

70.2 An exercise on interpretation of the gearing ratio

The figures given in question 70.1 are now supplemented with figures from the published accounts of the prior year.

For each company separately, calculate and compare gearing ratios for the current year and the prior year. Comment on any differences you may find, from one year to the next.

A.

A		
	current year	prior year
EQUITY	4 136	3 493
BORROWINGS		
current	1 025	2 839
non-current	14 686	10 287

Response

A		
	current year	prior year
EQUITY	<u>4 136</u>	<u>3 493</u>
BORROWINGS		
current	1 025	2 839
non-current	<u>14 686</u>	<u>10 287</u>
	<u>15 711</u>	<u>13 126</u>
EQUITY+DEBT	<u><u>19 847</u></u>	<u><u>16 619</u></u>
debt:equity	<u>15 711</u> <u>4 136</u>	<u>13 126</u> <u>3 493</u>
	=	=
gearing	<u>3.8</u>	<u>3.8</u>
debt:equity+debt	<u>15 711</u> <u>19 847</u>	<u>13 126</u> <u>16 619</u>
	=	=
gearing	<u>79.2%</u>	<u>79.0%</u>

Although this company has very high gearing, it is remarkably unchanged from prior year to current year, indicating (possibly) successful adherence to a strategically chosen target level of gearing.

B.

B		
	current year	prior year
EQUITY	11 868	10 065
BORROWINGS		
current	3 376	2 984
non-current	4 443	5 092

Response

B		
	current year	prior year
EQUITY	<u>11 868</u>	<u>10 065</u>
BORROWINGS		
current	3 376	2 984
non-current	<u>4 443</u>	<u>5 092</u>
	<u>7 819</u>	<u>8 076</u>
EQUITY+DEBT	<u>19 687</u>	<u>18 141</u>
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debt:equity	<u>7 819</u> <u>11 868</u>	<u>8 076</u> <u>10 065</u>
	=	=
gearing	65.9%	80.2%
<hr/>		
debt:equity+debt	<u>7 819</u> <u>19 687</u>	<u>8 076</u> <u>18 141</u>
	=	=
gearing	39.7%	44.5%

B has reduced its gearing (debt:equity+debt) from nearly 45% to less than 40%. This may be policy – even at nearly 40%, gearing remains rather high for a luxury goods company which (presumably) has comparatively few tangible fixed assets to provide security for loans, and for which demand and revenues cannot be forecast with any high degree of certainty.