LOGIT Test on the Information Content of the Debt Ratio Changes

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The Modigliani-Miller theorem on the irrelevancy of financial structure implicitly assumes an informationally perfect capital market where agents have full information about the activities of firms. If managers possess inside information, then the choice of financial structure signals information to the market about the firm's true quality. These inferences drawn from the signals are valid for estimating the firm's true intrinsic value in a competitive equilibrium. The theory implies that outside investors use capital structure changes as an information source in estimating the firm's true future earnings prospect in a risk neutral world. It also implies that they perceive an increase in firm's debt ratio as good news about the firm's future earnings potential.

This paper differentiates informational effects of capital structure changes from real effects, and then examines directly the question if investors use the capital structure changes for purely informational purposes in estimating the firm's earnings on quarterly bases.

A Logit analysis together with two-way analysis of covariance is employed using the I/B/E/S data base, quarterly Compustat and CRSP data from 1976 to 1983. Results show that investors may not use capital structure changes as an information source in assessing future earnings and the results do not empirically support the signaling hypothesis of capital structure.

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