3. Debt KPIs

Introduction to Debt KPIs

The amount that a company owes creditors is called debt. Loans from banks and other lenders are the most common forms of corporate debt. Debt is part of the liability section of a corporate balance sheet and creditors have a claim on the company's debt. As liabilities are obligations of the company, failure to make good on these obligations could result in bankcrupty.[27]

To determine the overall level of financial risk a company and its shareholders are facing debt KPIs can be used. The more debt a company holds, the greater the potential level of financial risk the company could face, including bankruptcy.

Debt is a form of financial leverage and the more levered a company is the greater the level of financial risk. On the other hand, a certain amount of leverage can as well contribute to a company's growth. That is why well-run companies seek an optimal amount of financial leverage for their situation.[28]

This section takes a look at two important short-term debt KPIs. First current ratio and its importance to an SME and its creditors is explained followed by the quick ratio. Finally, some tasks to guide you to calculate the ratios explained are provided. In the end of the section you can find the solutions of the tasks in order to check if you were right.

Debt

KPIs

Current Ratio

Example of calculation of current ratio:[29]

$$\text{Current ratio } (0{,}9) = \frac{\text{Current assets } (\$\ 90)}{\text{Current liabilities } (\$\ 100)}$$

CURRENT

RATIO

Why is it important?

COMPANY	BANK
• The current ratio in the example above is 0.9. • This ratio measures the ability of a company to pay all of its financial obligations in one year. • A current ratio of less than 1 indicates that a company would be unable to meet all of its financial obligations if they came due at the same time. • So in this example the company would not be able to meet all of its financial obligations because the ratio is 0.9.[30]	• For a bank it is very important that a company has enough current assets to be able to pay back its current liabilities, like short-term debt. • Through this ratio the bank can understand the solvency of the business by weighting current assets against current liabilities. • If this is not the case like in this example the company will not maintain a positive credit rating which is important for financing growth and expansion.[31]

How can a company improve the current ratio?

- Delaying any purchases of capital goods that would require any cash payments.
- Looking to see if any term loans can be re-amortized.
- Reducing personal drawings on the business.
- Selling any capital assets that are not generating a return to the business (and use the proceed to reduce current debt).[32]

Quick/ Acid ratio

Example of calculation of quick ratio:[33]

$$\text{Quick ratio (1,5)} = \frac{\text{Current assets (\$ 30)} - \text{Inventories (\$ 15)}}{\text{Current liabilities (\$ 10)}}$$

QUICK

RATIO

Why is it important?

COMPANY	BANK
• The quick ratio in the example above is 1.5. • It measures the company's ability to meet its short-term obligations with its most liquid assets, in other words: the dollar amount of liquid assets available for each dollar of current liabilities. • For this reason the ratio excludes inventories from current assets. • The point is that liquidating inventory is not practical for long-term business viability.[34]	• Solid quick ratios (>1) show that a company has the ability to keep up with short-term debt obligations. • This is important for creditors and investors because it means the company is at a lower risk of being overwhelmed by debt in future. • If this is the case the bank might be inclined to give loans with favorable terms.[35]

How can a company improve the quick ratio?

- By faster conversion of inventory into debtors and cash, the current assets would increase resulting in an improvement in the quick ratio.
- If the company has any unproductive assets, it is better to sell them and have improved liquidity. Reduction of such assets would result in better cash position and therefore improvement in the numerator of quick ratio.
- Current liabilities which form a part of the denominator of the quick ratio are to be reduced in order to have the better current ratio. This can be done by paying off creditors faster or faster payment of loans.[36]

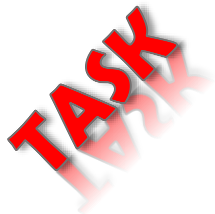
Task

Assume you are given the following information on a company:

Current assets	$ 8000
Current liabilities	$ 5000
Inventories	$ 4000

Feel free to solve the following questions in order to practice the contents of debt key performance indicators:

1) Calculate the current ratio.
2) How could a company improve the current ratio?
3) Calculate the quick ratio.
4) How could a company improve the quick ratio?



Solution

1)

$$\textbf{Current ratio } (\mathbf{1.6}) = \frac{\text{Current assets } (\$\,8000)}{\text{Current liabilities } (\$\,5000)}$$

2) Delay any purchases of capital goods that would require any cash payments, explore how term loans can be re-amortized, reduce personal drawings on the business, selling any capital assets that are not generating a return to the business (use cash to reduce current debt)

3)

$$\textbf{Quick ratio } (\mathbf{0.8}) = \frac{\text{Current assets } (\$\,8000) - \text{Inventories } (\$\,4000)}{\text{Current liabilities } (\$\,5000)}$$

4) Convert inventories into debtors and cash faster, sell unproductive assets, pay off creditors faster.

SOLUTION