ACF - 8

ASSIGNMENT - 8

1) Explain cost of debt and Benefits of debt

Cost of debt:-

* Cost of debt is the total interest expense owned on a debt. Simply, the cost of debt is the effective interest rate or the total amount of interest that a company or individual owes on any liabilities, such as bonds and loans.

* This expense can refer to either the before-tax or after tax cost of debt. The degree of the cost of debt depends entirely on the borrower's creditworthiness, so higher costs mean the borrower is considered risky.

* The cost of debt is the effective rate that a company pays on its debt, such as bonds and loans.

* Debt is one part of a company's capital structure, with the other being equity.

* Calculating the cost of debt involves finding the average interest paid on all of a company's debts.

After-Tax cost of debt:-

After-tax cost of debt = (Risk free rate + credit spread) × (1 - Tax rate)

Before tax of cost of debt:-

$$= \frac{(1 \text{ million}) \times \text{interest rate}) + (\text{loan} * \text{rate})}{1,200,000}$$

Calculating by average interest rate and pre-tax cost of debt.

Benefits of debt:-

* Tax Benefits:-
Interest expenses on debt are tax-deductible reducing taxable income.

* Lower cost of capital:-
Debt is generally cheaper than equity, especially for large, stable companies.

* Increased financial leverages:-
Debt amplifies returns on equity, enhancing shareholder value.

* Improved cash flow:-
Debt can provide liquidity, helping companies manage cash flow.

* Investment Financing:-
Debt facilitates Investments in assets, projects or acquisitions.

* Risk Management:-
Debt can hedge against interest rate or currency fluctuations.