MINICASE

The McGee Cake Company

In early 2005, Doc and Lyn McGee formed the McGee Cake Company. The company produced a full line of cakes, and its specialties included chess cake*, lemon pound cake, and double-iced, double-chocolate cake. The couple formed the company as an outside interest, and both continued to work at their current jobs. Doc did all the baking, and Lyn handled the marketing and distribution. With good product quality and a sound marketing plan, the company grew rapidly. In early 2010, the company was featured in a widely distributed entrepreneurial magazine. Later that year, the company was featured in *Gourmet Desserts,* a leading specialty food magazine. After the article appeared in *Gourmet Desserts,* sales exploded, and the company began receiving orders from all over the world.

Because of the increased sales, Doc left his other job, followed shortly by Lyn. The company hired additional workers to meet demand. Unfortunately, the fast growth experienced by the company led to cash flow and capacity problems. The company is currently producing as many cakes as possible with the assets it owns, but demand for its cakes is still growing. Further, the company has been approached by a national supermarket chain with a proposal to put four of its cakes in all of the chain's stores, and a national restaurant chain has contacted the company about selling McGee cakes in its restaurants. The restaurant would sell the cakes without a brand name.

Doc and Lyn have operated the company as a sole proprietorship. They have approached you to help manage and direct the company's growth. Specifically, they have asked you to answer the following questions.

QUESTIONS

1. What are the advantages and disadvantages of changing the company organization from a sole proprietorship to an LLC?
2. What are the advantages and disadvantages of changing the company organization from a sole proprietorship to a corporation?
3. Ultimately, what action would you recommend the company undertake? Why?

* Chess cake is quite delicious and distinct from cheesecake. The origin of the name is obscure.

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FINANCIAL STATEMENTS, TAXES, AND CASH FLOW

A WRITE-OFF BY A COMPANY frequently means that the value of the company's assets has declined. For example, in 2010, Bank of America announced a total of $34 billion in write-offs for bad loans. In addition, the company announced a $10.5 billion write-off because recent legislation reduced the value of its credit card business. The write-offs made by Bank of America during 2010 followed write-offs of $33.7 billion in 2009 and $16.2 billion in 2008. Of course, Bank of America was not alone. Moody's Investor Services estimated that banks had written off $476 billion during 2009 and 2010, and it expected bank write-offs of $286 billion during 2011.

Bank of America's write-off was a big one, but not a record. Possibly the largest write-offs in history were done by the media company Time Warner, which took a charge of $45.5 billion in the fourth quarter of 2002. This enormous write-off followed an earlier, even larger, charge of $54 billion.

So did stockholders in Bank of America lose $34 billion because of the write-offs? The answer is probably not. Understanding why ultimately leads us to the main subject of this chapter: that all-important substance known as *cash flow.*

LEARNING OBJECTIVES

After studying this chapter, you should understand:

- **LO1** The difference between accounting value (or "book" value) and market value.
- **LO2** The difference between accounting income and cash flow.
- **LO3** The difference between average and marginal tax rates.
- **LO4** How to determine a firm's cash flow from its financial statements.

In this chapter, we examine financial statements, taxes, and cash flow. Our emphasis is not on preparing financial statements. Instead, we recognize that financial statements are frequently a key source of information for financial decisions, so our goal is to briefly examine such statements and point out some of their more relevant features. We pay special attention to some of the practical details of cash flow.

As you read, pay particular attention to two important differences: (1) the difference between accounting value and market value and (2) the difference between accounting income and cash flow. These distinctions will be important throughout the book.