

DEPT-TO-ASSET RATIO

The Liabilities to Assets ratio shows the percentage of a company's assets that are financed through liabilities, such as loans or creditors. This reflects the extent to which the company relies on external financing to support its operations and investments.

This ratio helps to gain a deeper understanding of the company's capital structure by showing how much of the assets are owned by creditors rather than shareholders. It is an important measure for assessing the financial risk the company is taking on.

$$\text{Debt-to-Asset Ratio} = \frac{\text{Liabilities}}{\text{Assets}}$$

1. How to Calculate the Debt-to-Asset Ratio

To determine the debt-to-asset ratio, a company must first identify the total liabilities, which include:

- Current Liabilities: Shorty-term obligations due within 12 months, such as accounts payable and short-term debt.
- Long-term Liabilities: Debts due beyond one year, like mortgages or long-term loans, excluding the current portion.

To compute the ratio, these total liabilities are divided by the company's total assets which include:

- Current assets: Assets that are expected to be realized or economically utilized within the next 12 months, such as cash, trade receivables and inventories.
- Non-current assets: Assets that are not intended for immediate liquidation and remain in the enterprise for an extended period, such as fixed assets, long-term investments and intangible assets.

This calculation reflects the proportion of a company's resources that are funded through dept rather than equity.

EXAMPLE:

$$\text{Debt-to-Asset Ratio} = \frac{\text{Company's total liabilities (Current liabilities + long-term liabilities)}}{\text{Company's total assets (Current assets + long-term assets)}}$$

Here is the calculation:

YEAR 1:

$$\text{Debt-to-Asset Ratio} = \frac{\text{Liabilities}}{\text{Assets}} = \frac{3.500.000\text{€}}{7.000.000\text{€}} = \mathbf{0.50}$$

YEAR 2:

$$\text{Debt-to-Asset Ratio} = \frac{\text{Liabilities}}{\text{Assets}} = \frac{4.200.000\text{€}}{700.000\text{€}} = \mathbf{0.60}$$

2. How to interpret the Debt to Asset Ratio

It shows how much of a company's assets are financed by debt. A percentage above 1 means that the company owes more than it has.

High debt ratios indicate high financial leverage, which can support growth but also increases financial risk, especially in times of economic distress. The use of debt can be beneficial, but it must be managed carefully.

Lenders may charge higher interest rates or refuse to lend to companies with high borrowing rates because of the increased risk. This negatively affects the company's liquidity and profitability.

3. What is a Good or Bad Ratio?

A "good" ratio depends on the industry, company size and business model.

For example:

- Capital-intensive sectors may operate higher ratios (0.5-0.7)
- Service-based firms usually have lower ratios (0.2-0.4)

4. How Can a Company Improve its Ratio?

To reduce the debt-to-asset ratio, a company can:

- Pay down debt, starting with high-interest loans.
- Grow its asset base, particularly by reinvesting profits into productive or appreciating assets.
- Avoid unnecessary borrowing unless it adds long-term value.