



The Dividing Line between the Liquidity and Gearing of an Entity

F.K. Musweu¹

¹Business Studies Division, National Institute of Public Administration.

Abstract

In financial management the essential aim of both the liquidity and gearing of an entity is its ability to meet its financial obligations, although according to the interpretation of final accounts the liquidity of the company is separate performance from the gearing of the company. This focus of this paper is to establish the difference between the liquidity of the company and the gearing of the company and the title of the paper is “The dividing line between the liquidity and gearing of an Entity”. The information in article is entirely collected through secondary research due to the specialized nature of the study, specifically from scholarly articles accounting and finance, various text books in accounting and finance and journals from professional bodies.

Keywords: Liquidity, Current Ratio, Quick Ratio, Gearing, The Total Gearing Ratio, The Debt to Equity Ratio, Interest Coverage Ratio, Interest Payments, Capital structure, Financial Risk.

Introduction

This article details the dividing line between the liquidity and gearing of an entity and it initially discusses the term liquidity and gearing of an entity specifically focusing on the types of ratios that are used in determining the liquidity and gearing of an entity. Finally the article concludes by discussing the disparities between the liquidity and gearing of an entity.

Liquidity

The liquidity of an entity is measured through liquidity ratios. Liquidity ratios analyze the ability of an entity to pay off its obligations that fall due within an accounting period from the assets it expects to convert into cash within an accounting period. A standard accounting period most entities follow is usually one year.

The concern of the entity is its ability to easily convert current assets into cash to meet short term obligation. Difficulties in meeting or paying off short term obligations possess to be a major liquidity challenge for the entity. Examples of the current assets being referred to are accounts receivable, trading securities, inventory as well as cash. The short term obligations are referred to

current liabilities and the examples typically includes accounts payable, accrued expenses and taxes and other trade debt. Thus, all of these current assets and current liabilities go into the liquidity calculation of an entity.

Below are the most common liquidity ratios.

- Current Ratio
- Quick Ratio or Acid Test Ratio

Current Ratio

The current ratio also referred to as the working capital ratio, measures the entity's ability to pay liabilities due within one year from assets that it expects to convert into cash within one year. The assumption of the current ratio is that all current assets, if required, can immediately be converted to cash for the purpose of meeting all current liabilities immediately. A ratio of less than one (1) is often a cause of concern, particularly if it persists for any length of time "BPP Learning Media, 2007, Page 327". Although nowadays, it is not easy to prescribe an ideal current ratio due to technological advancements in inventory management aimed at reducing the value of inventory on many statements of financial position. In addition to the aggressive financial management strategies adopted particularly by huge corporation that result in higher levels of accounts payables, and a tightening grip on accounts receivables. Thus it is vital to look at the trend for an individual corporation, and to compare companies within the same industry segment.

Formula

The current ratio is computed by dividing current assets by current liabilities. It is stated in below:

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current Liabilities}}$$

Quick Ratio

The quick ratio also referred to as the acid test ratio is a liquidity ratio that assesses the entity's ability to pay obligations that fall due within one accounting period from quick assets. In computing the acid test ratio inventory is deducted from current assets. The inventory deducted includes finished goods, work in progress and raw materials if any. This is cautious approach that recognizes that stock is not always readily converted into cash at full value and it may take considerable amount of time for the conversion to be complete.

The emphasis of the acid test ratio is to show an entity can quickly convert its quick assets into cash in order to pay off its current liabilities i.e. it shows the level of quick assets to current liabilities.

Formula

$$\text{Quick Ratio or Acid Test Ratio} = \frac{\text{Current assets} - \text{stock}}{\text{Current Liabilities}}$$

Research indicates that levels of liquidity are of paramount importance in financial institutions as they depend upon borrowed money to a considerable extent thus they frequently need to be assessing their ability to repay back the borrowed “F.K. Musweu, 2021, Page 4”.

Gearing

The gearing of the company is measured through gearing ratios. This relates to an organisation’s ability to meet its long-term debts. The aim gearing ratios is to compare the capital invested in terms of borrowed funds to the capital invested in terms of shareholder’s funds or capital employed depending on the gearing ratio that is being computed. If it is the total gearing ratio we are using then the level of debt is compared to capital employed that is total assets less current liabilities. If it is the debt to equity ratio being used the level of debt is compared to the shareholder’s funds that is share capital plus reserves. “F.K.Musweu, 2019, Page 2”.

Here are the most common gearing ratios covering brief explanations about them and there formulas.

The Total Gearing Ratio

The debt equity ratio is the gearing shows the proportions of borrowed capital used to finance the business and capital employed.

$$\text{The total gearing ratio} = \frac{\text{Long term liabilities} + \text{Preference share capital} \times 100}{\text{Capital employed}}$$

The Debt to Equity Ratio

The debt equity ratio is the gearing shows the proportions of borrowed capital used to finance the business and the shareholder’s funds.

$$\text{Debt to Equity ratio} = \frac{\text{long term Liabilities} + \text{Preference Share Capital} \times 100}{\text{Equity (Ordinary share capital) + Reserves}}$$

It is worth noting that when calculating the financial leverage or gearing ratios preference share capital is treated the same way as debt implying that preference share capital is added to debt to represent the gearing of the company which is a numerator in debt ratio calculation.

Interest Coverage Ratio

Interest coverage ratio is the type of gearing ratio that assesses the entity’s cost long term liabilities to its profits. The focus is to determine the number of times the profit before interest and tax exceeds its interest payments and other related obligations. The higher ratio is desirable as it is an indication that the entity is in a better position to meet its interest payments. It is in this

manner interest coverage ratio assesses whether the company can afford commitments of level of gearing or not.

$$\text{Interest coverage ratio} = \frac{\text{Income (or Profit) before Interest and tax (EBIT or PBIT)}}{\text{Interest expense}}$$

Is a Higher Level of Gearing Ideal?

Financial managers face dilemma as to the desirable levels of gearing in an entity. Several entities require debt to fund their growth, attributed to the fact that equity as a form of funding is rarely sufficient to fund their growth. According to research in financial management higher levels of gearing are ideal if they signal positive cashflows in the future. On the other hand, the introduction of debt and gearing increases the financial risk in an entity. Financial risk is the risk that the entity may be unable to honour interest payments and other obligations in the future. It is a well-known fact the debt repayments are an obligation by the borrower and are not negotiable by law. Accordingly the debt repayments can be a burden if the borrower is not generating cashflows sufficient enough to honour the debt repayments “F.K. Musweu, 2018, Page 2”

Thus levels of levels of gearing differ significantly from one industry to another for instance an entity that need huge investment in tangible assets will usually be highly geared. Generalisations as to the ideal levels of gearing will be difficult.

Conclusion

Having discussed the terms liquidity and gearing and how they are determine we now focus on the disparities between the liquidity and gearing of an entity after confirming in our abstract that the essential similarities between the two is that they all focus on the entity’s ability to meet its financial obligations. The first disparity is that gearing focuses on the capital structure of the business that means the proportion of funding that is provided by debt relative to the funding provided by the shareholder’s funds or equity which is not the case with the liquidity of an entity. The other essential difference is in the time frame gearing focuses on the long-term financial stability of an entity i.e. the shareholder’s funds or capital employed is sufficient enough to pay off debt and other obligations such as interest on the loans. In other words it is liquidity in long term such that such experts in accounting and finance use the term Long term liquidity to refer to the gearing of an entity. On the other hand liquidity of entity focuses on an entity’s ability of the company to meet its short-term financial commitments such that some experts in accounting and finance use the term Short-term liquidity to refer to the liquidity of an entity. Finally having a longer time frame the risks and rewards associated with the gearing of an entity are higher those associated with liquidity of an entity.

References

- BPP Learning Media (2007) ZICA Textbook Financial Accounting Paper T1.
- BPP Learning media Ltd (2007) ACCA Paper F9 Financial management, First edition.
- Colin Firer, Stephen A Ross, Randolph. W. Westerfield & Bradford. D. Jordan (2004) Fundamentals of Corporate Finance, Third Edition.

Frank Wood & Alan Sangster (2005) Business Accounting, Tenth Edition.

Mr. F.K. Musweu “A Study on the Impact of Debt on Cashflows” Published by Eureka Journals-
The Corporate International-Vol. 2, Issue 1.

Shim, Jae K. and Joel G. Siegel (1988). Handbook of Financial Analysis, Forecasting, &
Modeling, Prentice Hall.

Saunders, A. and M.M. Cornett (2007) Financial Institutions Management: a Risk Management
Approach. McGraw-Hill/Irwin.

F.K. Musweu “Implications of Investments in Shares and Debt Instruments” Published by
Eureka Journals- International Journal of Public Finance, Law & Taxation Vol. 2, Issue
1-2018- ISSN: 2581-3420.

Pilbeam, Keith (2006). International Finance, 3rd Edition, Macmillan.

F.K. Musweu, “The Effect of Focusing on Liquidity at the Expense of Efficiency as Performance
Measures of an Entity” Published by Eureka Journals-Constitutionalism and Changing
Dimensions of Fundamental Rights in India.