

financial risks associated with the company's financial position. Basic financial risk concerns are typically assessed using **solvency** ratios and liquidity ratios.

Solvency refers to the long-term ability to generate cash internally or from external sources in order to meet long-term financial obligations. Solvency ratios mainly focus on the relative size of debt in the financial structure of the company. **Liquidity** refers to the company's ability to generate cash to meet its short-term obligations (essentially working capital needs and immediate debt repayment needs). Liquidity tests focus on the size of, and relationships between current assets and current liability (working capital components). The most common financial strength ratios are shown in Table 9.2.

Table 9.2

Financial
strength
ratios

A. Long-term solvency risk ratios

$$\text{Gearing (Debt/equity ratio)} = \frac{\text{Debt}}{\text{Equity}}$$

This ratio is also frequently computed on the basis of debt to total finance:

$$\text{Gearing (Total finance)} = \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Net interest charges}}$$

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}}$$

B. Short-term liquidity risk ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Acid test (or quick ratio)} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

Days outstanding of working capital components (see below)

The *debt/equity ratio* is the solvency ratio found most frequently in the financial press and reflects the relationship between loan finance and shareholders' funds. Recall that debt financing introduces risk because debt implies fixed commitments in the form of interest payments and principal repayment. Recall that default risk refers to potential failure to satisfy the fixed payments associated with debt which will ultimately result in bankruptcy. A lesser financial risk is that a heavily indebted company will have difficulty to obtain additional debt financing when needed or will have to pay significantly higher interest rates.

A high debt/equity ratio indicates high financial risk because it implies substantial interest charges and an exposure to interest rate movements: if interest rates are rising, this will imply lower profitability in the future. The existence of debt means that ultimately repayment must take place and a glance at the schedule of outstanding debt given in the notes to the accounts will indicate how early this may take place. Most agreements for the provision of long-term finance include stipulations as to the maximum debt/equity ratio the company