

# Chapter 13



## **Business Organization and Financial Data**



# Learning Objectives

- **LO 13.1 Explain the role of mission statements with regard to business planning**
- **LO 13.2 Describe the three major forms of business organization.**
- **LO 13.3 Distinguish between accounting and financial perspectives and the role of accounting principles in communicating information.**
- **LO 13.4 Describe and summarize the information in the income statement.**



# Learning Objectives

- **LO 13.5 Describe and summarize the information in the balance sheet.**
- **LO 13.6 Describe and summarize the information in the statement of cash flows.**
- **LO 13.7 Describe applications of financial statements analysis to different situations.**
- **LO 13.8 Identify the goal and functions of financial management.**



# Learning Objectives

- **LO 13.9 Describe the agency relationships in a business organization and their implications for financial management.**
- **LO 13.10 Explain the role of finance in the firm's organizational chart.**
- **(Learning Extension) LO 13.11 Compute a person's and a firm's income tax liability and explain the role of depreciation as a way for firm's to reduce their taxes.**



## **LO13.1 The Mission or Vision Statement**

- **Indicates firm's target market(s)**
- **Identifies goods/services the firm will produce, distribute, or sell**
- **Will guide major decisions**
- **Supported by business and financial plans to implement strategy**
- **Periodically reviewed and revised**



# **LO 13.2 Forms of Business Organization in the U.S.**

- **Proprietorships**
- **Partnerships**
  - Limited partnership
- **Corporation**
  - Subchapter S corporation
  - Limited liability company
- **Financial implications of organizational form (Table 13.1)**

**TABLE 13.1****Organizational Forms and Financial Characteristics**

| ORGANIZATIONAL FORM             | NUMBER OF OWNERS                                   | OWNER'S LIABILITY  | EQUITY CAPITAL SOURCES       | EASE OF START-UP | TAXATION  | LIQUIDITY OF OWNERSHIP | LIFE SPAN                      |
|---------------------------------|--|--|------------------------------|------------------|---|------------------------|--------------------------------|
| Proprietorship                  | 1  | Unlimited  | Self, friends, relatives     | Simple           | Personal taxation   | Difficult to sell      | Linked to owner                |
| Partnership (general)           | >1   | Unlimited, jointly and severally                               | Partners, friends, relatives | Not difficult    | Personal taxation   | Difficult to sell      | Linked to owners               |
| Limited partnership             | At least 1 general, any number of limited partners | Limited partners' liability is limited to partners' investment | General and limited partners | More difficult   | Personal taxation   | Usually poor           | Linked to general partner      |
| Corporation                     | Unlimited  | Limited to shareholders' investment                            | Common stock offerings       | Difficult        | Corporate taxation, but dividends are taxed twice, both as corporate earnings and personal income | Can be very liquid     | Unlimited                      |
| Subchapter S corporation        | <35  | Limited to shareholders' investment                            | Sub S equity investors       | Difficult        | Income flows to shareholders for taxation at personal rates                                       | Usually poor           | Unlimited                      |
| Limited liability company (LLC) | Unlimited  | Limited to owners' investment                                  | Common stock offerings       | Difficult        | Income flows to shareholders for taxation at personal rates                                       | Poor                   | Linked to current shareholders |



## LO 13.3 Accounting Principles

- **Public firm's statements must conform to Generally Accepted Accounting Principles**
- **Footnotes**
- **“Accrual” accounting versus cash flows**





## **Table 13.2 Comparison of Accounting and Financial Perspectives**

### **Accounting Focus**

**Matching Revenue and Expenses (accrual concept)**

**Use of different accounting can lead to manipulation of financial statements**

**Seek to Measure Firm Profitability**

**Emphasis is historical**

**Attempts to track assets and depreciate them**

### **Finance Focus**

**Identifying cash inflows and outflows**

**Track the cash flows to assess the “quality” of and earnings**

**Measure cash usage**

**Looks forward**

**Market value of assets**



# Annual Report

- **Information source for corporate shareholders**
- **Contains**
  - **Discussions of operating and financial information of past year**
  - **Future opportunities**
  - **Financial statements**



## LO 13.4 Income Statements

- **Reports the revenues generated and expenses incurred by a firm over an accounting period, such as a quarter or year.**
- **The accrual concept is used to construct the income statement.**
  - **“Revenues” don’t necessarily mean “cash inflows”....**
  - **“Expenses” don’t necessarily mean “cash outflows”**

# Walgreens Income Statements

| (in terms of \$ millions)   | 2018          | 2017           |
|---|---------------|----------------|
| <b>Revenue</b>  | <b>131537</b> | <b>118214</b>  |
| <b>Cost of Goods Sold</b>   | <b>100745</b> | <b>89052</b>   |
| <b>Selling, General, Administrative Expenses and Depreciation</b> | <b>24569</b>  | <b>22916</b>   |
| <b>Operating Income</b>   | <b>6223</b>   | <b>6246</b>    |
| <b>Interest Expense</b>   | <b>-577</b>   | <b>-643</b>    |
| <b>Other Expenses (Income)</b>                                    | <b>+376</b>   | <b>-742</b>    |
| <b>Income Before Taxes</b>  | <b>6,022</b>  | <b>\$4,861</b> |
| <b>Income Taxes</b>   | <b>998</b>    | <b>783</b>     |
| <b>Net Income</b>   | <b>5024</b>   | <b>4078</b>    |



## LO 13.5 Balance Sheet

- A statement of a company's financial position as of a particular date, usually at the end of a quarter or year.
- Whereas the income statement reflects the firm's operations over time, the balance sheet is a snapshot at a point in time.



# Balance Sheet

- It reveals two broad categories of information:
  - the **assets** or the financial and physical items owned by a business and
  - the **claims of creditors and owners** in the business assets.
    - The **creditors' claims**, which are the financial obligations of the business, are referred to as **liabilities**.
    - The company's **equity** is the **funds supplied by the owners** and represents their residual claim on the firm.



# Balance Sheet

- The “balance sheet” is so called as it must “balance”—that is:
- **Assets = Liabilities + Owners’ Equity**

# Walgreens Balance Sheet: Assets

|                             | 2018            | 2017            |
|-----------------------------|-----------------|-----------------|
| Cash & Cash Equivalents     | \$785           | \$3,301         |
| Accounts Receivable         | \$7,144         | \$6,528         |
| Inventories                 | \$10,976        | \$8,899         |
| Other Current Assets        | \$1,178         | \$1,025         |
| <b>Total Current Assets</b> | <b>\$20,083</b> | <b>\$19,753</b> |
| Net Fixed Assets            | \$13,821        | \$13,642        |
| Other Long Term Assets      | \$7,644         | \$6,826         |
| Goodwill & Intangibles      | \$28,393        | \$25,788        |
| <b>Total Fixed Assets</b>   | <b>\$49,858</b> | <b>\$46,256</b> |
| <b>TOTAL ASSETS</b>         | <b>\$69,941</b> | <b>\$66,009</b> |



# Walgreens Balance Sheet: Liabilities and Equity

|                                   | 2018     | 2017     |
|-----------------------------------|----------|----------|
| Accounts Payable                  | \$14,660 | \$12,494 |
| Short Term Debt                   | \$1,999  | \$251    |
| Other Current Liabilities         | \$8,440  | \$5,802  |
| Total Current Liabilities         | \$25,099 | \$18,547 |
| Long Term Debt                    | \$11,646 | \$12,684 |
| Other Liabilities                 | \$6,933  | \$6,504  |
| TOTAL LIABILITIES                 | \$43,678 | \$37,735 |
| Preferred Equity                  | \$0      | \$0      |
| Common Equity + Retained Earnings | \$26,263 | \$28,274 |
| TOTAL STOCKHOLDERS' EQUITY        | \$26,263 | \$28,274 |
| TOTAL LIABILITIES & EQUITY        | \$69,941 | \$66,009 |

# The Balance Sheet balances!

| <b>2017</b>         |          |                          |          |                 |
|---------------------|----------|--------------------------|----------|-----------------|
| <b>Total Assets</b> | <b>=</b> | <b>Total Liabilities</b> | <b>+</b> | <b>Equity</b>   |
| <b>\$66,009</b>     |          | <b>\$37,735</b>          |          | <b>\$28,274</b> |
|                     |          |                          |          |                 |
| <b>2018</b>         |          |                          |          |                 |
| <b>Total Assets</b> | <b>=</b> | <b>Total Liabilities</b> | <b>+</b> | <b>Equity</b>   |
| <b>\$69,941</b>     |          | <b>\$43,678</b>          |          | <b>\$26,263</b> |



## LO 13.6 Statement of Cash Flows

- **Financial statements are prepared using an accrual accounting system...**
- **Meaning that items are recorded as incurred but not necessarily when cash is received or disbursed.**
- **For example, a sale of \$100 is recorded as a sale this year even though the cash is not expected to be collected until next year.**



# Statement of Cash Flows

- ***A statement of cash flows* provides a summary of the cash inflows (sources) and cash outflows (uses) during a specified accounting period.**
- **...similar to how things may look in the firm's checkbook---indicating cash coming into the firm and cash flowing out of the firm.**



# Statement of Cash Flows

- **3 sections:**
  - **Cash flows from operating activities**
  - **Cash flows from investing activities**
  - **Cash flows from financing activities**
- **Their sum equals the change in the firm's cash balance over the year**



# Statement of Cash Flows:

## Sources of cash (cash inflows....)

- Amount of net income plus amount of depreciation
  - Remember depreciation is a non-cash expense—it doesn't represent spending!
- **Decrease** in an asset account
  - Example: sell a building, firm receives cash and fixed assets decline
- Increase in a liability account
- Increase in an equity account
  - Examples: if you sell bonds or common stock: firm receives cash and long-term debt (or equity) account rises



# Statement of Cash Flows:

## Uses of cash (cash outflows....)

- **Increase in an asset account**
  - Example: buy a computer, firm spends cash and fixed assets rise
- **Decrease** in a liability account
- **Decrease** in an equity account
  - Examples: if you pay off a loan or repurchase shares of stock: firm pays cash and long-term debt (or equity) account falls
- **Amount of cash dividends**
  - Cash given by firm to its shareholders



## **LO 13.7 Financial Statements of Different Companies**

- **Learn differences in how companies operate**
- **Compare composition of assets and liabilities, current versus long-term**
- **How they generate earnings, characteristics of their industries**
- **Common-size financials allow comparison of different-sized firms**



# Common Size Balance Sheet--Assets

|                                 | RETAIL<br>STORE      | SOFTWARE<br>FIRM     | OIL<br>COMPANY       |
|---------------------------------|----------------------|----------------------|----------------------|
|                                 | PERCENT<br>OF ASSETS | PERCENT<br>OF ASSETS | PERCENT<br>OF ASSETS |
| Cash & Marketable<br>Securities | 8.9%                 | 61.6%                | 6.1%                 |
| Accounts Receivable             | 8.9%                 | 6.5%                 | 13.9%                |
| Inventories                     | 36.8%                | 0.8%                 | 5.1%                 |
| Other Current Assets            | <u>1.1%</u>          | <u>5.1%</u>          | <u>1.2%</u>          |
| Total Current Assets            | 55.7%                | 74.1%                | 26.4%                |
| Net Fixed Assets                | 43.3%                | 2.8%                 | 60.2%                |
| Other Long Term Assets          | <u>0.9%</u>          | <u>23.1%</u>         | <u>13.4%</u>         |
| <b>TOTAL ASSETS</b>             | 100.0%               | 100.0%               | 100.0%               |



## Common Size Balance Sheets: Liabilities and Equity

|   | RETAIL<br>STORE | SOFTWARE<br>FIRM | OIL<br>COMPANY |
|---|-----------------|------------------|----------------|
| Accounts Payable                              | 18.2%           | 2.0%             | 8.8%           |
| Short Term Debt                               | 0.0%            | 0.0%             | 2.7%           |
| Other Current Liabilities                     | <u>11.8%</u>    | <u>15.6%</u>     | <u>10.5%</u>   |
| Total Current Liabilities                     | 30.0%           | 17.6%            | 22.0%          |
| Long Term Debt                                | 0.0%            | 0.0%             | 2.7%           |
| Other Liabilities                             | <u>6.9%</u>     | <u>5.8%</u>      | <u>23.7%</u>   |
| <b>TOTAL LIABILITIES</b>                      | 36.9%           | 23.3%            | 48.4%          |
| Preferred Equity                              | 0.0%            | 0.0%             | 0.0%           |
| Common Stockholders'<br>Equity                | <u>63.1%</u>    | <u>76.7%</u>     | <u>51.6%</u>   |
| <b>TOTAL LIABILITIES &amp;<br/>    EQUITY</b> | 100.0%          | 100.0%           | 100.0%         |

# Common Size Income Statements

|                            | RETAIL<br>STORE       | SOFTWARE<br>FIRM      | OIL<br>COMPANY        |
|----------------------------|-----------------------|-----------------------|-----------------------|
|                            | PERCENT OF<br>REVENUE | PERCENT OF<br>REVENUE | PERCENT OF<br>REVENUE |
| Revenue                    | 100.0%                | 100.0%                | 100.0%                |
| Cost of Goods Sold         | <u>71.9%</u>          | <u>13.2%</u>          | <u>60.9%</u>          |
| <b>GROSS PROFIT</b>        | 28.1%                 | 86.8%                 | 39.1%                 |
| Selling, General & Admin.  | 21.4%                 | 26.8%                 | 23.9%                 |
| Depreciation               | 1.1%                  | 4.5%                  | 4.2%                  |
| Research & Development     | <u>0.0%</u>           | <u>14.5%</u>          | <u>0.0%</u>           |
| <b>OPERATING INCOME</b>    | 5.7%                  | 41.1%                 | 10.9%                 |
| Interest Expense           | 0.0%                  | 0.0%                  | 0.1%                  |
| Other Expenses (Income)    | <u>-0.1%</u>          | <u>-4.7%</u>          | <u>-4.2%</u>          |
| <b>INCOME BEFORE TAXES</b> | 5.8%                  | 45.8%                 | 15.0%                 |
| Income Taxes               | <u>2.2%</u>           | <u>14.7%</u>          | <u>5.2%</u>           |
| <b>NET INCOME</b>          | 3.6%                  | 31.0%                 | 9.8%                  |

# GM and Ford Balance Sheets

(Amounts in \$ billions)

| General Motors                 | 2008 | 2009 | Net change |
|--------------------------------|------|------|------------|
| Cash and marketable securities | 15   | 37   | +22        |
| Current Assets                 | 44   | 59   | +15        |
| Total Assets                   | 91   | 137  | +46        |
|                                |      |      |            |
| Current Liabilities            | 76   | 52   | -24        |
| Total Liabilities              | 176  | 108  | -68        |
| Equity                         | -85  | 29   | +114       |

| FORD                           | 2008 | 2009 | Net change |
|--------------------------------|------|------|------------|
| Cash and marketable securities | 40   | 43   | +3         |
| Current Assets                 | 117  | 111  | -6         |
| Total Assets                   | 223  | 204  | -19        |
|                                |      |      |            |
| Current Liabilities            | 112  | 78   | -34        |
| Total Liabilities              | 239  | 210  | -29        |
| Equity                         | -16  | -7   | +9         |



## LO 13.8 Goal of a Firm

- **GOAL:**

**MAXIMIZE SHAREHOLDER WEALTH**

**SHAREHOLDER WEALTH =**

**Common Stock Price X Number Of  
Common Shares Outstanding**



# Why Shareholder Wealth?

- **Market is efficient; common stock price reflects available information and investor expectations**
- **In a competitive global economy, market directs capital to most efficient use with best risk/expected return features**
- **Need to treat customers, workers properly before shareholders benefit**



# Other Shareholder Wealth Issues

- **Market Value Added: wealth created by firm's managers, net of capital invested**
- **Peer review: compare firm's wealth performance with competitors to determine strategy's financial success or failure**
- **Criterion for non-public firms**



# What about ethics?

- **Deceitful practices will enhance virtually any financial or non-financial performance measure**
- **Poor ethics: short-term gain, long-term pain**
  - Management careers ruined
  - Company name, reputation ruined
  - Shareholder wealth ruined
- **Needed: adequate training, controls, oversight**





# A good quote....

**...obey the law and not cut corners by taking a little butter out of the butter cookie; take care of customers, not just giving them quality products but also a return policy they could trust; take care of employees; respect but be fair with suppliers; and then take care of shareholders, in that order of priority.”**

**Why is the shareholder at the end of the list?**

***“Because if we’re doing all these other things right, the shareholder will benefit [emphasis added]. That’s what drives long-term value.”***

**Richard Galanti, CFO, Costco**



# LO 13.9 Corporate Governance

- **Owners vs. Managers**
- **Shareholders vs. Professional Mgt.**
- **Principal vs. Agents**
- **The Principal-Agent Problem**
  - **Can be compounded by:**
  - **Weak Board oversight of Management**
  - **Management perks**
  - **Fighting takeover attempts, poison pills**



# Agency costs

## ■ Explicit Agency Costs

- Financial statement audits
- Director and officer liability insurance
- Monitoring of management by Board, consultants
- Inflated salaries, perks

## ■ Implicit Agency Costs

- Restrictions on management actions
- Loan covenants



# Ways to reduce the agency problem

- **Align management incentives with those of shareholders**
  - Stock options
  - Restricted stock
- **Sufficient oversight and accountability**
  - Additional independent directors
  - Sarbanes-Oxley Act of 2002



# Some Provisions of Sarbanes-Oxley

- **Public Company Accounting Oversight Board**
  - Registers auditors
  - Sets audit, ethics, quality standards
  - Audits the auditors
- **Auditor independence**
  - Auditor reports to Board's audit committee
  - Firm performing audit restricted from doing other accounting-related services for the firm



# More Sarbanes-Oxley Provisions

- **CEO/CFO certify financial statements conform**
- **Reduce investment banker conflicts of interest**
  - **Separate stock research from investment bank personnel**
  - **Stock analysts cannot be paid from investment banking fees**
  - **Stock analyst research reports must disclose if they own securities in the firm for which they have made an investment recommendation**



# **LO 13.10 Finance in the Organizational Chart**

- **Chief Financial Officer (CFO)**
  - Treasury function
  - Controller function
- **Compensation**
- **Finance and the Balance Sheet Structure**
  - Capital budgeting question
  - Capital structure question
  - Operations or net working capital question



# Learning Extension 13A

## Federal Income Taxation

### Example tax rates, married filing jointly

| <b>Taxable<br/>income</b> | <b>Marginal<br/>tax rate</b> |
|---------------------------|------------------------------|
| <b>\$0–19,400</b>         | <b>10%</b>                   |
| <b>19,400–78,950</b>      | <b>12</b>                    |
| <b>78,950–168,400</b>     | <b>22</b>                    |
| <b>168,400–321,450</b>    | <b>24</b>                    |
| <b>321,450–408,200</b>    | <b>32</b>                    |
| <b>408,200–612,350</b>    | <b>35</b>                    |
| <b>Over 612,350</b>       | <b>37</b>                    |





## Example tax rates, single

| <b>Taxable income</b>  | <b>Marginal<br/>tax rate</b> |
|------------------------|------------------------------|
| <b>\$0–9,700</b>       | <b>10%</b>                   |
| <b>9,700–39,475</b>    | <b>12</b>                    |
| <b>39,475–84,200</b>   | <b>22</b>                    |
| <b>84,200–160,725</b>  | <b>24</b>                    |
| <b>160,725–204,100</b> | <b>32</b>                    |
| <b>204,100–510,300</b> | <b>35</b>                    |
| <b>Over 510,300</b>    | <b>37</b>                    |



## Proprietor, married, \$50,000 income

**Compute the tax bill:**

$$0.10 \times \$19,400 = \$1,940.00$$

$$0.12 \times \underline{\$30,600} = \underline{3,672.00}$$

$$\begin{array}{r} \$50,000 \qquad \qquad \$ 5,612.00 \end{array}$$

**Marginal tax rate: 12%**

$$\begin{aligned} \text{Average tax rate} &= \$5,612.00 / \$50,000 \\ &= 11.2\% \end{aligned}$$



# Concepts

- **Ordinary taxable income**
- **Unrealized capital gains/losses**
- **Realized capital gains/losses**



# Corporate tax rates 2019

**Taxable income**

**Tax rate**

**Flat rate on all income:**

**21%**



# Depreciation Basics

- **Depreciation :**
  - a non-cash expense
  - reduces taxable income
  - reduces tax bill (“depreciation tax shield”)
  - conserves cash as tax outflow is less

## Example: The benefits of depreciation

|   | <u>WITH</u> | <u>WITHOUT</u> |
|---|-------------|----------------|
| Income before depr.<br>and income taxes | \$100,000   | \$100,000      |
| Less: Depreciation                      | 20,000      | 0              |
| Income before taxes                     | 80,000      | 100,000        |
| Less: Income taxes<br>(@ 30%)           | 24,000      | 30,000         |
| Net income                              | \$ 56,000   | \$ 70,000      |



# MACRS Percentages

## PERCENTAGE DEPRECIATION ALLOWED BY CLASS OF ASSET LIFE

### RECOVERY

| <u>YEAR</u> | <u>3-YEAR</u> | <u>5-YEAR</u> |
|-------------|---------------|---------------|
| 1           | 33.33%        | 20.00%        |
| 2           | 44.45         | 32.00         |
| 3           | 14.81         | 19.20         |
| 4           | 7.41          | 11.52         |
| 5           |               | 11.52         |
| 6           |               | 5.76          |

## Example: \$10,000 asset in 5-year class

| <u>YR</u> | <u>DEPREC</u> |   |        | <u>PERCENTAGE</u> | <u>DEPREC</u> | <u>AMOUNT</u> |
|-----------|---------------|---|--------|-------------------|---------------|---------------|
| 1         | \$10,000      | x | 0.2000 | =                 | \$2,000       |               |
| 2         | 10,000        | x | 0.3200 | =                 | 3,200         |               |
| 3         | 10,000        | x | 0.1920 | =                 | 1,920         |               |
| 4         | 10,000        | x | 0.1152 | =                 | 1,152         |               |
| 5         | 10,000        | x | 0.1152 | =                 | 1,152         |               |
| 6         | 10,000        | x | 0.0576 | =                 | <u>576</u>    |               |
| Total     |               |   |        |                   | \$10,000      |               |