ARTICLE 2: MEASURING A COMPANY'S FINANCIAL GEARING

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There are two approaches to measuring a company's level of financial gearing.

1. Debts repayment through liquidation of assets (called capital gearing)
2. Debts repayment through earnings or cash flow (called income gearing)

These two approaches will now be examined separately.

Capital Gearing

There are two approaches to measuring capital gearing:

i. Long-term debt ratio to shareholders funds (share capital plus reserves) and
ii. Long-term debt ratio to Long-term debt plus shareholders funds

Long-term debt ratio to shareholders funds

This measure addresses the issue of the firm's ability to sell assets in order to repay loans, so that shareholders funds reflects the book value of the company's net assets.

Limitations:
There is no upper limit to the ratio and so this reduces the clarity of inter-company comparisons of capital gearing.

Overcoming limitation:
The limitation can be overcome by using the alternative measure of long-term debt ratio to long-term debt plus shareholders funds explained below.

Long-term debt ratio to long-term debt plus shareholders funds

This approach has an upper limit of 100%, and does not simply look at the amount of debt finance relative to equity, but at the proportion of debt financing in the company's overall financing.

This measure makes inter-company comparisons of capital gearing more easily understandable.

However, another problem faced by both of these measures is that the balance sheet value of assets does not necessarily measure either the market value of the assets or their sale value. The market value of the company's assets may significantly exceed their book value and the sale value of the assets may be considerably less than their book value.

Both of these capital gearing measures may give a false impression of the company's true financial gearing risk exposure.

Another problem is that if a company has made significant charges for provisions of a highly likely future liability, it will correctly reducing the value of shareholders funds. However, where the provisions is less likely and considered sufficiently remote, the provision amount can be added back to shareholder funds. This amounts of provisions may distort both the capital gearing measures.

Finally there is an argument for including all debt financing in measures of capital gearing and not just longer-term debt. When long and short term debt is combined together, it is usually referred to as 'finance debt' and the two capital gearing ratios are then amended to finance debt/shareholders funds or finance debt/finance debt plus shareholders funds.

Potential difficulties:

i. The first concentrates on the company's ability to repay debts through the liquidation of assets.
ii. The second looks at a company's ability to 'service', (or pay the interest owing on). The year-end amount of short term debt may not be a reliable guide to the actual amount of short term debt exposure over the year as a whole.

To gain the most realistic measure of capital gearing, the measure of *net* finance debt i.e, long term plus short term debt minus cash and other liquid assets should be used to compute the capital gearing ratio.

Some of the assets that could be sold in order to repay debt might have actually been originally financed by that debt. Therefore, the ratio of total liabilities, (including both short *and* long term liabilities), to total assets is often used to give a more meaningful measure of a company's capital gearing.

Income Gearing

The level of income gearing is usually measured using the interest cover ratio i.e, interest liabilities over operating profit. The interest liability is the net of any interest receipts.

The interest gearing measures whether a company can pay its debts when they fall due, the lesser the ratio, the greater the risk of default in the face of any significant downturn in the company's operating profits.

However, interest obligations have to be paid for in cash, while operating profits are calculated on an accruals basis and are not cash. Therefore, a superior method of calculating interest gearing would be to use the ratio of net interest liabilities over operating net cash flow.

Measuring of financial gearing for Bank loan:

The bank and financial institutions would measure financial gearing in bank loan covenants as:

Net debt over EBITDA, where net debt is long term plus short term debt less cash and other liquid assets, and EBITDA is earnings before interest, tax, depreciation and amortisation.

This can be viewed as a ‘rough equivalent’ of operating cash flow. As a result, this ratio can be viewed as neither a capital gearing ratio, nor an interest gearing ratio, but as a merge of the two as it focuses on the amount.

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