

Project Financial Management

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PMG 615

Major forms of business ownership and Financial statements

Lecture 6



LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

LO 7.1 Describe the three major forms of business organization.

LO 7.2 Describe and summarize the information in the income statement.

LO 7.3 Describe and summarize the information in the balance sheet.

LO 7.4 Describe and summarize the information in the statement of cash flows.

LO 7.5 Identify the goal and functions of financial management.

LO 7.6 Describe the agency relationships in a business organization and their implications for financial management.

Forms of Business Organization in the United States

proprietorship (sole proprietorship) a business venture owned by an individual who personally receives all profits and assumes all responsibility for the debts and losses of the business

Three major forms of business ownership are used in the United States: proprietorships, partnerships, and corporations. Proprietorships are the most widely used form, although they are generally the smallest organizations in terms of assets. About 72 percent of U.S. firms are proprietorships, about 10 percent are partnerships, and the remaining 18 percent are corporations. In terms of revenues, 81 percent of sales are generated by corporations, about 15 percent by partnerships, and about 4 percent by proprietorships.³

The choice of a legal form of organization for a business is a strategic matter from many points of view. Managerial lines of authority and control, legal responsibility, and the allocation of income and risk are directly related to the form the organization takes. In this chapter, we look at the relationship between the legal form of organization and its sources and methods of financing, and its allocation of risk. [Table 13.1](#) summarizes some of the points of this discussion.

Proprietorship

The **proprietorship**, sometimes called a sole proprietorship, is a business venture owned by an individual who personally receives all profits and assumes all responsibility for the debts and losses of the business. Typically, the owner is the manager; he or she is in total control of the firm. Separating the owner from the firm is difficult. Proprietorships outnumber all other forms of business organization in the United States. However, the economic power of these firms, as measured by number of employees and size of payroll, is less than that of the nation's corporations.

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

The financial capital of proprietorships is, many times, limited to the savings of the owner and funds that may be borrowed from friends, relatives, and banks. The investment made by the owner is called **equity capital**, or owner's equity. As the business grows and larger investments in capital are required, the owner may reach the point where additional funds cannot be borrowed without an increase in owner's equity. Lenders will generally insist on an increase in the owner's equity, because that equity provides a margin of safety for the lender.

This point is where the proprietorship form of organization displays **its basic weakness**. In many cases, the owner's original investment exhausts his or her personal resources, and often those of friends and relatives. Unless profits from the venture are great enough to meet the increased equity needs, the firm is prevented from achieving its maximum growth. At this stage, it may be necessary to adopt a form of organization more appropriate for raising capital.

In addition, the life of the proprietorship is limited to that of the proprietor; when the proprietor dies, the business ends. Another weakness is the difficulty in transferring ownership (sometimes called ownership "liquidity") of the proprietorship. It can be difficult to sell a proprietorship. Among the complicating factors is that the firm is likely to sell at a discount, or for a percentage of its value, because of the difficulty in determining the business' past profitability, cash flows, risks, and future market potential. Much of what has made the proprietorship successful may be the proprietor or the information in the proprietor's mind.

equity capital investment made by the owner into the company

partnership a form of business organization that exists when two or more persons own a business operated for profit

Another weakness of proprietorship is that the owner's liability for debts of the firm is unlimited. Creditors may take the assets of the business to settle claims but they may take the personal assets of the proprietor as well. Thus, the proprietor may find his or her home and personal property under claim if the assets of the business are insufficient to meet the demands of creditors. The unlimited liability of the owner is, therefore, a serious disadvantage of the proprietorship.

On the positive side, a proprietorship business is easily started with minimal expense and, generally, has fewer government regulations to comply with than does a corporation. Profits from a proprietorship are taxed at personal, or individual, rates rather than at corporate income tax rates. Furthermore, converting a business that was established as a proprietorship into a corporation is easy when the need to finance growth warrants such a move.

Partnership

A **partnership** form of business organization exists when two or more persons own a business operated for profit. Although the partnership resembles the proprietorship, to some degree, there are important differences. See Table 13.1 for a summary.

Undoubtedly, one of the major reasons for the popularity of the partnership arrangement is that it allows individuals to pool their resources of money, property, equipment, knowledge, and business skills without the complications that often accompany incorporation. A partnership form may exist from the beginning of a business operation. In other cases, a firm that began as a proprietorship may reach the point where additional growth is impossible without increased equity capital. Bringing in new equity investors by converting to a partnership arrangement is one method of increasing the equity capital of a firm.

The number of partners that may be taken into a business venture is, theoretically, unlimited. However, the managerial difficulties and conflicts arising with many partners limit their number to a practical size. Thus, the partnership, like the proprietorship, eventually suffers from a lack of large amounts of equity capital. It is unusual to find more than a few partners in an industrial or commercial firm.

As is the case for a proprietorship, the life of a partnership is linked to that of its partners. Should a partner leave or die, the partnership officially dissolves unless a new partnership agreement is drafted. For purposes of taxation, the partnership's profits (and losses) are distributed to the partners and are taxable to the individual partner. Like proprietorships, partnerships typically have illiquid ownership stakes. The partners' shares of most small- to medium-sized business are often sold at a discount that reflects their lack of liquidity, their lack of majority control over the firm, and the need for the new partner to "fit" with the existing partners.

Like the proprietor, the members of a partnership team risk their personal assets as well as their investments in the business venture. In addition, if one of the partners negotiates a contract that results in substantial loss, each partner suffers a portion of the loss, based on a previously determined agreement on distribution of profits and losses. The other partners may, however, sue the offending partner if there is any violation of the articles of co-partnership.

More serious, perhaps, is a partner's liability for the actions of the business. In legal terms, each partner is jointly and severally liable for the partnership's debts. Under partnership law, **each partner has unlimited liability for all the debts of the firm. This permits creditors to claim assets from one or more of the partners if the remaining partners are unable to cover their share of the loss.**

These liability risks describe a **general partnership**. A **limited partnership** addresses the liability concern by identifying at least one general partner who has unlimited liability. The remaining **limited partners** face liability limited to their investments in the firm, meaning their personal assets cannot be attached to settle the firm's debts. They are "limited" as well in that they cannot participate in the operations of the firm. Operating decisions may be made only by the general partners. Some sports teams (such as the New York Yankees) are owned by limited partnerships. Broadway theater productions and real estate management and construction firms are other popular limited partnership vehicles.

limited partnership has at least one general partner who has unlimited liability; the liability of the limited partners is limited to their investment

limited partners face limited liability to their investments in the firm, meaning their personal assets cannot be attached to settle the firm's debt

Corporation

A **corporation** is a legal entity created under state law in the United States with an unending life and limited financial liability to its owners.

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A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. Among the most important are immortality and individuality, properties by which a perpetual succession of persons are considered as the same and may act as a single individual.

In essence, **the law has created an artificial being that has the rights, duties, and powers of a person.** The definition includes the concept **of many people united into one body that does not change its identity with changes in ownership.** **Advantages of being organized as a corporation** include unlimited corporate life that is not tied to that of the owners, the ability to attract outside capital, limited financial liability for the owners, and the ease with which ownership can be transferred from investor to investor.

A corporation that has been in existence only a short time, like most new ventures, usually finds it difficult to attract investment funds from outsiders. The corporate form of organization does not ensure a flow of investment funds into the business. Rather, it removes several of the barriers to the flow of capital that exist in other forms of business organization. After a corporation becomes established and offers attractive returns for investors, these special features of the corporate form become significant. One of the important reasons corporations can accumulate large sums of capital is that they are allowed to sell capital stock. The stock may be offered to existing stockholders or to new investors in amounts suited to their purposes. A firm can **go public** by first registering its shares with the Securities and Exchange Commission (SEC) and then selling them to the investing public. A corporation that has not gone through this process is a **privately held corporation**.

One of the advantages for corporate stockholders is the limitation on liability. Ordinarily, creditors and other claimants may look only to the assets of the corporation for satisfaction of their claims. They cannot take the personal assets of the owners (stockholders). This advantage is particularly appealing to the owner of a business who has built up considerable personal wealth and has other business interests. The limitation on liability may make it possible for promoters of new ventures to attract wealthy investors who would otherwise be unwilling to risk claims against their personal property.

On the other hand, the corporate form of organization may not always protect stockholders from personal risk beyond their investment when a business is relatively new or in a weak financial condition.

Creditors may require that one or more of the stockholders add their signatures to the obligation of the corporation, making them personally liable for the obligation. After a corporation has established a good credit reputation, however, creditors and suppliers seldom insist on personal guarantees on the part of the stockholders.

Another important advantage of the corporation is the ease with which ownership may be transferred. Corporate stock may be transferred freely from one person to another. The purchaser of the stock then has all the rights and privileges formerly held by the seller. The corporation is not a party to the transfer of ownership and has no power to interfere with the sale or purchase of its stock. In contrast, there must be unanimous approval of the members of a partnership before a new partner can be brought into the business.

However, like proprietorships and partnerships, the corporate form of organization has its drawbacks. First, setting up a corporation is more time-consuming and costly because of legal requirements. Individuals who wish to incorporate must hire a lawyer to prepare a charter and a set of bylaws. The charter provides a corporate name, indicates the intended business activities, provides the names and addresses of directors, and indicates how the firm will be capitalized with stock. A corporation is chartered in a specific state by filing the charter with the secretary of that state. The bylaws are the rules established to govern the corporation and include how the firm will be managed, how directors will be elected, and the rights of stockholders. After beginning operation, the corporation must file financial and tax statements with state and federal government agencies.

A second drawback of the corporate form of organization is that corporate earnings distributed as shareholder dividends are subject to double taxation. That is, corporate earnings are taxed first at the appropriate corporate income tax rate. Then, if the corporation pays out a portion of its after-tax earnings in the form of dividends, the stockholders must pay personal income taxes on this income.

Two special forms of corporate organization in the United States allow dividends to escape double taxation. A subchapter S corporation (named for the section of the tax code that discusses this organization) must have fewer than 35 shareholders, none of whom is another corporation. Income from a subchapter S corporation flows untaxed to the shareholders. Thus, it is taxed only once, as personal income of the shareholders.

A limited liability company (LLC) organizational form is similar to a subchapter S corporation. It offers owners limited liability, and its income is taxed only once, as personal income of the shareholders. Unlike a subchapter S corporation, however, an LLC can have an unlimited number of shareholders, including other corporations. The LLC can sell shares without completing the costly and time-consuming process of registering them with the SEC, which is a requirement for standard corporations that sell their securities to the public. The LLC structure has drawbacks in that, should an owner leave, all others must formally agree to continue the firm. Also, all of the LLC's owners must take active roles in managing the company. To protect partners from unlimited liability, some large accounting firms formerly set up as partnerships, such as PricewaterhouseCoopers, have become LLCs. Other partnerships have decided to go the corporate route to limit the partners' liability and to gain access to the capital market; Goldman Sachs, an investment banking firm, has converted from partnership to corporate status.

It is up to the firm's owners to weigh the pros and cons and determine which organizational form suits the needs of their firm best. Each has its own implications for taxation, control by the owners, ability to trade ownership positions, limitations on liability, firm life, and raising capital.

DISCUSSION QUESTION 1

If you are going to start a business, what organizational form would you select? Why? What drawbacks might you face in organizing a business this way?

charter provides the corporate name, indicates the intended business activities, provides names and addresses of directors, and indicates how a firm will be capitalized with stock

bylaws the rules established to govern the corporation and include how the firm will be managed, how the directors will be elected, and the rights of the stockholders

subchapter S corporation has fewer than 35 shareholders, none of which is another corporation; its income flows untaxed to the shareholders and is taxed only once, as personal income of the shareholders

limited liability company (LLC) an organizational form, similar to a subchapter S corporation, that offers owners limited liability; its income is taxed only once, as personal income of the shareholders, and the firm can have an unlimited number of shareholders

7.2 The Annual Report

An important component of manager–owner communication is the firm’s financial statements. Firms organized as proprietorships or partnerships are not required to prepare financial reports or statements except for tax purposes. Of course, proprietors and partners must gather financial data so as to be able to evaluate their financial performance over time. Requests for bank loans need to be accompanied by recent financial statements, too.

In contrast, companies organized as corporations are required to prepare financial reports annually for the benefit of their shareholders. Public corporations are required to file annual reports with the SEC.

An [annual report](#) contains descriptive information on operating and financial performance during the past year, a discussion of current and future business opportunities, and financial statements that provide a numerical record of financial performance. Usually, financial highlights are provided on the first page or two, followed by a letter to the stockholders by the firm’s chairman of the board and chief executive officer (CEO). The CEO summarizes the financial results for the year and identifies the firm’s strengths, such as employee talents and the size of its customer base. After the CEO’s letter, most companies describe their current business areas, future opportunities, and financial goals, such as a target return on equity or earnings growth rate.

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Three important financial statements are provided in the annual report: the statement of income (sometimes called the statement of operations), the balance sheet (sometimes called the statement of financial position), and the statement of cash flows. Management provides detailed notes to these financial statements.

7.3 Income Statement

The [income statement](#) 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. [Table 13.4](#) presents income statements for a firm, Walgreens, for 2015 and 2014. In 2015, Walgreens had net revenues of \$103.4 billion (which is the same as the \$103,444 million shown in the table—that is, \$103,444,000,000) compared with \$76.4 billion for 2014, which reflects an increase of over 35 percent. After deducting production costs and other expenses incurred in running the business, Walgreens’ net income was \$4,255 million in 2015, more than a 100 percent increase over 2014’s net income of \$2,031 million.

[income statement](#) reports the revenues generated and expenses incurred by the firm over an accounting period, such as a quarter or a year

TABLE 13.4 Income Statements for Walgreens (\$ MILLIONS)

	2014	2015
Revenue	\$76,392	\$103,444
Cost of goods sold	\$54,823	\$76,520
Selling, general and administrative expenses and depreciation	\$17,375	\$22,256
Operating income	\$4,194	\$4,668
Interest expense	\$156	0
Other expenses (income)	\$481	(\$643)
Income before taxes	\$3,557	\$5,311
Income taxes	\$1,526	\$1,056
Net income	\$2,031	\$4,255
Earnings per share	\$2.03	\$4.05

Why is there such the large increase in income statement (and, as we shall see below, balance sheet) items? In 2015, Walgreens completed a merger with a large European firm, Alliance Boots; the combined firm's official name is Walgreens Boots Alliance but we refer to it as "Walgreens" as that is shorter, and that is the name we see on drugstores across America. Prior to the merger, Alliance Boots was a pharmacy-led health and beauty products firm that was formed in 2006 after another merger, that of Boots Group and Alliance Unichem. For the fiscal year 2014, Alliance Boots had revenue of £23.4 billion and profit of £971 million. At U.S. dollar–British pound exchanges rates, the Alliance Boots revenue was approximately \$39 billion with profits of \$1.6 billion.

Let's look at some of the major income statement accounts in greater detail. The starting point of the income statement reflects the revenues or sales generated from the operations of the business. Often, gross revenues are larger than net revenues. This is due to sales returns and allowances that may occur over the time period reflected in the income statement. Some-times, when customers make early payment on their bills, cash discounts are given by the firm. If customers buy in large quantities, trade discounts may be given. Thus, discounts will reduce gross revenues.

The costs of producing or manufacturing the products sold to earn revenues are grouped under cost of goods sold (COGS). These expenses reflect costs directly involved in production, such as raw materials, labor, and overhead refers to the ongoing costs of running a business that are not directly related to creating or selling a product or service such as rent & insurance costs. and, thus, vary with the level of production output.

Selling, general and administrative expenses tend to be stable or fixed in nature and cover requirements such as record keeping and preparing financial and accounting statements. These expenses reflect the costs associated with selling the firm's products. This includes salaries and/or commissions generated by the sales force as well as promotional and advertising expenditures.

Depreciation is an estimate of the reduction in the economic value of the firm's plant and equipment caused by the creation of the firm's products or services. Each financial period's income statement shows the amount of depreciation expense specific to that period. Accumulated depreciation, or the sum of prior period depreciation expense, appears in the balance sheet. No cash outflow is associated with depreciation, so it is considered to be a noncash expense.

Operating income is a firm's income before interest and income taxes, and is sometimes referred to as earnings before interest and taxes (EBIT).

Interest expense is subtracted from operating income. When a portion of a firm's assets are financed with liabilities, interest charges usually result. This is true for bank loans and long-term corporate bonds. Operating income less interest expense gives the firm's pretax earnings, or earnings before taxes.

Businesses are required to pay federal income taxes on any profits. Most states tax business profits. Taxable earnings, or profit, are defined as income remaining after all other expenses have been deducted from revenues, except income taxes. Effective income tax rates can vary substantially depending on whether the firm is organized as a proprietorship, partnership, or corporation. The net income, or profits, remaining after income taxes are paid reflects the earnings available to the owners of the business. This income may be retained in the business to reduce existing liabilities, increase current assets, and/or acquire additional fixed assets. On the other hand, some or all of the income may be distributed to the owners of the business.

Because of accrual accounting, a firm's net income over some period may not be the same as its cash flow. The amount of cash flowing into the firm can be higher or lower than the net income figure.

For a corporation, a firm commonly shows its net income on a per-share basis. This is referred to as the earnings per share (EPS) and is calculated by dividing the net income by the number of shares of common stock that are outstanding. For Walgreens, EPS rose from \$2.03 in 2014 to \$4.05 in 2015. Although net income rose by nearly 110 percent, EPS rose "only" 100 percent in 2014–2015. The reason for this is the denominator of the EPS calculation: the number of shares outstanding rose between 2014 and 2015, so the EPS did not rise as much as net income.

In some instances, corporations have both preferred and common stockholders. Dividends are paid to the "preferred" stockholders out of net income; the remaining earnings are called "income available to common stockholders." For example, if Walgreens had paid \$200 million in preferred stock dividends in 2015, the remaining earnings available for common stockholders would have been \$4,255 – \$200 = \$4,055 million.

Corporations frequently pay cash dividends to their common stockholders. The percentage of net income, or earnings, paid out as dividends is referred to as the dividend payout ratio. For example, in 2015 Walgreens paid common stock dividends of \$1,384 million (this figure is given in Table 13.6); this represents a dividend payout ratio of about 33 percent (\$1,384 million in dividends divided by net income of \$4,225 million). The remaining earnings are retained in the business; for example, they can be used to repay debt, buy back shares of stock, or purchase new plant and equipment.

7.4 The Balance Sheet

The balance sheet is 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. It reveals two broad categories of information: (1) the assets, or the financial and physical items owned by a business, and (2) 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 company.

In addition to providing a snapshot of a firm's financial condition, the balance sheet reveals much of the inner workings of the company's financial structure. The various types of assets indicate the results of recent business operations and the capacity for future operations. The creditors' claims and the owners' equity in the assets reveal the sources from which these assets have been derived. The term "balance sheet" indicates a relationship of equality between the assets of the business and the sources of funds used to obtain them that may be expressed as follows:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

This "balance sheet equation" or "accounting identity" shows that every dollar of a firm's assets must be financed by a dollar of liabilities (typically some type of credit or borrowing).

balance sheet statement of a company's financial position as of a particular date, usually at the end of a quarter or year

assets financial and physical items owned by a business

liabilities creditors' claims on a firm, which are the financial obligations of the business

equity funds supplied by the owners and represents their residual claim on the firm

a dollar of owner's equity, or some combination of the two. The firm's asset total shows what the firm owns; the total of liabilities and equity shows what the firm owes to its creditors and owners.

The balance sheet for Walgreens shown in [Table 13.5](#) reveals this equality of assets and the financial interests in the assets. Total assets were \$68,782 million in 2015, an 85 percent increase over 2014's asset level of \$37,182 million. **As we mentioned above, this large increase in assets (as well as most other balance sheet accounts) is because of the merging of two firms, Walgreens and Alliance Boots, into one firm: Walgreens Boots Alliance during 2015.**

Because of the merger, total liabilities increased from \$16,725 million to \$37,921 million, which is an increase of over 126 percent. Owner's equity, which for Walgreens is stockholders' equity, provided the balancing figure with \$30,861 million in 2015 and \$20,457 million in 2014. This was an increase of about 51 percent. **This brief comparison shows the large increase in assets was financed mainly by an increase in debt (total liabilities), and some was financed by the increase in equity.**

Assets

Assets that are most liquid are typically listed first. By liquidity, we mean the time it usually takes to convert the assets into cash. Two broad groups are identified on the balance sheet: current assets and fixed assets.

TABLE 13.5 Balance Sheets for Walgreens (\$ MILLIONS)

	2014	2015
Cash & Cash equivalents	\$2,646	\$3,000
Accounts receivable	\$3,218	\$6,849
Inventories	\$6,076	\$8,678
Other current assets	\$302	\$1,130
Total Current Assets	\$12,242	\$19,657
Net fixed assets	\$12,257	\$15,068
Other long-term assets	\$10,324	\$17,685
Goodwill & intangibles	\$2,359	\$16,372
Total Fixed Assets	\$24,940	\$49,125
TOTAL ASSETS	\$37,182	\$68,782
Accounts payable	\$4,315	\$10,088
Short-term debt	\$774	\$1,068
Other current liabilities	\$3,806	\$5,401
Total Current Liabilities	\$8,895	\$16,557
Long-term debt	\$3,736	\$13,315
Other liabilities	\$4,094	\$8,049
TOTAL LIABILITIES	\$16,725	\$37,921
Preferred equity	\$0	\$0
Common equity + Retained earnings	\$20,457	\$30,861
TOTAL STOCKHOLDERS' EQUITY	\$20,457	\$30,861
TOTAL LIABILITIES & EQUITY	\$37,182	\$68,782

The **current assets** of a business include cash and other assets that are expected to be converted into cash within one year. Current assets thus represent the **working capital** needed to carry out the normal operations of the business. The principal current assets of a business are, typically, its cash and marketable securities, accounts receivable, and inventories.

Cash and marketable securities include cash on hand and cash on deposit with banks; marketable securities, such as commercial paper issued by other firms; and U.S. government securities in the form of Treasury bills, notes, and bonds.

Accounts receivable, generally, arise from the sale of products, merchandise, or services on credit. The buyer's debts to the business are, generally, paid according to the credit terms of the sale.

The materials and products that a manufacturing firm has on hand are shown as inventories on the balance sheet. Generally, a manufacturing firm categorizes its **inventories** in terms of raw materials, goods in the process of manufacture, and finished goods. Sometimes, the balance sheet will reveal the amount of inventory in each of these categories.

Fixed assets are the physical facilities used in the production, storage, display, and distribution of the products of a firm. These assets normally provide many years of service. **The principal fixed assets are classified into two categories:** (1) plant and equipment and (2) land. Intangible assets, which are assets you cannot see or feel, are accounted for on the balance sheet as they are created as the firm conducts business. An example of this is **goodwill**, which is an accounting concept as it represents the excess funds paid, when one firm merges with or purchases another, over and above the accounting value of the firm's net assets. For example, if a firm's net assets are worth \$100 million but it has loyal customers, good workers, or a strong brand image, another firm may pay \$125 million to purchase the firm. \$25 million will appear on the balance sheet, after the merger, to reflect the value of the goodwill sold in the transaction. The large increase in the goodwill account in 2015 shows the effects of the Walgreens acquisition of Alliance Boots—the price paid by Walgreens far exceeded the net assets of Alliance Boots.

In a manufacturing firm, a large investment in plant and equipment is usually required. As products are manufactured, some of the economic value of this plant and equipment lessens. This is called **depreciation** and accountants reflect this using up of real assets by charging off depreciation against the original cost of plant and equipment. Thus, the net plant and equipment information at any point in time is supposed to reflect their remaining useful lives. The net is calculated by subtracting the amount of depreciation that has accumulated over time from the gross plant and equipment.

Some firms own the land or real property on which their buildings or manufacturing plants are constructed. Other firms may own other land for expansion or investment purposes. The original cost of land owned is reflected on the firm's balance sheet. Under the tax code, land cannot be depreciated.

current assets cash and all other assets that are expected to be converted into cash within one year
working capital assets needed to carry out the normal operations of the business.

Marketable securities are securities that can easily be sold.

goodwill an intangible asset that represents the excess funds paid, when one firm merges with or purchases another, over and above the accounting value of the firm's net assets

depreciation devaluing a physical asset over the period of its expected life

Liabilities

Liabilities are the debts of a business. They come into existence through direct borrowing, purchases of goods and services on credit, and the accrual of obligations, such as wages and income taxes. Liabilities are classified as current and long-term.

The current liabilities of a business may be defined as those obligations that must be paid within one year. They include accounts payable, notes payable, and accrued liabilities that are to be met out of current funds and operations. **Although the cash on hand plus marketable securities of the Walgreens is \$3,000 million compared with current liabilities of \$16,557, it is expected that normal business operations will convert receivables and inventory into cash in time to meet current liabilities as they become due.**

Accounts payable are debts that arise primarily from the purchase of goods and supplies on credit terms. Accounts payable arising from the purchase of inventory on credit terms represent trade credit financing as opposed to direct short-term borrowing from banks and other lenders. An account payable shown on one firm's balance sheet appears as an account receivable on the balance sheet of the firm from which goods were purchased.

A **note payable** is a written promise to pay a specified amount of money to a creditor on or before a certain date. The most common occurrence of a note payable takes place when a business borrows money from a bank on a short-term basis to purchase materials or for other current operating requirements.

Current liabilities that reflect amounts owed but not due as of the date of the balance sheet are called **accrued liabilities, or accruals**. The most common forms of accruals are wages payable and taxes payable. These accounts exist because wages are, typically, paid weekly, biweekly, or monthly and income taxes are paid quarterly.

Business debts with maturities greater than one year are **long-term liabilities**. one of the common methods used by businesses for obtaining a long-term loan is to offer a mortgage to a lender as collateral for a corporate bond. In the event that the borrowing business fails to meet the obligations of the loan contract, the mortgage may be foreclosed; that is, the property may be seized through appropriate legal channels and sold to satisfy the indebtedness.

Owners' Equity

All businesses have owners' equity in one form or another. Owners' equity is the investment of the owners or owner in the business. It initially results from a cash outlay to purchase assets to operate the business. In some cases, the owners of a business may place their own assets, such as machinery, real estate, or equipment with the firm for its operation. In addition to contributing cash or property, owners' equity may be increased by allowing profits to remain with the business. On the balance sheet, the amount of owners' equity is always represented by the difference between total assets and total liabilities of the business. It reflects the owners' claims on the assets of the business as opposed to the creditors' claims.

In the case of a corporation, the owners' equity can be broken down into three different accounts. **First**, Walgreens has no preferred stock outstanding, so the preferred equity or stock account balance is zero. **Second**, the common stock, or common equity, account reflects the number of outstanding shares of common stock carried at a stated or par value and **the capital paid in excess of par**.

The third account is called the retained earnings account, and it shows the accumulated undistributed earnings (i.e., earnings *not* paid out as dividends) of the corporation over time. These retained earnings do not represent cash. They have been invested in the firm's current and/or fixed assets over the firm's lifetime. **Together, these three accounts (preferred equity, common equity, and retained earnings) comprise the corporation's stockholders' equity.** In the case of Walgreens, all of the stockholders equity belongs to common shareholders.

7.5

Statement of Cash Flows

In addition to the income statement and balance sheet, corporate annual reports also want to measure changes in cash flows. All three of the previously described financial statements are prepared using an **accrual accounting system** whereby 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.

A **statement of cash flows** provides a summary of the cash inflows (sources) and cash outflows (uses) during a specified accounting period. The statement consists of three sections: operating activities, investing activities, and financing activities.

statement of cash flows provides a summary of the cash inflows (sources) and cash outflows (uses) during a specified accounting period

The primary approach to constructing a statement of cash flows begins with the net income from the income statement as a cash inflow. We add back any noncash deductions, such as depreciation, which were deducted by accounting principles although no cash outflow occurred. The other “cash flow” adjustments are made by examining the differences in the accounts from two consecutive balance sheets. More specifically, cash flows are determined as follows:

Sources

1. Amount of net income plus amount of depreciation
2. Decrease in an asset account
3. Increase in a liability account
4. Increase in an equity account

Uses

1. Increase in an asset account
2. Decrease in a liability account
3. Decrease in an equity account
4. Amount of cash dividends

Changes in the cash account are excluded. In the statement of cash flows, all of the firm’s sources and uses of cash are added together. Their sum equals the change in the firm’s cash account. If the statement of cash flows is constructed correctly, the sum of the items should equal the difference in the cash account between the two balance sheets used to generate it.

Let’s examine these more closely:

- Assets. The purchase of raw materials or an increase in the amount of finished goods held requires additional cash. Thus, it is a use and is, therefore, subtracted in the statement of cash flows. In contrast, collections of accounts receivable frees up cash; the reduction in accounts receivable is a source and is added in the statement of cash flows.
- Liabilities and equity. Borrowing money from a bank or receiving an added investment from a partner or stockholder represents a source of cash to the firm. In contrast, paying off a bank loan or repurchasing shares of stock is a use of cash.

Table 13.6 shows the statement of cash flows for Walgreens based on the 2015 income statement and the balance sheets as of fiscal year-end 2014 and 2015. Due to the accounting changes and firm consolidation that occurred with the 2015 merger, some numbers may not match with differences in the 2014 and 2015 balance sheets. We will focus on the basic structure of the statement of cash flows in our discussion.

Notice that cash flows are grouped on the basis of operating activities, investing activities, and financing activities. **Sources of funds from operations** begin with net income of \$4,255 million, other income of \$24 million, and depreciation of \$1,742 million to reflect the fact that depreciation is a noncash charge against the firm’s revenues. **A use of cash from operations** was in the form of a \$338 million increase in accounts receivable and a \$154 million decrease in other current liabilities. **Sources of cash** included a \$719 million reduction in inventory and a \$268 million increase in accounts payable. The overall result was a net cash inflow from operations during 2015 of \$5,664 million. The cash from operations is an important figure for businesses. It may be negative for growing firms, but generally, a firm cannot exist long if it continually creates net cash outflows from its operations.

Table 13.6 shows that Walgreens invested \$1,251 million in plant and equipment in 2015. It also invested over \$4,000 million in an investment in another firm, probably its acquisition of Alliance Boots. **Overall, there was a net cash outflow of \$4,276 million because of the firm’s investing activities.**

TABLE 13.6 Statement of Cash Flows, Walgreens, 2015 (\$ millions)

OPERATING ACTIVITIES	
Net income (Loss)	4,255
Other income	24
Depreciation & amortization	1,742
(Increase) Decrease in receivables	-338
(Increase) Decrease in inventories	719
(Increase) Decrease in other current assets	
Increase (Decrease) in payables	268
Increase (Decrease) in other current liabilities	-154
Other adjustments, Net	-852
CASH FROM OPERATIONS	5,664
INVESTING ACTIVITIES	
Capital expenditure	-1,251
Acquisitions	-4,018
Sale of property, plant & equipment	
Investments (increase)	-49
Other investing cash flow	1,042
CASH FROM INVESTMENTS	-4,276
FINANCING ACTIVITIES	
Issuance of capital stock	-1,226
Net debt increase (decrease)	1,587
Dividends	-1,384
Other cash in (out) flow	108
CASH FROM FINANCING	-915
Effect of exchange rates	-119
NET CHANGE IN CASH	354

The net cash flow from financing activities amounted to a \$915 million outflow during 2015. This net figure includes the payment of cash dividends of \$1,384 million, a stock repurchase of \$1,226 million, and proceeds from a sale of bonds of \$1,587 million. As the firm had global operations in 2015 following the merger of Alliance Boots, fluctuating exchange rates affected its dollar cash flows. The firm's cash flow was \$119 million lower due to the effect of unfavorable exchange rate changes on the value of its cash flows. The overall result of operating, investing, and financing activities during 2015 was a \$354 million increase in the cash account.

Please note: Capital expenditure or capital expense is the money an organization or corporate entity spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.

Goal of a Firm

Although a firm may have a mission statement espousing goals of quality, customer service, quality products offered at fair prices, and so on, such qualitative statements are only a means to an end. The firm's managers need a definite, measurable benchmark against which to evaluate alternatives. The goal of any firm should be financial; namely, the maximization of the owners' (or the common shareholders') wealth.

Creditors have a fixed claim that usually doesn't change with variations in the value of the firm's assets over time. As we learned in Chapter 10, shareholders have a residual or junior claim on the firm's assets. Therefore, variations in a firm's value will be mainly reflected in the fluctuating value of the owners', or shareholders', wealth in the firm. Managers will want to select strategies that are expected to increase shareholders' wealth. Alternatives that harm shareholders' wealth should be rejected.¹⁴

This view is consistent with the process of attracting and acquiring capital and investing it to earn rates of return in excess of the investors' expected returns. If a firm is able to do this, the excess return will accrue to the firm's owners, the shareholders.

Measuring Shareholder Wealth

Shareholder wealth is measurable, and it is observable daily in the financial sections of newspapers (at least for firms whose common stock is publicly traded). Shareholder wealth is nothing more than the market value of a firm's common stock. This market value of the shareholders' claim on a firm is equal to the following:

$$\text{Shareholder wealth} = \text{Common stock price} \times \text{Number of common shares outstanding}$$

This relationship allows analysts to keep track of changes in shareholder wealth on a regular basis to see which firms are most successful at returning value to shareholders. *As long as the number of common stock shares outstanding does not change appreciably, the market's perception of the firm and of its management's actions appears in the firm's stock price.*

For shareholder wealth maximization to be a realistic goal, the financial markets need to provide reasonably accurate information about the value of a firm. The stock market is sometimes criticized in the popular press as being shortsighted and unpredictable. Can it determine a fair value for the firm? The evidence on efficient markets from Chapter 12 suggests it can. Many studies show the market is oriented toward the long-run health and well-being of firms.¹⁵ The weight of evidence favors the idea that the market generally does price stocks fairly. Stock price changes show the effect on firm value from the market's evaluation of the news.

Focusing on shareholder value does not mean other aspects of good management are ignored. Smart managers make decisions to service customers in a cost-efficient manner. Many studies have showed the value enhancement that occurs from maintaining the current customer base rather than having to continually find new customers to take the place of those who are dissatisfied. Similarly, smart managers treat and pay employees fairly. [Table 13.10](#) shows the effect of unsatisfying jobs, employee turnover, and the cost impact of needing to hire and train replacement workers. Unmotivated and unhappy employees become unproductive employees who increase costs and prevent the firm from satisfying its goals.

TABLE 13.10 Happy and Productive Employees Help Increase Shareholder Wealth

A. Selected Industry-Wide Costs of Replacing Employees	Annual Turnover Rate (%)	Industry-Wide Costs (Direct Replacement Costs Only) (\$ Billions)	Costs as a Percentage of Industry Earnings (%)
Specialty retail	97	23.2	50
Call centers	31	5.4	43
High tech	25	44.3	43
Fast food	123	3.4	16

Source: Sibson & Co.

B. Turnover Rates and Hiring Costs	Annual Turnover Rate (%)	Cost Per New Hire
Banking	16.0	\$6,110
Consumer products	23.0	\$17,450
Insurance	13.1	\$9,902
Manufacturing	17.8	\$11,408
Pharmaceuticals	12.6	\$13,632
Telecommunications	21.0	\$7,176

Source: SaratogaSM Institute

Research indicates that higher levels of employee satisfaction lead to higher stock prices. Investment in capital (fixed asset) resources should lead to higher levels of production, efficiency, and profits as it is with human capital. Research indicates the value of employee and manager training programs in increasing shareholder wealth over time. By focusing on firm value, managers work to maintain satisfactory relationships with financing sources so funds will be available to finance future growth needs. Focusing on shareholder wealth is the best means of helping the long-term survival of the firm in a dynamic, global economy.

Shareholder wealth as a measure of firm performance is objective and forward looking, and it incorporates all influences on the firm and its stakeholders. No other measure of firm performance is so inclusive and practical for evaluating a firm's strategies.

A measure used in identifying successful firms, and that is growing in popularity, is **market value added (MVA)**. The MVA measures the value created by the firm's managers. It is equal to the market value of the firm's liabilities and equity, minus the amount of money **investors** paid to the firm (this is the "book value" found in the firm's financial statements) when these securities were first issued.

That is, market value added (MVA) equals the following:

$$\begin{aligned} \text{MVA} &= \text{Market value of stock} + \text{Market value of debt} \\ &\quad - \text{Book value of stock} - \text{Book value of debt} \end{aligned}$$

Usually, a firm's market value of debt closely approximates its book value, so a close estimate of MVA is the market value of equity less the book value of equity. Stern Stewart & Company, a financial consulting firm, regularly reports firms' MVAs.

market value added (MVA) measures the value created by the firm's managers; is equal to the market value of the firm's liabilities and equity minus the amount of money investors paid to the firm when these securities were first issued

What About Ethics?

Critics frequently argue that emphasizing shareholder wealth may lead managers to focus on quick fixes to problems, even resorting to unethical behavior to maintain firm value. Some managers, unfortunately, do make decisions to ignore product quality or safety, worker safety, and the well-being of communities or to use deceitful selling practices. As long as, these practices are not discovered or publicized, they may help keep shareholder value higher than it should be. But let's take a closer look at this type of behavior.

Unethical managers will make improper decisions regardless of the performance measure, so using shareholder value as a performance measure probably will not affect such abusive practices. By inflating firm revenues, keeping costs artificially low, or diverting scarce resources from needed to less-productive uses, unethical practices would improve nearly any performance measure, be it sales, costs, or market share. Thus, to blame ethical lapses on financial measures of firm performance is inappropriate.

Some would argue that all stakeholders (employees, customers, suppliers, bondholders, bankers, and shareholders) should be considerations in managers' decision making. They argue that focusing solely on shareholder wealth creates short-term thinking by managers. Holders of this perspective argue that managers focus on the current stock price and what will make it rise this year, with the result that managers resort to accounting tricks to increase short-term earnings reports, decide to conserve cash flow, or forgo undertaking long-term projects, so investment and innovation is discouraged.

However, focusing on firm value may keep management's eyes on the longer-term consequences of its actions. Firms engaged in unethical or careless behavior run the danger of having this behavior exposed. Such revelations can harm the firm's reputation and shareholder value for extended periods as customers and employees feel their trust has been violated. Some evidence from a recent study suggests that firms with a social conscience may gain more financially in the marketplace. An important aspect to corporate ethics is the control systems that a firm has in place to discourage such activity and to catch it if it occurs. As shareholders are many and dispersed, it is the role of the board and corporate governance to ensure managers are working for the shareholders' best interests rather than for a "quick fix" or their own selfish interests. Compensation systems that reward managers for longer-term company performance and share price performance can ensure that managers make appropriate decisions for the well-being of all stakeholders as well as shareholders.

7.7

Corporate Governance

In most proprietorships and partnerships, the owners are the managers and they play an active role in managing their business. But in many firms, someone other than the owners make business decisions; there is a separation of ownership and control. For example, professional managers run public corporations in the place of the shareholders. This arrangement may result in ethics problems. For example, dishonest managers can make decisions that increase expenses in order to benefit themselves (such company-owned vacation villas, corporate jets, high salaries) over shareholders. Or they can send stock prices higher by manipulating transactions and accounting rules so the firm appears more profitable than it is.

Corporate governance is the structure of rules, practices, and processes used to direct and manage a company. A company's board of directors is the primary force influencing corporate governance. Bad corporate governance can cast doubt on a company's operations and its ultimate profitability. Corporate governance is the system by which companies are directed and controlled.

Unfortunately, the early 2000s brought a number of corporate scandals to light. Some stock analysts and their investment banking firms were accused of “hyping” stocks to attract lucrative investment banking fees. Firms such as Enron, Global Crossing, Parmalat, Rite- Aid, Tyco, WorldCom, and Xerox were accused of incorrect accounting practices and had to restate past years’ financials; some executives were fined and sent to jail. Arthur Andersen, a venerable accounting firm, was restricted from doing further auditing work after employees shredded documents relating to Enron’s accounting irregularities. Most of the scandals were caused by poor ethical decisions dealing with accounting practices that inflated earnings and stock prices.

CRISIS The 2007–2009 Great Recession brought to light other shortsighted corporate practices. Lack of oversight and proper risk management brought some Wall Street firms to the brink of bankruptcy, and some, such as Bear Stearns and Lehman Brothers, did fail. Panic created by concerns over the strength of the U.S. and global financial systems led to massive intervention by the Federal Reserve Board and central banks of other countries and massive increases in government spending as fiscal policy and monetary policy were jointly used to prevent a feared collapse. Workers’ retirement plans were cut in half, and sometimes more, if they were heavily invested in the falling stock market during late 2007 to early 2009.

principals owners of the firm
agents managers hired by the principals to run the firm
principal-agent problem a problem in corporate governance in which conflict of interest occurs between the principals and agents

Principal-Agent Problem

In legal parlance, the **principals**, or owners of the firm, hire managers (the **agents**) to run the firm. The agents should run the firm with the best interests of the principals in mind. However, ethical lapses, self-interest, or the principals’ lack of trust in the agent can lead to conflicts of interest and suspicions between the two parties. This problem in corporate governance is called the **principal–agent problem**.

FINANCE In a corporation, the common shareholders of a firm elect a board of directors. In theory, the board is to oversee managers and ensure they are working in the best interests of the shareholders. However, in practice, the board often has a closer relationship with management than with the shareholders. For example, top managers commonly sit on the firm’s board of directors, and the firm’s top managers often nominate candidates for board seats. For example, as recently as 1995, the board of Archer Daniels Midland (a grain processor) included the firm’s CEO and three of his relatives. Other firms have had relatives of management as members of the board’s audit committees, the important group that oversees the firm’s financial controls.²¹ These relationships can obscure loyalties and make the board a toothless watchdog for share-holders’ interests.

Managers, acting as agents, may seek their own interest by increasing their salaries, the size of their staffs, or their perquisites. Better known as “perks,” the latter include club memberships, the use of company planes or luxurious company cars, gardening expenses, low- interest or no-interest loans, and lifetime benefits, such as paid long-term care insurance, the use of company cars and drivers, and access to company planes. Firms may also do business with other businesses in which the CEO has an ownership stake, blurring the distinction between doing what is best for shareholders and doing favors for the top officer.

At times the company’s top managers make a bid to take the company private. Such situations can lead to conflicts of interest, as who knows better than the company’s top managers how to increase profits from their company’s—and why don’t they do so for the firm’s current shareholders?

Because of these behaviors, the principal-agent problem imposes **agency costs** on shareholders. Agency costs are the tangible and intangible expenses borne by shareholders because of the actual or potential self-serving actions of managers. Agency costs include **explicit**, out-of-pocket expenses. Examples of these include the costs of auditing financial statements to verify their accuracy, purchasing liability insurance for board members and top managers, monitoring managers' actions by the board or by independent consultants, and paying inflated managerial salaries and perks.

Implicit agency costs do not have a direct expense associated with them, but they harm shareholders anyway. Implicit agency costs include restrictions placed against managerial actions (e.g., requiring shareholder votes for some major decisions) and covenants or restrictions placed on the firm by a lender.

agency costs tangible and intangible expenses borne by shareholders because of the actual or potential self-serving actions of managers

The end result of the principal-agent problem is a reduction in firm value. Investors will not pay as much for the firm's stock because they realize that the principal-agent problem and its attendant costs lower the firm's value. Agency costs will decline, and firm value will rise, as principals' trust and confidence in their agents rises. We will discuss some ways of reducing agency costs in the next section.

Reducing Agency Problems

Solutions to the principal-agent problem aim to align the interest of both parties. There are two main areas of improvement to address the problem:

1. Contract design

The main purpose of contract design is the creation of a contract framework between the principal and the agent to address issues of information asymmetry, stimulate the agent's incentives to act in the best interests of the principal, and to determine procedures for monitoring agents.

2. Performance evaluation and compensation

The agent's compensation is the primary method of aligning the interests of both parties. In order to address the principal-agent problem, the compensation must be linked to the performance of the agent.

The performance of the agent is usually measured by subjective evaluation because it is a more flexible and balanced assessment method for complex jobs. Common methods of agent compensation include **stock options**, profit-sharing, and deferred compensation. Tying the agent's compensation closely to the benefits obtained for the principal helps to eliminate conflicts of interest.

stock options allow managers to purchase, at a future time, a stated number of the firm's shares at a specific price