RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM VI SEM.

SUBJECT: Corporate Tax Planning

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LECTURE-2

VALUE OF THE FIRM AND CAPITAL STRUCTURE

Value of the firm depends on the earnings of the firm and earnings of the firm depend upon the investment decisions of the firm. Investment decision influences the size of the EBIT. The EBIT is shared among three main claimants:

The Debt holders, who receive their share in the form of interest.

The Government, which receives its share in the form of taxes.

The Shareholders, who receive the balance.

Thus, the investment decisions of the firm determine the size of the EBIT pool while the capital structure mix determines the way it is to be sliced. The total value of the firm is the sum of the value to the debt holders and its shareholders. Therefore investment decisions can increase the value of the firm by increasing the size of the EBIT whereas capital structure mix can affect the value only by reducing the share of the EBIT going to the government in the form of taxes.

Thus, the value of the firm, investment decisions and capital structure decisions are closely related and are depicted by the following diagram.