When Is Debt Good for Business?

Want to make a small business owner cringe? Try uttering the word "debt" around them. That's because debt has become widely associated with negativity and out of control spending. But debt isn't always a red flag in business. In fact, it can actually be good for a growing business to take on debt. Read on to learn more about when you should be taking on debt and how to draw the line between "good debt" and "bad debt."

Understanding Your Debt Ratio

This simple calculation can help you measure where your business stands in terms of debt. The debt to equity ratio is simple: Money financed for company operations ÷ total available capital = debt ratio

Ex: ($50 million financed) ÷ $200 million total capital = 25% debt ratio

In essence, the higher your debt ratio, the more your business relies on borrowed funds.

Good Debt

Taking on debt can be an important growth factor for many small businesses. However, it's important to be smart about when and how much debt to take on. If your business has the capital/assets to cover your expenses, but financing will get you a better rate of return, then taking on debt is a smart move. It's also important to keep your debt ratio in mind. While every business is different, it is generally recommended to maintain a debt ratio of less than 1 to prevent instability and maintain financial control over your business.

Bad Debt

Taking on too much debt (i.e., debt ratio greater than 1) can mean financial turmoil for many businesses and can also appear extremely risky to investors. While it can work to the advantage of some businesses where interest rates act as tax write-offs, it is recommended to keep your debt ratio below 1 to prevent overspending and a heavy reliance on borrowed funds.

When to Take on Debt

These financial tips are a great way to get you started thinking about debt. However, every business is different. For a customized assessment of your business, it's best to see a professional consultant who can review your business's financial situation and help you understand how debt will best work for you and your business.