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What is solvency ratio?

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WHAT DOES IT MEAN?

Solvency ratio is an important metric to assess a firm's ability to pay off its debt in the long run. There are two types: debt-solvency ratios and coverage-solvency ratios.

Debt-solvency ratios can be obtained from the items in the balance sheet while coverage-solvency ratios can be obtained from those in the income statement.

Debt-solvency ratios include debt-to-equity, debt-to-assets, total assets-to-equity, and long-term debt-to-total capitalisation. Total capitalisation is defined as the sum of long-term debt and equity.

Coverage-solvency ratios include times interest earned (which is defined as earnings before interest and taxes, or Ebit, divided by interest expense) and cash coverage (which is defined as the sum of Ebit and depreciation divided by interest expense).

The most commonly used debt-solvency ratio is the long-term debt-to-total capitalisation. The most widely used coverage-solvency ratio is times interest earned.

WHY IS IT IMPORTANT?

To get a better picture of a firm's ability to pay its debtors, investors should look at both types of solvency ratios.

For example, a higher times interest earned ratio and a lower long-term debt-to-total capitalisation ratio represents better credit-worthiness of a firm.

Solvency ratios can vary significantly across different industries. Hence, it is better to compare one firm's solvency ratio with other firms' in the same industry.

It is also important to note that solvency ratios do not necessarily capture a complete picture of a firm's credit risk.

For example, if the firm has poor cash management practices, it may still face difficulty paying the debt obligations when they are due.

IF YOU WANT TO USE THE TERM, JUST SAY:

"Solvency ratio is one of the commonly used metrics to assess a firm's ability to pay off its debt obligations in the long term."

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