

THE SENSE AND AVAILABILITY OF INDUSTRY STANDARDS OF INDEBTEDNESS FOR BUSINESSES IN THE CZECH REPUBLIC

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Abstract: The aim of this article was to reveal attitude of businesses in the Czech Republic towards capital structure optimization and the use of industry standards as benchmarks for their level of leverage. Despite several decades of capital structure theories development and refinement, none of the theories indicating how managers should act seem to be ready to determine the definite ratio of debt and equity used in corporate capital structure yet. The use of debt offers a company both pluses by creating more investment opportunities, and minuses associated with the higher risk for investors. Most capital structure models assume vigorous approach of companies towards capital structure optimization. Companies may, however, exert rather a passive approach towards their capital structure. The questionnaire survey indicated that majority of respondents had no target value of the debt ratio. This contribution was focused on the sense and availability of sectoral recommendations concerning corporate indebtedness that might serve as a useful benchmark for companies. By comparing financial ratios to other businesses in the same industry, it is possible to make judgements about a company's basic financial health. The sense of the use of industry standards for the debt ratio is that the ratio appropriate for other firms in a similar branch should be appropriate for the company as well. Availability of industry standards in countries with highly developed capital markets is extensive. Availability and accessibility of industry standards for companies in the Czech Republic proved to be requiring more effort and knowledge. The questionnaire survey indicated that most respondents don't use industry standards for the debt ratio as they have no interest in comparison with the indebtedness in the sector. However, there was a noticeable group of respondents which stated that they don't use any industry standards for indebtedness at present, but they would appreciate if such standards were more accessible.

Keywords: benchmarking, capital structure, debt ratio, indebtedness, industry standards.

JEL Classification: G32

INTRODUCTION

The capital structure of the company is constituted by the long-term liabilities and owners' equity accounts on the firm's balance sheet. These accounts record the combination of debt, retained earnings, and common equity used to finance the firm's assets. The use of debt in the capital structure, or financial leverage, has both benefits as well as costs. While the principal attraction of debt is the tax benefit, its cost is financial distress and reduced commercial profitability. Debt serves as a tax

subsidy in most countries of the world. However, the proportion of debt in the corporate capital structure varies widely across companies and especially industries. The theories of capital structure use rational economic models, by means of which they attempt to describe how firms should establish and adjust their capital structure. In theory, it might seem easy to define the optimal capital structure, but it is very difficult to design it in practice under normal business activities of a company. Utilization of traditional or modern capital structure theories assumes

the proactive approach of companies towards the process of capital structure optimization. Companies may, however, exert rather passive approach based on the utilization of industry standards for corporate indebtedness. The sense of the use of industry standards is that the debt ratios appropriate for other firms in a similar branch should be appropriate for the company as well. Industry standards can serve as a useful benchmark for all commonly used financial ratios, not just for the debt ratio. Therefore, the aim of this article is to reveal the attitude of businesses in the Czech Republic towards the capital structure optimization and the use of industry standards as benchmarks for their level of leverage.

1. THEORETICAL BACKGROUND

Despite several decades of capital structure theories development and refinement, none of the normative theories indicating how managers should act seem to be ready to determine the definite ratio of debt and equity used in corporate capital structure yet.

One of the first theories of capital structure was the famous irrelevance theory of Modigliani and Miller (1958). This theory, often called the “nothing matters” proposition, holds that a firm’s capital structure does not affect its value if markets have perfect information and there are no taxes or bankruptcy costs. Their theory was extended by effects of taxation in 1963, by justifying the preference of the debt capital in order to take advantage of the tax shield effect.

Static trade-off models assume that each firm has a value-maximizing optimal capital structure that minimizes its overall weighted average cost of capital (WACC). As the after-tax cost of debt is usually less expensive than equity, companies will add debt up to the point where the risk of bankruptcy raises to the WACC. This theory comes from MM proposition, and points out that firms will favour debt as a source of financing when it enjoys a tax shield.

The pecking order theory based on informational asymmetry suggests that firms

do not have leverage targets. They use debt only when retained earnings are insufficient and raise external equity capital only as a last resort. Brealey and Myers (1996) indicate that the most important source of corporate financing is the private equity consisting of owners deposits and retained earnings. Additional source of financing of great importance is debt, according to them.

Signalling models, developed by Miller and Rock (1985), are similar to the pecking order theories in that they invoke information asymmetries; their motivation however substantially differs. In signalling theory, internal funding still dominates all external sources. Companies do not have a preference among external sources because the act of financing externally signals an unavailability of internal financing.

The agency cost theory of Jensen and Meckling (1976) says that management can maximize firm value by issuing both debt and equity and can thereby minimize agency costs. However this model doesn’t deal with the proportions or preferences for debt or equity instruments.

In general, the capital structure is said to be optimum when the marginal real cost (explicit as well as implicit) of each available source of financing is identical. With an optimum debt and equity mix, the cost of capital is minimal and the total value of the firm is maximal (Khan, 2007).

Various foreign empirical studies have already examined empirical relevance of the fundamental capital structure theories. However their results are not perfectly applicable for the corporate sector in the Czech Republic, as there are fundamental differences in attitude towards corporate financing arising from traditional strength of the banking sector and the rigid capital market.

Horová and Hrdý (2007) focus on research of corporate investment decisions and used assessment methods in the Czech Republic. The study reveals that only 20% of companies attempt to optimize its capital structure in long-term, withal these companies aim to minimize debt and maximize profits. At the same time,

these companies strive to sustain their determined debt ratio. Firms predominantly use internal sources of financing, and for more extensive investment projects mainly loans are used. The study identified surprisingly large proportion of companies (22%) that do not optimize their capital structure at all.

Prášilová (2012) examines the effects of internal and external factors on the company's capital structure, like the return on assets, the business sector, the company's growth opportunities, the company's size, the tax and interest rate, the cost of the debt, and the cost of the equity. The findings of the paper indicate that the total gross debt is positively affected by the firm's age, and negatively affected by the return on assets. The author found some evidence for the validity of both capital structure theories, the trade-off theory and the pecking order theory, which is consistent with research results from recent years.

There are substantial differences in the capital structure among various industries and even among individual firms within the same industry. According to fundamental concepts of financial management theory, industry is supposed to be one of the most determining factors for the corporate capital structure. Firms operating in the same industrial sector tend to have similar external conditions for their business activities. Therefore, it is also possible to find a correlation between the business sector and the capital structure of companies - as shown, for example, by Bradley, Jarrell and Kim (1984).

At the same time, the average indebtedness may be a factor that influences the indebtedness of a particular company: Chevalier (1995) found that individual companies compare their own debt ratios with industry averages and directly (by setting a target debt levels) or indirectly adjust their own financial policy to these averages.

Talberg et al. (2008) dealt with the debt within a particular industrial sector and discovered the differences within individual industries. These inter-sectoral differences in capital

structure he explains by the different level of risk within industries. In accordance with the theory of financial distress, the company with higher risk levels should get less indebted.

The study of Hull (1999) has shown that the market's reaction to leverage decrease announcements depends on how a firm's debt ratio changes relative to its industry debt-to-equity norm. Simultaneous test of optimal capital structure models confirmed that optimal models predict a decrease (or an increase) in firm value when a firm moves away from (or closer to) its optimal debt ratio.

Frank and Goyal (2009) claim that firms belonging to industries in which the median leverage ratio is high, tend to have higher leverage. One explanation for this finding is that managers use industry median leverage ratios as target ratios for their own firms.

Hovakimian, Opler and Titman (2001) also report that firms actively adjust their leverage ratios towards the industry average.

2. THE USE OF INDUSTRY STANDARDS OF INDEBTEDNESS BY THE BUSINESSES

In countries with highly developed capital markets, the businesses monitor very carefully so called industry standards of various financial indicators and measures produced by financial analyses. The gathered information is used to improve company processes and thereby to improve performance. The availability of industry standards abroad is splendid. Companies can use various publicly available sources, such as the annual and quarterly reports of Thomson Reuters, the Bloomberg database, the statistics elaborated by Google Finance, Yahoo! Finance Stock Screener, MSN Money or Standard & Poor's NetAdvantage. Information on sectoral averages published by financial institutions, banks or organized capital markets can also be used for benchmarking.

The financial ratios reference book published in the United States called Almanac of Business and Financial Ratios, also known as Troy (Troy,

2015), is one of the fundamental sources that offer the comparison of the company ratios to other businesses in the same industry. This publication provides operation and financial ratios for approximately 160 industries. The drawback of the Almanac is its high acquisition cost.

In the Czech Republic, the analyses of sectoral development are performed periodically (annually or quarterly) by the Ministry of Industry and Trade, which processes basic economic and financial data for selected sectors. To the processed analyses belong, for example: the Survey of the Czech Economy and MIT Sectors, the Financial Analysis of the Business Sphere and the Panorama of the Manufacturing Industry.

The Benchmarking diagnostic system of financial indicators INFA is the result of cooperation between the Ministry of Industry and Trade and the academic sphere. INFA was intended to serve businesses for verification of their financial health and for comparison of their economic results with the best companies in the sector, or with the average of the sector. INFA ranks among pyramid indicators and is focused on three basic groups of financial indicators. The first group of indicators, called the evaluation of the level operational area (creation of EBIT/ assets), gives a view of what the business produces regardless of the origin of the capital and the taxation level. The second group of indicators evaluates the financial policy of a company (distribution of EBIT/ assets among creditors (interest), the state (taxes) and owners (net profit)). The last group of indicators is focused on the assessment of the company's liquidity level (defines the stable financial conditions under which EBIT/ assets is created and distributed). The authors of this diagnostic system, the Neumaier's (2008), themselves recognize that the INFA users fail to behold the options of this system and therefore neither appreciate it, nor use it, as it is necessary to spend more effort to familiarize with the system and to understand its conceptual framework and options.

The Czech Statistical Office processes official statistics and provides complex analyses in the economic, environmental, and social spheres for various public and private organisations, central and local government authorities, as well as businesses. The most complete overview of the economic, social, and environmental state of our country is the cardinal and comprehensive statistical publication of the Czech Statistical Service, the Statistical Yearbook of the Czech Republic. It presents a wide spectrum of pure statistical data.

There are several private enterprises that offer analytical sectoral studies on a commercial basis. For example the company Bisnode Czech Republic offers studies processed separately for selected industrial segments which include an analysis of the particular business sector, profiles of major companies operating in that sector and analytical software. The disadvantage of these studies is the high acquisition cost of each particular study and the absence of a comprehensive analytical study for all industries.

In neither of these analytical materials it is possible to find concrete sectoral recommendations on the debt ratio. Although the materials of the Ministry of Industry and Trade based on the data provided by the Czech Statistical Office contain sectoral averages for total assets and equity separately, debt ratios could therefore be calculated consequently, it might be found by businesses as too complicated to calculate. INFA offers more specific indicator which might be used by companies as a benchmark for indebtedness – the equity ratio. Equity ratio is a financial ratio indicating the relative proportion of equity used to finance the company's assets. This ratio represents the opposite view to financial leverage than the debt ratio indicating the relative proportion of debt used to finance a company's assets. The INFA system offers for benchmarking data with the time-lag of approximately two to three years.

Hrdý (2013) suggests concrete values of industry standards for the debt ratio of companies in the Czech Republic. His

suggestions are based on the leverage analysis based on the book and market values in selected industrial sectors. Recommended values of the debt ratio were set on the basis of comparison with foreign data from Europe and the USA. He points to similar values of corporate debt ratio in selected industries in the Czech Republic and the USA. Unfortunately, his study is limited to only five selected manufacturing sectors: the mining of coal and lignite, the production of electrical devices, railways and rail transportation, the treatment of water, and production of beverages.

3. METHODOLOGY

The study combines an analytical and a descriptive approach. It was conducted with the help of analysis of scientific publications, research papers, and publicly available materials, on the basis of which the literature overview was compiled.

The empirical research was performed in 2015. The questionnaire used in this study was distributed by the students of Faculty of Economics to 220 CFOs of companies across the Czech Republic. Via personal interviews students managed to get 197 properly completed questionnaires, which can be considered as a sample of the great magnitude. The questionnaire included questions concerning corporate financial decisions with the emphasis on the attitude of companies towards indebtedness. The data

evaluation was carried out using methods of descriptive statistics.

Various indicators of financial analysis serve as measures of corporate indebtedness, e. g. debt ratio, equity ratio, financial leverage ratio, debt-to-equity ratio, interest coverage. Leverage in this empirical study refers to the financing methods of the company and its ability to meet its financial obligations, and is measured by the debt ratio, also referred to as the debt-to-assets ratio. The debt ratio indicates the relative amount of corporate debt in proportion to the assets of a company. It is calculated by dividing total liabilities (i.e. long-term and short-term liabilities) by total assets:

$$\text{Debt ratio} = \text{Total liabilities} / \text{Total assets}. \quad (1)$$

4. RESEARCH RESULTS

The questionnaire survey was focused on selected areas of investment decisions making process, targeted debt ratio and businesses' perception of the usefulness of industry standards as the benchmarks of corporate indebtedness. The respondents also answered questions concerning the legal forms of business, prevailing business sector and the company size.

4.1. Assessment of the inquiry - descriptive statistics

Tables 1 to 3 represent the distribution of respondents according to the legal form of business, business sector and company size.

Tab. 1: Distribution of respondents according to the legal form of business

Legal form of business	Quantity	Percentage
Joint-stock company	43	21.8 %
Limited liability company	115	58.4 %
Limited partnership	0	0.0 %
Partnership	1	0.5 %
Cooperative	2	1.0 %
Private entrepreneur	22	11.2 %
Other	14	7.1 %
Total	197	100.0 %

Source: own elaboration

A limited liability company is statistically the most frequently significant legal form of business.

Tab. 2: Distribution of respondents according to the prevailing business sector

Business sector	Quantity	Percentage
C - Manufacturing	58	29,4%
G - Wholesale and retail trade; repair of motor vehicles and motorcycles	46	23,4%
M – Professional, scientific and technical activities	20	10,2%
N - Administrative and support service activities	15	7,6%
F - Construction	14	7,1%
A - Agriculture, fishery, and forestry	9	4,6%
J - Financial and insurance activities	8	4,1%
L - Real estate activities	4	2,0%
H - Transportation and storage	7	3,6%
I - Accommodation and food service activities	7	3,6%
D - Electricity, gas, steam and air conditioning	6	3,0%
B - Mining and quarrying	2	1,0%
E - Water supply; sewerage, waste management and remediation activities	1	0,5%
Total	197	100.0 %

Source: own elaboration

The frequency of respondents with the prevailing business activities C – Manufacturing, G - Wholesale and retail trade; repair of motor vehicles and motorcycles, and

M – Professional, scientific and technical activities are represented statistically more significantly than respondents with other prevailing business sectors.

Tab. 3: Distribution of respondents according to company size (measured by the number of employees)

Number of employees (company size)	Quantity	Percentage
0-9 employees (micro-sized enterprise)	60	30.5 %
10-49 employees (small-sized enterprise)	50	25.4 %
50-249 employees (medium-sized enterprise)	44	22.3 %
250 and more employees (large-sized enterprise)	43	21.8 %
Total	197	100.0 %

Source: own elaboration

With respect to the total number of respondents there is no statistically significant difference in the frequency of respondent enterprises.

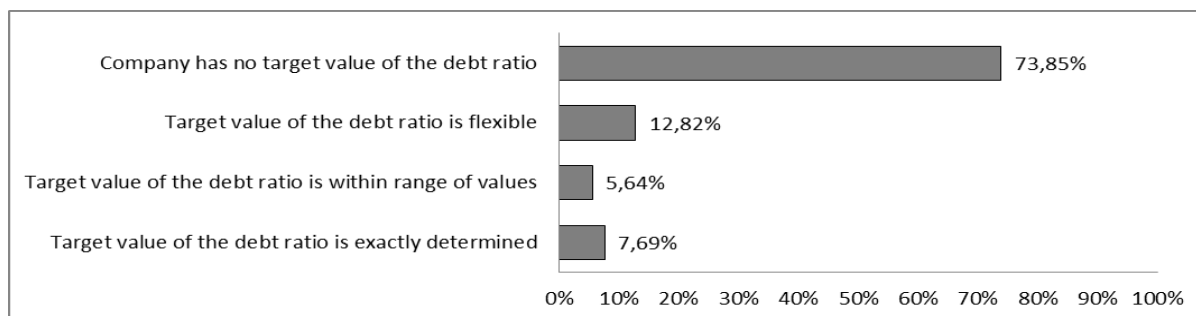
Considering the structure of the respondents, it is not possible to generalize the validity of the expressed conclusions and apply them to all businesses in the Czech Republic, but rather on the enterprises active in the manufacturing and processing sectors with the legal form of the limited liability company.

4.2 Assessment of the inquiry – empirical results

The empirical research identified significant difference between companies that do not monitor their debt ratio and companies that track this ratio to various extents. Companies that monitor their debt ratio could have chosen

from those possibilities: our target value of debt ratio is flexible, target value is set within predetermined target range of values, or the target value is exactly specified. The distribution of answers is presented in Figure 1. The astonishing number of 73.85 % of respondents in the Czech Republic has no target debt ratio. Another 12.82 % of respondents have a flexible target, and 5.64 % have a somewhat tight target or range. Only the remaining 7.69 % have a very strict target debt ratio. These results provide support for the notion that firms don't have leverage targets, like the pecking order theory based on the information asymmetry. Under this theory firms use debt only when retained earnings are insufficient and raise external equity capital only as a last resort.

Fig. 1: How companies monitor their debt ratio: the distribution of answers

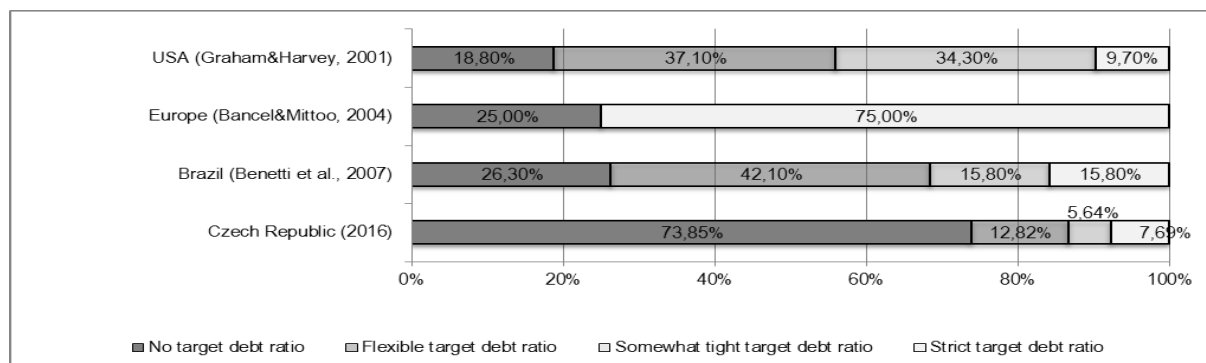


Source: own elaboration

The comparison of these results to foreign studies brings several interesting findings (Fig. 2). The results of Graham and Harvey (2001) provided mixed support for the notion that companies trade off costs and benefits to derive an optimal debt ratio. In terms of target debt ratios, the US firms set targets slightly more

strictly than their counterparts in Brazil (Benetti et al., 2007) where more than 68% of the firms claim to have no or loose target ratios. According to Bancel and Mittoo (2004) about 75 % of the European firms have a target debt-to-equity ratio (this survey didn't used the same four levels scale as the other surveys).

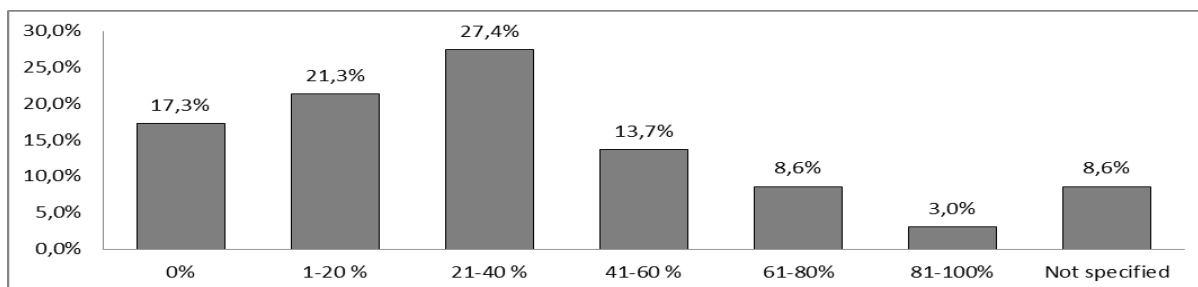
Fig. 2: Cross-country comparison: Survey responses to the question: "Does your firm have a target range for your debt ratio?"



Source: Graham and Harvey (2001), Bancel and Mittoo (2004), Benetti (2007), own elaboration

Figure 3 represents estimated debt ratio of companies.

Fig. 3: Estimated debt ratio: distribution of answers

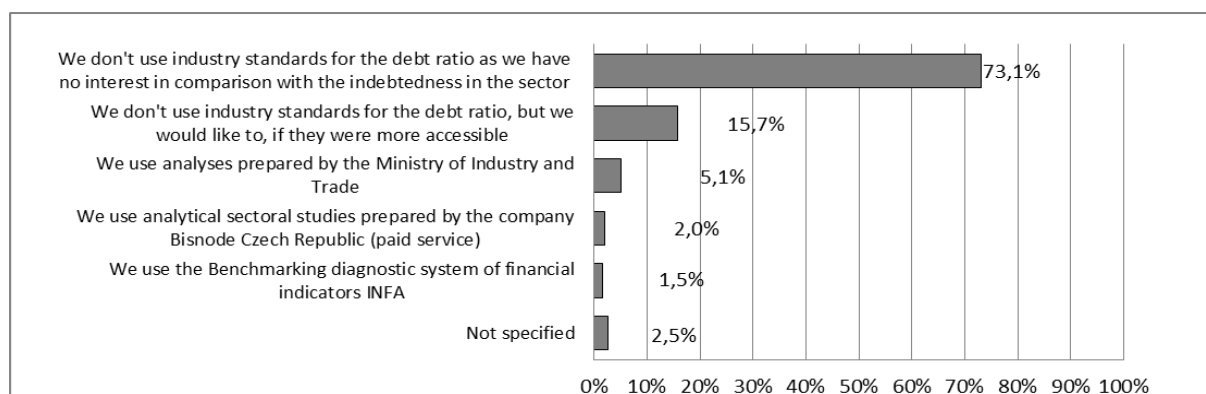


Source: own elaboration

Results show that most companies rely primarily on equity as the internal source of financing. Statistically significant frequency can be found in the interval of debt ratio between 21 and 40 % (27.4 % of respondents).

The attitude of the Czech companies towards industry standards of the debt ratio is illustrated in Figure 4. Respondents were to answer question whether they used any industry standards of debt ratio as a benchmark.

Fig. 4: The attitude of the Czech companies towards industry standards of the debt ratio



Source: own elaboration

Statistically significant difference was found in the category "We don't use industry standards of the debt ratio as we have no interest in comparison with the indebtedness

in the sector". Majority of respondents (73.1 %) doesn't see the sense of industry standards of indebtedness for their business. Only limited number of respondents (8.6 %) reported they

used any analytical material concerning indebtedness as a benchmark (5.1 % of respondents used analyses prepared by the Czech Ministry of Industry and Trade, 2.0 % of respondents used sectoral studies prepared by the private company Bisnode Czech Republic, and 1.5 % of respondents used the Benchmarking diagnostic system of financial indicators INFA).

A significant potential can be seen in 15.7 per cent of respondents which stated that they don't use any industry standards of indebtedness at present, but they would appreciate if such standards were more accessible. This noticeable group of respondents represent potential for the proposal of methodology for concrete values recommendations of industry standards that might serve as benchmarks of the corporate debt ratio within the particular sector.

Detailed analysis of respondent answers according to the company size, business sector and legal form of business can be found in Table A1 in Appendix to this article.

CONCLUSION

The discipline of corporate finance still lacks a unifying capital structure theory which would be capable to explain all aspects of the capital structure choice. While each theory can successfully account for some of the facts, it has trouble with some of the others. The current state of the literature suggests as one of the most reliable factors for explaining corporate leverage an average industry leverage, inter alia.

Financial ratios serve as essential sources of information for company financial data analysis. By comparing the ratios to previous years or to other businesses in the same industry, it is possible to make judgements about a company's basic financial health and to determine operating trends. This contribution is focused on the sense and availability of sectoral recommendations concerning corporate indebtedness. Performed investigation revealed that it is considerably complicated to locate industry benchmarks

of selected financial ratio – the debt ratio – for companies operating in the Czech Republic. The availability of industry standards for companies in the Czech Republic is quite limited in comparison to foreign countries. There are several institutional and some commercial analyses and indicators available, but in neither of available analytical materials it is possible to find concrete sectoral recommendations on the debt ratio.

The questionnaire survey indicates that majority of respondents has no target value of debt ratio. Companies rely primarily on equity as the internal sources of financing. The ratio of respondents with no target debt ratio is noticeably high in comparison to results of foreign studies. Even if most respondents state that they don't use industry standards for the debt ratio as they have no interest in comparison with the indebtedness in the sector, there was a noticeable group of respondents which stated that they don't use any industry standards for indebtedness at present, but they would appreciate if such standards were more accessible. The results of this study provide support for the notion that firms don't have leverage targets, like the pecking order theory based on the information asymmetry.

In conclusion, the leverage ratio research suggests that the market views the comparison of a company's debt ratio with industrial average as a valuable indicator of firm's financial position, and wealth maximizing norm only marginally. This may be explained by the low awareness of enterprises about these benchmarks and their difficult availability. Nevertheless, this study found a significant potential of the use of company's industry debt ratio standard in practice - in empirical tests as a benchmark to set an appropriate amount of debt used by a company. Further theoretical research in this area could be aimed at determining the methodology for the standard definition of sectoral debt benchmark that hasn't been conclusively determined yet.

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APPENDIX

Tab. A1: Analysis of survey responses according to company size, business sector and legal form of business

	Sample %	Company size		Business sector			Legal form of business				
		SME (%)	Large (%)	Manuf. (%)	Retail/Wh. (%)	Others (%)	JSC (%)	LLC (%)	Others (%)		
Target debt ratio											
No target value of the debt ratio	73.85	60.51	13.33	20.00	17.44	36.41	13.33	44.62	15.90		
Target value of the debt ratio is flexible	12.82	9.74	3.08	5.13	2.05	5.64	4.10	6.15	2.56		
Target value of the debt ratio is within range of values	5.64	2.56	3.08	3.08	1.03	1.54	2.56	3.08	0.00		
Target value of the debt ratio is exactly determined	7.69	5.64	2.05	1.54	3.08	3.08	2.05	4.10	1.54		
Long-term debt ratio											
0 %	17.26	15.74	1.52	3.55	5.08	8.63	3.05	6.60	7.61		
1-20 %	21.32	17.77	3.55	6.60	5.08	9.64	3.05	14.21	4.06		
21-40 %	27.41	22.34	5.08	8.63	6.09	12.69	5.58	16.24	5.58		
41-60 %	13.71	9.14	4.57	3.55	3.55	6.60	4.57	9.14	0.00		
61-80 %	8.63	3.05	5.58	4.57	1.52	2.54	2.54	6.09	0.00		
81-100 %	3.05	2.54	0.51	1.02	1.02	1.02	1.02	1.52	0.51		
Not specified	8.63	7.61	1.02	1.52	1.02	6.09	2.03	4.57	2.03		
Attitude of companies towards industry standards of the debt ratio											
Don't use any industry standards, no interest in sector comparison	73.10	57.36	15.74	21.32	18.78	32.99	13.71	42.13	17.26		
Don't use industry standards, but they would like to, if they were more accessible	15.74	14.21	1.52	5.08	4.06	6.60	4.06	9.64	2.03		
Use analyses prepared by the Ministry of Industry and Trade	5.08	3.05	2.03	1.02	0.00	4.06	1.52	3.55	0.00		
Use analytical sectoral studies prepared by the company Bisnode Czech Republic	2.03	1.02	1.02	1.52	0.00	0.51	0.51	1.52	0.00		
Use the Benchmarking diagnostic system of financial indicators INFA	1.52	1.02	0.51	0.51	0.51	0.51	1.02	0.51	0.00		
Not specified	2.54	1.52	1.02	0.00	0.00	2.54	1.02	1.02	0.51		

Note: Sample – 197 companies; % - is the percentage of positive response to the given question. Company size: SME - less than 250 employees, Large - more than 250 employees. Business sector: Manuf. – (C) Manufacturing, Retail/Wh. – (G) Wholesale and retail trade; repair of motor vehicles and motorcycles, Others – other business sectors. Legal form of business: JSC - joint stock company, LLC - limited liability company, Others - other legal forms of business.
Source: own investigation