## Liquidity / Solvency Ratios

### Current ratio / Acid Test

These two ratios focus on whether a business is able to have enough cash available to pay for any bills or expenses.

| | | Good News | Bad News |
|---|---|---|---|
| Current assets £ | | | |
| | Cash in bank | 20,0000 | 5,000 |
| | Debtors | 2,0000 | 3,000 |
| | Stock | 30,0000 | 25,000 |
| Total current assets = | | | |
| Current liabilities | | | |
| | Creditors | 35,0000 | 40,000 |

### Current ratio

= current assets / current liabilities

Value of 1.5 to 2 to 1 is seen as preferable. Below this and a business might not have enough spare money to pay for bills and any unexpected expenses. Above this and the business might not be investing money wisely e.g. too much money might be tied up in stock or cash in bank could be invested to help grow the business.

**Acid test**

= current assets - stock / current liabilities

This takes stock out of the current ratio formula. Why might it not be good to have too much money in stocks?

**Calculate for** Good News Bad News

**Gearing** focuses on the capital structure of the business – that means the proportion of finance that is provided by **debt** relative to the finance provided by **equity (or shareholders).**
The gearing ratio is also concerned with liquidity. However, it focuses on the long-term financial stability of a business.
Gearing (otherwise known as "leverage") measures **the proportion of assets invested in a business that are financed by long-term borrowing**.
In theory, the higher the level of borrowing (gearing) the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends. However, gearing can be a

financially sound part of a business's capital structure particularly if the business has strong, predictable cash flows.

gearing % = long term liabilities
---------------------------------------- x 100
Capital employed

If a business has long term loans of £100,000 and its total capital employed is £300,0000. Its gearing would be?

Long-term liabilities include loans due more than one year + mortgages
Capital employed = Share capital + retained earnings (profits) + long-term liabilities
How can the gearing ratio be evaluated?

- A business with a gearing ratio of more than 50% is traditionally said to be "highly geared".
- A business with gearing of less than 25% is traditionally described as having "low gearing"
- Something between 25% - 50% would be considered normal for a well-established business which is happy to finance its activities using debt.

| | Good News | Bad News |
|---|---|---|
| Long term loans | 25,000 | 50,000 |
| Share capital | 40,000 | 25,000 |
| Retained profits | 10,000 | 5,000 |

| | Good News | Bad News |
|---|---|---|
| Gearing %= | | |

It is important to remember that financing a business through long-term debt is not necessarily a bad thing! Long-term debt is normally cheap, and it reduces the amount that shareholders have to invest in the business.
What is a sensible level of gearing? Much depends on the ability of the business to grow profits and generate positive cash flow to service the debt. A mature business which produces strong and reliable cash flows can handle a much higher level of gearing than a business where the cash flows are unpredictable and uncertain.

A business could reduce its gearing by ? ………...