



SECTION - 9

EFFECT OF FINANCING DECISIONS ON BALANCE SHEET AND RATIOS

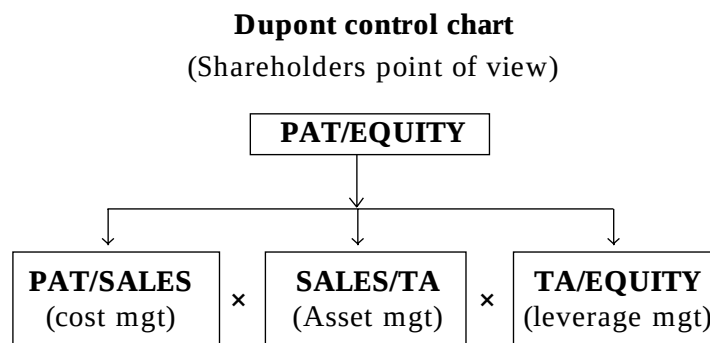
This Section includes

- **Effect of Financing Decisions on Balance Sheet and Ratios**

9.1.0 Financing decisions like debt or equity or leasing, have an impact on the balance sheet and consequently on the ratios. The higher the amount of debt, higher will be the interest cost, but this will be to some extent off-set by the lower tax outflow. The capital structure decision will not have any impact on the earnings before interest and taxes [EBIT], but will have an impact on the Earnings after tax [EAT]. EBIT is known as operating profit .

9.1.1 Dupont control chart and the family of ratios

The relationship among all the ratios is very well depicted in the following diagram, which is known as the Dupont control chart.



9.1.2 The above chart can be used to summarize the performance of any company. It says that the Return on equity[ROE] is a function of Return on sales[net profit margin], asset turnover and leverage[debt to equity ratio measured as total assets to equity]

9.1.3 The first two ratios namely, the net profit margin and asset turnover will not be affected by the capital structure decisions. It is margin times the turnover, which defines the business performance of the company. It is driven by the efficiency with which a company manages its revenue, costs and assets. An efficient company can manage higher levels of revenue with relatively lower levels of investment in assets.

9.1.4 The final ratio namely, the ROE, is influenced by the financing decision, namely the debt to equity ratio, measured by total assets to equity. If this ratio is 1, it means, it is 100 percent financed by equity.

9.1.5 An illustration of Dell computers and Compaq.

ROE	1995	1996	1997
Dell	33%	58%	90%
Compaq	22%	22%	22%
Net Profit Margin	1995	1996	1997
Dell	5.10%	6.70%	7.70%
Compaq	5.40%	6.60%	7.50%
Asset turnover	1995	1996	1997
Dell	2.83	3.02	3.4
Compaq	2.38	1.99	1.82
Leverage	1995	1996	1997
Dell	2.3	2.89	3.46
Compaq	1.69	1.69	1.61

Dell computers performance in the year 1997 is mainly influenced by superior asset turnover and higher leverage.

Companies resort to lease financing for leaving the capital structure intact. This is why, leasing is known as off-balance sheet financing. But in today's context, the present value of future lease payables is taken as debt and considered for debt to equity ratio. Accounting standards on lease transactions disclosure requires present value of future lease payables to be shown as debt.