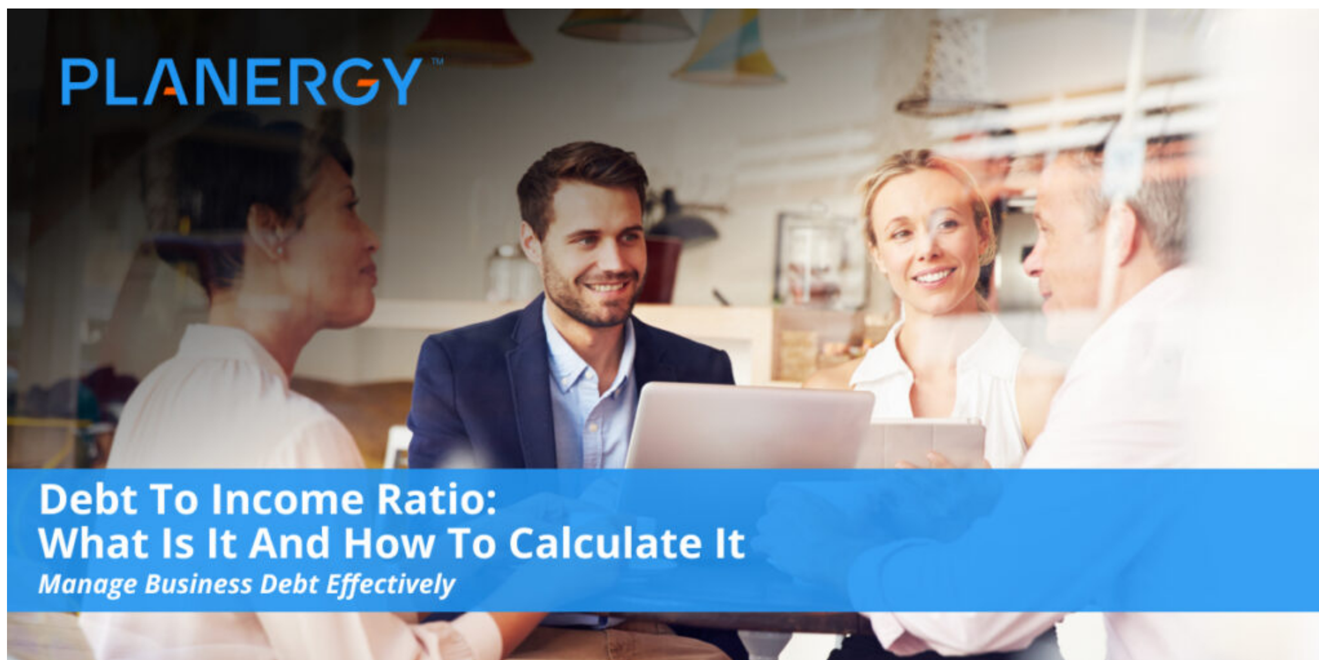
Debt To Income Ratio: What Is It and How To Calculate It



Running a small business requires owners to wear many hats. While it's a good idea to use an accountant or CPA to assist with important matters, business owners would be well served to learn how to calculate accounting ratios.

Accounting ratios are a series of calculations that can help accounting managers, CFOs, and business owners measure business efficiency and profitability.

In most cases, these metrics are easy to calculate and provide valuable insight for business owners, potential and current investors, and financial institutions.

One ratio that is of particular interest to financial institutions is the debt-to-income ratio.

Along with your credit score, the debt-to-income ratio is used to view current debt levels, and determine your potential eligibility for a specific type of loan.

What is the Debt-to-Income Ratio?

The debt-to-income ratio or DTI looks at all of your current debt along with your total monthly income.

DTI is always expressed as a percentage and helps potential lenders see how well you're currently managing your debt, as well as let them know whether as a borrower, you're in a position to add more debt.

A lower debt-to-income ratio is always better than a higher DTI.

For example, if your debt-to-income ratio is 20%, that means that 20% of your gross income is used to repay your debt.

But if your debt-to-income ratio is 50%, that means that half of your current gross income is being used to repay debt. A potential lender will look favorably at a business with a DTI of 20%, while it will likely decline an application from a business with a 50% DTI.

The debt-to-income ratio is more frequently used in small businesses, while more established businesses use the Debt Service Coverage Ratio, which is used to better analyze company income compared to current debt obligations.

How to calculate your debt-to-income ratio

The formula for calculating your DTI ratio is simple. But first, you'll need to calculate both your total monthly recurring debt payments, and then calculate the total gross income for your business.

Recurring Monthly Debt Payments

Your recurring debt payments are payments made each month for current debts. These debts can include the following monthly bills:

Mortgage payment	$2,000
Line of credit	$2,500
Minimum credit card payments	$1,000
Property taxes	$ 200
Vehicle loans	$ 475
Equipment leases	$2,500

Total Monthly Recurring Debt Payments	$8,675

When calculating your recurring debt payment total, do not include standard operating expenses such as advertising, utilities, or postage.

If your business is very small or operates out of your home, a lender may also factor in expenses such as personal loans, car payments, credit card debt, child support, and even student loan payments.

Gross Monthly Income

Gross monthly income is the total revenue your business earns in one month minus your cost of goods sold (COGS). Cost of goods sold includes all expenses related to producing your products or services including the following:

- Material cost
- Labor costs
- Shipping costs

Once you subtract your total cost of goods sold from your monthly sales income, you'll have your monthly gross income. You can then calculate gross profit.

For example, if your cost of goods sold for the month of June was $18,000 and your monthly sales revenue was $55,000 you would calculate your gross profit as follows:

$55,000 – $18,000 = $37,000

Now that you've calculated your total monthly debt payments and your gross income, you're ready to calculate your debt-to-income ratio. The formula for calculating DTI is simple:

Total recurring debt payment / total gross income = debt-to-income ratio

Let's calculate the debt-to-income ratio using the totals from the examples above:

$8,675 / $37,000 = 0.23

This means that the business above has a debt-to-income ratio of .23 or 23%

If you're applying for a loan or other line of credit, your lender will look at your current DTI and then add in the potential loan amount to see what the new ratio is.

For example, the business above has a current DTI of 23%, with monthly recurring expenses of $8,675. They apply for a new line of credit with a monthly payment of $250.00. You would add the $250 to the $8,675 to determine the new recurring debt payment amount.

$8,675 + $250 = $8,925

They can then complete the DTI calculation as follows:

$8,925 / $37,000 = 0.24 or 24%

The new debt only adds an additional point to the debt-to-income ratio, so it's likely that the application would be approved.

> *A DTI of 35% or less is considered good, with a greater chance that your loan application will be approved. A DTI of 50% or higher, it's unlikely that you'll be qualifying for a loan.*

What is a good debt-to-income ratio?

Though requirements vary from lender to lender, in general terms, a DTI ratio of 36% or less is considered acceptable, though some lenders may go to 40%, while others prefer a more conservative 30%.

These are considered the industry benchmarks for the debt-to-income ratio.

Ratio Amount	Results Detail
Less than 36%	A DTI of 35% or less is considered good, with a greater chance that your loan application will be approved.
36% – 49%	A DTI of between 36% – 49% is in a gray area. Considered decent, many lenders may still approve your application, but the approval rate starts to decrease at this level

50% and higher	If your DTI has reached 50% or higher, it’s unlikely that you’ll be qualifying for a loan. With a high DTI ratio, your best option would be to reduce expenses and apply at a later time.

Of course, these are not hard and fast rules, since lenders vary in their requirements.

There are other things that are also considered when applying for a loan that can impact your acceptance, such as credit history, your current credit score, or whether you’ve done business with the lender before.

Why is the debt-to-income ratio important?

The debt-to-income ratio is important for several reasons.

First, it provides lenders with a good look at your current debt burden, allowing them to quickly determine your ability to qualify for a loan.

But it’s also important to you as a business owner; allowing you to see how much debt your business is currently carrying and whether some of that debt should be reduced or eliminated.

Finally, if you’re considering applying for a loan, calculating your DTI can give you better insight into whether you should apply for a loan or wait until your ratio is better.

What your DTI will not tell you

Calculating your debt-to-income ratio is valuable, but it doesn’t provide the entire picture regarding the financial health of your business.

For example, while the DTI can let you know how much debt you’re carrying in regards to income, it does not:

- Distinguish between different types of debt
- Provide you with the interest rate that your loans carry
- Provide extensive financial information about your business

- Address credit limits or your credit history
- Provide a detailed credit report
- Provide a credit utilization ratio

How to improve a high debt-to-income ratio

Calculating your debt-to-income ratio is a good way to see if your current gross income is sufficient to pay all existing monthly debt payments.

You already know that a lower DTI is better. But what happens if your DTI is at 50% or higher? Luckily, there are ways to lower your DTI, including the following:

- **Increase your revenue.** Increasing revenue will directly impact your DTI. Increasing revenue can be accomplished in a variety of ways that don't have to include raising prices, although that remains an option. You can try offering additional products and services or expanding a product line. For example, if you currently manufacture ceramic pots in one size, you can try adding additional sizes or colors, which won't significantly increase costs, while bringing in additional revenue.
- **Refinance high-interest loans and credit cards.** Refinancing current debt and lowering your interest rates will reduce debt payment obligations, raising your DTI. This can be done by transferring current debt onto a low-interest or interest-free credit card. You may also want to look at debt consolidation if you're able to secure a business loan with a significantly lower interest rate.
- **Pay off current loans faster.** While this is a much longer process than the solutions above, putting more money into paying off current debt can help reduce your debt-to-income ratio over time. This can include doubling up on current payments or paying off loans with smaller balances.
- **Re-examine the cost of goods sold.** Remember, when calculating your DTI, you need to first subtract your cost of goods sold from your sales revenue to arrive at gross income for the month. If your costs are getting out of control, consider switching vendors to lower materials costs. You can also take a look at labor costs, perhaps reigning in overtime costs, or

streamlining production to eliminate unnecessary positions.

Do you know what your debt-to-income ratio is?

Debt-to-income ratio isn't just useful for business owners.

As a consumer, it's always helpful to know what your personal DTI is, particularly if you're in the process of qualifying for a home loan, purchasing a vehicle, or making another large purchase.

DTI guidelines for consumers generally follow those for businesses, though they may be less stringent in some cases.

For example, you can have a DTI of 40% and still qualify for a mortgage loan, although that qualification number will vary from one financial institution to the next, with the mortgage rates likely higher for those with higher monthly debt obligations.

In the U.S., the median income has continued to rise over the last two decades, from an average of $44,000 in 2000 to $79,000 in 2021. And while median income has risen significantly, average debt has risen as well.

Today, Debt.org states that the average American has $90,460 in debt. This includes all kinds of debt, from unsecured debt like credit cards, to auto loans, mortgage loans, and student loans, with those ages 40 to 55 typically carrying more than $140,000 in debt.

Whether you're calculating your debt-to-income ratio for your business or for personal use, understanding what the results mean and actively working to keep your DTI low can mean more financial security.

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