HEARSAY The legal podcast

Episode 24: Summary

Episode name: Accounting for Lawyers
Guest(s): Nik Ahkin

What area(s) of law does this episode consider?	This episode discusses the basics of accounting for lawyers.
Why is this topic relevant?	Accountants and lawyers often work together, yet few lawyers have a good understanding of the basics of accounting. This is important in commercial contexts as accounting is the so-called language of business and can help lawyers understand how to read the key documents that detail a business' performance. Accounting and finance permeate other aspects of the law as well, such as examining a statement of assets and liabilities in family law – and at the end of the day, everyone earns an income that they need to pay tax on. Knowledge of basic accounting can help lawyers better understand their clients' businesses and their own, and bring objectivity based on facts and figures when negotiating in commercial dealings.
What legislation is considered in this episode?	No legislation mentioned in the episode, but generally accepted accounting principles (GAAP) are used as a tool to ensure consistency across the accounting industry. The global accounting standard is referred to as the International Financial Reporting Standards (IFRS) and are issued by the IFRS Foundation and the International Accounting Standards Board. Click here for a link to a PDF of the current 2020 IFRS Standards. The Australian Professional and Ethical Standards Board publishes accounting standards which are followed by Australian accountants. Click here to access the ATO's practical compliance guidelines.
Key accounting terminology	• EBIT = earnings before interest and tax. • EBITDA = earnings before interest, tax, depreciation and amortisation. Both EBIT and EBITDA measure the performance of the business, ignoring how the business is financed. • The three key accounting documents are: 1) Balance sheet – shows assets, liabilities and equity in a business. 2) Income statement – displays revenue, expenses, profit. 3) Cash flow statement – money going in and out of the business, including operational cash flows, investments and how the business is financed. • Free cash flow formula = capital expenditure minus EBITDA and networking capital.

- Balance sheet equation = the assets must equal equity plus liabilities.

What are the main points?

- Balance sheets do not describe all of the valuable assets of a business – only those which can be given a monetary. In a tech business, there might be mass expenditure to build the technology on which the business is based, but this expenditure may not result in any balance sheet asset. Similarly, a professional services firm will not record its most valuable asset – its highly skilled workforce – on its balance sheet, and this workforce will only be represented by liabilities (unpaid employee entitlements) and expenses (salaries).

- The three primary financial accounting documents – the balance sheet, the income statement and the cash flow statement – each given a different, incomplete perspective on a business. In the episode, Nik Ahkin describes how to take insights from all three documents to determine the 'free cash flows' of the business, which gives a holistic view of performance.

- There are two types of costs: variable and fixed (operating costs such as electricity, rent, salaries). A business' operating leverage is the ratio of its fixed costs to its total costs – businesses with a high operating leverage stand to earn more profit on increases in revenue, but risk heavy losses if their revenue drops, while businesses with low operating leverage – whose costs are mostly variable – are better able to weather an unexpected reduction in revenue.

- Customer acquisition costs need take into account the time, effort and energy spent by partners and employees in acquiring new customers, whether through posting blogs, investing in social media or long lunches.

What are the practical takeaways?

- Having separate bank accounts for different purposes, such as operating expenses, profit and growth and tax and employment obligations, is a useful technique to understand how much cash is going to each area.

- A good business will be financed by an ideal mix of combination of debt and equity, which produces leverage but without a heavy burden of high interest payments.

- It's important to carry some WIP, to maximise revenue opportunities, but not to carry too much that it inhibits your cash flow.

- Annual, long service leave and other employment costs are liabilities that should be recorded to ensure the business understands their obligations.

- Dissect what services/products you are providing, what customers are buying the most of, the profitability of that sale, and how efficiently you are producing it. Consider automation of administrative tasks and streamlining workflow.

- Consider your **business value chain**, which is made up of:
  1) Marketing – attracting customers
  2) Sales – how much and what you're selling

3) Fulfilment – how you deliver the product/service.

What processes and products do you have in place at each link in the chain?

- Focusing on improving the service you already provide can lead to organic growth through natural referrals. It’s 8 times cheaper to keep a customer than to acquire a new one.

Show notes Financial Management guide prepared by Nik Ahkin