

Chapter 2

The Business, Tax, and Financial Environments

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After studying Chapter 2, you should be able to:

1. Describe the four basic forms of business organization in the United States – and the advantages and disadvantages of each.
2. Understand how to calculate a corporation's taxable income and how to determine the corporate tax rate - both average and marginal.
3. Understand various methods of depreciation.
4. Understand why acquiring assets through the use of debt financing offers a tax advantage over both common and preferred stock financing.
5. Describe the purpose and make up of financial markets.
6. Demonstrate an understanding of how letter ratings of the major rating agencies help you to judge a security's default risk.
7. Understand what is meant by the term "term structure of interest rates" and relate it to a "yield curve."

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The Business, Tax, and Financial Environments

- The Business Environment
- The Tax Environment
- The Financial Environment

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The Business Environment

The US has four basic forms of business organization:

- Sole Proprietorships
- Partnerships (general and limited)
- Corporations
- Limited liability companies

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The Business Environment

Sole Proprietorship **– A business form for which there is one owner. This single owner has unlimited liability for all debts of the firm.**

- **Oldest form of business organization.**
- **Business income is accounted for on your *personal income tax form*.**

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The Business Environment

Partnership **– A business form in which two or more individuals act as owners.**

- **Business income is accounted for on each partner's *personal income tax form*.**

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Types of Partnerships

General Partnership **– all partners have *unlimited liability* and are liable for all obligations of the partnership.**

Limited Partnership **– limited partners have *liability limited* to their capital contribution (investors only). At least one general partner is required and all general partners have unlimited liability.**

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The Business Environment

Corporation **– A business form legally separate from its owners.**

- **An artificial entity that can own assets and incur liabilities.**
- **Business income is accounted for on the *income tax form of the corporation*.**

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The Business Environment

Limited Liability Companies **– A business form that provides its owners (called "members") with corporate-style limited personal liability and the federal-tax treatment of a partnership.**

- ***Business income*** **is accounted for on each "member's"** ***individual income tax form*****.**

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Corporate Income Taxes

Corp. Taxable Income		Tax	
At Least	But <	Rate	Tax Calculation
$ 0	$ 50,000	15%	0.15x(Inc > 0)
50,000	75,000	25%	$ 7,500 + 0.25x(Inc > 50,000)
75,000	100,000	34%	13,750 + 0.34x(Inc > 75,000)
100,000	335,000	39%	*22,250* + 0.39x(Inc > 100,000)
335,000	10,000,000	34%	113,900 + 0.34x(Inc > 335,000)
10,000,000	15,000,000	35%	3,400,000 + 0.35x(Inc > 10,000,000)
15,000,000	18,333,333	38%	5,150,000 + 0.38x(Inc > 15,000,000)
18,333,333		35%	6,416,667 + 0.35x(Inc > 18,333,333)

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Depreciation

Depreciation represents the **systematic allocation** of the cost of a capital asset over a period of time for financial reporting purposes, tax purposes, or both.

- Generally, profitable firms prefer to use an accelerated method for tax reporting purposes.

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Common Types of Depreciation

- **Straight-line (*SL*)**
- **Accelerated Types**
  - **Double Declining Balance (*DDB*)**
  - **Modified Accelerated Cost Recovery System (*MACRS*)**

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Depreciation Example

Lisa Miller of *Basket Wonders (BW)* is calculating the depreciation on a machine with a depreciable basis of $100,000, a 6-year useful life, and a 5-year property class life.

She calculates the annual depreciation charges using MACRS. [Note – ignore "bonus" depreciation discussed in 2–25]

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MACRS Schedule

Recovery Year	Property Class		
	3-Year	5-Year	7-Year
1	33.33%	20.00%	14.29%
2	44.45	32.00	24.49
3	14.81	19.20	17.49
4	7.41	11.52	12.49
5		11.52	8.93
6		5.76	8.92
7			8.93
8			4.46

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Interest Deductibility

Interest Expense **is the interest paid on outstanding debt and is *tax deductible*.**

Cash Dividend **is the cash distribution of earnings to shareholders and is *not* a tax deductible expense.**

The after-tax cost of debt is:

(Interest Expense) X (1 – Tax Rate)

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Handling Corporate Losses and Gains

- Corporations that sustain a net operating loss can carry that loss back (*Carryback*) 2 years and forward (*Carryforward*) 20 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.

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Financial Environment

- Businesses interact continually with the financial markets.
- *Financial Markets* are composed of all institutions and procedures for bringing buyers and sellers of financial instruments together.
- The purpose of financial markets is to efficiently allocate savings to ultimate users.

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Financial Markets

- **Financial Markets are the meeting place for people, corporations, and institutions to buy or sell securities.**

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Kinds of Financial Markets

- Public and corporate financial markets.
- Domestic and international markets.
- Money and capital markets.

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Money Markets

- Deals with short-term securities that have a life of one year or less.
- Securities in these markets include:

1. Commercial paper. It is a debt instrument sold by Corporations or Banks.

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Money Markets

2. Certificates of Deposit. It is a debt instrument with a maturities of less than 12 months sold by banks.

3. Banker's Acceptance. It is a time draft drawn on and accepted by bank for import-export transactions.

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Money Markets

4. Treasury Bills. It is short-term securities with maturities of one year or less issued at discount from face value.

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Capital Markets

- **Deals with securities that have a life of more than one year. Long-term markets.**
- **Securities include:**

1.Common Stock 2. Preferred Stock

3. Corporate & Government Bonds

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Kinds of Financial Markets

- 1. Primary Market. Where new issued securities are sold.
- 2. Secondary Market (Stock - Exchange Market). It is organized marketplace where securities are bought and sold amongst the investors. Prices of securities keep changing continually in this market.

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Kind of Investors

- 1. Long-term Investors
- 2. Speculators
- 3. Gamblers

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Securities Analysis

- 1. Fundamental Analysis
- 2. Strategic Analysis
- 3. Technical Analysis

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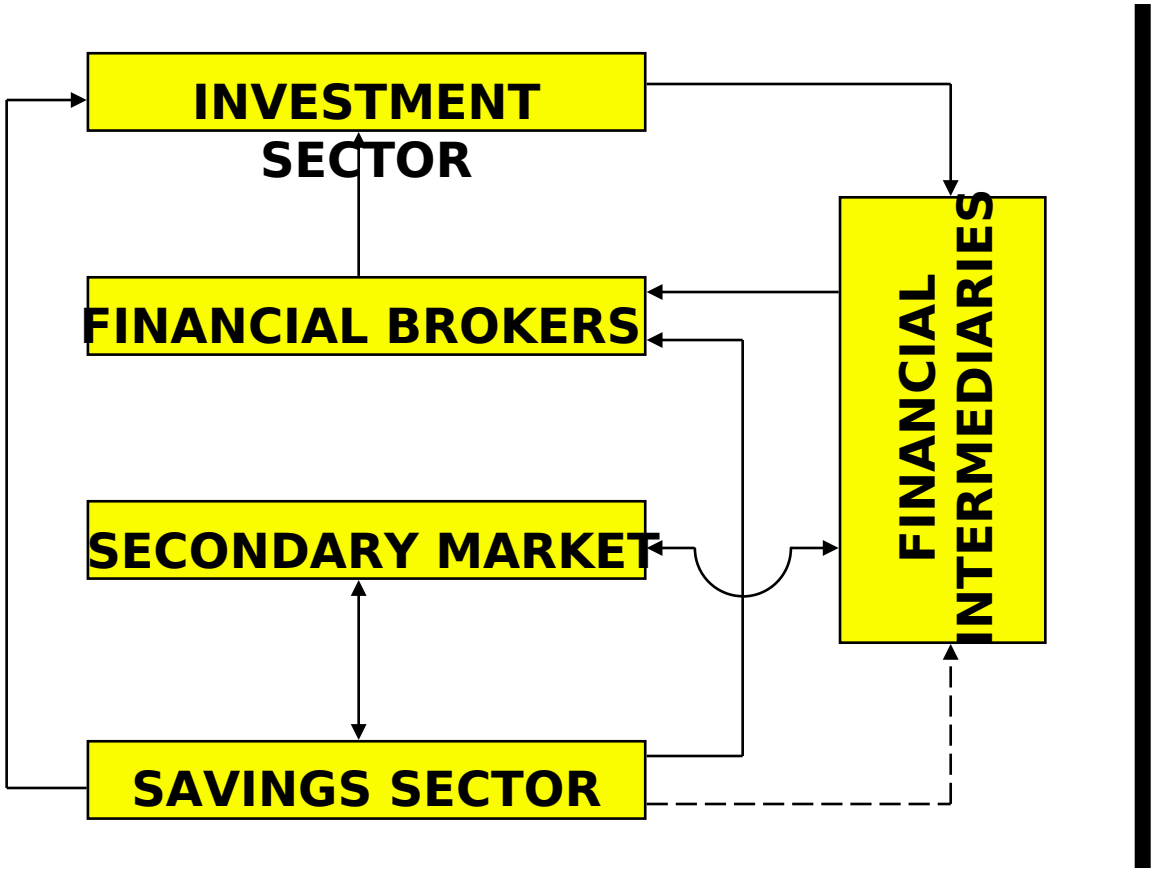
Securities Value

- 1. Par Value (Subscription Value)
- 2. Book value (Accounting Value)
- 3. Market Value (Price of stock)
- 4. Real Value (Good Well)

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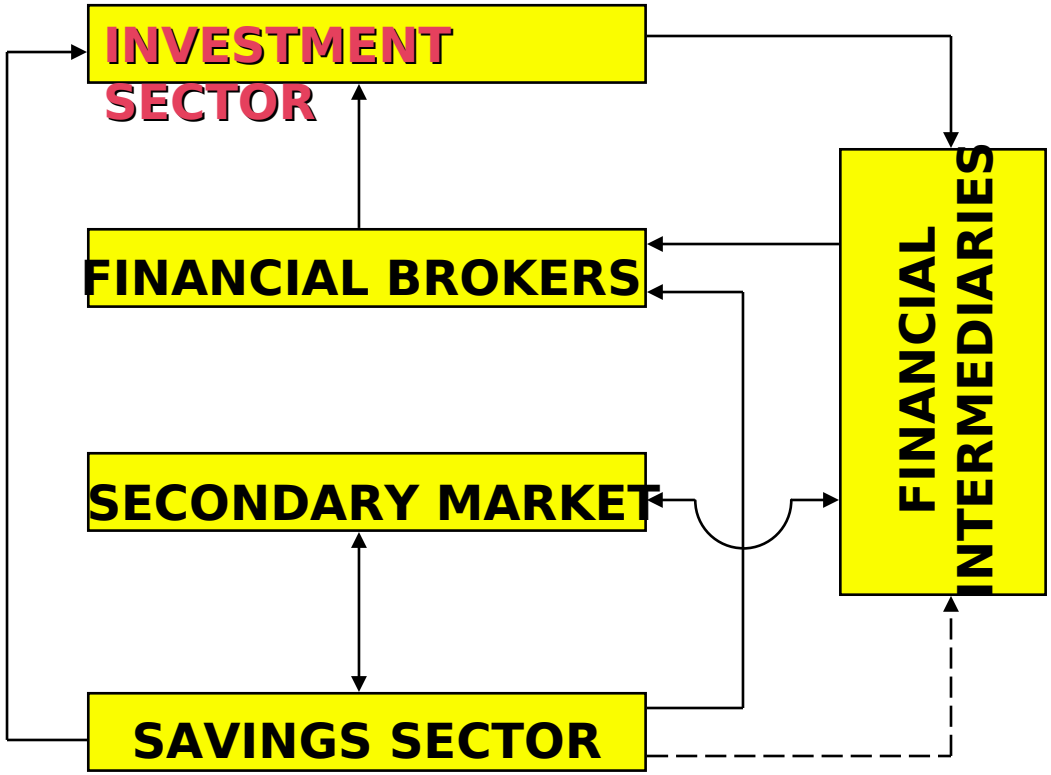
Flow of Funds in the Economy



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Flow of Funds in the Economy



INVESTMENT SECTOR

Businesses

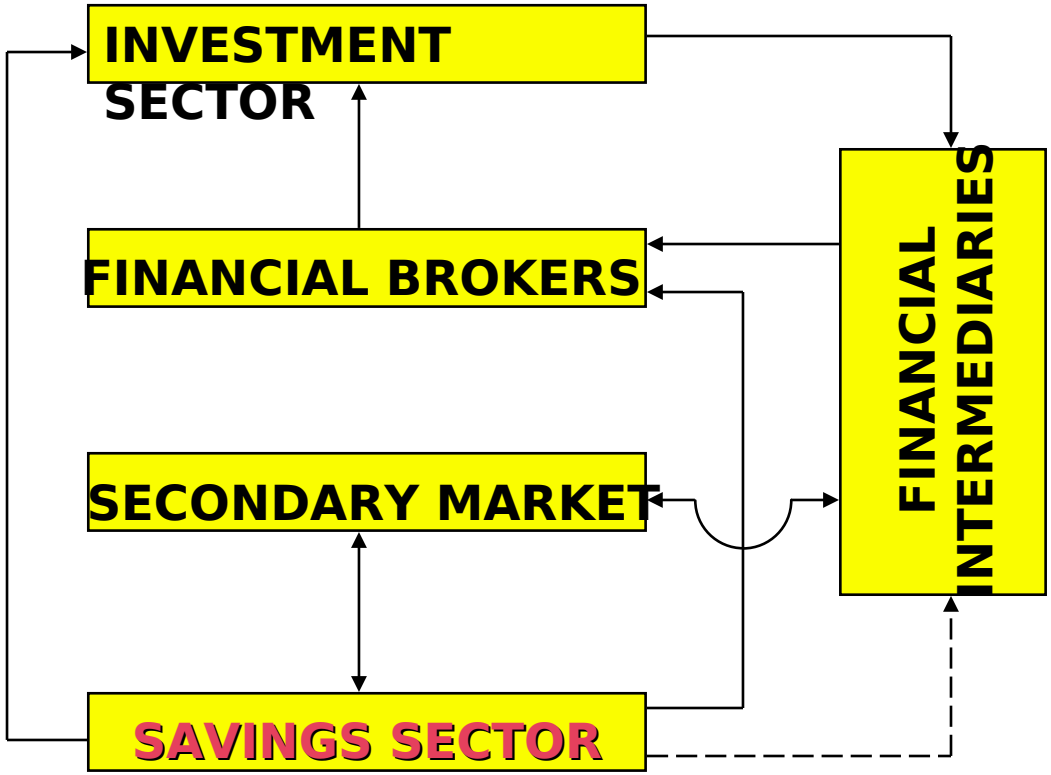
Government

Households

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Flow of Funds in the Economy



SAVINGS SECTOR

Households

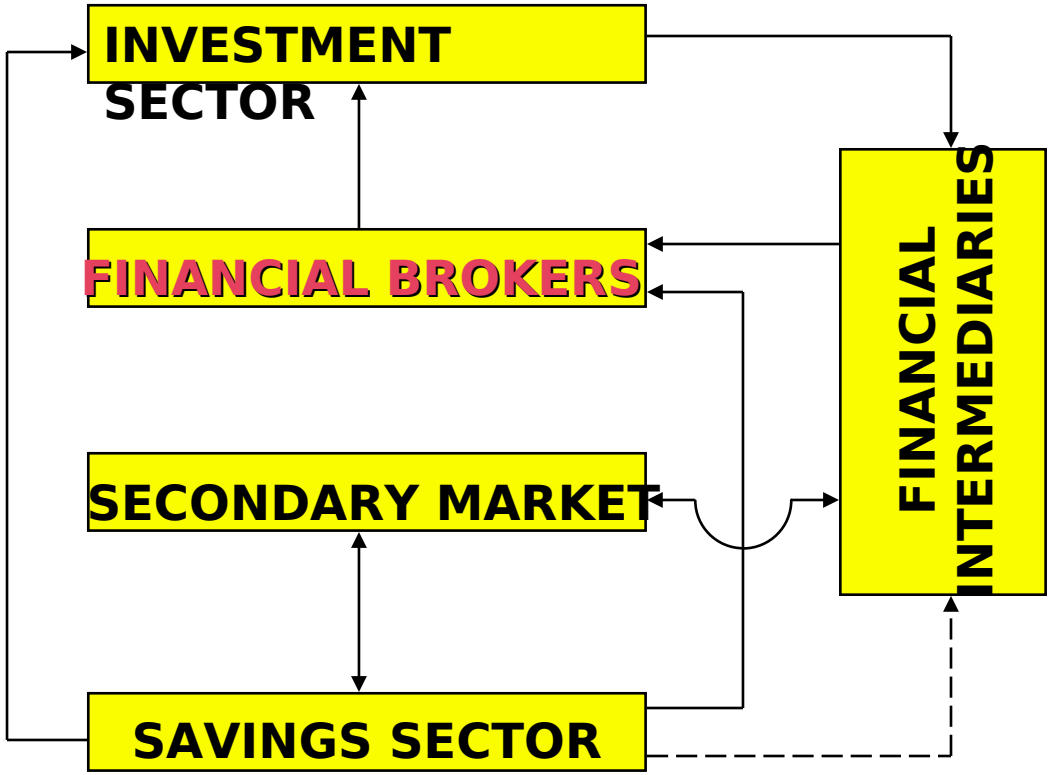
Businesses

Government

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Flow of Funds in the Economy



FINANCIAL BROKERS

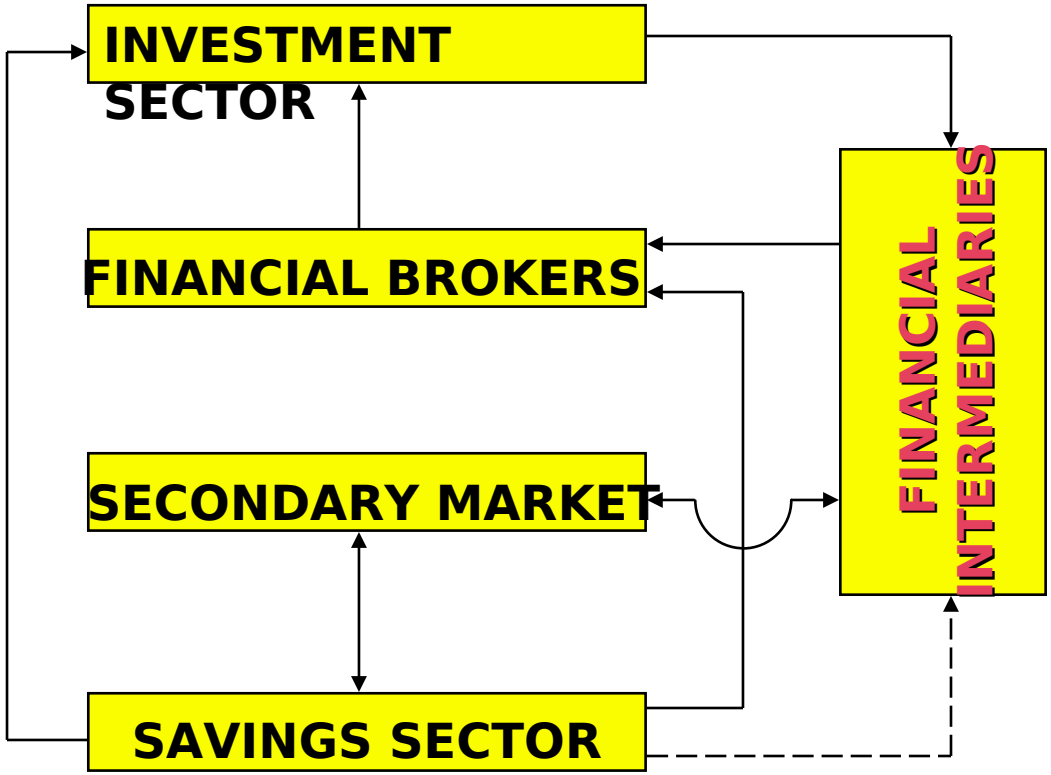
Investment Bankers

Mortgage Bankers

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Flow of Funds in the Economy



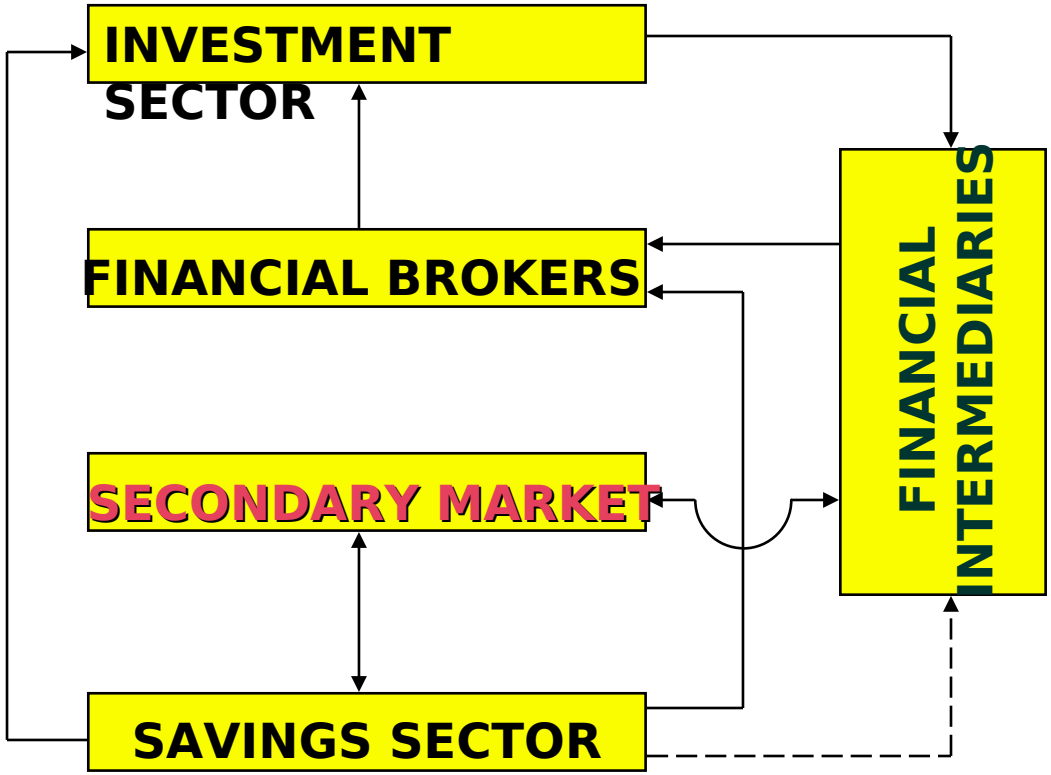
FINANCIAL INTERMEDIARIES

Commercial Banks
Savings Institutions
Insurance Cos.
Pension Funds
Finance Companies
Mutual Funds

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Flow of Funds in the Economy



SECONDARY MARKET

Security Exchanges

OTC Market

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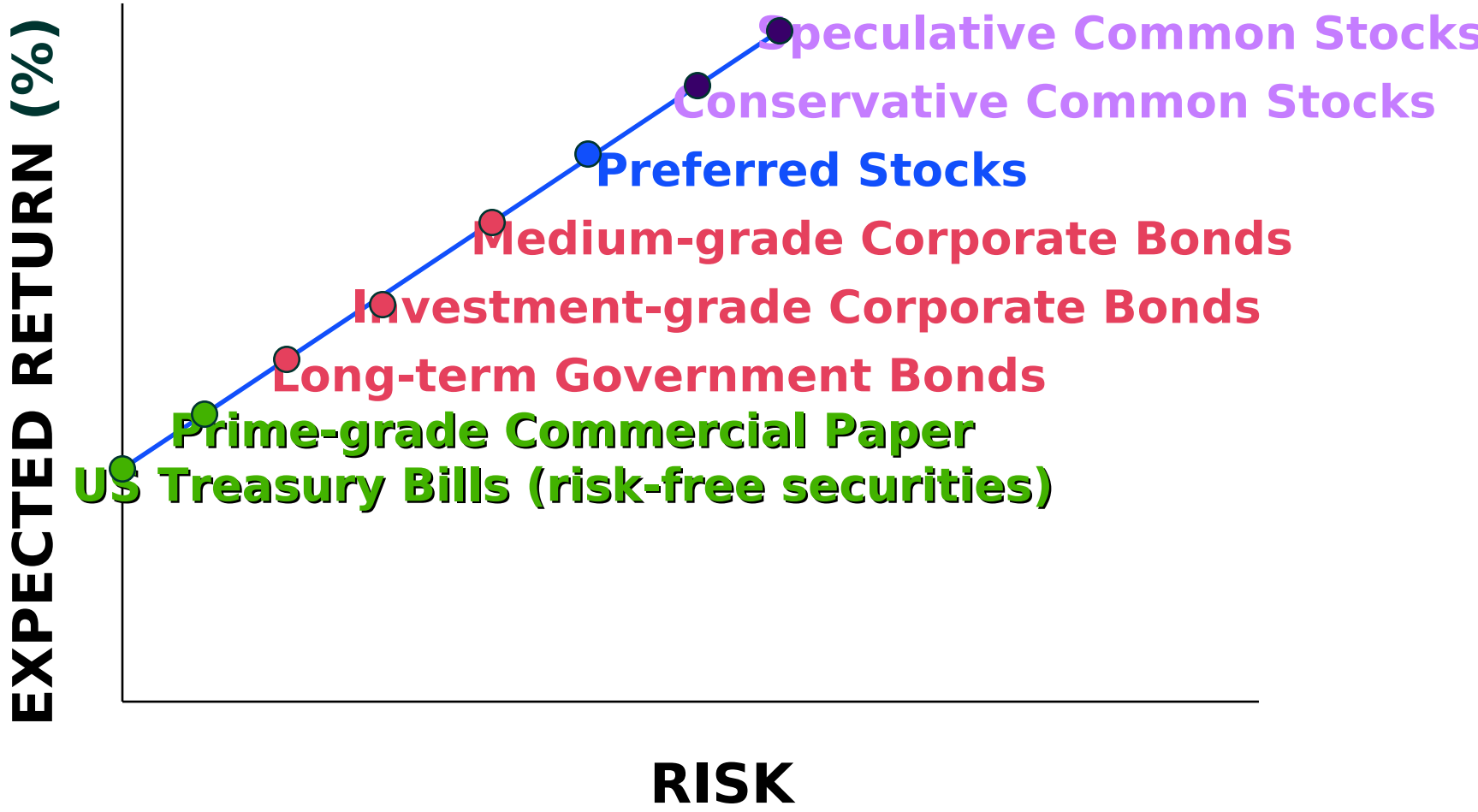
Allocation of Funds

- Funds will flow to economic units that are willing to provide the greatest expected return (holding risk constant).
- In a rational world, the highest expected returns will be offered only by those economic units with the most promising investment opportunities.
- ***Result***: Savings tend to be allocated to the most efficient uses.

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Risk-Expected Return Profile



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What Influences Security Expected Returns?

- ***Default Risk*** **is the failure to meet the terms of a contract.**
- ***Marketability*** **is the ability to sell a significant volume of securities in a short period of time in the secondary market without significant price concession.**

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Ratings by Investment Agencies on Default Risk

MOODY'S INV SERVICE		STANDARD & POOR'S	
Aaa	Best Quality	AAA	Highest Grade
Aa	High Quality	AA	High Grade
A	Upper Med Grade	A	Higher Med Grade
Baa	Medium Grade	BBB	Medium Grade
Ba	Possess Speculative Elements	BB	Speculative
⋮	⋮	⋮	⋮
C	Lowest Grade	D	In Payment Default

Investment grade **represents the top four categories**

elow investment grade **represents all other categorie**

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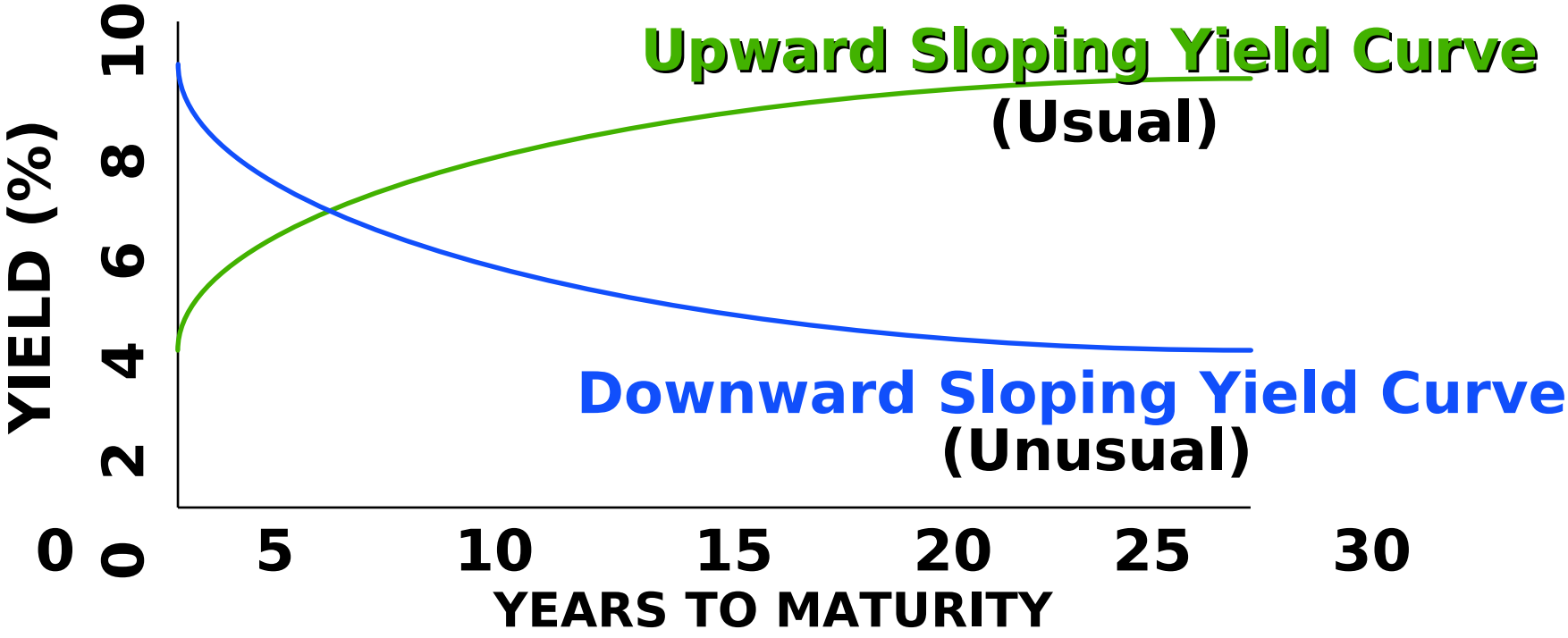
What Influences Expected Security Returns?

- ***Maturity*** **is concerned with the life of the security; the amount of time before the principal amount of a security becomes due.**
- ***Taxability*** **considers the expected tax consequences of the security.**

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Term Structure of Interest Rates



A yield curve is a graph of the relationship between yields and term to maturity for particular securities.

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