Q4. The liquidity of a business firm is measured by its ability to satisfy its long-term obligations as they become due. What are the ratios used for this purpose?

Solution:

The liquidity of a business firm is measured by its ability to pay its long-term obligations. Long-term obligations include payments of principal amount and interest on its respective due date. Long-term solvency of any business can be calculated on the basis of the following ratios:

a. Debt-Equity Ratio: It represents the relationship between borrowed funds and owner's funds. Lower the debt-equity ratio, higher will be the degree of security to the lenders. Therefore, low debt-equity ratio implies that the company can easily meet its long-term obligations.

$$\text{Debt - Equity Ratio} = \frac{\text{Long-term Debt}}{\text{Equity/Share holders Fund}}$$

b. Total Assets to Debt Ratio: It represents the relationship between total assets and long-term loans. A high total assets to debt ratio implies that more assets are financed by the owner's fund and the company can easily meet its long-term obligations. Thus, a higher ratio implies more security to the lenders.

$$\text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long - term Debt}}$$

c. Interest Coverage Ratio: This ratio represents the relationship between the amount of profit consumed for paying interest and the amount of interest payable. A high interest coverage ratio implies that the company can easily meet all its interest obligations out of its profit.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Loans}}$$

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