Low debt ratio: how does it contribute to company performance? assignment

Business

Low Debt Ratio: How Does it Contribute to Company Performance?

Introduction It has been said that you must measure what you expect to manage and accomplish. The same is true when one considers business performance. In a business measurement drives improvement which drives satisfaction. In turn, satisfaction results in loyalty from customers which means the financial success of a business. Without measurement, one has no reference to work with and thus, tends to operate in the dark.

One way of establishing references and managing the financial affairs of an organization is to use ratios. Ratios are simply relationships between two financial balances or financial calculations. These relationships establish our references so we can understand how well we are performing financially. Ratios also extend our traditional way of measuring financial performance; i. e. relying on financial statements. By applying ratios to a set of financial statements, we can better understand financial performance. Statement of the Problem

The debt ratio compares a company’s total debt (the sum of current liabilities and long-term liabilities) to its total assets (the sum of current assets, fixed assets, and other assets such as ‘ goodwill’), which is used to gain a general idea as to the amount of leverage being used by a company. It compares the funds provided by creditors to the funds provided by shareholders and gives a quick measurement of the amount of debt that the company has on its balance sheet. As more debt is used, the Debt to Equity Ratio will increase.

Since we incur more fixed interest obligations with debt, risk increases. On the other hand, the use of debt can help improve earnings since we get to deduct interest expense on the tax return. It is ideal to balance the use of debt and equity such that we maximize our profits, but at the same time manage our risk. It is said that companies with low debt ratios perform better than companies with high debt ratios. Before any conclusion is made, the relationship between the company performance and debt ratio must be explored. Purpose

It is important to understand whether there is a direct relationship between a company’s debt ratio and it’s performance. The purpose of this research is to determine whether companies with a low debt to equity ratio perform better than companies with a high debt to equity ratio. One would assume that, because a company with a low debt to equity ratio has less debt, they would have better performance. Significance of the Study The results of this study will shed light on whether or not companies with a low debt ratio perform better than those with high ratios.

By doing so, investors or potential investors will be aware of the debt ratio of the companies they would like to invest in. Hypothesis The lower the debt ratio, the less total debt the business has in comparison to its asset base. On the other hand, businesses with high total debt ratios are in danger of becoming insolvent and/or going bankrupt. When the debt ratio is high, the company has a lot of debt relative to its assets. It is thus carrying a bigger burden in the sense that principal and interest payments take a significant amount of the company’s cash flows.

When the debt ratio is low, principal and interest payments don’t command such a large portion of the company’s cash flows, and the company is not as sensitive to changes in business or interest rates from this perspective. I believe that companies with a low debt to equity ratio perform better than companies with a high debt to equity ratio. Literature Review The article, “ Debt Ratio and Equity” by Sara Lepro, discusses tradeoff theory of capital structure predicts that firms aim to approach a target debt ratio.

The theory provides several firm characteristics that determine this target debt ratio. In contrast, the pecking order model rejects a target debt ratio, because firms are expected to finance investments subsequently from equity, debt and (external) equity. A fundamental problem in empirical studies is that having a target debt ratio or not is unobservable from public data. They use survey evidence from 235 Chief Financial Officers (CFOs) to discriminate static tradeoff firms from pecking order firms and relate the responses to public data.

For the two sets of firms we estimate standard capital structure models and find that pecking order firms contaminate static tradeoff theory-based estimations. This article relates to the study by confirming the relationship between debt, equity, and financial investments. The article, “ Measuring Success” by David White, examines an interview with Mark McMahon, a partner with Moss Adams LLP, is presented. He offers ways on how a company can start with benchmarking including preparing financial statements, calculating the important ratios and comparing the results of these calculations to peers in the construction industry.

He explains the kinds of ratios that should be analyzed by companies which include debt to equity and current assets versus current liabilities. He emphasizes the importance of measuring gross profit. This article relates to the study by confirming how important it is for companies to' measure their performance by calculating important ratios. Methodology In providing further research on this study methodology will be applied. In doing so, one must focus on the purpose of this study, which is to determine whether a company performs better when there is a lower debt to equity ratio.

If research evidence proves this relationship to be true, what significant advantages and disadvantages would it have on investors? If research evidence proves this relationship to be false, what significant advantages and disadvantages would it have on investors? The population for this study is defined as the sample population of 60 that are publicly traded. Of the companies, half will have low debt ratios (lower than . 7) and the remaining companies shall have high ratios (higher than . 7). The company's performance will be measured by the price of the company's stock.

Each company, along with relative data will be entered into SPSS to compare the information and analyze the results. Hypothesis testing for independent samples was used. Conclusion In this quantitative study, the research hypothesis was supported. This indicates that the alternative hypothesis was accepted, which states that companies with low debt ratios perform higher than those with high debt to equity ratios. This means that by using the debt to equity ratio, investors can determine exactly how well a company is performing and whether or not to invest.