

Financial, Business & Tax Environment



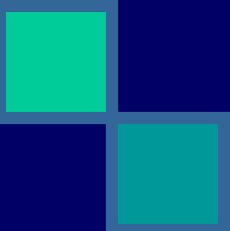
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Corporate Income Taxes

1. The annual budget decides it every year
2. Presently in the range of 15% to 37.5% [taking care of exemptions such as concept of Minimum Alternative Tax (MAT) and backward area benefits]
3. MAT is a special tax for zero tax liability companies (generally not equal to taxable income). Firms pay the maximum of MAT or regular tax liability
4. Quarterly Payments require firms to pay 25% of their estimated annual tax liability every quarter



Taxes

- The one thing we can rely on with taxes is that they are always changing
 - Marginal vs. average tax rates
 - Marginal – the percentage paid on the next dollar earned
 - Average – the tax bill / taxable income
 - Other taxes
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Example: Marginal Vs. Average Rates

- Suppose your firm earns Rs 4 crores in taxable income.
 - What is the firm's tax liability?
 - What is the average tax rate?
 - What is the marginal tax rate?
- If you are considering a project that will increase the firm's taxable income by Rs 1 crore, what tax rate should you use in your analysis?

Depreciation

- ❖ What is Depreciation?
 - ❖ It represents the systematic allocation of the cost of a capital asset over a period of time for financial reporting purposes, tax purposes, or both.
 - ❖ What are the different methods of depreciation?
 - ❖ Generally, profitable firms prefer to use an accelerated method for tax reporting purposes.

Common Types of Depreciation

- Straight-line (*SL*)
- Accelerated Types
 - Double-Declining-Balance (*DDB*) or Written Down Value (*WDV*) method
 - Modified Accelerated Cost Recovery System (*MACRS*)

Interest Deductibility

- Interest Expense is the interest paid on outstanding debt and is *tax deductible* in India
- Dividend is the cash distribution of earnings to shareholders and is *not* a tax deductible expense
- What is the after-tax cost of debt?
- The after-tax cost of debt is:
$$(\text{Interest Expense}) \times (1 - \text{Tax Rate})$$
- Thus, debt financing has a tax advantage in most countries!

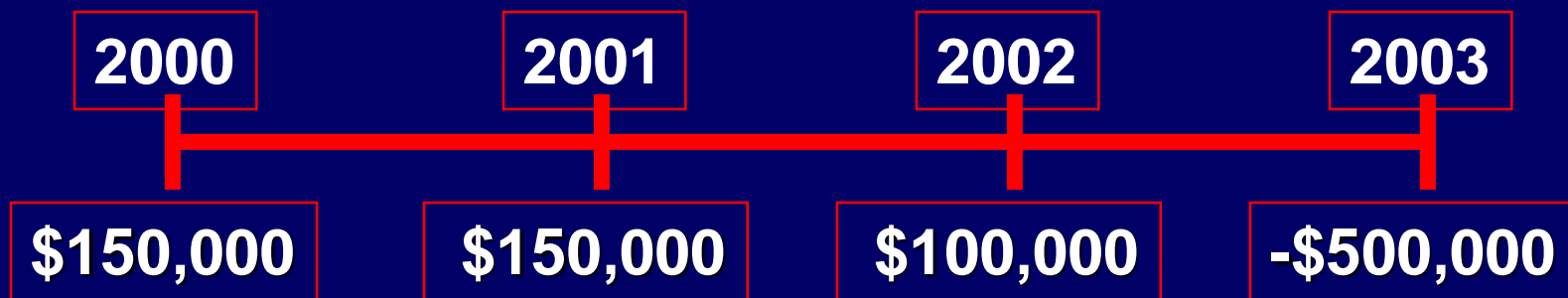
Handling Corporate Losses and Gains

- ◆ Corporations that sustain a net operating loss can carry that loss back (*Carryback*) X years and forward (*Carryforward*) Y years to offset operating gains in those years.
- Losses are generally carried back first and then forward starting with the earliest year with operating gains.

Corporate Losses and Gains Example

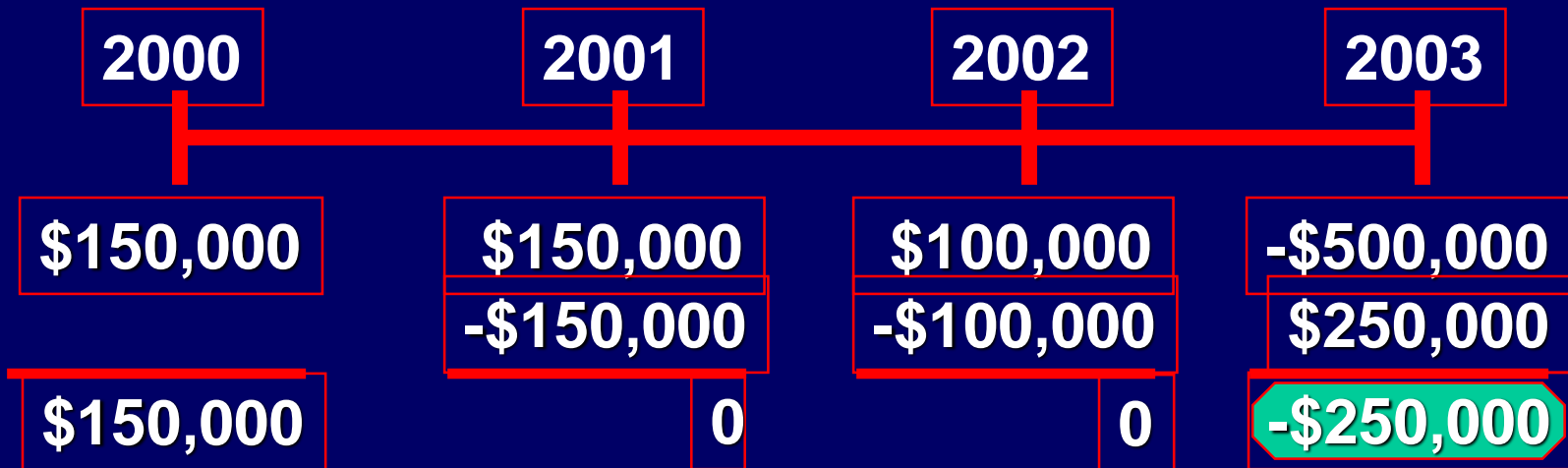
Das is examining the impact of an operating loss at *Das Automobile Trade Enterprises (DATE)* in 2003.

The following time line shows operating income and losses. **What impact does the 2003 loss have on DATE?**



Corporate Losses and Gains Example

The loss can offset the gain in each of the years 2001 and 2002. The remaining \$250,000 can be carried forward to 2004 or beyond.



Corporate Losses and Gains Example

typical belief

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | |
|----------------|-----|---|----|----|----|-----|-----|----|-----|----|----|
| PBT | -10 | 5 | 10 | 25 | 55 | -45 | -30 | 10 | 100 | 55 | |
| <u>tax@40%</u> | 0 | 2 | 4 | 10 | 22 | 0 | 0 | 4 | 40 | 22 | |
| PAT | -10 | 3 | 6 | 15 | 33 | -45 | -30 | 6 | 60 | 33 | 71 |

Indian system of x and y as 0 and 8 years

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | |
|----------------|-----|---|----|----|----|-----|-----|----|-----|----|-----|
| PBT | -10 | 5 | 10 | 25 | 55 | -45 | -30 | 10 | 100 | 55 | |
| <u>tax@40%</u> | 0 | 0 | 2 | 10 | 22 | 0 | 0 | 0 | 14 | 22 | |
| PAT | -10 | 5 | 8 | 15 | 33 | -45 | -30 | 10 | 86 | 33 | 105 |

US system of x and y as 2 and 3 years

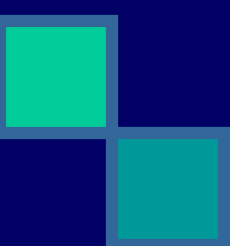
| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | |
|----------------|-----|---|----|----|----|-----|-----|----|-----|----|-----|
| PBT | -10 | 5 | 10 | 25 | 55 | -45 | -30 | 10 | 100 | 55 | |
| <u>tax@40%</u> | 0 | 0 | 2 | 10 | 22 | -18 | 0 | 0 | 32 | 22 | |
| PAT | -10 | 5 | 8 | 15 | 33 | -27 | -30 | 10 | 68 | 33 | 105 |

Corporate Capital Gains/Losses

- ◆ Generally, the sale of a “capital asset” generates a capital gain (asset sells for more than original cost) or capital loss (asset sells for less than original cost)
- Often in the past, capital gains income has received an unfavorable tax treatment than operating income.
- The above statement is applicable for most countries

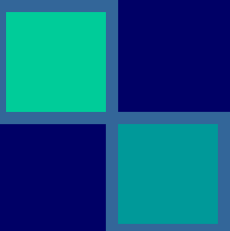


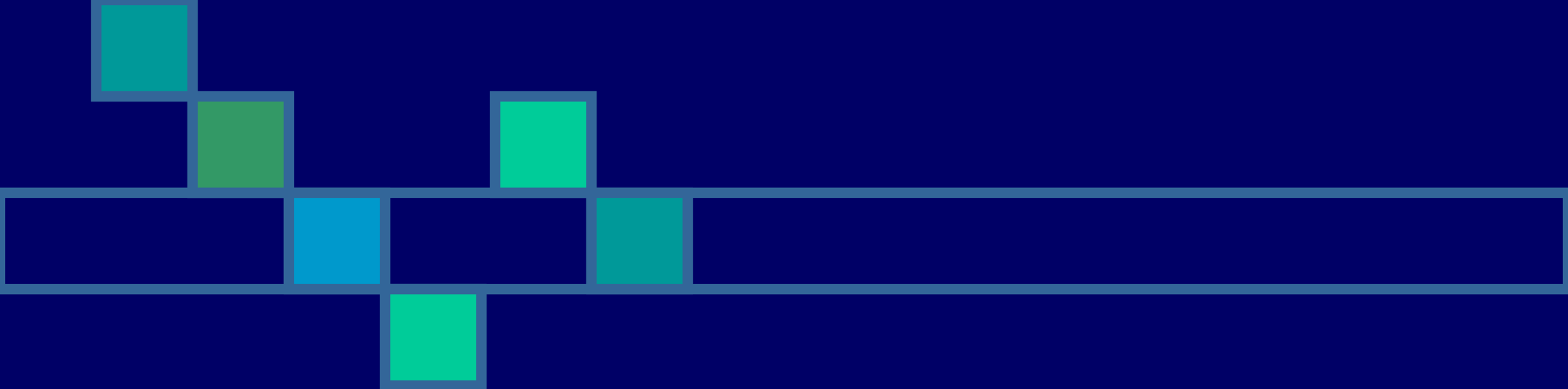
Corporate Capital Gains / Losses

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- Capital losses are deductible only against capital gains



Personal Income Taxes

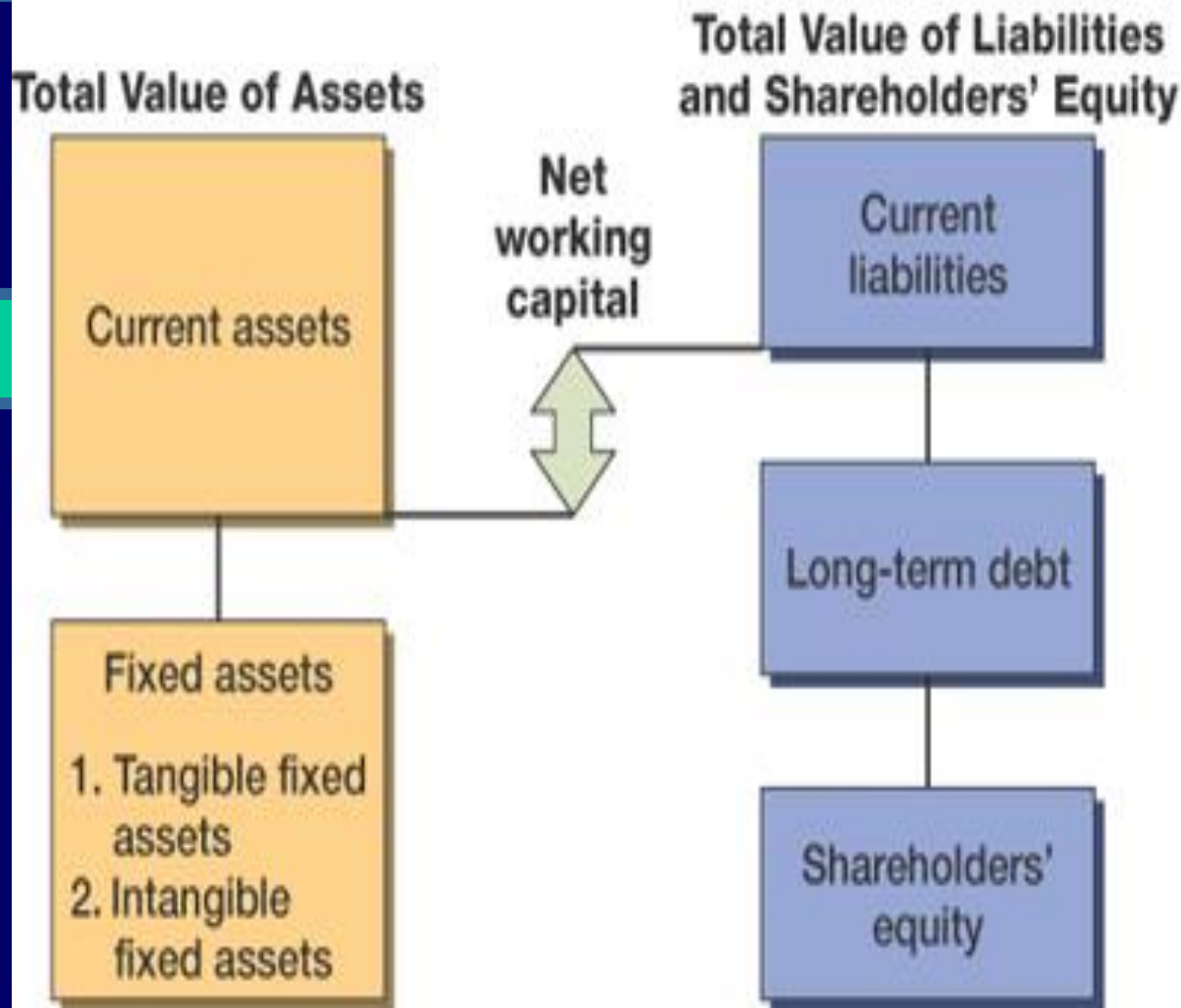
- Usually, it is a progressive tax structure
 - Personal income taxes are determined by taxable income, filing status, and various credits
 - Maximum personal tax rate in India is ??%
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Different Instruments



The Balance Sheet



<< FIGURE 2.1

The Balance Sheet.
Left Side: Total Value of Assets. Right Side: Total Value of Liabilities and Shareholders' Equity.

Common Stock and Its Features

Common Stock -- Securities that represent the ultimate ownership (and risk) position in a corporation.

Basic Terms

Authorized Shares

Issued Shares

Outstanding Shares

Types of Common Stock Value

■ Par Value -- The face value

- It is merely a recorded figure in the corporate charter and is of little economic consequence.

■ Stock should never be issued below par value.

■ The difference between the issuing price and the par or stated value is *additional paid-in capital*.

- Market Value (per share) -- The current price at which the stock is currently trading.

Rights of Common Shareholders

- Right to Income -- entitled to share in the earnings of the company only if cash dividends are paid (via approval by the board of directors).
- Right to Purchase New Shares (Maybe) -- the corporate may provide current shareholders with a preemptive right, which requires that these shareholders be first offered any new issue of common stock or an issue that can be converted into common stock.
- Voting Rights -- because the shareholders are owners of the firm, they are entitled to elect the board of directors.

Voting Rights

- ◆ Shareholders are generally geographically widely dispersed.

- ◆ Two methods of voting: (1) in person or (2) by proxy

Proxy -- A legal document giving one person authority to act for another.

- SEBI regulates the solicitation of proxies and requires companies to disseminate information to their shareholders through proxy mailings.
- Most shareholders, if satisfied with company performance, sign proxies in behalf of management.

When Debt & Equity are Not Enough

Debt

- Contractual interest & payments no upside
- Senior claims
- Control via restrictions

Equity

- Residual payments
- Upside and downside
- Residual claims
- Voting control rights

- Collateralized
- Asset-securitized
- Project-financing

- Preferred
- Warrants
- Convertible

Certain kinds of *market imperfections* allow corporations to reduce costs by improving the financing mix

Debentures and Their Features

Debenture -- A long-term debt instrument with a final maturity generally being 3 years or more.

Basic Terms

Par Value
Maturity

Coupon Rate
Bond Ratings

Types of LT Debt Instruments

Debenture -- A long-term, unsecured debt instrument.

- Investors look to the earning power of the firm as their primary security.
- Investors receive some protection by the restrictions imposed in the bond

Types of LT Debt Instruments

Income Bond -- A bond where the payment of interest is contingent upon sufficient earnings of the firm.

- Frequently, there is a *cumulative feature*, which provides that any unpaid interest in a particular year accumulates.

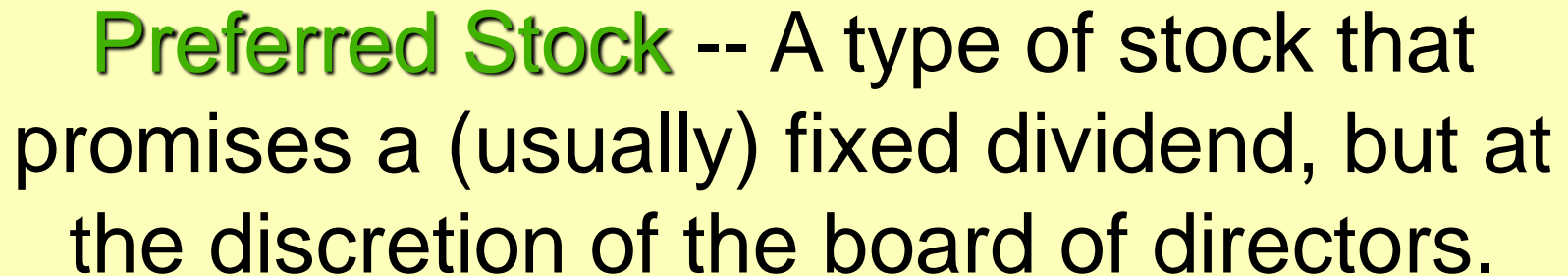
Call Provision

Call Provision -- A feature in an indenture that permits the issuer to repurchase securities at a fixed price (or series of fixed prices) before maturity; also called *call feature*.

- Not all bonds are callable. In periods of low interest (hence, low coupon) rates, firms are more likely to issue non-callable bonds.
- When a bond is callable, the call price is usually above the par value of the bond.



Preferred Stock and Its Features



Preferred Stock -- A type of stock that promises a (usually) fixed dividend, but at the discretion of the board of directors.

Basic Terms

Par Value

Dividend Rate

Maturity




Cumulative Dividends Feature

Cumulative Dividends Feature -- A requirement that all cumulative unpaid dividends on the preferred stock be paid before a dividend may be paid on the common stock.

- For example, if the board of directors omits a Rs. 6 preferred dividend for two years, it must pay preferred shareholders Rs. 12 per share (Rs. 100 par value) before any dividend can be paid to common shareholders.
- The corporation does not have to make up the dividend even if it is profitable, as long as the firm has no plans to pay dividends to common shareholders.



Voting Rights in Special Situations

- Preferred stockholders are not normally given a voice in management unless the company is unable to pay preferred stock dividends during a specified period.
 - Any situation in which the company defaults under restrictions in the agreement (similar to bond indenture) may lead to voting power for preferred shareholders.
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Convertible Securities

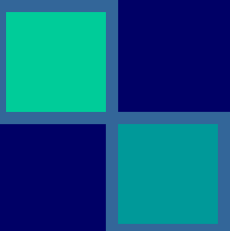

- A conversion feature is an option that is included as part of a bond or preference share issue
- It allows the holder to change the security into a stated number of common equity shares
- The conversion feature typically enhances investor interest in the issue → it enhances the value of the issue
- Example – Reliance Triple Option Convertible Debentures, Arvind Mills Convertibles

Other Instruments, etc.

- Floating rate instruments: Linked to a particular market-related interest rate (Ex: SBI Floating Rate Bonds)
- Warrant: Right to buy shares from a company at a stipulated price before a set date



Market Vs. Book Value

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- The balance sheet provides the book value of the assets, liabilities and equity.
 - Market value is the price at which the assets, liabilities or equity can actually be bought or sold.
 - Market value and book value are often very different. Why?
 - Which is more important to the decision-making process?
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Web Resources

http://highered.mcgraw-hill.com/sites/0070600538/information_center_view0/



www.smartmoney.com

www.moneychimp.com/features/rule72.htm

www.mhhe.com/business/finance/corpfonline

www.bankrate.com/brm/default.asp

www.financenter.com

