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by Daniel A. Lasman and Roman L. Weil

Adjusting the Debt-Equity Ratio

► Debt-equity ratios prepared using traditional (GAAP) accounting numbers can mislead unwary analysts. In many cases, the necessary adjustments will result in substantially reduced debt-equity ratios. LIFO balance sheets, for example, often show inventories based on prices that, in today's inflationary environment, are far below current market. Marketable securities are often carried at values below current market and, although there are exceptions, the current value of plant usually exceeds the balance sheet cost. Finally, the reserve for deferred taxes usually includes differences between reported and taxable income that will never reverse.

On the other hand, the necessary adjustments to leases, pensions and unconsolidated subsidiaries may increase debt-equity ratios. Up to now, many leases with all the characteristics of debt have not been recognized as such on the balance sheet; their recognition will increase debt without affecting equity. Because they constitute an interest-bearing liability of the corporation, unfunded pension benefits also belong on the balance sheet—albeit with an offsetting adjustment for taxes. And the effect on the parent's debt-equity ratio of consolidating subsidiaries' debt is clearly unfavorable.

The authors demonstrate the effect of the individual adjustments on the debt-equity ratios of Penney's, Sears, G.M., Zenith and Kodak, and present adjusted debt-equity ratios for all 30 Dow Jones Industrials. ►

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ANALYSTS use financial ratios to assess a firm's profitability, liquidity and solvency. For purposes of determining profitability, the analyst generally relates items in the income statement to other items in the income statement (for example, net income to sales) or to items in the balance sheet (net income to owners' equity). In determining liquidity, he will generally relate current assets (or some portion of them, such as quick assets) to current liabilities. In assessing solvency, he will generally look at various coverage ratios and at the debt-equity ratio.

Unfortunately, the analyst who constructs his financial ratios from financial statement figures prepared in accordance with generally accepted accounting principles (GAAP) may be misled. Although the reader is probably familiar with at least some of GAAP's misrepresentations, he may never have stopped to consider their combined impact. Comparing debt-equity ratios computed from GAAP inventory, leases, pensions, deferred taxes and unconsolidated subsidiaries with debt-equity ratios based on more realistic accounting treatments shows that this impact can be large.

The Debt-Equity Ratio

We concentrate on the debt-equity ratio because it highlights the impact of various accounting treatments without complicating the issues. The debt-equity ratio is debt divided by equity. There are, however, almost as many definitions of this ratio as there are analysts who compute it. The numerator of the debt-equity ratio can include all liabilities, all but current liabilities, or only long-term, interest-bearing debt; a given company's debt may be reduced to the extent that the company holds debt of other companies or of the government.[1] The analyst must decide whether to include deferred taxes (to be discussed later) and minority interest. The numerator of the conventional debt-equity ratio used in this article consists of long-term debt including capitalized leases, but excludes current liabilities,

1. Footnotes appear at end of article.

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