plate grip is visible on the right side. A small metal tab with a screw is on the left.

Setting Reserves

- In the accounting world, companies must set aside money in “reserve” to cover, among other things, impaired assets and potential payouts in litigation. While a necessary task, no one is happy about it because setting a reserve takes money away from other uses.
- As an in-house lawyer, I was involved in setting dispute/litigation reserves. It’s a challenging task. The governing rule in the U.S. is called [ASC 450 \(formerly “FAS5”\)](#) and is a standard set by the FASB. A company must set a reserve (or an accrual) for a dispute/litigation if (a) the likelihood of losing or having to pay out is “probable,” and (b) the amount that the company would have to pay out can be “reasonably estimated.”

Setting Reserves

- As you can see, there is a lot of grey in this task. “Probable” in ASC450 is defined as “likely to occur.” With litigation, it is extremely hard to predict if something is “likely.” I use a rule of thumb of a 75% chance of occurring as being “probable.” Equally challenging is estimating any payout, especially if – as is often the case – the other side has not yet put forth any damages number or if the damages number you get is clearly garbage
- Still, it is a task you may be called upon to undertake and you need to bring all of your judgment and skill to bear. Here is a great article on setting legal reserves via the ACC a good many years ago. [Click here](#) to read it. For a more current article, [click here](#)
- Also, watch out for issues regarding [waiver of the attorney-client privilege](#) when dealing with auditor letter requests

Additional Resources

[Finance and Accounting for Lawyers in a Nutshell](#)

[Complete MBA for Dummies](#)

[ACC Mini MBA Course for Lawyers](#)

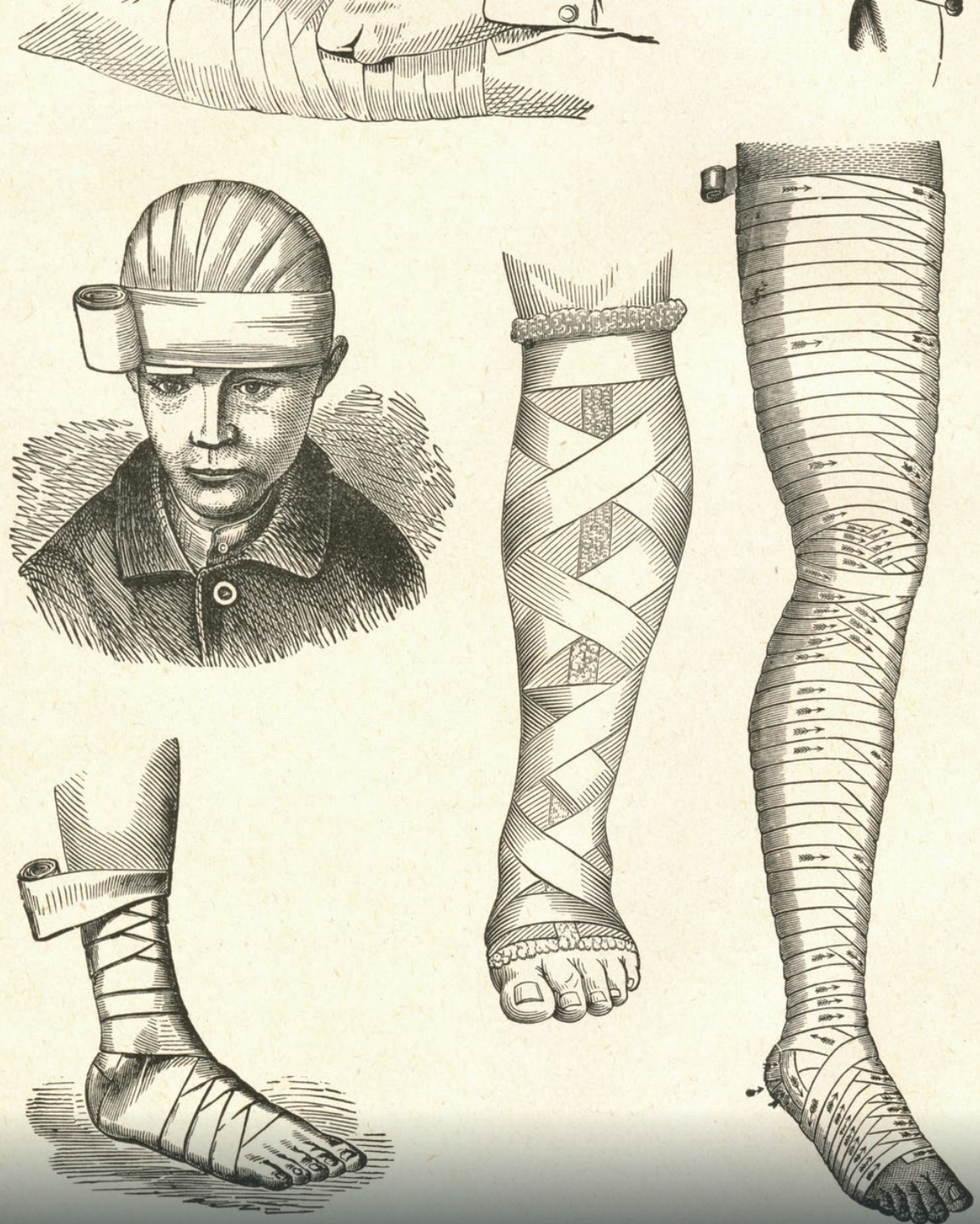
www.AccountingCoach.com

[How to Read Financial Statements](#) (YouTube)

[Financial Accounting Ratios and Formulas](#)

[Finance and Accounting Glossary](#)

Wrapping Up



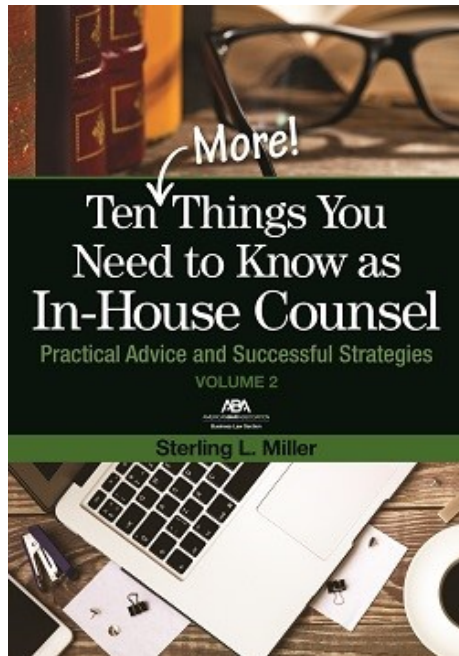
Wrapping Up

As an in-house lawyer it is important that you know the basics of finance and understand the drivers of your company's overall financial performance, i.e., how does your company make money and how is your company doing overall?

As you move up the ladder, your level of understanding and sophistication needs to increase in order to keep up with the business and for you to provide your best legal counsel and opinion. If you become general counsel, you need to understand basic finance in order to properly manage the legal department's P&L

Make a friend in Finance and get their input on what the important financial metrics are for the company. These will be the things to focus on at the beginning. If you have access to your company's financial statements, take time to read them and to try to understand them

Most importantly, start your own notebook and focus on learning the company's business – the products and services, and its finances

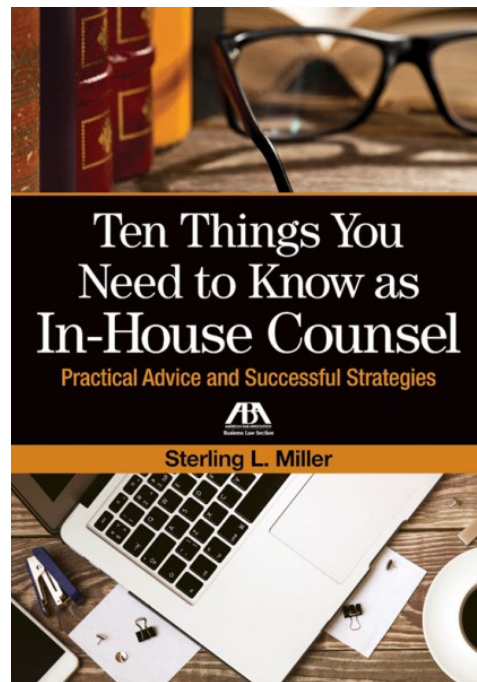


Thank You!

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Questions?