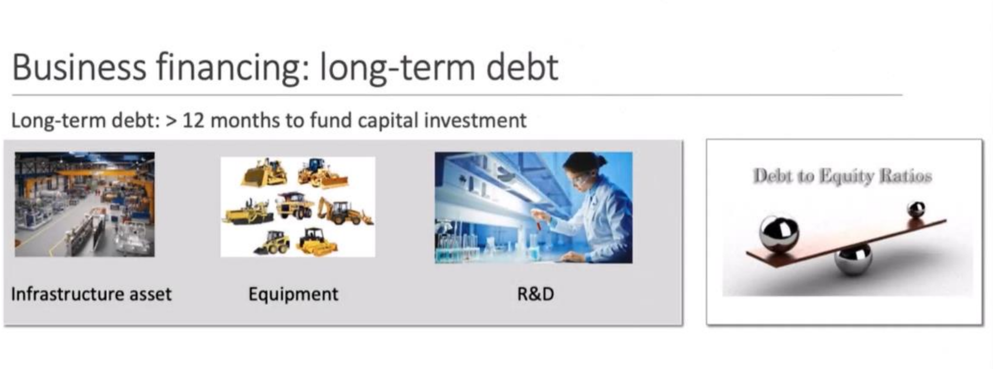
M7L4. Long-term & Short-term Debt

Slide #1

In this topic, we will discuss long-term and short-term debt.

Slide #2



What is long-term debt? Long-term debt consists of loans and financial obligations lasting over one year. It is also called long term liabilities on a firm's financial statement.

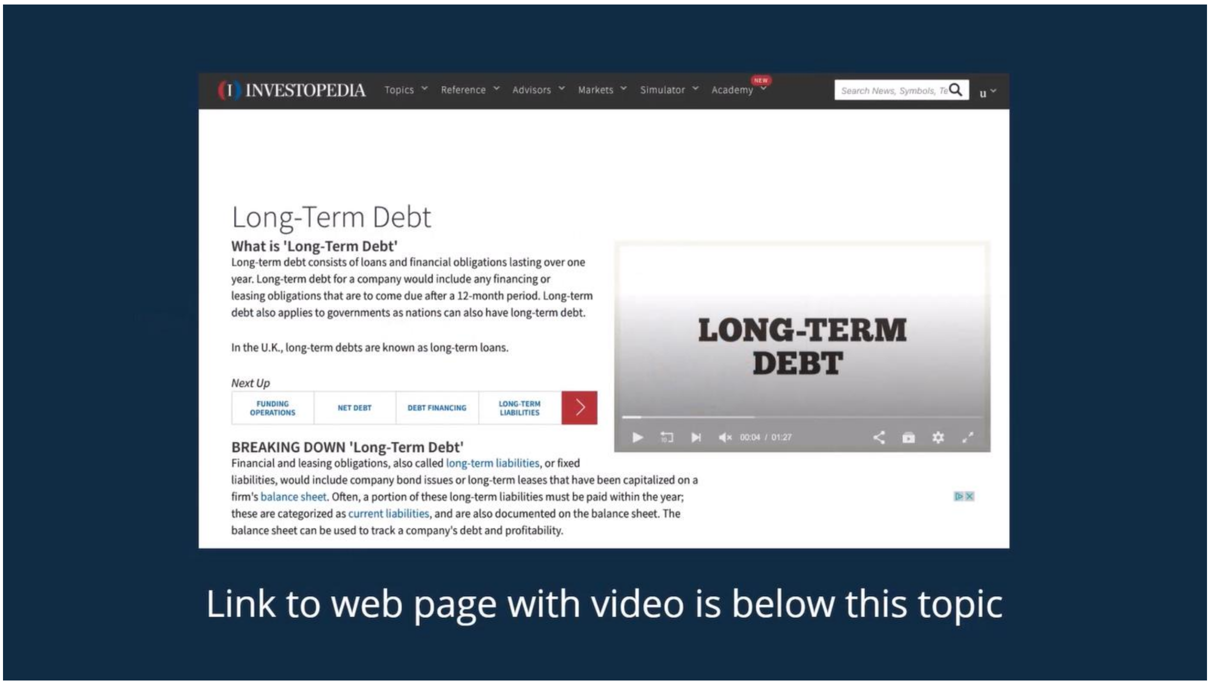
Companies take on long term debt in order to acquire capital.For instance, a company may take out a long-term loan to purchase infrastructure asset, procure major equipment, or invest in research and development.

Since debt sums tend to be large, these loans take many months or even years to pay off. Companies with too much long-term debt will find it hard to pay off this debt and continue to thrive, since most of their capital is devoted to interest payments, making it difficult to allocate the money to other areas.

A company can determine whether it has accrued too much long-term debt by examining its debt-to-equity ratio.

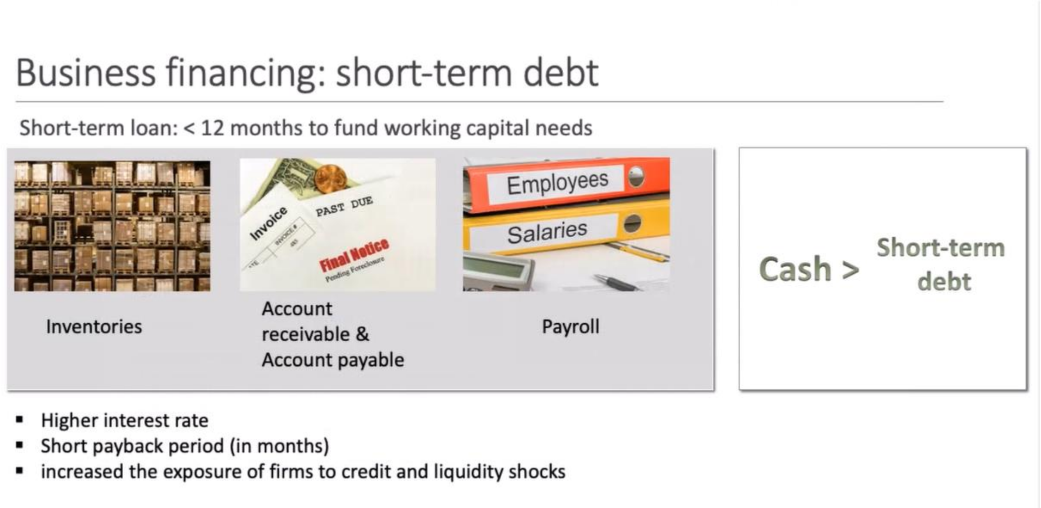
If the ratio is too high, the company is at risk of financial difficulties as it has to spend too much cash on interest payment. You will learn this from the optimization case.

Slide #3



Please watch the video clip to know more about long-term debt.

Slide #4



Short-term debt usually refers to short term bank loans due within some months.

Typically, the interest rate of short-term debt is higher than that of long term debt.

The short-term debt is registered in the current liabilities in a company's financial statement.

Companies take-out short-term loans from banks to finance operations activities, such as purchase raw materials, maintain inventories, manage account receivables and account payables, as well as fund employees payroll.

The total amount of long-term debt account is very important when determining a company's performance.

If the account is larger than the company's cash and the cash equivalents, this suggests that the company may be in poor financial health and does not have enough cash to pay off its short-term debts.

So a company must carefully manage its short term debt to avoid being unable to pay the principal of the short term debt.