

Firms, the Stock Market, and Corporate Governance

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Google: From Dorm Room to Wall Street



Learning Objectives

- 5.1 Categorize the major **types of firms** in the United States.
- 5.2 Describe the typical **management structure** of corporations and understand the concepts of **separation of ownership from control** and the **principal-agent problem**.
- 5.3 Explain how firms obtain the **funds** they need to **operate** and **expand**.
- 5..4 Understand the information provided in corporations' **financial statements**.
- 5.5 Understand the role of government in **corporate governance**.

APPENDIX Understand the concept of **present value** and the information contained on a firm's **income statement** and **balance sheet**.

Types of Firms

Sole proprietorship A firm owned by **a single individual** and not organized as a corporation. Ex:

Partnership A firm owned jointly by **two or more persons** and not organized as a corporation. Ex: law firms, accounting firms

Corporation A legal form of business that provides the owners with **limited liability**.

Types of Firms

Who Is Liable? Limited and Unlimited Liability

Asset Anything of value owned by a person or a firm.

Limited liability The legal provision that shields owners of a corporation from losing more than they have invested in the firm.

Table 5-1

Differences among Business Organizations

	SOLE PROPRIETORSHIP	PARTNERSHIP	CORPORATION
ADVANTAGES	<ul style="list-style-type: none"> • Control by owner • No layers of management 	<ul style="list-style-type: none"> • Ability to share work • Ability to share risks 	<ul style="list-style-type: none"> • Limited personal liability • Greater ability to raise funds
DISADVANTAGES	<ul style="list-style-type: none"> • Unlimited personal liability • Limited ability to raise funds 	<ul style="list-style-type: none"> • Unlimited personal liability • Limited ability to raise funds 	<ul style="list-style-type: none"> • Costly to organize • Possible double taxation of income

Making the Connection

What's in a "Name"? Lloyd's of London Learns about Unlimited Liability the Hard Way



Investors in Lloyd's of London lost billions of dollars during the 1980s and 1990s.

1600s: Established

1700s: more formal, Names

1980s: 34,000 Investors(Names)

1980s-early 1990s:

series of disasters: Exxon oil spill in Alaska; Hurricane Hugo in SC; earthquake in San Francisco.

1989: lost \$3.85 billion

1990: lost \$4.4 billion

30 Names committed suicide.

Today: Names provide 20% funds

Types of Firms

Corporations Earn the Majority of Revenue and Profits

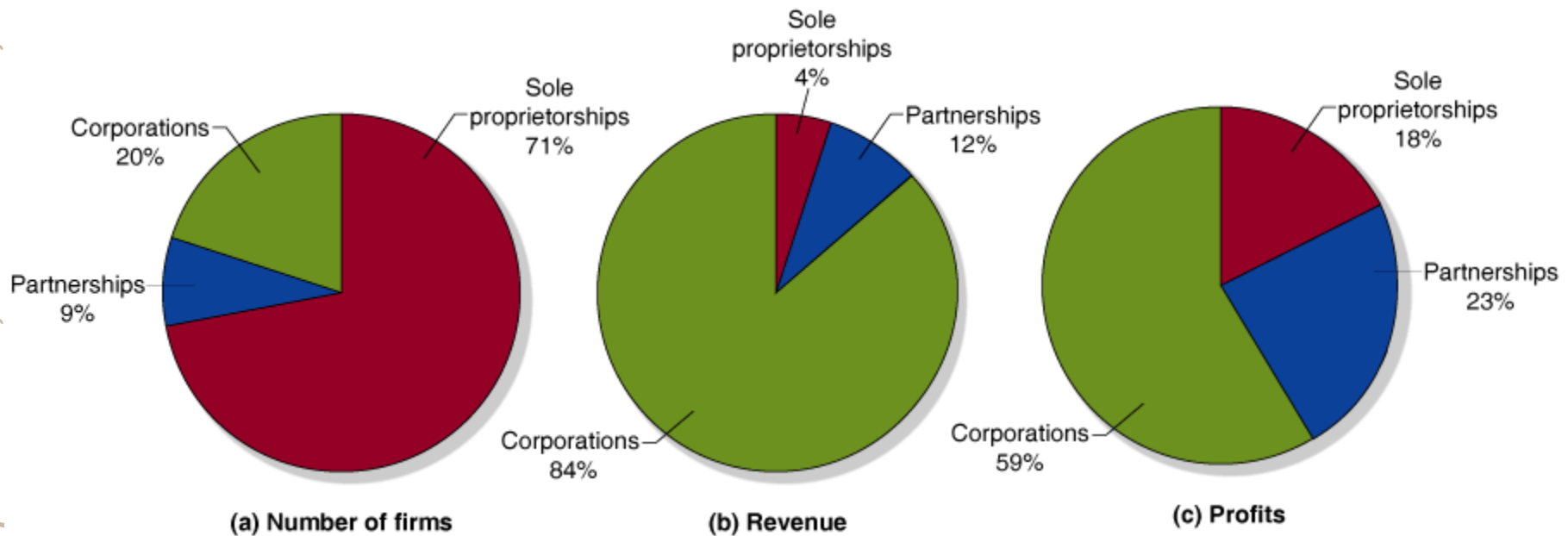
FIGURE 5-1

Business Organizations: Sole Proprietorships, Partnerships, and Corporations

5million firms in US

Large Corporation accounts for 85% of total profit of all corporation in US.

Ex: GE, Google, Microsoft



The Structure of Corporations and the Principal–Agent Problem

Corporate governance The way in which a corporation is structured and the effect a corporation's structure has on the firm's behavior.

Corporate Structure and Corporate Governance

Separation of ownership from control

A situation in a corporation in which the top management, rather than the shareholders, control day-to-day operations.

Principal–agent problem A problem caused by an agent pursuing his own interests rather than the interests of the principal who hired him.

Corporate Structure



How Firms Raise Funds

- 1 If you are making a profit, you could reinvest the profits back into your firm. Profits that are reinvested in a firm rather than taken out of a firm and paid to the firm's owners are retained earnings.
- 2 You could obtain funds by taking on one or more partners who invest in the firm. This arrangement would increase the firm's financial capital.
- 3 Finally, you could borrow the funds from relatives, friends, or a bank.

How Firms Raise Funds

Sources of External Funds

Indirect finance A flow of funds from savers to borrowers through financial intermediaries such as banks. Intermediaries raise funds from savers to lend to firms (and other borrowers). Small business rely on bank loans.

Direct finance A flow of funds from savers to firms through **financial markets**, such as the New York Stock Exchange.

Bond and Stock

How Firms Raise Funds

Sources of External Funds

Bonds

Bond A financial security that represents a promise to repay a fixed amount of funds.

Coupon payment An interest payment on a bond.

Face value: Principal

Interest rate The cost of borrowing funds, usually expressed as a percentage of the amount borrowed.

Maturities: ex 30 years

$$\frac{\$60}{\$1000} = 0.06, \text{ or } 6\%$$

How Firms Raise Funds

Sources of External Funds

Stocks

Stock A financial security that represents partial ownership of a firm.

Dividends Payments by a corporation to its shareholders.

How Firms Raise Funds

Stock and Bond Markets Provide Capital—and Information

Changes in the value of a firm's stocks and bonds offer important information for a firm's managers, as well as for investors.

A higher bond price indicates a lower cost of new external funds, while a lower bond price indicates a higher cost of new external funds.

Don't Let This Happen to YOU!

When Google Shares Change Hands, Google Doesn't Get the Money

Making the Connection

Following Abercrombie & Fitch's Stock Price in the Financial Pages

	Symbol	Open	High	Low	Close	Net Chg	%Chg	Vol	52 Week High	52 Week Low	Div	Yield	PE	Year- To-Date %Chg
ABB LTD ADS	ABB	15.95	16.21	15.94	15.96	-0.56	-3.39	4,478,028	19.3	10.1	0.1	0.6	25	-11.2
ABBOTT LABORATORIES	ABT	52.80	53.59	52.72	52.75	-0.26	-0.49	6,910,610	55.1	40.6	1.30	2.5	48	8.3
ABERCROMBIE & FITCH CO.	ANF	74.54	75.07	73.37	73.42	-1.52	-2.03	1,580,908	83.8	50	0.7	1.0	16	5.4
ABITIBI- CONSOLIDATED INC.	ABY	2.72	2.74	2.70	2.70	-0.03	-1.1	965,400	4.53	2.23	5.5
ACADIA REALTY TRUST SBI	AKR	26.65	26.77	26.30	26.36	-0.49	-1.82	429,604	28.1	19.5	.80	3.0	22	5.4

Yield=Div/Closing price

PE=price/earning per share

Using Financial Statements to Evaluate a Corporation

Liability Anything owed by a person or a firm.

The Income Statement

Income statement A financial statement that sums up a firm's revenues, costs, and profit over a period of time.

Getting to Accounting Profit

Accounting profit A firm's net income measured by revenue minus operating expenses and taxes paid.

Making the Connection

A Bull in China's Financial Shop



Will China's weak financial system derail economic growth?

Using Financial Statements to Evaluate a Corporation

The Income Statement

. . . And Economic Profit

Opportunity cost The highest valued alternative that must be given up to engage in an activity.

Explicit cost A cost that involves spending money.

Implicit cost A nonmonetary opportunity cost.

Economic profit A firm's revenues minus all of its implicit and explicit costs.

Using Financial Statements to Evaluate a Corporation

The Balance Sheet

Balance sheet A financial statement that sums up a firm's financial position on a particular day, usually the end of a quarter or year.

Corporate Governance Policy

The landmark Sarbanes-Oxley Act of 2002 requires that corporate directors have a certain level of expertise with financial information and mandates that CEOs personally certify the accuracy of financial statements.

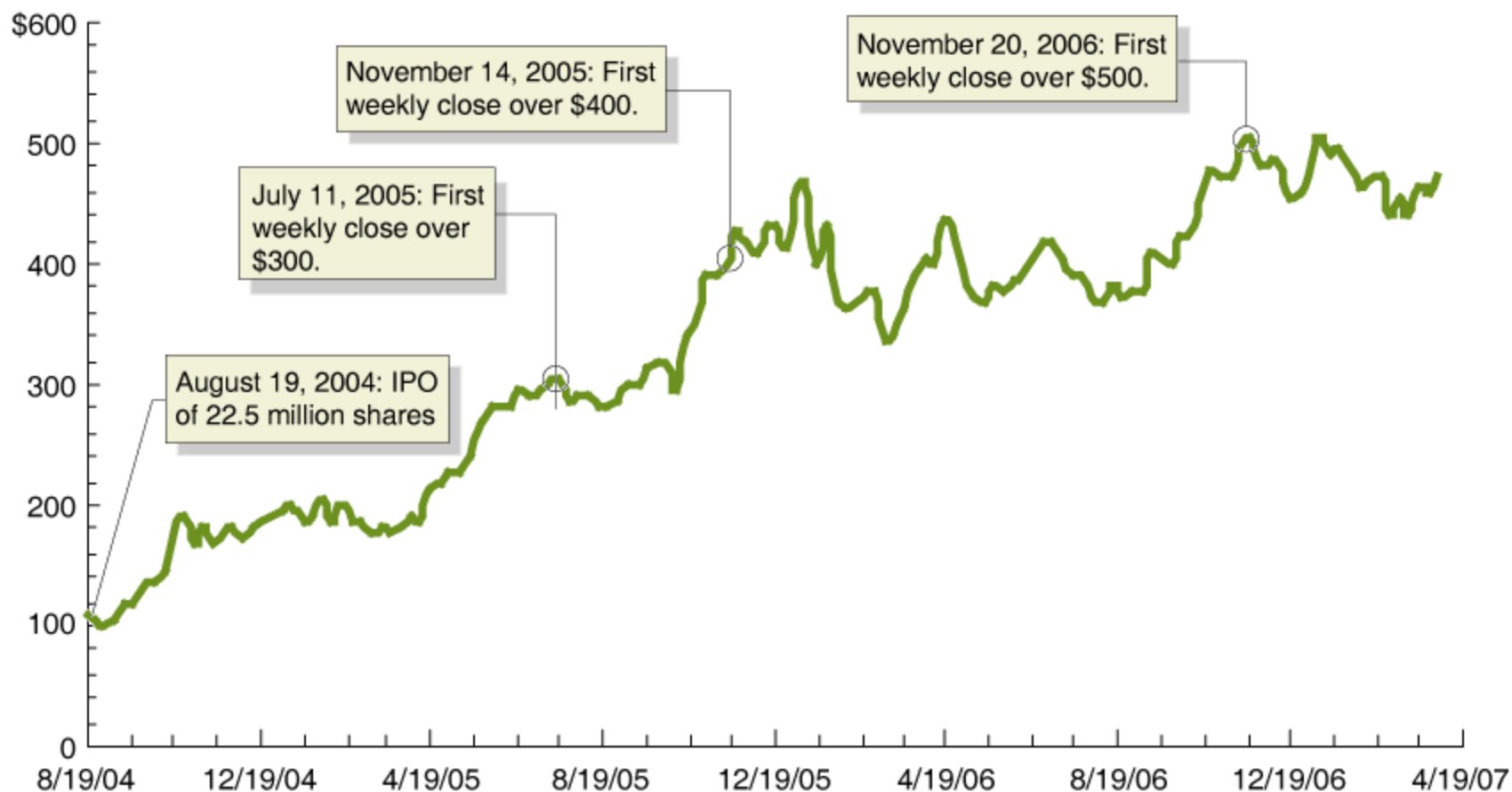
Perhaps the most noticeable corporate governance reform under the Sarbanes-Oxley Act is the creation of the Public Company Accounting Oversight Board, a national board that oversees the auditing of public companies' financial reports.

Solved Problem | 5-5

What Makes a Good Board of Directors?

- a) What is an “independent outsider” on a board of directors?
- b) Why is it good for a firm to have a large majority of independent outsiders on the board of directors?
- c) Why would it be good for a firm to have the auditing and compensation committees composed of outsiders?
- d) Why would it be good for a firm if its directors own the firm’s stock?

Google CEO, Co-Founders Get \$1 Salary



Key Terms

Accounting profit

Asset

Balance sheet

Bond

Corporate governance

Corporation

Coupon payment

Direct finance

Dividends

Economic profit

Explicit cost

Implicit cost

Income statement

Indirect finance

Interest rate

Liability

Limited liability

Opportunity cost

Partnership

Principal–agent problem

Separation of ownership from control

Sole proprietorship

Stock

Appendix

Tools to Analyze Firms' Financial Information

Using Present Value to Make Investment Decisions

Present value The value in today's dollars of funds to be paid or received in the future.

$$\text{Present Value} = \frac{\text{Future Value}_n}{(1 + i)^n}$$

Using Present Value to Calculate Bond Prices

$$\text{Bond Price} = \frac{\text{Coupon}_1}{(1 + i)} + \frac{\text{Coupon}_2}{(1 + i)^2} + \dots + \frac{\text{Coupon}_n}{(1 + i)^n} + \frac{\text{Face Value}}{(1 + i)^n}$$

Appendix

Solved Problem | 5-5

How to Receive Your Contest Winnings

Suppose you win a contest and are given the choice of the following prizes:

Prize 1: \$50,000 to be received right away, with four additional payments of \$50,000 to be received each year for the next four years

Prize 2: \$175,000 to be received right away

Explain which prize you would choose and the basis for your decision.

Appendix

Tools to Analyze Firms' Financial Information

Using Present Value to Calculate Stock Prices

$$\text{Stock Price} = \frac{\text{Dividend}_1}{(1 + i)} + \frac{\text{Dividend}_2}{(1 + i)^2} + \dots$$

A Simple Formula for Calculating Stock Prices

$$\text{Stock Price} = \frac{\text{Dividend}}{(i - \text{Growth Rate})}$$

Appendix

Going Deeper into Financial Statements

Analyzing Income Statements

FIGURE 5A-1

Google's Income Statement for 2006

Revenue	\$10,605	Revenue from sales
Operating expenses		
Cost of revenues	4,225	Categories of costs
Research and development	1,229	
Sales and marketing	850	
General and administrative	752	
Total operating expenses	7,056	Total cost
Operating income	3,549	Operating income = revenue – operating expenses
Investment income	461	
Income before income taxes	4,010	Before-tax accounting profit
Income taxes	(934)	
Net income (accounting profit)	3,076	After-tax accounting profit

Note: All numbers are in millions of dollars.

Appendix

Going Deeper into Financial Statements

Analyzing Balance Sheets

Stockholders' equity The difference between the value of a corporation's assets and the value of its liabilities; also known as net worth.

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Appendix

Going Deeper into Financial Statements

Analyzing Balance Sheets

FIGURE 5A-2

Google's Balance Sheet as of December 31, 2006

ASSETS		LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Assets	\$13,040	Current Liabilities	\$1,305
Property and Equipment	2,395	Long-term liabilities	129
Investments	1,032	Total Liabilities	1,434
Goodwill	1,545	Stockholders' Equity	17,040
Other long-term assets	461		
Total Assets	18,473	Total liabilities and stockholders' equity	18,473