From the book:

Cash Flow Lending – Principles Based on Sustainable Cycles

Enhanced Ratio Analysis
Liquidity & Debt Repayment

The discovery of the Current Portion of Fixed Assets (CPFA) revolutionizes the calculation of liquidity and debt repayment. CPFA is the "**missing piece in liquidity calculations**." [1]

Following is a brief explanation of the ratios appearing in the table on the next page. The table is taken from Figure 4.1 and is fully described in Chapter 4 of the book.

1. New ***primary coverage ratios*** measure the liquidity and sustainability of each balance sheet cycle (page 22), matching the natural source of cash from assets in the cycle to the liabilities of the cycle.

If either of the primary coverage ratios indicates weakness—very tight or a deficient in cash flow coverage—the next step is to consider if other cycles are strong enough to contribute cash flow to the deficient cycle.

2. ***New (inclusive) current ratio:*** Combining the two primary coverage ratios produces a *new* Current Ratio that measures *all* assets to be used in the current period (trading assets plus the *current* portion of fixed assets) in generating revenue, cash flow, to repay *all* debt due in the current period. Combining the two asset cycles yields the second, more inclusive tier of liquidity. (page 26; Two tiers page 27).

Imbalance between the cycles can cause cash flow problems but restructuring the debt may be an easy solution (Chapter 6).

Net profit should not be needed for debt repayment; it should be used to finance *growth* (Chapter 5: recycling vs. growth cash flows; Chapter 7 financing growth). Nevertheless, if the current ratio is weak, investment in growth can be delayed and net profit can be used as a supplemental source of cash to cover debt payments.

3. The new ***comprehensive coverage ratio*** is the logical result of adding net profit to the current ratio.

4. ***Net Profit –*** has traditionally been added to the long-term debt ratio (DSCR) but alternatively can provide supplementary cash flow to the trading cycle (page 54).

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[1] *The Missing Piece in Liquidity Calculations – Why calculating the "current portion of fixed assets" would provide a more accurate picture of financial health*
The Journal of Accountancy April 2012 Available at www.sme-lending.com

Enhanced Liquidity & Repayment Ratios

From the book: Cash Flow Lending – Principles Based on Sustainable Cycles

PRIMARY COVERAGE RATIOS – first tier liquidity

Trading Cycle:

TRADING RATIO = Trading Assets / Trading Liabilities

Fixed Asset Cycle:

PRIMARY DEBT SERVICE COVERAGE RATIO (PDSCR)

= CPFA / CPLTD (or = depreciation / CPLTD)*

**** CPFA*** *= Current Portion of Fixed Assets =* <u>*next*</u> *year's depreciation expense.*
Until CPFA is reported, substitute Depreciation Expense from last year's income statement.

Trading Assets *= old definition of Current Assets which excludes CPFA;*
Trading Liabilities *= Current Liabilities minus CPLTD (Current Portion of Long-term Debt).*

NEW CURRENT RATIO – second tier liquidity

Combined Trading & Fixed Asset Cycles:

(new) Current Ratio = (new) Current Assets / Current Liabilities
= Trading Assets + CPFA* / Current Liabilities

(new) Working Capital = (new) Current Assets - Current Liabilities
= Trading Assets + CPFA* - Current Liabilities

New Current Assets *= include trading assets and CPFA*
Current Liabilities *does not change; already includes trading liabilities and CPLTD.*

COMPREHENSIVE COVERAGE RATIO

$$\frac{\text{Trading Assets + CPFA + (Net Profit – Dividends)}}{\text{Trading Liabilities + CPLTD}}$$

PRIMARY COVERAGE *plus* NET PROFIT

Trading Cycle:

$$\frac{\text{Trading Assets + (Net Profit – Dividends)}}{\text{Trading Liabilities}}$$

Fixed Asset Cycle: **Debt Service Coverage Ratio** =

$$\frac{\text{CPFA* + (Net Profit – Dividends)}}{\text{CPLTD}}$$

This new DSCR with CPFA is superior; however until CPFA is reported, substituting Depreciation Expense yields the old DSCR.