Finance 1 Notes

Entity: is anyone or anything that can undertake legal obligations, sue and be sued, pay taxes, conduct business, etc. Some examples of entities are: individual persons, private companies, public companies. A child under 18 years is too young to be an entity. A trust is not an entity: the trustee is the entity that acts for the trust.

Contract: is an agreement between entities. There are many types of contracts, like:

i. Purchase of soap by individual from grocery store where grocer gives individual Lux bathing soap upon receiving payment of Rs. 12.
ii. Employment contract between individual and private company where the individual agrees to complete X work and company agrees to pay Y rupees;
iii. Sale of house between 2 individuals where owner of house agrees to give house to purchaser in exchange for payment of Rs. Z.
iv. Deed of gift between donor and charity trust where donor agrees to give shares to charity trust without payment.

Although a contract may be oral (like the purchase of soap from grocery store), important contracts should be written. The parties (entities) to an agreement must carefully think about all possible situations (eg, in the sale of house, suppose the house burns down before payment). Even if the answer seems obvious, it must be written down to avoid future disputes. The parties must write down all of the contract terms. **ALL parties must sign the contract** and date it. The contract must be witnessed, stamped and registered. Each party must take a copy of the contract. Disputes can be settled by referring to the contract.

Consideration: is what is given by one party to another. Money is usually (but not always) consideration. Sometimes, other forms of payment is acceptable. For example, in a marriage contract, the gentleman may agree to give X jewellery to the

lady who marries him. A company may agree to give Y house to Z worker after Z worker completes 25 years service.

Deed: is a very solemn contract made on special stamped paper. The contract has a title of "Deed" and on the execution page (where the parties sign), it is specifically stated "Executed as a deed". Consideration is not necessary for a Deed. Gifts of property are recorded in a Deed so later on, the donor cannot demand payment for the property.

Option: is a contract where one party provides consideration to obtain a future right. Example: A pays Rs.10,000 to B so in 1 year's time, A may (or may not) decide to pay B a further sum of Rs.9 lakhs and B must transfer their 1,000 shares in J company to A. A has the right to exercise the option. If A exercises the option and makes the 2nd payment, B cannot refuse because B has accepted the 1st payment and the written contract exists. Computer and pharmaceutical companies often pay in options. Options are very risky and unsafe. Sometimes, workers are forced to buy a minimum amount.

Power of attorney: One party to the contract may be unable to sign a contract. For example, they may be sick or abroad. That party (called principal) appoints an Attorney (an agent) to sign papers on their behalf. This is done through another contract called Power of Attorney. A Power of Attorney must be stamped and registered by the Government before it can be used. The Attorney may be paid or may work for free: this is stated in the Power of Attorney. The Power of Attorney should specify in detail exactly what the Attorney can and cannot do because the Principal is bound by whatever the Attorney signs. The Principal cannot later say "I never agreed to this" if the Attorney acted according to the Power of Attorney. The other parties to the contract must carefully read the Power of Attorney to ensure that

the Attorney has the power to sign their contract. Whenever the Attorney signs any paper, he/she must write “Signed as Attorney under Power of Attorney dated DATE on behalf of X”.

Stamping: The Government taxes transactions between people. If A sells or gifts a house to B, B must pay stamp duty tax on the market value of the house. If A sells shares to B, B must pay stamp duty tax on the market value of the shares. The rates of stamp duty tax and the stamp duty calculation formula are contained in the laws of India. **Copies of the laws are available in the Stamp Office and on the web-sites (eg, .** Stamps of the proper value must be purchased from the Stamp Office. The contract must be stamped by the Officers of the Stamp Office. Stamp duty can be paid either before or after the contract is signed. There is a deadline for stamping. If a contract is not stamped or understamped (less payment is made) or is stamped after the deadline, the Government can impose a heavy penalty plus charge interest on the unpaid amount. The Government can imprison the persons responsible.

Registration: The Government maintains records of who owns which property. Registration means recording the transfer in the Government records. After the contract has been stamped, the signed and stamped contract must be given to another Government Department, Office of Subregistrar, for registration. There is a deadline for registration and heavy penalties for being late. If a contract is not registered, the property legally belongs to the previous owner. For example, even if the purchaser has paid the complete price and lived for 40 years in a house, because the contract was not registered, the house belongs to the previous owner.

Property tax: Every year, the owner must pay a property tax to the Government. This is calculated on the market value of the land and buildings. The formula is contained in the laws of India. If the correct amount of property tax is not paid, the

Government can charge penalty and interest plus imprison the persons responsible.

Trust: A trust exists whenever one entity holds property on behalf of another entity (or entities). For example, the Prophet (peace be upon him) frequently took care of property of other people. Due to the good care he took, people called him ALAMEEN (bharosaywala aadmi). Trustee and Attorney are different:

i. The legal papers of the property show the Trustee's name in case of Trust;

ii. The legal papers of the property show the Principal's name in case of Attorney.

A trust may be a private trust (private arrangement between a few parties like a family trust) or it may be a public trust. A public charitable trust is when the Trustees hold Trust Property for the benefit of the public to carry out certain specific purposes like Education; Alleviation of poverty; or Other good cause (like medical). Not all purposes are recognized as charitable (eg, religion, entertainment). The purposes of the trust, who the beneficiaries are, the trust property, the duties of the officers and how work must be carried out is recorded in various papers (ie, Trust Deed, Memorandum, and Articles of Association). Every year, the Government checks the Trust Accounts to ensure that the Trustees are doing proper work (not gol-mol). Every year, the Government issues a certificate called 80-G (after section 80-G of the Income Tax Assessment Act) giving income tax exemption to the charity trust and informing the public that "This year, it is okay to donate to this trust:". The Trust must give a Pukka receipt for each donation.

Pukka receipt: is a clearly written receipt with full name, address and details of recipient, the name of payer, amount of payment in words and numbers, whether payment was made in cash or cheque, details of the cheque like cheque number and bank, purpose of the payment, date on which payment was made, and signature of recipient on Rs.1/- stamp. The Rs.1/- stamp can be purchased in newsagent. Particularly for large amounts, a pukka receipt is essential. Each scholarship student

is required to obtain pukka receipt for each Demand Draft issued for university fees.

Cheque: is an order on a bank instructing the bank to pay Rs.X to Entity A. The name and address of the bank, the bank number and cheque number, the recipient's full name, the amount in words and numbers, and the payer's signature must be clearly written. For convenience, cheque books containing pages of blank cheques are issued by the Bank. A cheque can contain crossings. A cheque that is not crossed can be cashed by anybody. If you drop an uncrossed cheque in the street, anybody who finds it can go to the bank, present the cheque and get cash. If a cheque is crossed "not negotiable", the bank officer must obtain the identification and ensure it is the correct person being paid. If the cheque is crossed "account payee", the money must be deposited into the account of the correct person: even the correct person cannot receive cash. You should always take care when writing a cheque and lock up the cheque book. You must not lose your cheque book. If your cheque book is lost or stolen, immediately inform the bank. You must **never** sign a blank cheque. A cheque takes some days to clear. The recipient must wait to receive payment. Delay is caused because the recipient's bank and payer's bank have to transfer money and settle accounts. **You should make all payments by cheque so there is a clear record of the transaction in your bank statement.**

Demand Draft: also called Bank cheque. It is a special type of cheque issued by the bank on the customer's instruction. The Bank Manager signs this cheque (not the customer). Although it is supposed to take less time to clear, this is not always the case.

Correspondent Bank: The bank issuing a demand draft or cheque must have a correspondent banking relationship with the receiving bank. The banks must transfer money and settle accounts. Sometimes, there is a chain of in-between banks to do the

transfer (eg, HSBC via Canara Bank to State Bank). Each bank in the chain must be **trusted** not to steal money. In these days of financial instability, banks do not trust each another (eg, HSBC does not trust SBI). Students have difficulty in demand drafts payments to universities in distant locations (eg, Latur). Each bank charges fees.

Original documents: A mistake commonly made by many persons, old and young, is they do not realize the consequences of altering original documents. It is a crime and punishable by prison. Changing original documents for any reason is **FRAUD**. Once you get a criminal record and go to prison, nobody will give you a job. Your life will be ruined. Better to contact me and ask what to do Aneesa_Parker@y7mail.com. I promise to always give prompt reply and will find some way to help you. For examples, one student did not get Rs.1/- stamp on pukka receipt from University officer. So, the student stuck the Rs.1/- stamp himself. This is fraud. Another example is putting thumb impression on Power of Attorney **after** it has been attested by Consulate General Officers. Another example is changing the words of a contract **after** everybody signed. One girl accidentally tore her passport. She must immediately give to Embassy Officer for repair. Instead, she stuck scotch-tape. She can be arrested.

Tax planning: There is no need to do tax evasion or tax fraud because the Government gives you the legal ways to reduce your tax or pay no tax on your income. For example, you can buy upto Rs.2 lakhs of Reserve Bank of India Government Bonds that give 9% per annum tax-free income every 6 months and are safer than Bank Fixed Deposit. For example, you can pay upto Rs.60,000/- per annum into your Public Provident Fund to earn 9% per annum cumulative interest that is tax-free for 15 years. You can then request an extension for a further 5 years. There are so many ways of increasing your income and LEGALLY reducing your

tax. Please read Mr. Shanbaug's In the Wonderland of Investment. Principal Ateeque Shaban has a copy of this book. If he does not, please contact me and I will fix this. Aneesa_Parker@y7mail.com

Fixed term deposit: Although, fixed term deposits are issued by banks, they can be issued by companies (like Tatas). The investor invests principal amount Rs. X for time period Y beginning on start date D1 and ending on maturity date D2 earning interest at R% per annum payable at Z intervals. The interest calculation may be simple interest or compound interest. For compound interest, the period of compounding is specified. The name and full details of issuer must be specified on Certificate of Fixed term deposit plus all above details about the Fixed term deposit and the investor's full name. The Certificate must be issued on proper letterhead and signed and dated. Each Certificate has a serial number. For example, State Bank of India, Malegaon Main branch issued Fixed Term Deposit 889977 to Mr. A with principal of Rs.5000/- for 3 years starting 2 April 2009 ending 1 April 2012 earning 8% simple interest per annum payable every 3 months to his account 334455.

Joint ownership: It is safer to put the property (whether house or money in bank or shares) in joint names with close and trusted family member like mother. Joint names may be "either or" basis (meaning either party can sign) or "and" basis (meaning all parties signatures is needed). Under taxation law, the income is regarded to be the income of the first person mentioned. So order of persons is very important. If one person dies or becomes mad or very sick, the other person can operate the account. Some investments (like Public Provident Fund) do not permit joint holders. In this case, a nomination form is used to record who inherits the money or property. For further safety, it is best to write a simple will that states who inherits what property. If these simple precautions are not taken, the Bank etc will not give the property without a **very long and expensive** legal procedure called "grant of probate". If the

property is in joint names, transfer is very simple and quick. Nobody likes to think about death or sickness but the wise person plans for these misfortunes that occur to everyone on Earth.

<u>Execution:</u> means signing the contract or legal document. Only after every party has signed the contract, has the contract been executed. **It is important to carefully read and understand EVERY PAPER that you sign. When there is pressure ("Please quickly sign. This is not important paper. There is no time. Stop asking silly questions"), DO NOT SIGN without FULLY UNDERSTANDING everything.** One student's father signed his house to the University without understanding because he was desperate for admission. There is a proper procedure for signing that must be followed. The correct number of witnesses must be present. Their full name and correct address must be checked with passport and written in contract. All parties must be present at time of signing. Sometimes, the signing must be done in Government office in front of correct Government officer. The document must be **attested** by the Government officer (means witnessed by the Government officer who puts special seal and signs). The document must be dated and the place where it was signed must be written (Mumbai or Sydney). You must **never** scratch or make last minute changes to documents before signing. Everything must be thoroughly checked and pukka before you sign. Some documents must be typed on special paper called judicial paper with certain margins. You buy such paper from the Court. Ditto for special stamp paper.

<u>Insurance:</u> is a special contract issued by an insurance company to cover risk. Property or person specified in the contract is insured against specified risks. For example, A gets life insurance. If he dies or accident or illness, the insurance company will pay his family a lump sum of Rs.X and/or monthly payments of Rs.Y for Z number of years. In return, A must pay monthly premium of Rs.W. Another

example, Trust T gets building insurance for Building B against fire, flood, terrorist attack, earthquake, and decay. T must pay the insurance company Rs.Y every month. If the building is damaged or destroyed, the insurance company must pay T the lump sum amount Rs.X. It is important to get house and buildings insured. There are tax benefits for life insurance plus financial safety for small children, uneducated wife in case something happens.

Bond: is money loaned to a company (like Tata Electric Company) or government (like Reserve Bank of India bonds). The company or government issues papers called bonds. Each bond has a face value (like Rs.100), starting date, maturity date, interest rate, and when interest is payable. In this way it is similar to bank fixed term deposit. What is different about bonds is:

i. Bonds can be bought and sold on a bond market. Fixed term deposits cannot be bought and sold on a market.
ii. Bonds can be bought and sold at a premium or a discount to their face value. For example, a bond with face value of Rs.100 may be sold for Rs.90 (discount) or for Rs.110 (premium). This depends on the interest rate, prevailing economic conditions, and the time left to maturity.

Some bonds earn tax-free income (like Reserve Bank of India upto Rs.2 lakhs).

Share: An entity can participate in the running of a public or private company by becoming a shareholder (ie, by paying money to acquire shares). A share certificate shows the name of the company, the name of the shareholder, the number of shares, the face value of the shares (like Rs.10), date of issue of shares, and type of shares. Some shares are ordinary shares: the shareholder can vote at general meetings and, if the company declares a profit, can obtain a dividend (earnings) on his shares. A preference share does not carry voting rights but has higher dividend often at a fixed rate. Shares in a private company are difficult to trade. Shares in a public company

are often listed on the stock exchange (like Mumbai Stock Exchange). Their prices are published in the newspapers. Share prices can fluctuate dramatically. **Shares are very risky: you can lose ALL your money very quickly**. Some people have business of gambling about share prices. “Bears” predict that the future price will fall: bears “sell short” (sell shares that they do not have then buy them in the future at a lower price and give them to the entity they sold them to). “Bulls” predict that the future price will increase: bulls “buy long” (buy shares in the hope of selling them later at a higher price).

Debenture: is a fixed term deposit issued by a company that may convert into shares. Under some arrangements, the debenture holder has the choice (option) to request shares instead of being repaid the principal of the fixed deposit. In other cases, the debenture holder does not have this choice. There are many variations.

Share Issue: A company has a project X. It makes a prospectus explaining to the public details of its project including the investment amounts, market for product, and their expected profits. The company collects subscriptions and issues shares at face value (usually Rs.10 or Rs.100). The fact that the shares may trade for higher or lower price on the Stock Exchange is irrelevant. At issue, the company only receives the face value. A public company share issue must be carefully checked by the Government. A private company share issue has fewer Government controls (eg, no prospectus required).

Calls: Investors often do not have sufficient money to purchase their shares or debentures. The company collects the money in stages (by X date, please pay 20%; by Y date, please pay 40%; by Z date, please pay 40%). Each stage is a “call”. If an investor cannot pay by the deadline, they lose their share or debenture. Some companies demand that investors pay money on application. The company keeps the

subscription money for some months before refunding. In the meantime, the company earns interest income: the investors have provided a free loan to the company. This happens when shares issues are oversubscribed (like Reliance Petrochemicals was). "Oversubscribed" means many more applications were received than shares were available.

Limited Liability Company: People run business through limited liability company of which they are shareholders and directors. The company protects these people in case of financial collapse of the company. The company's creditors (entities to whom the company owes money) cannot access the personal assets of the directors or shareholders. Suppose XYZ Widgets Pty Ltd buys steel from ABC Steel Pty Ltd and does not pay bill of Rs.1 crore. Suppose XYZ company directors own expensive Flat. If the XYZ becomes liquidated due to bankruptcy, ABC cannot force XYZ directors to sell their Flat to pay ABC bills. The Flat does not belong to the XYZ company: it belongs to the directors.

Personal guarantee: Businessmen are usually not such fools to give such large credit without taking some security (promise that their debt will be repaid). A personal guarantee is obtained from the directors that, if the company cannot pay the debts, the directors will instead pay from their personal assets (like expensive Flat). Parents of students are required to provide personal guarantee for payment of University fees.

Security: When an entity lends money to another entity, it requires a promise (security) that it will be repaid. A company's director may provide a personal guarantee to the company's creditor. Banks obtain mortgage over house as security for loan to purchase house. If the borrower does not repay the loan on time, the lender can exercise their security rights. The company's creditors can obtain the

company director's personal assets. The bank can repossess the house and sell it to recoup their loan money. Mortgage is noted on the legal documents. It is impossible for the borrower to sell the house to a third party without the lending Bank's permission.

Bankruptcy/Administration: When a person cannot pay their debts, they may be declared to be bankrupt. The creditors then take all their assets (like home, car, business), sell them and recover their unpaid bills. When a company cannot pay its debts, the company is placed under administration (for the purpose of selling all its assets and paying creditors). The company is liquidated (officially recorded as deceased).

Subprime Mortgage: Banks in USA lent money to unemployed poor people to buy expensive houses. The banks charged a high interest rate (because the risk of lending to baykaar gareeb log was too high) and obtained mortgage security over the expensive houses. This arrangement was called "subprime mortgage loan". When the gareeb log could not repay their bank loans, the Banks repossessed their houses and sold them. Because too many such homes were sold, the market price fell dramatically. Sometimes, an entire house was sold for US$1,000 ! The Banks suffered huge losses and collapsed. The people who had fixed term deposits in those Banks lost their savings.

Securitization: Banks do not want loans that maybe borrowers cannot repay. Then the Bank must undergo expense and trouble of repossessing and selling the house at a loss. Solution: banks sell loans to financial companies that buy loans and pay the Bank less than the loan amount. (eg, a Bank lends $1 million to X. The Bank sells loan to Financial Company for $9,50,000). The Bank makes up the loss by service fees (ie, collecting interest from borrowers and giving these to Financial Company

after deducting service fees. If a borrower defaults, repossessing house, selling and giving payment to Financial Company after deducting service fee). The Financial Company issues shares to obtain money to buy loans from banks. The BANK LOAN is converted into SHARES. This process is called “securitization”. It causes great instability because it encourages reckless lending because banks do not carry the RISK of losing money.

Hire purchase: A contract between a landlord and tenant that the tenant will pay Rs.X monthly rental for Y years. At the end of this period, the property will belong to the tenant. If house market is down, a house may be bought on hire purchase. Companies routinely buy expensive equipment on hire purchase. Cars, scooters, washing machines, etc can be bought on hire purchase (eg, Tata Finance Co). The difference between mortgage and hire purchase is important. In mortgage, the property legally belongs to the borrower from the first payment even if the lender has a security over it. In a hire purchase, the property legally belongs to the landlord until the last payment is completed and the landlord signs the transfer documents to the tenant.

Credit card: A contract between a bank and a customer who has a bank account with a large balance. The bank agrees to pay the customer’s bills whenever the customer uses his credit card (for example, in restaurants, shopping, car hire, entertainment expenses). The total bills cannot exceed the maximum credit limit (eg Rs.5000/-). At month end, the bank charges interest and fees and deducts the customer’s bank account. The interest rate may be high. Criminals love credit cards because it is easy to do fraud. On the Internet, criminals buy and sell credit card numbers. **Credit cards are very risky.**

Over the Counter OTC: Small investors have small numbers of shares and

debentures and bonds. Sometimes, brokers are not interested in helping them. The Government has made special market arrangements, called OTC, to assist the small investors in contacting one another for the purpose of buying and selling their small investments.

Capital gain /loss: When an investor holds an asset (eg, land, flat, share, debenture, bond) for a period of time, the value of the asset may increase (capital gain) or decrease (capital loss). If the asset has been held for less than 12 months, the change in value is called "short term capital gain/loss" otherwise, it is called "long term capital gain/loss". If the investor sells the asset, the capital gain/loss is "crystallized". If the investor has a capital gain, they must pay "capital gains tax CGT" on the amount of their capital gain. The rate of CGT depends on the type of asset and whether it is a short time CG or long term CG. If the investor has a capital loss, their capital loss can be set off against any other capital gain. The capital loss cannot be used to reduce income or income tax.

Letter of credit: When X company (in country X) wants to trade with Y company (in country Y), the problem of trust arises. If X sends the goods before receiving payment, what is guarantee for receiving payment? If Y pays X before receiving goods, what is guarantee for receiving goods? Banks that have branches in both countries can issue a "Letter of Credit" for Amount Z. Y has a business Bank account against which the Bank issues a "Letter of Credit": the Bank promises X payment for Amount Z. X accepts the Letter of Credit and releases the goods to Y. If Y does not pay the bill, the Bank must pay. The Bank can deduct Y's business bank account.

Hedging: The foreign exchange rate keeps fluctuating. (eg, sometimes, US$1 buys Rs.80 and other times, only Rs.65). Companies need certainty to plan their business. They enter into "forward contracts" with currency dealers that guarantee fixed

exchange rates (in the future, I will pay you US$1 and you promise to pay me Rs.70). The currency dealer must pay this rate whatever the market price is. Some companies enter into "hedging contracts" that involve the **difference** in the exchange rates (eg, Rs15 difference between Rs.80 and Rs.65). There are many variations on these arrangements.

Bill of exchange/promissory note: is like a fixed deposit but can be issued by a bank or company. It promises payment of X amount on D date to the holder. If the reputation of the bank or company is good, the businesspeople are confident that they will be paid. In such cases, the BOE can be freely traded at a premium or discount.

Treasury Bill: is a short term fixed deposit issued by the Government to raise money. Bills are usually sold to banks, large financial institutions and charitable trusts that are required by law to hold them. Bills pay low interest rates but are very reliable. Bills are not paid only if the Government falls (eg, overthrown after rebellion). Change of Government after normal election does cause problems in payment. The Government can always print more money in the Mint to meet debts. This causes inflation.

Inflation: When there is too much money in circulation, everyone has high income and more cash to spend. The supply of goods is limited. Prices increase. People cannot increase their living standard because higher income is absorbed by increased prices.