TACKLING "ARITHMOPHOBIA": TEACHING HOW TO READ, UNDERSTAND, AND ANALYZE FINANCIAL STATEMENTS

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Paula J. Williams

My name is Paula Williams, and I teach at the University of Tennessee College of Law. I have been Teaching the Business Law Clinic since 2002. What we're going to focus on in this session is Arithmophobia, which is a word that my co-presenter Eric Franklin has coined to describe a common phenomenon I see among my students: fear of working with numbers, fear of spreadsheets. I have heard some students say, "I went to law school so that I wouldn't have to deal with numbers."

So Kris Tobin and I have developed some very basic information about financial statements to introduce our students to the idea, to make sure that they have some sense of why financial statements are important, and how they can use them in the clinic setting. In the clinic students learn to introduce their clients to basic concepts of managing their money, financial record keeping, and business financial planning, so that the clients can become more comfortable working with financial statements as well. Arithmophobia affects not only our students, but our clients as well.

The clients that we work with in our clinic are startup businesses, for the most part, who sometimes come to us before they even have a well-developed business plan. Talking to them about their business plan involves questions like How much money is needed to get the business started? Where will the start-up funds come from? What will be the source of the business' revenue? How much revenue is projected for the first year? When will the business become profitable? A consideration of these questions requires some basic understanding of financial statements on the part of both students and clients.

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I think one of the important things to do in presenting financial statements to students is to tackle the fears head on. I try to find out whether Arithmophobia is in fact an issue for them, or not. If not, the students may be ready to work with their clients on financial issues without a lot of introduction to the basics. The students that I have this semester are much less arithmophobic than they have been in other semesters. For the most part, these students were finance or accounting majors in undergraduate school, but that is pretty unusual. We have one case in the clinic this semester, where the students have gotten the client's permission, have gathered extensive financial records from the client's accountant and have been analyzing those records throughout the semester.

Most law students, however, have very little background or comfort with financial statements. So the first step is to acknowledge that there may be some discomfort or even fear for students in addressing financial issues with their clients. I like to present this topic as part of the fact gathering or fact investigation part of the case handling process. As a part of gathering information about the client's business (the initial stage of the problem solving process) we talk about what kind of financial information is needed from the clients, why the information is important, and what the documents provided by the client or the client's bookkeeper actually mean.

One of the big goals that I have in the clinic is to have my students become good counselors of their clients. I want them to understand the flow of money, understand the money needs that the business has -- the whole notion of breaking even and when the business expects to become profitable is something that the student attorneys will need to counsel clients about. Often, when we say to the client, "what kind of records are you keeping for your business?" we get kind of a hazy look, and the response "You know, well, we try to keep track of things," but what are their systems? The client is often so excited about their business idea, so excited to come forth with producing something and getting to market with something that they often fail to think about how to handle the money issues. As we encourage the students to get over their fears, we are also having the students deliver critical financial information to the clients as well.

What we're going to do today is really basic. Kris Tobin is going to present to you the financial statements we use with startup businesses, and that we present to my students in the clinic. Kris is someone who I admire very much, because not only is she not afraid of numbers, but she's a master with them. Kris is 1) a business lawyer, 2) an attorney with an LL.M. in Tax, and 3) a CPA. (Imagine all the letters she has following her name!) Kris comes to my clinic class each semester, as a guest speaker, and presents the basic financial statement information that you will see here, and it has been extremely helpful. So, with that I present Professor Kris Tobin who will get into the whole area of financial statements.

Kris Anne Tobin

I would like to get to know you, my audience. I'd like to know, with a show of hands, how many of you have an accounting or a finance background? Counting quickly it appears that about half of the audience has either an accounting or finance background.

You're probably wondering "How in the world does a law librarian end up teaching financial skills? My undergraduate degree is in accounting, and I have a CPA from the State of Louisiana. When Paula found out about my financial accounting background, she asked me to help her teach her business clinic students basic accounting skills. . I stepped up to the plate and began to help her teach her students financial statement analysis.

I found this gem of a quote in the May 2012, Volume 61 issue of the Journal of Legal Education. Robert C. Illig put together a business lawyer bibliography of books that every dealmaker should read. During opening remarks, we heard about "transactional law as the law of deals." Illig's bibliography is a great resource for educating oneself on "Books Every Dealmaker Should Read." The quote in the article that I choose to highlight for our presentation is that what most lawyers need is a tutorial on financial statement analysis. Our role as lawyers is not to create the statements but to be able to decode them. Eric is going to help us with decoding financial statements after I finish covering the basic financial statements. He's going to help with the application and decoding of financial statements to figure out a business' weaknesses or strengths, as well. My focus today, is teaching students how to read and analyze the three basic financial statements: the income statement, the balance sheet, and the statement of cash flow.

I teach legal research, and I have to remind myself constantly that my students have never seen these materials before. I am so familiar that I forget the basics, and the same thing happens when you're teaching financial statements.

Understanding financial statements -- there are many different users of financial statements : owners, managers, lenders, and investors. They each rely on financial statements to provide data about many different organizations in our economy. I want to highlight the book *Financial Statement Analysis and Business Evaluation for the Practical Lawyer*. If I were teaching accounting for lawyers to law students, this would be my textbook. It is the second edition, the author is Robert B. Dickie and it's an ABA publication. The first five chapters are a gold mine.. At the end of each chapter, Dickie includes a section titled Implications for Counsel. This section helps students to practice thinking about the consequences of helping clients in different business situations.

Robert Dickie succinctly explains the tools used by accountants in their daily work as the "common law of accounting." These tools set out the rules requiring certain items to be included on the balance sheet, income statement and statement of cash flow. The primary tools governing financial statements include Generally Accepted Accounting

Principles, fondly called GAAP s and Financial Accounting Standards Bulletins or (FASB). Both apply to private and public companies. In addition auditors follow Generally Accepted Accounting Standards, or GAAS, when auditing a company. .

For this presentation I choose Amazon.com as a teaching tool because most of us have a familiarity with that site. Just Google "Amazon Investor Relations" and the website will appear first in the list as "Amazon.com Investor Relations: IR Home – Merrill Lynch & Co., Inc." Their annual reports and proxies are available in PDF files back to 1998 to use as teaching tools.. The presentation handout includes the balance sheet, income statement, and statement of cash flow from Amazon's 2011 annual report. If I were teaching Accounting for Lawyers, I would have my students read the entire Amazon.com 88-page annual report. The best information is in the annual report and especially in the Notes to Consolidated Financial Statements. When you work with students and annual reports emphasize the importance of the notes to the financial statements as these describe a company in detail. A quiz or an entire examination could be based on an annual report. The goal of either the quiz or the exam being to get your students completely comfortable and familiar with the inner workings of an annual report. .

This next slide is a list of additional teaching tools for use in the classroom. I Google searched each of these individual companies: Facebook, Google, Ebay, Gap, and Journeys by using the company name followed by the search terms investor relations. For example, "Facebook Investor Relations" (be sure to inform students to use quotation marks). Quotation marks force the search engine to search for the exact phrase. Facebook went public in 2012. Using Facebook as a teaching tool demonstrates for students what happens when a company goes from private to public. Students will see first-hand there is very little financial information available in the first years after an initial public offering. Both Google and Ebay have their own Investor Relations websites.. Gap is a retail organization. They own Banana Republic and Old Navy. The last company on the list is the retail store Journeys, (where I purchase my "Doc Martins"). Journeys is a Nashville based specialty retailer owned by Genesco, Inc. Locating financial information for Journeys is challenging because first, we must determine the parent company for Journeys and then Google search "Genesco Investor Relations" to locate the annual reports. When I was trying to come up with additional corporations that students could study, I tried to come up with a list of companies that students are familiar with in their daily lives .

The purpose of the income statement is to reflect a company's revenue and expenses and to show whether a company made a gain or in some cases a loss. The income statement covers a period of time, a month, a quarter, or a year. Revenue less expenses equals income. If expenses are more than revenue the business will incur a loss.

The revenue line is the best place to begin analysis of an income statement. Begin with Gross Sales Revenue. Gross Sales Revenue only includes sales transactions that relate to the purpose of the business. Returns are sales that have been returned within the same period of time that the Income Statement covers. Next, subtract sales returns from gross sales revenue, to arrive at net sales revenue. Just to clarify Gross Sales Revenue less Sales Returns for the period equals Net Sales Revenue.

The next item on the 2011 Amazon Income Statement is Operating Expenses. Since Amazon is a retail company, Cost of Goods Sold is calculated to eventually determine Gross Profit. To calculate Cost of Goods Sold by a business during a specific period of time, start out with beginning inventory. Add the inventory purchases that coincide with the time period of the Income Statement, then subtract ending inventory to arrive at Cost of Goods Sold.

From the Cost of Goods Sold line we move onto the gross profit line. Net Sales Revenue less Cost of Goods Sold equals Gross Profit. Once we arrive at Gross Profit a commonly used ratio Gross Margin is calculated by dividing gross profit by revenue. The gross margin ratio measures a company's power in the marketplace to increase its prices. This percentage should rise from period to period.

Audience: I'm Doug Levene, at Peking University. There are different types of ratios. The ratios you're talking about now go to operating efficiency. How important is it for law students, future lawyers, to understand operating efficiency ratios?

K. Tobin: I think very important, and I'm going to ask my panelists to join in because that information -- operating efficiency gives the lawyer information about how well the company is doing financially., Future lawyers need to understand operating efficiency ratios to be able to better advise their clients on the effects of different business transactions the company may be contemplating engaging in.

E. Franklin: This is something that I'm going to touch on at the end of my presentation, but if you represent an acquirer in an M&A transaction, for example, you should have an in-depth understanding of what's going on in the financial statements. There may be something that your client has overlooked, as many potential acquirers are willfully blind to financial issues after they've committed to an acquisition. Technically speaking, this may not be a lawyer's job but it's always good to show your value.

Audience: I have another perspective. We teach -- Jim and I teach hardcore finance to -- real estate finance -- law students and business students. And on the real estate side, I don't know about the retail side, but on the real estate side, that's the difference between a lawyer and a counselor. That's the difference between somebody who is a real -- who the clients really need and want, somebody who can come in and understand the deal, understand -- the numbers are everything in the real estate. And so to have a lawyer, who can look at those numbers, who can catch things that don't look right, who can ask questions, who, when negotiating the deal itself, understands the financial ramifications of everything you're talking about is critical. It's what made him a great real estate broker.

Audience: The lawyer, who does not understand the client's business, is a scrivener. If you want to really be a good practitioner, counselor, whatever, you better know your client's business and things like ROEs and ROIs are really important.

K. Tobin: Did you have a comment?

Audience: Michael (Slazenger), from John Marshall, (in Chicago). For me, I think my perspective on it is, is that what do we want recent graduates to know when they leave. And we certainly want them to know these -- and I agree with you 100%, when you mature and get experience. But we certainly want them to leave law school knowing these fundamental tools, financial tools, so they can sit across the table from somebody and at least be in the room. From there, they can build and grow, but this foundational knowledge to me, in my perspective, is essential. That's what this is, and it carries, whether it's a real estate transaction, different numbers, different whistles and bells, same thing. You've got to understand the fundamentals. These are the fundamentals.

Audience: And lawyers don't all practice law. I'm a lawyer that doesn't practice law. I mean this background is critical. I mean there are a lot of lawyers that are going to end up in business. To have this background is really important.

Next let's analyze Amazon's Operating Expenses on the Income Statement.Selling expenses are the expenses that Amazon directly incurs to sell their goods or services. Selling expenses for Amazon include Fulfillment, Marketing, Technology and content. One of the expenses unique to Amazon is Fulfillment. Fulfillment expenses cover all of the costs that Amazon incurs to get their products in the box out of the fulfillment facility and in the mail, to UPS or FedEx on out to the customer.

Operating expenses are further broken down into General and Administrative expenses. G & A are the expenses the company incurs to keep up normal business operations. G & A expenses include payroll and employee related expenses, facilities and equipment expenses such as depreciation and rent and professional fees paid for accounting and legal services.

Accountants have a different parlance for the word cost. When we introduce students to the terms cost and expenses, (they tend to automatically think of these terms as equal), we need to be careful to test their understanding of these two terms of art. Accountants categorize costs in two different ways, those costs that are expensed in the period that the cost is incurred or those costs that are capitalized, labeled as an asset and then expensed or depreciated over time. .

Depreciation is the cost of property, plant, and equipment that will benefit a business enterprise beyond a years' time. The cost (purchase price) of the property, plant or equipment is allocated or "expensed" over the service life of the asset rather than expensing it in the year of purchase. The asset cost is capitalized and placed on the Balance Sheet as an asset.

Here's a simple depreciation calculation that you can teach your students. Straight-line depreciation is the easiest for students to understand of the many different depreciation methods. The asset cost less the salvage value is divided by the useful life of the asset in years. An asset costs $10,000. We determine that the useful life of this asset will be eight years. The salvage value at the end of eight years will be is $2,000. The asset cost minus the salvage value, in the example here (10,000 minus 2,000 equals 8,000) divided by the useful life of the asset of eight years equals an annual depreciation expense of $1,000 per year.

Operating profit or income from operations shows what the company earned entirely from operations. Operating Profit is the amount available to the business to cover interest expense and taxes. It's also the basis for defining earnings before interest and taxes.

The purpose of the balance sheet is to provide a snapshot of a company at a given point in time at the end of a fiscal year or at the end of a quarter. The Balance Sheet is separated into assets, liabilities and shareholder's equity. Assets are categorized into current assets and fixed assets. Liabilities are categorized into current liabilities and long-term liabilities.

Every Balance Sheet must balance. Assets must equal Liabilities plus Shareholder's equity. Businesses and governments have kept records of their assets over time those assets include equipment, cash, land, building, inventory, and investments. The claims against the assets are the liabilities. When a company borrows money to purchase a building, the creditor has a claim against the company's assets. What remains after the liabilities have been deducted from assets is equity. Another way to think about equity is if the company is liquidated. When all of the liabilities have been deducted from the assets, and the company is liquidated, then what remains after the debt is paid the shareholder's can take home. .

Current assets are those assets expected to be converted into cash within a year. Current assets include cash, accounts receivable, inventory, supplies, and prepaid expenses, like insurance. Fixed assets are those assets that are not going to be converted into cash within a year. Fixed assets include equipment, furniture, fixture, buildings, land, and goodwill. Current liabilities are financial obligations that must be paid within one year. Accounts payable are expenses that have been incurred but not yet paid. Notes payable are small loans. Salaries are paid within the current year along with income taxes. Long-term liabilities are any obligations that are going to take more than one year to repay such as a mortgage, a loan for purchasing a building and/or land. Notes payable for large loans -- money owed to buy a company vehicle or a large expensive piece of equipment.

The last section of the Balance Sheet is shareholders' equity which consists of stated capital. Stated Capital is the number of shares issued times the par value per share. Amazon is a public company with a line for "paid in surplus" this is the amount paid in excess of par value by shareholders on the issuance of shares. Retained earnings are the total earnings of the business less any losses incurred since the incorporation of the business less dividends paid out. As part of a balance sheet, retained earnings changes from period to period as a cumulative number.

For example, the date of incorporation for Company A is March 1, 2011 and their fiscal year ends on December 31. At the end of their fiscal year (December 31, 2011) they earned $50,000. Dividends paid during the year to shareholders equal $10,000. Earnings less dividends paid out (50,000 less 10,000) retained earnings equals $40,000. When teaching students, I try to keep the numbers simple. Simple calculations help them get over their fear of numbers, and they can actually do the math. I try also to do numbers so you can add, subtract, multiply or divide in your head, and especially when they're first learning about -- and they're very first exposed, it seems to build confidence. I visually look at my students all the time because I can read their faces, and I can see what they're thinking. And I can see that they can add it up or subtract it in their heads. And then you'll see the grin on their face. And you know that they get it.

I just did our simple calculation. This is what you're going to see on the balance sheet for Amazon. Amazon does have treasury shares. Treasury shares are the aggregate amount paid by the company, since its incorporation, to repurchase shares. There's also another category listed on Balance Sheet's named "Other Comprehensive Income," "OCI." OCI includes asset value changes even though there has been no transaction such as foreign currency translation adjustments.

A Statement of Cash Flows informs lawyers as to whether a company is a cash generator or a cash absorber. Cash Flow Statements reveal what management is doing with its discretionary cash. Management can invest its discretionary cash and increase its cash by investing with interest. This statement consists of three components: operating activities, investing activities, and financing activities.

For Amazon, they've shown cash generated from operations and the most important source of cash is net income. Non-cash expenses deducted on the income statement are added back, and those are depreciation and an increase in deferred tax liabilities.

Cash generated from operations will increase or (decrease) from a change in current assets or an increase or (decrease) in current liabilities. Those are all the cash flow changes due to operating activities. The second section of the statement of cash flows analyzes corporate investment activities such as purchasing fixed assets, acquisitions, sales of securities and other investments.

Finally, financing activities include excess tax benefits, common stock repurchased by the company and proceeds received from long-term debt -- the company takes out a mortgage or a loan and receives cash from that transaction, the cash flow statement will reflect the increase in cash from the transaction. Repayments of long-term debt, capital leases, and the refinance of leases will be reflected as a decrease in cash on the Cash Flow Statement.

Eric Franklin

When I teach financial statement analysis, I begin with something very similar to what Kris just described: a very simple vocabulary lesson on financial statements. Then we apply it to a sample financial statement, something like Amazon, and use the vocabulary to navigate the statements.

I teach in a transactional clinic, and one of the first things that we did in setting up the clinic was to ask potential employers for a list of skills they would like to see in our graduates. Besides the obvious skills, such as an ability to clearly communicate, employers regularly listed financial statement analysis as a desired skill. I find that students are very impressed with this information, and it helps maintain their focus on the simulation.

Once the students learn the vocabulary and have an understanding of the basic analytical ratios and tools, I ask the students to apply these skills in a simulation. I provide two financial statements of energy companies from 1998 through 2000 with the company names redacted. I then tell them that their client has asked the students to have a look at these two companies to provide advice as to which one would be a viable, long-term partner.

In addition to the financial statements, the students are provided the following information:

	February 1998	**February 1999**	**February 2000**	**February 2001**	**Percentage Increase**
Company A	$43.31	$63.13	$67.81	$80	45.86%
Company B	$31.34	$35.19	$39.94	$42.40	26.09%
Dow Jones (approx.)	**$7,965.04**	**$10,006.78**	**$11,722.98**	**$10,646.15**	**25.18%**

With this information, they note that Company A's stock price is doing very well, with a percentage increase of 45%. Company B boasts a more modest 26%, still better than the Dow Jones but not quite as astronomical or as exciting as Company A. At this point, I give them about half an hour to apply the different ratios and tools to address their client's request.

As you see here, the profit margins of each company reveal, despite the astronomical revenues of Company A, that Company B looks healthier.

	1998	**1999**	**2000**
Company A			
Net Income	703	893	979
Total Revenue	31,260	40,112	100,789
	2.25%	2.23%	0.97%
Company B			
Net Income	8,074	7,910	17,720
Total Revenue	169,642	185,527	232,748
	4.76%	4.26%	7.61%

In addition, the free cash flow, also favors Company B.

	1998	1999	2000
Company A			
Cash Flow From Operations	1,640	1,228	4,779
Cash Spent on Investing/Financing	-3,965	-3,507	-4,264
	-2,324	-2,279	515
Company B			
Cash Flow From Operations	16,436	15,013	22,937
Cash Spent on Investing/Financing	19,118	15,764	17,463
	-2,682	-751	5,474

Despite the fact that the revenues of Company A were almost exponential, the gross profit analysis reveals a more sober picture.

	1998	**1999**	**2000**
Company A			
Total Revenue	31,260	40,112	100,789
Cost of Goods	26,381	34,761	94,517
	4,879	5,351	6,267
Company B			
Total Revenue	169,642	185,527	232,748

Cost of Goods	62,145	77,011	108,951
	107,497	108,516	123,797

Finally, the students are asked to determine the debt to equity ratio, and they learn that Company A is quite leveraged, almost 90%, whereas Company B's debt to equity ratio is 19%.

		2000
Company A		
	Total Debt	10,229
	Total Equity	11,470
		89.18%
Company B		
	Total Debt	13,441
	Total Equity	70,757
		19%

In my experience, the students come up with the correct numbers and correctly advise their client to partner with Company B

At this point, I reveal that Company A was Enron and Company B was Exxon. More importantly, as Kris said, these financial statements were public documents because they were publicly traded companies. In other words, anyone could have discovered that Enron was not necessarily what it said it was. I've found this to have a strong effect on the students.

Perhaps even more impactful is the fact that Enron's collapse was thought to be a surprise. Most financial experts said that we couldn't have seen the collapse coming. But the students learn that this is not true.

After the simulation, I like to provide readings to help the students understand what they've done. Fortune Magazine called the Enron financial statements "impenetrable" and the New York Times called Enron a "master of obfuscation." The students feel empowered once they realize that they successfully navigated such notoriously difficult financial statements.

I've used this simulation several times, and I've found it to be incredibly rewarding. . All the information you'll need to perform the simulation is on the jump drive, and you'll only need to redact the financial statements. It has consistently been one of the classes that the students mention in class evaluations as a really beneficial class. Students have even come back after their summer internships to thank me for teaching them how to read a financial statement.

Please have a look at the information whenever it's distributed, and please let me know if you have any questions.

Audience: How do you evaluate your students?

E. Franklin: I teach in a clinic, and have very early stage clients which don't usually have very mature financial statements. I think it would be a disservice to our students to restrict the financial statement analysis to our clients, as they are entities that have only been around for six months or a year or so. So I use this simulation to impart these skills.

As such, I don't use this simulation as an evaluative tool. If you have a suggestion as to how there might be a way to evaluate students, I'd like to hear it. That'd be great.

Audience: You just asked the fundamental question that we've all struggled with in this entire area. That is, you're trying to teach transactional skills. You're trying to teach them to work together to work with each other and to work in ways where they actually learn. How the heck do you evaluate them in the context of the traditional law school?

E. Franklin: I have the luxury of not teaching accounting for lawyers, or something where I feel the need to evaluate them on this simulation. Perhaps you wouldn't do as much hand-holding as I do. You could just provide the reading, something similar to what Kris went through, and the financial statements. That would be a much better test, and I think you'd see separation between the better students and the less well-performing students.

Robert J. Rhee

Good afternoon. My presentation is on connecting accounting to finance to practice. When you talk about accounting, you also should connect it to the finance component and then connect it to practice. I also add a comment on curriculum, because I recently saw NYU's new curriculum reform,[1] and I thought it was really interesting. NYU's curricular reform focuses on five facets. Three are global fluency, the role of government, and leadership and collaboration. On this third point, I think what this is trying to get at is trying to bring more of a business school model.

But I really want to talk about the fourth and fifth components of the NYU program. One is to have professional pathways allowing 3L students to develop specialized knowledge and training in areas of important demand in the marketplace. One such professional pathway that NYU identified was law and business, essentially a concentrating study in the 3L program. The fifth component of NYU's recommended curriculum is to increase instructions for JD candidates at all levels to ensure basic business and financial literacy, and this includes teaching business concepts in the 1L program, as part of the lawyering programs, which I think makes a lot of sense. This facet of teaching business concepts is more directly connected to this session, which is devoted to basic business and financial literacy. So there have been several recent commentaries. So here are two different takes on requiring financial and business literacy. Some commentators are critical of this. Others seem to embrace it. I also have talked about this in some prior writings, and I think that business literacy is a separate language and must be taught.[2] It's a separate language when we talk about EPS, valuation, assets, liabilities, and equity, and all of the different hundreds of potential terms and concepts that are out there.

So there's a question of accounting and financial literacy, and law schools have a special problem with our students. We have many philosophy, political science, English, and humanities majors in our classrooms. There's no reason why we should actually expect them to have this core knowledge, and so their training is up to us or law firms. Law firms seem to be complaining about this and saying that law schools should pick up the slack a little bit more on training students, and I think that's right. Think about the many very sophisticated business concepts in the basic Business Associations course. I think that training in business concepts is really an important task.

From my perspective, law school students need to see a connection between finance and accounting and practice, and it's a real challenge to contextualize this foreign language and concepts to something that they will be doing but haven't yet done. Often times it's hard enough for law students to contextualize what they'll be doing as lawyers in general. I think these concerns are behind the movement toward simulations and experiential learning. We have to contextualize a lot of these foreign concepts. So we're layering on foreign concepts

[1] New York University School of Law Board of Trustees Strategy Committee Report and Recommendations (October 5, 2012).

[2] *See* Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure, and the Business Education of Lawyers*, 35 J. CORP. L. 363 (2009). *See also* ROBERT J. RHEE, ESSENTIAL CONCEPTS OF BUSINESS FOR LAWYERS (2012).

on top of foreign concepts, and it's quite overwhelming. And I think that's where the challenge is.

One way to possibly contextualize it is to suggest that maybe the financial statements are like the human body. You have the skeletal system, which is the balance sheet. We have the circulatory system, which is the cash flow statement. We have the digestive system, which is the income statement. We also have the human brain as well, and we can't quite capture that in financial statements. The financial statements are pretty important, but this also shows another key lesson to teach, which is that financial statements are limited. We see information that accountants cannot capture. We can run through, for example, exercises like a comparison of the market value of equity to the book value, and note that sometimes the two values deviate. We see that the markets are telling us something different about the value of the equity than what the accountants are telling us. This doesn't mean that the accountants are wrong. This just means that there are certain limitations to accounting. One such thing might be, for example, that big brain. You can't capture human capital in the balance sheet. We can't inventory that.

There are different ways to look at financial statements. So here's the accounting statement that we're all familiar with. Assets equal liability plus equity, but we can also teach it as a statement of ownership, and suggest that all assets have to be claimed by certain groups of people, by certain people with different priorities of claims. There are things called fixed claims, and then there are residual claims. There's a line of people, and certain people have priority ahead of that line. We can think about equity as a statement of risk and saying that a residual claimant stands last in line and takes the greatest amount of risk.

We typically draw a vertical division in the balance sheet and say that assets are on the left side, and liabilities and equities on the right side. But we can also draw the line horizontally and suggest that the top of the line is the firm's working capital. Current liabilities might include, for example, commercial paper. It might include bank loans. It includes things related to working capital. We can say that here are where a lot of corporate transactions are going to take place. In the bottom of the line are long-term liabilities and long-term equities to fund these long-term assets. So when you drive down I-90 and see that billion-dollar Hyundai plant or the Honda plant, someone has to finance that, and that financing is going to come from long-term debt and long-term liability. This is what lawyers are going to be doing, working on these transactions, working on these debt transactions, working on these equity transactions.

I turn now to the income statement. We can talk about terminology just to make sure that they understand that there are different terms that are thrown out there and to get them comfortable with these terms. So net income, net profit, earning, profit, and profit are not the same thing as pretax profit or operating income, and just explain that this is the language of trade. This is the way that people talk, and we really should understand some of these words and terminologies, just the way that we understand very special legalese -- things like summary judgment motion, motion to dismiss, things that we know that other people outside of the profession do not know.

We can then think about, for example, taking a look at the income statement and really breaking it down by line items. In the balance sheet, we saw the concept of priority, the concept of a line of people. Here we see the income statement from the perspective of claimants in this line. Once again we see a priority, and so we can describe these foreign concepts in somewhat intuitive fashion, and try to bring it down as intuitive as possible for the students so that they understand these concepts.

And with respect to a cash flow statement, I really love this quote: "*Oh. My. God.* This was Finance 101. Companies need to keep track of their cash to know when they're experiencing shortfalls, to know when they could pay their bills. It was the same reason people *balance their checkbooks*! If Enron didn't know how much cash it had, it couldn't know how much it how much it could draw down on its revolver!"[3] So Enron was collapsing in the whole scheme of fraud, but suppose that fraud was not involved. Suppose this was just a poorly managed firm that lawyers are called in to restructure, and if doing so, then the lawyers should really understand what's going on with this firm.

We should get students to appreciate the fact that these statements are interconnected -- that they're an interconnected whole, and we can spend some time kind of going through this exercise. We can show the interconnections of the income statement, cash flow statement, and the balance sheet.

Simple ratios. We can explain the significance of these ratios. Efficiency in terms of assets and in terms of equity, liquidity ratios, solvency ratios, solvency ratios for the balance sheet. Once again we can contextualize it in terms of some recent events. For example, the debt ratios of the investment banks leading up to the financial crisis and the sharp increase in the ROE as the firm started to lever up until of course the big crash.

I think accounting and finance are connected. A lot of the practice concerns the core issue of valuation. I think central to all corporate transactions is the issue of value. Is this transaction creating value? What's our stock value? Can we issue stock? Can we issue bonds? Can we buy this company? All of these are tied to the question of values. Of course lawyers aren't going to be doing valuations, but I think it's really important that we understand the concept of value in the context of transactional work. Obviously valuations are going to be found in transactional documents, merger proxies, SEC filings, litigation, regulatory law, criminal law, family law, and even consumer law. Also, there are a lot of

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[3] KURT EICHENWALD, CONSPIRACY OF FOOLS: A TRUE STORY 559-60 (2005).

lawyers who go into business, but there are also a lot of lawyers who are engaged in the business of law practice. They need some general business skills.

How we show the contextualization can be done through different examples. This is an LLC's operating agreement. It's a case that I worked on, not as a party and not as a lawyer but it's a case that I'm familiar with. In this particular case, one real problematic issue came to be that Section 13.4, which was drafted by a law firm, a big one in D.C, had this provision about five times EBIDA as being the exit multiple for dissociating members. It seemed to me that there wasn't a whole lot of thought given to putting this number into this document. The five times EBIDA was based upon certain sales multiples that they had gotten. But one of the issues was in the litigation is, well, does this create a run on the bank. Suppose the firm is not as valuable as five times EBIDA would suggest. Then does this innocuous little provision create a run on the bank in a way that destabilizes the firm?

Another way, for example, is to actually show case opinions. Here's an opinion, *Agranoff v. Miller*.[4] It runs through the multiple analyses to calculate the value of certain stock and shares. You see the court is engaging in significant financial analysis.

Here's the Time Warner merger proxy, where they talk about the comparable companies analysis, which is only a tiny little snippet of the proxy itself, but here you see that lawyers are actually using financial outputs in the drafting process.

And here's a bankruptcy case, *In re Pullman Construction Industry Inc*.[5] It discusses various measures of value, and then actually in the case opinion it goes through all of the financial analysis. It's a pretty detailed, sophisticated financial analysis that the court runs through, engaging all of these different evaluation techniques.

These examples show students that "yes" lawyers really need to know this, and we have to understand these basic concepts. Once again, I don't think any lawyer will be engaging in a DCF analysis, but we ought to know what the inputs are and what the outputs are. We ought to know that such analysis is part science and part art, and there's a lot of judgment that goes into these things. A sophisticated, financial analyst can actually manipulate the numbers and the outcomes that comes out of these models. And we ought to know how that process is done, how the judgment aspects actually go in to actually produce or manipulate the numbers that may come out of that.

In 2009, I presented in an article my idea to teach business concepts.[6] I think the best way to do this is actually to make law professors like me redundant, which means that right now I teach this business material. The better way to go about it in the perfect world is

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[4] 791 A.2d 880 (Del.Ch. 2001).

[5] 107 B.R. 909 (Bkrp.N.D.Ill. 1989).

[6] Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure, and the Business Education of Lawyers*, 35 J. CORP. L. 363 (2009).

to actually ship these students off to the business school. Have them take accounting, three credits, and have them take minimum corporate finance, three credits, and possibly a few more credits up to the ABA limit on the number of credits you can actually take outside of school and to give them basically an "MBA lite." It's not a joint degree, but there's a lot of merit to taking some core courses at the business school.

That is the ideal. In the meantime, I do think that it's really important to teach our students basic business literacy. It's something that our clients expect of their business lawyers and it's something that we as law schools should do. So let me end it there.

Audience: So I ask my students to fill out Survey Monkey, where they gave me their salary before they went to law school, salary they think they're going to get out of graduation five years out and fifteen years out, and then we calculate the ROI on their tuition.

R. Rhee: Do they come back?

Audience: Most of them shouldn't. They have such unreasonable expectations on their future incomes that it actually works. But it makes it very, you know, how present value works and how ROI works.

R. Rhee: That's great.

Audience: Is this presentation on the USB stick as well?

R. Rhee: No.

Audience: Can you email it to us?

Audience: Send it to Edna.

Audience: Could you email it to us?

R. Rhee: Sure.

Audience: Because I'd like to see it.

Audience: Are they going to be posted on a website or --

Audience: They're supposed to go into the Emory Exchange, but if you brought yours with you, it may not get there until you send it to me or to Edna. We'll get it there. We'll make sure you get it.

Audience: Okay. Thank you.

Audience: I may be the oldest one here, I think. But there was a time that law schools did require three credits in accounting before going to law school, and if you didn't have it, you took it in the first semester as an additional course with no credit. So at one time, we did have the accounting side, but we didn't have the finance side. But they had the accounting side at one time.

R. Rhee: And some of my senior colleagues, the ones that attended Harvard, actually said the same thing, that Harvard required accounting a long time ago, and I think at Maryland we had a course on accounting, a couple of credits, taught by an accountant, and I think we implemented that in 2002, of course Sarbanes Oxley and Enron, and then we just took it out because of lack of demand. But we have another course that actually fills that need, which is my course.

Audience: There was a course at Emory in the 70s. I don't know if it still exists, but it used to be here, and it was pretty popular.

Audience: That's what I teach here now. They started it a couple of years ago, but we're struggling.

Audience: Yeah, there are other models too, for example, teaching basic accounting and finance in the same course. You know, to Dennis' point, we do something called Introduction to Business Transactions. It's a two-credit hour class over the course of the semester where you do (present valuing) and the financial statements. You look at mergers not from a statutory standpoint but from a non-financial standpoint.

R. Rhee: That's great. And I do a similar thing. Right now it's in the evolution, but what I have been doing is a one-credit crash course. It's 12 straight hours of lectures from me prior to the start of the fall semester of the second year before they take BA. We call it the fall pre-mester, and it's one week, so Wednesday, Friday, and Sunday, four hours of lecture each day broken down into two hours and two hours. And in between the two-hour lectures they have, I think, 3 or 4 hours in which they do group projects to work on some problem sets and solutions. And they do that in between the break and in the evening. And so it's a very intense crash course designed to at least gear them up to take BA. And when they take BA, they understand what a bond is. They understand what a stock is, so that basic language is covered.

Audience: It's like an introductory period for upper division students. I love it. That's a great idea.

R. Rhee: Okay, well thank you.