HOW TO GET THE MOST VALUE FROM RMA'S ANNUAL STATEMENT STUDIES®:
UNDERSTANDING LEVERAGE RATIOS

PART 3 IN A SERIES OF 7 GUIDES
RMA’s Annual Statement Studies: Financial Ratio Benchmarks features 19 of the most widely used ratios in the financial services industry, including various types of liquidity, coverage, leverage, and operating ratios.

On each data page of the Financial Ratio Benchmarks book, below the common size balance sheet and income statement information, you will find a series of ratios computed from the financial statement data.

The information in this document will explain leverage ratios and how to calculate related ratios.

LEVERAGE RATIOS

How much protection do a company’s assets provide for the debt held by its creditors? Highly leveraged firms are companies with heavy debt in relation to their net worth. These firms are more vulnerable to business downturns than those with lower debt-to-worth positions. While leverage ratios help measure this vulnerability, keep in mind that these ratios vary greatly depending on the requirements of particular industry groups.
1. FIXED/WORTH

<table>
<thead>
<tr>
<th>HOW TO CALCULATE:</th>
<th>Divide fixed assets (net of accumulated depreciation) by tangible net worth (net worth minus intangibles).</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Fixed Assets</td>
</tr>
<tr>
<td></td>
<td>Tangible Net Worth</td>
</tr>
<tr>
<td>HOW TO INTERPRET:</td>
<td>This ratio measures the extent to which owner’s equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of a substantial number of fixed assets that are leased—and not appearing on the balance sheet—may result in a deceptively lower ratio.</td>
</tr>
<tr>
<td></td>
<td>Fixed assets may be zero, in which case the quotient is zero. If tangible net worth is zero, the quotient is undefined (UND). If tangible net worth is negative, the quotient is negative.</td>
</tr>
</tbody>
</table>

Note:
Like the sales/working capital ratio discussed above, this fixed/worth ratio is a nonlinear array. In other words, it is an array that is NOT ordered from highest positive to highest negative as a linear array would be. The ratio values are arrayed from the lowest positive to the highest positive, to undefined (UND), and then from the highest negative to the lowest negative.

If the Fixed/Worth ratio is positive, then the top quartile would be represented by the lowest positive ratio. However, if the ratio is negative, the top quartile will be represented by the highest negative ratio! In a nonlinear array such as this, the median could be either positive or negative because it is whatever the middle value is in the particular array of numbers.
**2. DEBT/WORTH**

<table>
<thead>
<tr>
<th>HOW TO CALCULATE:</th>
<th>Divide total liabilities by tangible net worth.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Liabilities ___________________________</td>
</tr>
<tr>
<td></td>
<td>Tangible Net Worth __________________________</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>HOW TO INTERPRET:</th>
<th>This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. Basically, it shows how much protection the owners are providing creditors. The higher the ratio, the greater the risk being assumed by creditors. A lower ratio generally indicates greater long-term financial safety. Unlike a highly leveraged firm, a firm with a low debt/worth ratio usually has greater flexibility to borrow in the future.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tangible net worth may be zero, in which case the ratio is undefined (UND). Tangible net worth may also be negative, which results in the quotient being negative. The ratio values are arrayed from the lowest to highest positive, to undefined, and then from the highest to lowest negative.</td>
</tr>
</tbody>
</table>

**Note:**
Like the sales/working capital ratio discussed above, this debt/worth ratio is a nonlinear array. In other words, it is an array that is NOT ordered from highest positive to highest negative as a linear array would be. The ratio values are arrayed from the lowest positive to the highest positive, to undefined (UND), and then from the highest negative to the lowest negative.

If the debt/worth ratio is positive, then the top quartile would be represented by the *lowest positive* ratio. However, if the ratio is negative, the top quartile will be represented by the *highest negative* ratio! In a nonlinear array such as this, the median could be either positive or negative because it is whatever the middle value is in the particular array of numbers.
How to Get the Most Value from RMA’s Annual Statement Studies*: Understanding Leverage Ratios
(#3 in a series of 7 Guides)

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The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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