Reading Assignment

Chapter 1:
Foundations

Chapter 2:
Financial Background: A Review of Accounting, Financial Statements, and Taxes

Supplemental Reading

See information below.

Learning Activities (Non-Graded)

See information below.

Key Terms

1. Agency
2. Assets
3. Capital gains tax
4. Corporation
5. Financial asset
6. Financial markets
7. Financial statements (balance sheet, income statement & statement of cash flows)
8. Financing (sources of capital)
9. Income tax
10. Liabilities
11. Partnership
12. Proprietorship
13. Real asset

Learning Objectives

Upon completion of this unit, students should be able to:

1. Discuss the nature of financial assets (securities) and financial markets.
2. Explain the role of financial management in corporations and its relationship to accounting information and economic theory.
3. Contrast the forms of business organization.
4. Analyze the goal of maximizing shareholder wealth, agency theory and conflicts of interest.
5. Assess basic accounting information and data used in financial decision making.
6. Apply federal taxes in calculations.

Written Lecture

Welcome to BBA 3301! In this class you will study corporate finance and be exposed to many tools and techniques used in managerial financial decisions. As you work through the class, you will note that much of the course applies to "real world" situations. Whether it is planning your retirement, purchasing insurance or obtaining a loan, finance is everywhere. Enjoy the class!

Finance involves many different areas including investments, financial markets, and corporate financial decision making. Corporate finance includes the management and control of money and money-related operations within a business.

In each of these areas, different types of assets are sold, purchased or exchanged. There are two primary classes of assets:

- Real assets: tangible or physical assets that can be used in production of a good or service, or possibly have intrinsic value in trade.
- Financial assets: represent a claim to some future income. Examples include financial securities, insurance contracts, and derivative instruments. Financial assets, such as bonds and stocks issued by corporations to raise money are bought by investors in financial markets. Financial markets are exchanges or organizations in which people can buy/sell securities.

Often corporations use financial markets to attract capital (money) from investors. There are three primary ways by which corporations finance their budgets and future growth:

- Issuing stock: equity financing
- Borrowing money: debt financing
- Internal financing: retaining earnings

14. Securities
15. Stakeholders

Investors buy securities for the future cash flows expected from them. The link between company management and investors is derived from this relationship between stock price and expected financial results.

Accounting and economics are important to finance. Often accounting is referred to as “the language” of finance. Most finance practitioners have some knowledge of accounting and are able to interpret financial statements including the balance sheet, income statement, and statement of cash flows. Accounting data and information is utilized with economics to make financial decisions. Finance is an offshoot of economic theory in the 1950’s that relies heavily on economic theory and tools. Accounting is usually focused on the recording of historic information while finance is focused on future cash flows.

Prior to delving into finance, you must first understand the different forms of business organization, including the proprietorship, the partnership, and the corporation. In studying each of these forms, there are differences in their ability to raise capital (money), types of taxation (exposure), and levels of liability to the owners/shareholders.

For analytical purposes the proprietorship and partnership are very similar in the following characteristics:

- Relatively easy to start (legal requirements are minimal).
- Profit is taxed as personal income and is taxed only once.
- Access to capital (money) is limited and can be difficult for owners to acquire.
- Owners may be subject to unlimited liability for business issues, losses and lawsuits.

In contrast to the above, the corporate form offers benefits in regard to liability, but distinct disadvantages in complexity of actually creating the corporation as well as significantly higher taxation:

- Difficult to start, requires resources, capital (money) and staff to incorporate.
- Profit is taxed twice, once at the corporate level then at the individual level (shareholder) as individual income. There are exceptions to this double taxation involving an S-Corporation and LLC’s where taxation is similar to a partnership, and income is taxed once.
- Raising capital is easier for corporations because they can access capital markets by issuing securities.
- Shareholders’ losses are limited to their investment. Unless they have some additional responsibility (management or director), they have no additional personal liability.

As you study finance, you should keep in mind the goal of the firm:

- Economically—goal is to maximize profit. This definition runs into short/long run problems.
- Financially—goal is to maximize stockholders’ wealth by maximizing stock price. Under this definition, investors take a broad look at corporate actions when bidding stock prices up or down.

In addition to understanding the importance of maximizing shareholder wealth, often corporate management must consider stakeholders including: stockholders, employees, suppliers, creditors, the local community, and management.

In considering the goal of the firm, you will note the possibility for an agency conflict. This may occur when ownership of a widely held corporation is dispersed so no one has enough control to influence/remove management. When this occurs, it allows top management to become entrenched in positions controlling large amounts of resources and using them for their own benefit. Agency conflict can be controlled through active shareholder involvement and monitoring and tying management compensation to stock prices.

The second part of this unit is a review of content that is usually covered in a basic accounting course. Often, students find the need to brush up on the financial statements and taxes as they begin finance. Don't forget, accounting is the "language of finance."

There are three core financial statements (and their respective components) that are important to finance and financial decision making. They are listed below along with their key features:

1. Income statement
   - Sales
   - Cost and expense
   - Gross margin
   - Interest and earnings before interest and taxes (EBIT)
   - Interest expense
   - Earnings before taxes
   - Taxes
   - Net Income (profit or earnings after taxes)

2. Balance sheet
   - Assets = liabilities + equity
   - Assets and liabilities are arranged in order of decreasing liquidity – ease with which an asset becomes cash
   - Assets can be broken down into current assets which include cash, accounts receivable and inventory; or they can be longer lived assets known as fixed assets such as plant, property and equipment. Note that depreciation is a non-cash expense that lessens tax obligations while reducing book value of assets.
   - Liabilities are what is "owed," and includes accounts payable, accruals, and forms of long-term debt (loans). The percent of debt in capital structure, also known as leverage, impacts returns to shareholders because of the fixed nature of interest payments.
   - Working Capital = Current Assets – Current Liabilities
   - Equity includes all common stock, preferred stock, and retained earnings.
   - Beginning Equity + Net Income – Dividends + New Stock Sold= Ending Equity

3. Statement of cash flows
   - Created from one income statement and two balance sheets.

In finance it is important to understand the impact taxes have on decisions and the after tax returns to investments. There are three classes of taxes: those on wealth, income, and consumption (sales). Total effective tax rate (TETR) is the total or combined rate to which the taxpayer is subject and is found with the following equation

$$TETR = T_f + T_s (1 - T_f)$$

where

T_f = federal tax rate

T_s = state tax rate

U.S. income taxes, whether corporate or individual, are progressive in nature. This means the percentage tax actually increases on a marginal benefit. As higher income is earned, a higher percentage of each incremental dollar earned is levied by the government. The current individual and corporate tax rates are identified in the charts below:

Single Individuals		Married Couples Filing Jointly	
Income ($)	Rate (%)	Income ($)	Rate (%)
0–8,350	10	0–16,700	10
8,350–33,950	15	16,700–67,900	15
33,950–82,250	25	67,900–137,050	25
82,250–171,550	28	137,050–208,850	28
171,550–372,950	33	208,850–372,950	33
Over 372,950	35	Over 372,950	35

The above table can be found in your textbook on page 50.

Corporate Tax Rate

Income ($)	Rate (%)
0–50,000	15
50,000–75,000	25
75,000–100,000	34
100,000–335,000	39
335,000–10,000,000	34
10,000,000–15,000,000	35
15,000,000–18,333,333	38
Over 18,333,333	35

The above table can be found in your textbook on page 54.

There are two primary types of income taxes, those on ordinary income and those on capital gains (profits on selling assets). Historically, capital gains tax rates have been lower than taxes on ordinary income.

Now take a look at the supplemental reading materials and the problems in the assignment section. Along with the lecture, you have good review tools and the beginnings of your financial foundation. It won't be long and you may consider yourself a financial whiz kid.

Supplemental Reading

From the CSU Library:

Rapoport, M. (2012, February 21). U.S. nears accounting shift. *Wall Street Journal (Online).* Retrieved from Wall Street Journal database.

Anonymous. (2012, March 20). The U.S. Is number one; On April 1, Japan cedes the highest corporate tax rate to America. *Wall Street Journal (Online)*. Retrieved from Wall Street Journal database.

Anonymous. (2012, January 23). Keeping accounting honest, useful. *Wall Street Journal (Online)*. Retrieved from Wall Street Journal database.

Learning Activities (Non-Graded)

Calculate the tax liability for corporations with the following EBTs:

a. $250,000
b. $500,000
c. $15,000,000
d. $50,000,000

Calculate the process in detail. You do not need to submit this learning activity to your professor.