Does the mixture of debit and equity in a firm's financial structure matter? Why?

The capitalization (Debit to equate) structure of a firm depends on a number of factors. The goals of the firm, management aptitude, corporate culture, along with other factors such as economic/market forces all conspire to make this a complex question to answer. The primary reason for the complexities regarding such question lye in the fact that deferent people in the same situations would react in different ways.

"The debit to equity can also be referred to also as gearing or leverage"1. Debit to equity (also debit/worth) measures the risk of the firm's capital structure (also called financial structure) in terms of amounts of capital contributed by creditors and that contributed by owners (includes stockholders). It expresses the guard provided by owners for the creditors. In addition, low Debt/Equity ratio implies ability to borrow. While using Debt implies risk (interest payments must be paid), it also introduces the potential for increased benefits to the firm's owners. This benefit results mainly from the leverage gained, e.g., £100,000 would buy one house outright, and £100,000 split on ten 10% deposit mortgages with sit in tenants would effectively allow the individual to control assets in the region of £1,000,000. "When Debt is used successfully (operating earnings exceeding interest charges) the returns to shareholders are magnified through financial leverage"2. The debit ratio measures the percent of total funds provided by creditors. Debt includes both current liabilities and long-term debt. Creditors prefer low debt ratios. The lower the ratio, the greater the cushion against creditor's losses in liquidation. Owners may seek high debt ratios, either to magnify earnings or because selling new stock would mean giving up control. Owners want control while "using someone else's money. But creditors take a general debit ratio specific to the individual firms preserved future economic situation. The main applications where mixture of debit and equity in a firm's financial structure matter relates to large and small firms, and there fiscal goals.

The fundamental question is how does a firm capitalize itself most effectively, which financial structure most suits the firm. The simplest definition of "capitalization" is merely how the corporation will finance its business, whether it is with funds from the owners, lenders or other third parties. Well it depends on the specific firm. Most entrepreneurs understand and expect the immediate need for capital to meet start-up costs. However, to grow and stay competitive, most businesses will need additional infusions of capital at some point in their existence. After determining the need for additional capitalization, the owners also need to determine if that additional capitalization should be in the form of debt or equity. In other words, should the money be obtained by securing a loan or by selling an ownership interest in the corporation? Answering that question requires careful consideration of numerous financial and legal factors, this requirement varies in accordance with the size of the firm.

Most larger corporations can raise capital in several ways, including issuance of common and preferred stock, issuance of bonds and other debt instruments, and use of retained earnings. The Company, a subsidiary of corporations, issues its own bonds secured by utility assets but does not issue its own stock. "A wholly owned subsidiary of a corporation, will have access to the corporation's equity capital. In raising capital, management seeks to minimize capital costs while maintaining the financial integrity of the Company. Financial stability and integrity are important for both stockholders and customers"3. The cost of debt and equity depend in part on capital structure. The larger the equity ratio, the lower is financial, or capital-structure, risk. As the firm's equity ratio increases, however, the overall cost of capital rises because equity capital usually commands a higher return than debt. An optimal combination of capital structure and capital costs exists that will minimize the overall cost of capital while maintaining the company's financial health.

Unlike the cost of debt, the cost of equity capital is not explicit but is competitively determined in the financial markets as the return required to attract investment in the company's stock. The authorized rate of return on common equity is a key determinant of revenue requirement and thus rates for utility service. Though these rates provide the company the opportunity to earn this return, there is no implied guarantee it will actually earn the allowed return because the efficiency of company management and the fortunes of the marketplace intervene.

An authorized rate of return does not insulate the company from business or financial risks, but is set in recognition of them. Companies may use alternative approaches to estimate a reasonable range for the cost of equity capital. "With the annual version of the Discounted Cash Flow (DCF) model, a number of companies of risk and size similar to a particular firm are analyzed. Consensus earnings forecasts are used to estimate long-term dividend growth. These growth rates plus spot prices for company stock produce a range of estimates of required return on equity. This method relies on Value Line's projected return on common equity for each company. A Capital Asset Pricing Model (CAPM) analysis provides another estimate. Short-term and long-term versions of this model yield empirical estimates"4. Most of the methods used in lager firms are unnecessary with smaller firms.

Most start-up corporations seek as much financing in the form of debt as is possible. This is particularly true if financing is available from third parties, and not merely the owner lending his or her own personal money to the corporation. If the corporation is able to obtain third-party financing, the return to the third party is simply the amount of the loan and a pre-determined (and presumably reasonable) rate of interest. Sam Walton founder of wal-mart eloquently reinforces the above point when he said; "Helen and I were also in debit up to our eyeballs-several million dollars worth"

Most owners would not be willing to risk their funds without the opportunity to share in the positive aspect (the corporations' profits) as a reward for the risk. To share in the benefit, usually some amount of equity, or ownership, is sold to the investor. Along with ownership comes control. Unsurprisingly, many owners are wary of giving a voting interest and the right to participate in important corporate decisions to third parties. Moreover, a basic foundation of equity that is in the form of stock is that it is fully and freely transferable. It can be bought and sold, as long as there are sellers willing to sell and buyers willing to buy. The owner may feel the corporation is taking a risk in effectively losing all control as to who the other voting members of the corporation are. While some of this can be accounted for with the use of voting or shareholder agreements, the lack of control or ability to freely sell the stock will naturally affect the amount of capital an individual is willing to contribute for his or her interest.

In addition to ownership and control issues, careful consideration must be given to the tax aspects of capitalization. "As a rule, because interest payments are usually tax deductible, loans have a much greater tax advantage to the corporation than equity. Additionally, because the tax concerns involved with the sale of equity can be remarkably complex, it should not be attempted without competent accounting advice"5. The short-term success or failure depends upon meeting the expectations of the investors. It is also often helpful to the owners of the corporation who derive benefits because the process of writing the PPM helps clarify strategies and goals of the company. The long-term success of the PPM depends on keeping its status as a disclosure document and not converting it to a sales brochure.

I construe, the debit to equity question depends more on a corporations goals both long-term and immediate. Many so called experts (analysts) during recent times (1998-2000) wanted firms to hold less in the way of equity and more in the way of debits, due mainly to

the immediate payoffs within the direct spherical influences of the current stock market, you only needed to see the ratios of some of the dot com firms to see this.. But many successful firms bucked this trend and have remained immensely successful why'll consistently holding immense liquid equate, such as Standard Oil, and Microsoft, this is more a trend that occurs when the firm has reached maturity. Other firms have remained successful why'll been immensely debit laded in there foremost expansion period, but once this growth spurt was over have become very successful firms, such as Starbucks and Wall-Mart. Both the latter firms still hold debit but considerably less than they previously did.

I conclude that higher debit ratios are essential for a firm's expansion plans to be met, but extremely dangerous if the firm ceases to expand and reaches maturity within the industry, mainly due to the risks of operating in a mature market, as firms find it increasingly hard to externally increase revenues. The entire question of debit to equity can be summed up by a quote from Sam Walton "I was never really comfortable with debit. But I recognized it as a necessity of doing business"

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