Leverage Ratio: Notes for IAS Exam

A leverage ratio is one of several financial measurements that glances at how much capital comes in the form of debt (loans), or weighs the capacity of a company to meet its financial obligations.

How is Leverage Ratio used in Businesses?

Too much debt can be dangerous for a company and its investors. However, if a company's operations can generate a higher rate of return than the interest rate on its loans, then the debt may help to fuel growth. Uncontrolled debt levels can lead to credit downgrades or worse. On the other hand, too few debts can also raise questions. A reluctance or inability to borrow may be a sign that operating margins are tight.

There are several different ratios that may be categorized as a leverage ratio, but the main factors considered are debt, equity, assets, and interest expenses.

A leverage ratio may also be used to measure a company's mix of operating expenses to get an idea of how changes in output will affect operating income. Fixed and variable costs are the two types of operating costs; depending on the company and the industry, the mix will differ.

Finally, the consumer leverage ratio refers to the level of consumer debt compared to disposable income and is used in economic analysis and by policymakers.

What are the types of Leverage Ratio?

There are several different leverage ratios that may be considered by market analysts, investors, or lenders. Some accounts that are considered to have significant comparability to debt are total assets, total equity, operating expenses, and incomes.

Below are 5 of the most commonly used leverage ratios:

1. Debt-to-Assets Ratio = Total Debt / Total Assets
2. Debt-to-Equity Ratio = Total Debt / Total Equity
3. Debt-to-Capital Ratio = Today Debt / (Total Debt + Total Equity)
4. Debt-to-EBITDA Ratio = Total Debt / Earnings Before Interest Taxes Depreciation & Amortization (EBITDA)
5. Asset-to-Equity Ratio = Total Assets / Total Equity.

Relevant questions about Leverage Ratio

What is the ideal Leverage Ratio?

A figure of 0.5 or less is ideal. In other words, no more than half of the company's assets should be financed by debt. In other words, a debt ratio of 0.5 will necessarily mean a debt-to-equity ratio of 1. In both cases, a lower number indicates a company is less dependent on borrowing for its operations.

Why is a high Leverage Ratio considered less than ideal for businesses?

A high leverage ratio indicates a company, bank, home or other institution is largely financed by debt. A high leverage ratio also increases the risk of insolvency. In other words, it becomes more difficult to meet financial obligations when a highly-levered company's assets suddenly drop in value.