

Alternative Forms of Business Organization

- Sole proprietorship
- Partnership
- Corporation

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Sole proprietorships & Partnerships

- Advantages
 - Ease of formation
 - Subject to few regulations
 - No corporate income taxes
- Disadvantages
 - Difficult to raise capital
 - Unlimited liability
 - Limited life

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Corporation

- Advantages
 - Unlimited life
 - Easy transfer of ownership
 - Limited liability
 - Ease of raising capital
- Disadvantages
 - Double taxation
 - Cost of set-up and report filing

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Financial Goals of the Corporation

- The primary financial goal is shareholder wealth maximization, which translates to maximizing stock price.
 - Do firms have any responsibilities to society at large?
 - Is stock price maximization good or bad for society?
 - Should firms behave ethically?

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Is stock price maximization the same as profit maximization?

- No, despite a generally high correlation amongst stock price, EPS, and cash flow.
- Current stock price relies upon current earnings, as well as future earnings and cash flow.
- Some actions may cause an increase in earnings, yet cause the stock price to decrease (and vice versa).

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Agency relationships

- An agency relationship exists whenever a principal hires an agent to act on their behalf.
- Within a corporation, agency relationships exist between:
 - Shareholders and managers
 - Shareholders and creditors

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Shareholders versus Managers

- Managers are naturally inclined to act in their own best interests.
- But the following factors affect managerial behavior:
 - Managerial compensation plans
 - Direct intervention by shareholders
 - The threat of firing
 - The threat of takeover

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Shareholders versus Creditors

- Shareholders (through managers) could take actions to maximize stock price that are detrimental to creditors.
- In the long run, such actions will raise the cost of debt and ultimately lower stock price.

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Factors that affect stock price



- Projected cash flows to shareholders
- Timing of the cash flow stream
- Riskiness of the cash flows

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CHAPTER 2 Financial Statements, Cash Flow, and Taxes

- Balance sheet
- Income statement
- Statement of cash flows
- Important Measures
- EVA
- Federal tax system

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The Annual Report

- Balance sheet – provides a snapshot of a firm's financial position at one point in time.
- Income statement – summarizes a firm's revenues and expenses over a given period of time.
- Statement of cash flows – reports the impact of a firm's activities on cash flows over a given period of time.

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Balance Sheet: Assets

	2002	2001
Cash	7,282	57,600
A/R	632,160	351,200
Inventories	1,287,360	715,200
Total CA	1,926,802	1,124,000
Gross FA	1,202,950	491,000
Less: Dep.	263,160	146,200
Net FA	939,790	344,800
Total Assets	<u>2,866,592</u>	<u>1,468,800</u>

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Balance sheet: Liabilities and Equity

	2002	2001
Accts payable	524,160	145,600
Notes payable	636,808	200,000
Accruals	489,600	136,000
Total CL	1,650,568	481,600
Long-term debt	723,432	323,432
Common stock	460,000	460,000
Retained earnings	32,592	203,768
Total Equity	492,592	663,768
Total L & E	<u>2,866,592</u>	<u>1,468,800</u>

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Income statement

	2002	2001
Sales	6,034,000	3,432,000
COGS	5,528,000	2,864,000
Other expenses	519,988	358,672
EBITDA	(13,988)	209,328
Depr. & Amort.	116,960	18,900
EBIT	(130,948)	190,428
Interest Exp.	136,012	43,828
EBT	(266,960)	146,600
Taxes	(106,784)	58,640
Net income	<u>(160,176)</u>	<u>87,960</u>

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Statement of Cash Flows (2002)

OPERATING ACTIVITIES	
Net income	(160,176)
Add (Sources of cash):	
Depreciation	116,960
Increase in A/P	378,560
Increase in accruals	353,600
Subtract (Uses of cash):	
Increase in A/R	(280,960)
Increase in inventories	(572,160)
Net cash provided by ops.	(164,176)

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Statement of Cash Flows (2002)

L-T INVESTING ACTIVITIES	
Investment in fixed assets	(711,950)
FINANCING ACTIVITIES	
Increase in notes payable	436,808
Increase in long-term debt	400,000
Payment of cash dividend	(11,000)
Net cash from financing	825,808
NET CHANGE IN CASH	(50,318)
Plus: Cash at beginning of year	57,600
Cash at end of year	<u>7,282</u>

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Important Measures: NOPAT

$$\text{NOPAT} = \text{EBIT} (1 - \text{Tax rate})$$

Sales
 -COGS
 -Other expenses
 = EBITDA
 -Depreciation
 = EBIT
 -Interest Exp.
 = EBT
 -Taxes
 = Net income

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Important Measures: Net Operating Working Capital

$$\text{NOWC} = \text{Current assets} - \text{Non-interest bearing CL}$$

CA = Cash, A/R & Inventories

CL = A/P, Notes Payable, Accruals

Notes are interest bearing and must be excluded from the NOWC calculation

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Important Measures: Operating Capital

Operating capital = NOWC + Net Fixed Assets

Net Fixed Assets are PPE less Depreciated portion of the assets

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Important Measures: Cash Flows

NCF = Net Income + Depreciation

OCF = NOPAT + Depreciation

FCF = NOPAT – Net investment in Operation Capital

FCF is the most important Cash Flow measure – it is the cash actually available for distribution to all investors

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Economic Value Added (EVA)

EVA = After-tax Operating Income – After-tax Capital costs

= Funds Available to Investors – Cost of Capital Used

= NOPAT – After-tax Cost of Capital

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EVA Concepts

- In order to generate positive EVA, a firm has to more than just cover operating costs. It must also provide a return to those who have provided the firm with capital.
- EVA takes into account the total cost of capital, which includes the cost of equity.

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Corporate and Personal Taxes

- Both have a progressive structure (the higher the income, the higher the marginal tax rate).
- Corporations
 - Rates begin at 15% and rise to 35% for corporations with income over \$10 million.
 - Also subject to state tax (around 5%).
- Individuals
 - Rates begin at 10% and rise to 38.6% for individuals with income over \$307,050.
 - May be subject to state tax.

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Tax treatment of various uses and sources of funds

- Interest paid – tax deductible for corporations (paid out of pre-tax income), but usually not for individuals (interest on home loans being the exception).
- Interest earned – usually fully taxable (an exception being interest from a (muni)).
- Dividends paid – paid out of after-tax income.
- Dividends received – taxed as ordinary income for individuals (“double taxation”). A portion of dividends received by corporations is tax excludable, in order to avoid “triple taxation”.

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