Financial, Business, & Tax Environment – Some Discussion

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Financial Environment

- Businesses interact continually with the financial markets.
- Financial Markets are composed of all institutions/ procedures for bringing buyers & sellers of financial instruments together.
- The purpose of financial markets is to efficiently allocate savings to ultimate users.
- In other words this … facilitates price discovery, liquidity, reduces cost of transacting, etc.

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

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:

  (Interest Expense) X (1 - 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 Autmobile Trade Enterprises (DATE)* in 2009. The following time line shows operating income and losses. What impact does the 2009 loss have on *DATE*?

2006	2007	2008	2009
$150,000	**$150,000**	**$100,000**	**-$500,000**

Corporate Losses and Gains Example

The loss can offset the gain in each of the years 2007 and 2008. The remaining $250,000 can be carried forward to 2010 or beyond.

2006	2007	2008	2009
$150,000	$150,000	$100,000	-$500,000
	-$150,000	-$100,000	$250,000
$150,000	0	0	-$250,000

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	
tax@40%	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	
tax@40%	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	
tax@40%	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

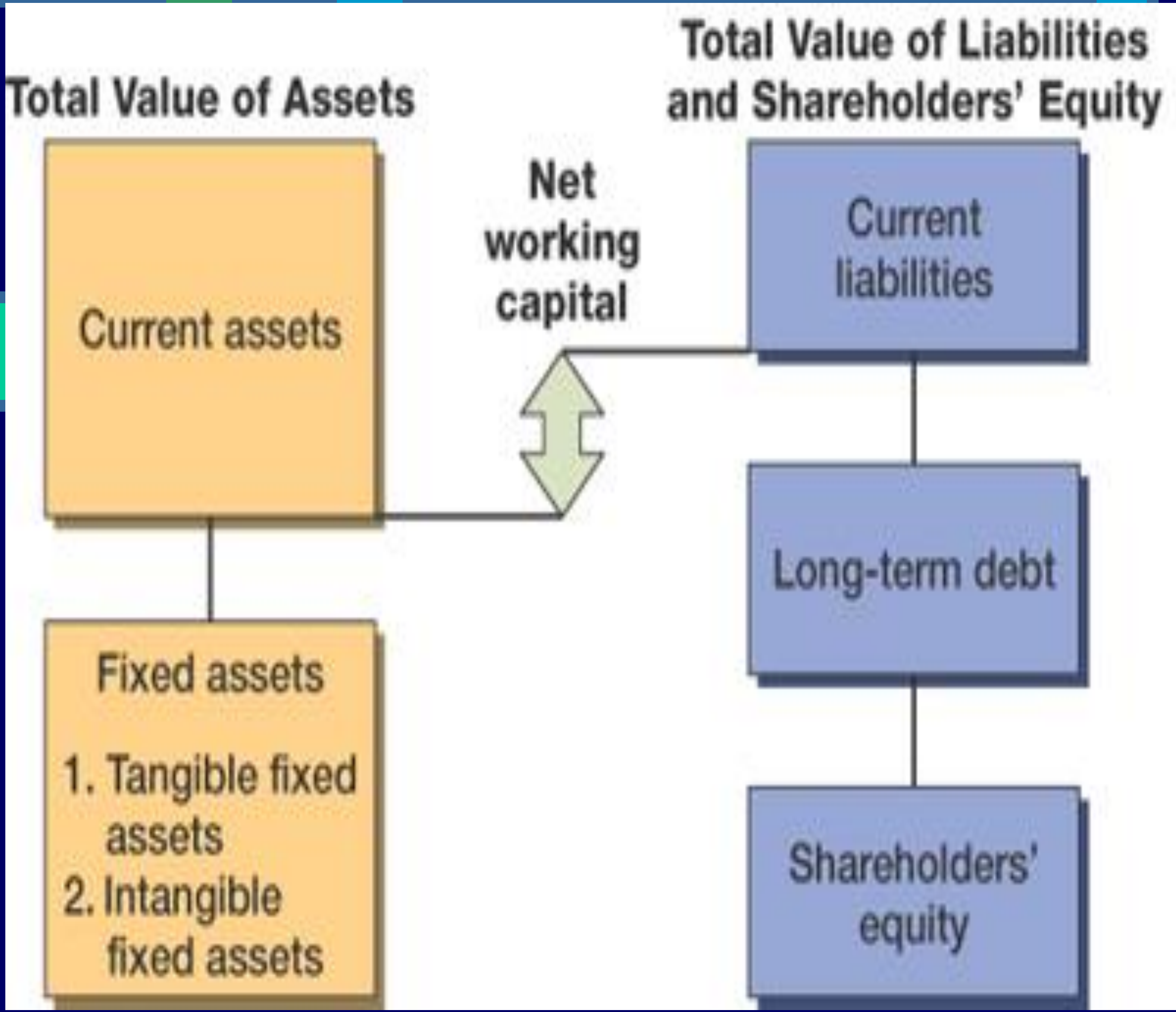
- Capital losses are deductible only against capital gains

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 ??%

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.

<u>Basic Terms</u>

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.

What Influences Security Expected Returns?

- Default Risk is the failure to meet the terms of a contract.
- Liquidity/Marketability is the ability to sell a significant volume of securities.
  - Some financial assets have less active secondary markets than others
- Maturity is concerned with the life of the security; the amount of time before the principal amount of a security becomes due.

What Influences Security Expected Returns?

- Taxability considers the expected tax consequences of the security.
- Inflation is a rise in the average level of prices of goods and services. The greater inflation expectations, then the greater the expected return.
- Embedded Options provide the opportunity to change specific attributes of the security.

Ratings by Investment Agencies on Default Risk

Standard & Poor, Moody, Fitch, CRISIL, CARE, ICRA

Investment grade represents the top 3-4 categories.
Below investment grade represents all other categories.