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A Contingent Approach to Corporate Liquidity and Leverage: Evidence from UK FTSE-100 Firms

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Abstract

This study investigates the effect of corporate liquidity on capital structure decisions among 40 non-financial firms listed on the UK's FTSE 100 from 2011 to 2019. Using Panel Data Regression analysis across six models, the results demonstrate that UK corporate leverage policy is primarily sensitive to asset-based measures of debt but statistically insensitive to equity-based measures. Crucially, the findings reveal a mixed financing motive; while the CRatio exhibits a significant negative relation with asset-based leverage, supporting the POT, the QRatio shows a significant positive link, supporting the TOT. This seemingly contradictory evidence suggests that FTSE 100 managers adopt a contingent approach to capital structure, treating different types of liquid assets as having distinct funding capabilities. This conclusion contributes to the literature by demonstrating that a single theory is unable to fully explain the corporate financing decisions of large UK firms.

Keywords

Corporate Liquidity; Capital Structure; Leverage; FTSE 100; Panel Data; Pecking-Order Theory (POT); Trade-Off Theory (TOT).

نهج مشروط لسيولة الشركات ورافعتها المالية: أدلة من شركات مؤشر فوتسي 100 البريطانية

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الملخص

تستقصي هذه الدراسة تأثير السيولة المؤسسية على قرارات هيكل رأس المال بين 40 شركة غير مالية مدرجة في مؤشر FTSE 100 البريطاني من عام 2011 إلى 2019. باستخدام تحليل الانحدار للبيانات المقطعية الطولية (Panel Data Regression) عبر ستة نماذج، تظهر النتائج أن سياسة الرفع المالي للشركات البريطانية تتأثر بشكل أساسي بمقاييس الدين القائمة على الأصول، ولكنها لا تتأثر إحصائياً بالمقاييس القائمة على حقوق الملكية. والأهم من ذلك، تكشف النتائج عن دافع تمويلي مختلط؛ ففي حين تُظهر نسبة التداول (CRatio) علاقة سلبية ذات دلالة إحصائية مع الرفع المالي القائم على الأصول، مما يؤيد نظرية التدرج المالي (POT)، تُظهر نسبة السيولة السريعة (QRatio) علاقة إيجابية ذات دلالة إحصائية، مما يؤيد نظرية المقايضة (TOT). هذه الأدلة المتناقضة في ظاهرها تشير إلى أن مديري شركات FTSE 100 يتبنون نهجًا شرطيًا تجاه هيكل رأس المال، يعاملون أنواعًا مختلفة من الأصول السائلة على أنها تمتلك قدرات تمويلية متميزة. يساهم هذا الاستنتاج في الأدبيات من خلال إظهار عدم قدرة نظرية واحدة على تفسير قرارات التمويل المؤسسي للشركات الكبيرة في المملكة المتحدة بشكل كامل.

الكلمات المفتاحية

الرفع المالي، السيولة المؤسسية، البيانات المقطعية الطولية، نظرية التدرج المالي(POT) ، نظرية المقايضة(TOT) ، هيكل رأس المال، FTSE 100.

1. Introduction

The complicated relation between a firm's liquidity and its funding choices, defined by its capital structure, stands as a critical determinant of firm finance and its long-term value. Management's decisions related to capital structure are considered as one of the most important decisions that can be made which directly affect ownership wealth. While an optimal capital structure, theoretically, maximizes a firm's financial performance, the practical way to achieve this performance is complex, faces many challenges such as information asymmetry and agency problems.

Many theories tried to determine the framework by which firms select their ideal capital structure. Modigliani and Miller (1958) were earliest to propose that firm's value is entirely unaffected by its financial leverage. However, this theory's reliance on the assumption of perfect information, makes it vulnerable to criticism.

In contrast, the Trade-Off Theory (TOT) posits that firms seek to strike a balance between the marginal benefits of debt and marginal costs of debt to avoid any potential bankruptcy costs. The Pecking-Order Theory (POT) focuses on a sequential preference for financing sources. (Myers & Majluf, 1984)

Recent evidence underscores that the liquidity-leverage nexus is increasingly dynamic; while Philippas et al. (2018) demonstrate how UK monetary policy and liquidity injections shape corporate leverage, Ho (2024) finds that equity liquidity significantly accelerates the speed of capital structure adjustments in the UK market. Furthermore, the persistent role of liquidity as a primary determinant of financing preferences is reaffirmed by Pane et al. (2025), supporting the continued applicability of the Pecking Order Theory in modern markets.

Liquidity refers to the company's ability to meet its short-term obligations on time. Although high liquidity ratios generally signal financial health and the capacity to fulfill obligations in perfect time, these high ratios could cause the loss of many investment opportunities. The exact nature of liquidity's impact, however, remains both empirically complex and inconclusive, as evidenced by the varied and sometimes contradictory findings in existing studies. (Akinlo, 2011)

For instance, some research concluded that firm's liquidity reduced the company’s need to rely on debt, aligning with principles of POT where internal funds are preferred over external fund. In contrast, other results, sometimes supported by TOT, suggest a positive relation, Suggesting that high liquidity could lead to lower bankruptcy risk, thus enabling companies to comfortably take on greater amounts of tax-advantaged debt (Sbeiti, 2010;Yue, 2011). It gets harder when distinguishing between short-term and long-term borrowing, where liquidity's relation could reflect across different marketplaces around the world. Overall, while there is no single accepted theory for determining the optimum mix between debt and equity, the prevailing theories offer a strong foundational understanding of the elements guiding investment decisions.

This paper contributes to ongoing debate by investigating the impact of liquidity on leverage ratios within the UK's FTSE 100 market. Liquidity has a massive effect on financial leverage, and the specific nature of the impact among UK firms, as previous studies on optimal capital structure have found mixed results. For example, some results suggest that liquidity of UK firms limits dependence on debt, while others found a positive relation between UK liquid assets and borrowing levels. This study aims to uncover the perfect investment decision

that could be made by FTSE 100 managers. In addition, the paper determines which capital structure theory (POT or TOT) best explains the use of internal resources in relation to external debt. Employing a quantitative research approach using Panel Data Regression analysis, this study analyzes a sample of 40 firms from the FTSE 100 over the period from 2011 to 2019, using the Quick Ratio (QRatio) and the Current Ratio (CRatio) as proxies for liquidity against six different measures of corporate leverage. The subsequent sections will detail the methodology, present the empirical results, and interpret the findings to provide new insights into the liquidity-leverage nexus in the UK market.

2. Literature Review

Liquidity has a massive effect on financial leverage, but this element may result in a positive or negative impact on the capital structure decisions taken by management. There are some opinions and theories that attempt to explain how companies choose an optimal capital structure. Modigliani and Miller (1958) indicated that the value of the company is affected only by operating profits and not impacted by the financial leverage of the company. However, this theory has been subjected to various criticisms and challenges. For instance, the Modigliani and Miller model assumes that investors have perfect information about a company's operating performance and that there are no transaction costs associated with issuing debt or equity. In reality, companies face many challenges in making capital structure decisions, including information asymmetry, agency problems, and transaction costs.

In contrast, the Trade-off theory states that companies finance their projects by choosing a mixture of debt and equity to obtain the optimum level of capital structure in which the wealth of owners is maximized (Seelanatha, 2010). Consequently, this theory is based on the assumption that companies set a specific proportion of debt by making a comparison between benefits (tax shield profit) and debt costs (bankruptcy costs). The company reaches its maximum financial performance when this optimal ratio is achieved, where the marginal benefit of debt is equal to its marginal costs. (Kouki & Said, 2012; Lim, 2012).

Examining the interplay between liquidity and debt, Ayoush et al. (2021) found that while liquidity has a positive and significant impact on firm performance, excessive financial leverage can be detrimental if not supported by adequate liquidity buffers. This underscores the importance of maintaining a balance between debt levels and liquid assets to ensure financial stability.

According to Pecking-order theory, companies give specific priority to how their projects are financed (Myers & Majluf,1984). Managers first rely on retained earnings as a source of financing because it requires no issuance costs and no disclosure of company data needed (Bevan & Danbolt, 2002). In case retained earnings are insufficient to cover financing needs, the company turns to debt financing (Sbeiti, 2010; Yue, 2011). If the company wants additional sources of financing, it tends to issue equity. Several previous studies support the Pecking-order theory (Eriotis, Vasiliou, & Ventoura-Neokosmidi, 2007; Rajan & Zingales, 1995; Seifert & Gonenc, 2010; Sheikh & Wang, 2011).

Furthermore, a systematic literature review by Pane et al. (2025) confirms the continued dominance of the Pecking Order Theory (POT) in explaining corporate financing decisions. Their analysis of studies between 2020 and 2025 highlights that liquidity and profitability remain the primary determinants of

funding preferences, where firms prioritize internal resources to minimize information asymmetry.

Furthermore, liquidity has a major impact on financing policies of corporate debt. The high liquidity ratio reflects the company's ability to fulfil its obligations on time, while a low rate may expose the company to financial risks. In general, there is no typical form or specific theory for choosing between equity and debt. However, there are clear theories that give a wide understanding about the capital structure composition should be chosen by management (Akinlo, 2011). As a result of that, some important empirical studies on liquidity and corporate capital structure in multiple sectors and markets are discussed.

Ahi (2015) indicated that liquidity limits the UK company's dependence on debt, compared to its equivalent in the same industry. While Submitter and Anderson (2002) showed a positive relation between the liquidity ratio and long-term borrowing. It can be interpreted that the company maintains liquid assets as a precaution to confront the risks of long-term financial leverage, which may cause financial problems for the companies. They also showed a negative link between liquid assets and short-term debt. It can be explained that when there are high levels of liquidity, managers tend to issue long-term loans for financing. Surprisingly, they conducted the same test on a sample of Belgian companies, and their results stated a positive relation between liquidity and short-term loans, while the link between liquidity ratios and long-term borrowing is negative.

Anderson and Carverhill (2007) investigated research on the relationship between asset liquidity and capital structure. Especially, results referred that higher level of long-term borrowing will cause more decrease in the ideal use of short-term borrowing and higher levels of percent of liquidity holding. Furthermore, The firm's value is not sensitive to long-term borrowing level. The clarification is that by choosing suitable liquid asset, the firm can cover different purchasing prerequisites in a way that maintains roughly the same corporate value for various set of long-term borrowing levels.

Altman and McHough (1981) conducted a study on the rules that impact the debt policy among UK companies. The findings revealed a positive link between liquid asset and borrowing levels. Moreover, Fatouh et al. (2024) emphasized that in the United Kingdom, regulatory requirements regarding leverage ratios directly influence corporate risk-taking behavior. Their research indicates that firms must constantly re-optimize their financing structures in response to liquidity and capital mandates imposed by UK financial authorities.

Complementing the institutional perspective in the UK, Philippas et al. (2018) examined the transmission channels of Quantitative Easing (QE) and its impact on the leverage decisions of different types of financial institutions. Their study highlights that the effectiveness of monetary stimulus in boosting economic activity is heavily contingent on the degree of financial leverage and the composition of bank balance sheets. Specifically, they found that during periods of unconventional monetary policy, UK commercial banks often exhibit risk-taking behavior by increasing leverage to improve profitability. This evidence suggests that leverage is not merely a structural choice but a dynamic response to the macroeconomic environment and liquidity injections from the Bank of England, which aligns with the 'contingent approach' observed in contemporary UK corporate finance.

In a recent study focused on the UK market, Ho (2024) investigated the impact of equity liquidity on dynamic leverage adjustments. The findings revealed that higher liquidity significantly increases the speed of adjustment (SOA) towards target leverage ratios, suggesting that liquidity provides firms with the necessary flexibility to optimize their capital structure more efficiently.

Sibilkov (2009) examined the impact of liquidity on capital structure for public listed firms on the U.S. market. The results revealed that leverage is positively linked with liquidity. More examination displayed that the connection between secured loan and liquidity ratios is positive, whilst the connection between unsecured loan and liquidity ratios is curvilinear.

The results are consistent with the view that economic recessions and significant financial distress affect capital structure policies. Chakraborty (2010) examined the factors determining typical capital structure including liquidity. The findings found that Trade-off theory and the pecking order theory play an essential role in determining the need of internal or external funds in the stock market. Easton and LaFond (2000) explained determinants of reliance on financing by debt or equity in the UK. Consistent with Trade-off Theory, the results discovered a positive relationship between leverage and liquidity.

Šarlija and Harc (2012) explored the impact of liquidity on the capital structure based on 1058 recorded company in Croatia. Results displayed that there were significant relationships between debts proportions and liquidity proportions. Additionally, there were significant connections between debts ratios and current assets' structure. Moreover, the connection between short-term debt and asset liquidity was stronger than between the long-term debt and liquidity ratios. The increases of liquidity ratios led to a less leveraged company. Meanwhile, long-term leveraged firms were more liquid. Expanding inventory amount led to an increase in debt volume, though increasing liquid cash led to a decrease in the long-term and the short-term debt. Results by Rajendran and Achchuthan (2013) illustrated that leverage funds policies were exceedingly depending on the administration of liquidity ratios among listed Sri Lankan firms on Telecom sector.

Therefore, firms should focus on the administration of liquidity to take the decision on capital structure which ought to keep the firm value in the long-term side. Ahmad and Aris (2015) examined the factors of determine typical capital structure in industry sector of Bursa Malaysia. The result revealed that the availability of cash greatly negatively affects debt decisions in firms.

3. Hypotheses Development

Based on the theoretical framework of the Pecking Order Theory (POT) and the Trade-off Theory (TOT), and considering the unique characteristics of the UK FTSE-100 firms, this study tests the following hypotheses:

Hypothesis 1 (H1): *There is a significant negative relationship between corporate liquidity (measured by the Current Ratio) and financial leverage.*

- **H1a:** Current Ratio (CRatio) has a negative impact on Asset-based leverage.
- **H1b:** Current Ratio (CRatio) has a negative impact on Equity-based leverage.

Hypothesis 2 (H2): *There is a significant positive relationship between corporate*

liquidity (measured by Quick Ratio) and financial leverage.

- **H2a:** Quick Ratio (QRatio) has a positive impact on Asset-based leverage.
- **H2b:** Quick Ratio (QRatio) has a positive impact on Equity-based leverage.

4. Research Methodology

This study employed a quantitative research approach using Panel Data Regression analysis to examine the impact of liquid assets ratio on leverage ratios in the FTSE 100 market. The study utilized a random sample of 40 firms from various sectors, including Basic Material, Oil and Gas, Consumer Goods, Technology, Telecommunications, Health and Care, and Consumer Services.

In addition, three criteria should be available in the selected firms. Firstly, selected companies should be listed in the FTSE 100 market during 2011 to 2019. Secondly, the selected companies should continuously depend on the financing methods, whether internal or external in their capital structure during the years under study. Thirdly, the financial data ought to be accessible for each variable. To ensure the stability and robustness of the findings, this study focuses on the pre-pandemic financial period spanning from 2011 to 2019 avoiding the extreme volatility and unprecedented economic disruptions introduced by the COVID-19 pandemic starting in 2020.
The choice of the UK market and the application of Panel Data Regression in this study are consistent with recent methodological frameworks in corporate finance. Following Philippas et al. (2018), who utilized a panel vector autoregressive (PVAR) approach to capture dynamic interdependencies in the UK financial sector, this research employs a robust panel framework to mitigate heterogeneity across firms. Additionally, the focus on the UK's FTSE-100 aligns with the approach of Ho (2024), who emphasizes that large-cap firms in the UK provide a more transparent environment for testing the speed of leverage adjustments (SOA). Moreover, by incorporating diverse liquidity proxies (CRatio and QRatio), this study addresses the complexities highlighted by Fatouh et al. (2024) regarding the regulatory and risk-based constraints that dictate how UK firms optimize their leverage ratios in response to liquidity shifts.

Multiple regression analysis is carried out to explain the impact of liquid asset on capital structure during nine years on the FTSE 100 market. This method was previously used by Chijuka and Enakirerhi, (2016); Hair, Black, Babin, and Anderson, (2010) to uncover the impact of liquidity on leverage. This study used SPSS 25 and the data were extracted from DATASTREAM Database and annual reports. The independent variable is liquidity, which is measured by two main common ratios, current ratio (CRatio) and quick ratio (QRatio). While the dependent variable is capital structure, where debt equity ratio (DER) and debt asset ratio (DAR) are calculated on the basis of short- term, long-term and total debt.
The research was designed to examine the impact of liquid assets ratio on leverage ratios by applying multiple regression analysis through IBM SPSS Statistics. Capital structure is examined by using six proxies, divided on six models that are mentioned below.

$$TDebt / TAsset_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 1}$$

$$TDebt / TEquity_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 2}$$

$$LongDebt / TAsset_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 3}$$

$$LongDebt / TEquity_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 4}$$

$$ShortDebt / TAsset_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 5}$$

$$ShortDebt / TEquity_{it} = \alpha_0 + \beta_1 QRatio_{it} + \beta_2 CRatio_{it} + \beta_3 SZ_{it} + \beta_4 AG_{it} + \varepsilon_{it} \quad \text{Model 6}$$

Where:

α: The constant, TDebt: Total Debt, TAsset: Total Assets, TEquity: Total Equity, LongDebt : Long-term Debt, ShortDebt : Short-term Debt, QRatio: Quick ratio, CRatio: Current Ratio, SZ: represents the firm size, AG: firm age, e_{it} = Random Error β: the regression coefficient, t : shows time period, and i : represents cross sectional units (firms).

5. Research Results:

Figure 1 shows that the debt-to-equity ratio in the UK was low in 2013 due to post-crisis deleveraging, as firms reduced their debt levels to improve financial stability. Low interest rates also encouraged firms to rely on equity financing. Additionally, many UK companies issued new equity to raise capital, increasing their equity base and reducing their debt-to-equity ratios.

However, by 2015, the debt-to-equity ratio had increased. This was driven by the UK's economic recovery, which led to increased borrowing by firms. Businesses began to invest more, financing these investments with debt, which increased debt levels and contributed to a higher debt-to-equity ratio. The surge in M&A activity in 2015 also played a role, as companies used debt to finance their acquisitions.

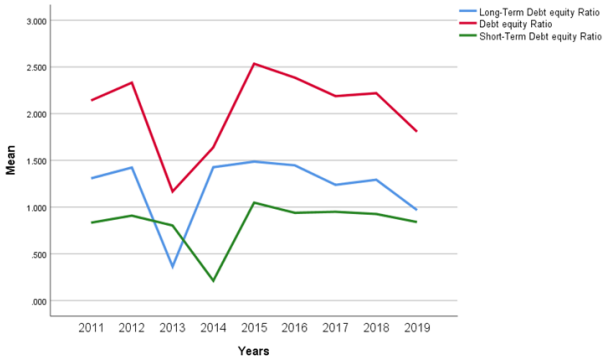

Figure 1. Debt/Equity ratios trends from 2011 to 2019 (SPSS)

Figure 2 illustrates that the debt-to-asset ratio in the UK was high in 2016 due to a combination of factors. The UK's decision to leave the European Union, known as Brexit, led to economic uncertainty and a decline in asset values. This decrease in asset values, particularly in the property market, increased the debt-to-asset ratio.

However, in 2017, the debt-to-asset ratio decreased. This was largely driven by an increase in asset values, particularly in the property and equity markets. The UK economy showed signs of resilience despite the Brexit uncertainty, and asset prices began to recover. As a result, the value of assets increased, reducing the debt-to-asset ratio.

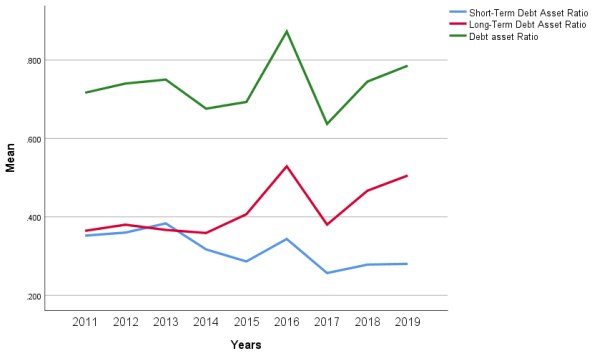

Figure 2. Debt/Asset ratios trends from 2011 to 2019 (SPSS)

Figure 3 shows that the QRatio and CRatio over the period from 2011 to 2019, it can be seen that both ratios reached a peak in 2012. The year 2012 was a part of the post-2008 financial crisis recovery

period. So firms may have aimed to maintain higher liquidity ratios to ensure they could meet their short-term obligations in case of economic instability.

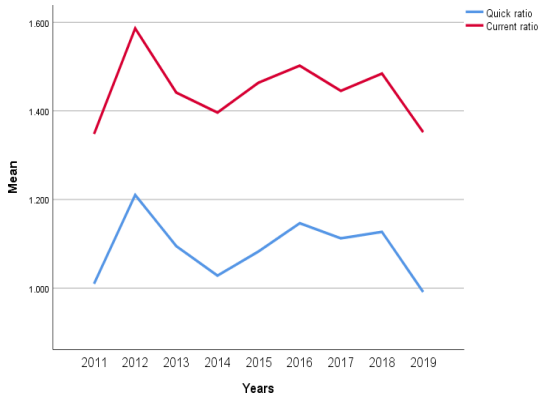

Figure 3. QRatio and CRatio ratios trends from 2011 to 2019 (SPSS)

Table 1 shows that the Quick Ratio (1.089) and the Current Ratio (1.446) suggest that, on average, the companies in the sample have sufficient current assets to cover their current liabilities. The minimum values for both ratios (0.00034 and 0.001, respectively) indicate that some companies may be facing liquidity challenges.

The short-term debt to asset ratio (0.318) and long-term debt asset ratio (0.418) indicates that, on average, the companies in the sample have moderate levels of debt relative to their assets.

The debt asset ratio (0.735) and debt equity ratio (2.046) suggest that the companies have a significant amount of debt relative to their assets and equity, respectively.

Table 1. Descriptive statistics (SPSS)

Variables	*Obs.*	*Mean*	*Std. Dev*	*Min*	*Max*
Quick ratio	360	1.089	1.190	0.00034	10.898
Current ratio	360	1.446	1.438	0.001	12.306
Short-Term Debt Asset Ratio	360	0.318	0.375	0.027	3.579
Long-Term Debt Asset Ratio	360	0.418	0.409	0.012	5.103
Short-Term Debt equity Ratio	360	0.829	2.237	0.0034	7.693
Long-Term Debt equity Ratio	360	1.217	2.347	0.0298	11.723
Debt asset Ratio	360	0.735	0.660	0.087	8.682
Debt equity Ratio	360	2.046	3.959	0.0408	16.884

6.1 Correlations between study's variables

The Correlations table provides insights into the links between the variables and, crucially, serves as a primary tool for diagnosing multicollinearity before interpreting the regression models.

The most critical observation from the table is a very high positive correlation between the two independent liquidity measures, the Quick Ratio (QRatio) and the Current Ratio (CRatio); link is showing an $r \approx 0.94$. This extreme correlation signals severe multicollinearity; the reason for the high correlation between the Current Ratio and the Quick Ratio is due to the close similarity in their basic formulas.

Focusing on the link with the dependent variable, the Short-Term Debt Asset Ratio, both ratios show a statistically significant negative relation. The CRatio correlation is around $r = -0.171$, and the QRatio is $r = -0.145$. This negative correlation provides evidence supporting the Pecking-Order Theory (POT). It suggests that, in the

FTSE 100 sample, companies with higher internal liquidity tend to reduce their reliance on short-term external funding, preferring to fund operations and investments internally. This is the normal behavior under the POT supports.

Firm Size (SZ) exhibits a significant negative relation (r=−0.250) with the Short-Term Debt Asset Ratio. This is an expected result across finance literature, indicating that larger FTSE 100 companies likely prefer greater financial flexibility, allowing them to replace short-term, potentially higher-cost debt with more favorable, long-term funding arrangements.

Firm Age (AG) presents a very weak link (r=0.037) with short-term debt, suggesting that age, when viewed in isolation, is not a strong predictor of a firm's immediate need for short-term borrowing compared to its size or current liquidity position.

Table 2: Correlations between study's variables (SPSS)

Relationship (X vs. Y)	Pearson Correlation (r)	Sig. (p)
Current Ratio vs. Quick Ratio	0.938	0.000
Current Ratio vs. S-DAR	-0.171	0.001
Quick Ratio vs. S-DAR	-0.145	0.006
Current Ratio vs. TDAR	-0.142	0.007
Current Ratio vs. L-DAR	-0.072	0.175
Size vs. S-DAR	-0.25	0.000
Age vs. S-DAR	0.037	0.485
Size vs. TDAR	-0.192	0.000

6.2 Model Fit and Diagnostics (All Models)

Based on the diagnostic tests for all six regression models the F-statistic, confirmed that only the Short-Term Debt Asset Ratio Model (Model 5) was statistically significant (Sig. F Change=0.000). The explanatory power which is measured by the R2, was modest, accounting for a 12.1% variance, while other models, such as the Debt equity Ratio (Model 2), were not significant and showed low R2 values of 1.4%. Crucially, the analysis for multicollinearity confirmed a high degree of shared variance between the CRatio and QRatio. Nevertheless, the VIF for both CRatio (8.735) and QRatio (8.712) remained below 10 which is acceptable (Neter, Wasserman, & Kutner, 1983). Despite the high statistical correlation between the Current Ratio (CR) and the Quick Ratio (QR), both measures were retained in separate models to capture the nuanced differences in liquidity quality. From an accounting perspective, The CR includes inventory, a less liquid asset while the QR focuses on near-cash assets. Maintaining both allows this study to distinguish whether capital structure decisions are driven by total liquid resources or immediate cash availability, thereby avoiding the loss of critical managerial insights.

Table 3: Model Fit Statistics (SPSS)

Model	Dependent Variable (Y)	R2	Sig.F
Model 1	Total Debt / Total Assets (TDAR)	0.090	0.000
Model 2	Total Debt / Total Equity (DER)	0.014	0.28
Model 3	Long-Term Debt / Total Assets (L-DAR)	0.044	0.003
Model 4	Long-Term Debt / Total Equity (L-DER)	0.018	0.175

Model 5	Short-Term Debt / Total Assets (S-DAR)	0.121	0.000
Model 6	Short-Term Debt / Total Equity (S-DER)	0.012	0.373

Model 5 achieves the best statistical fit between six models, with a significant R2 of 0.121. The model's strength is centered on the CRatio coefficient, which is significantly negative (B=−0.115, p=0.003). This finding is in line with result for short-term funding, it confirms that as FTSE 100 managers increase internal resources, they correspondingly reduce their reliance on short-term external borrowing. POT supports this behavior, where companies prioritize internal funds over external debt to avoid the transaction costs and agency problems. This result is consistent with studies of Myers and Majluf,1984: Bevan and Danbolt, 2002: Sbeiti, 2010; Yue, 2011. Furthermore, SZ confirms that larger FTSE 100 companies are better able to substitute short-term borrowing with internal financing or cheaper, long-term options, aligning with both POT and TOT perspectives on firm size.

In contrast to Model 5, Model 6 is statistically insignificant, and the coefficients for both CRatio and QRatio in this model are also insignificant. it examines that when short-term debt is measured against the company's equity, liquidity loses its predictive power. This suggests that short-term capital structure decisions are strongly tied to the firm's ability to cover obligations with assets, rather than being sensitive to changes in the equity. The overall behavior confirms that the POT strongly governs the decision to use or avoid short-term debt, but only when measured against total assets.

The analysis of Models 3 and 4, focusing on Long-Term Debt, presents the most complex and theoretically challenging results of the study, directly engaging the conflict between the Trade-Off Theory (TOT) and the precautionary motives suggested by other literature.

Model 3 is statistically significant (Sig. F=0.003) with a modest R2 of 0.044, but the model yields contradictory and significant coefficients for the liquidity ratios. The CRatio is significantly negative (B=−0.155, p=0.000), while the QRatio is significantly positive (B=0.166, p=0.002). Based on the TOT, high liquidity should be positively related to long-term borrowing: liquidity refers to financial health, thereby reducing bankruptcy risk and increasing the company's capacity to take on tax-shielded borrowing.

However, the negative coefficient of CRatio contradicts the TOT and some results of UK studies, like Altman and McHough (1981) and Lee and Kim (2013), who found that UK firms with high liquidity tended to have a higher proportion of debt. Instead, the negative sign supports the view that FTSE 100 managers may prioritize a precautionary motive, using high liquidity to reduce dependence on all forms of external debt to mitigate long-term risk.

In contrast to Model 3, Model 4 is statistically insignificant (Sig. F=0.175) with a mere R2 of 0.018. These indicators support the same previous result which suggests that FTSE 100 managers' decisions regarding long-term leverage are predominantly sensitive to their asset structure rather than their equity composition.

model 1 and model 2 confirm that the results are consistent with the previous models where CRatio is significantly negative and QRatio is significantly positive for model 1, plus both ratios are statistically insignificant for model 2.

The divergent results between CR (negative relationship) and QR (positive relationship) justify the inclusion of both metrics and confirm that they represent

distinct economic signals. The negative impact of CR aligns with the Pecking Order Theory, suggesting that firms prioritize their overall internal liquidity to reduce external debt. Conversely, the positive impact of QR supports the Trade-off Theory, indicating that high immediate liquidity may enhance a firm's creditworthiness or serve as collateral, facilitating more debt. This confirms that FTSE-100 managers do not view liquidity as a monolithic concept but rather adopt a contingent approach based on the specific type of liquid asset.

This 'contingent approach' is also consistent with recent evidence from Ho (2024), who suggests that the impact of liquidity on UK firms' leverage is not static but moderates the speed of adjustment toward target ratios. Furthermore, the significant negative impact of CRatio aligns with the updated findings of Pane et al. (2025), reaffirming that UK firms prioritize internal liquidity to minimize external debt costs, as predicted by the Pecking Order Theory. On the other hand, the positive sensitivity of leverage to QRatio reflects a strategic risk-taking behavior similar to that observed by Philippas et al. (2018) and Fatouh et al. (2024), where UK financial and non-financial entities optimize their leverage in response to liquidity availability and regulatory environments to boost profitability.

To sum up, Models M1, M3, and M5 (H1a and H1b were accepted) were statistically significant, demonstrating that asset-based leverage measures are sensitive to liquidity policy. However, models M2, M4, and M6 (H2a and H2b were rejected) were statistically insignificant, concluding that total debt policy is sensitive to the asset base, not the equity base, and that liquidity holds no predictive power when measured against equity.

Table 4. Estimation results (SPSS)

Model	Dependent Variable (Y)	Predictor	Coefficient (B)	P-Value (p)	VIF
M1	Total Debt / Total Assets	Current Ratio (CRatio)	-0.270	0.000	8.735
		Quick Ratio (QRatio)	0.240	0.004	8.712
M2	Total Debt / Total Equity	Current Ratio (CRatio)	-0.406	0.345	8.735
		Quick Ratio (QRatio)	0.551	0.288	8.712
M3	Long-Term Debt / Total Assets	Current Ratio (CRatio)	-0.155	0.000	8.735
		Quick Ratio (QRatio)	0.166	0.002	8.712
M4	Long-Term Debt / Total Equity	Current Ratio (CRatio)	-0.323	0.203	8.735
		Quick Ratio (QRatio)	0.523	0.089	8.712
M5	Short-Term Debt / Total Assets	Current Ratio (CRatio)	-0.115	0.003	8.735
		Quick Ratio (QRatio)	0.074	0.109	8.712
M6	Short-Term Debt / Total Equity	Current Ratio (CRatio)	-0.082	0.735	8.712
		Quick Ratio (QRatio)	0.028	0.923	8.735

7. Recommendations

Financial managers in the UK should adopt a nuanced liquidity management strategy, recognizing that different liquidity components exert varying influences on leverage. Specifically, while broad liquidity (CRatio) can be used to mitigate debt costs, quick assets should be leveraged strategically to enhance corporate creditworthiness. Furthermore, firms are encouraged to maintain precautionary liquidity buffers to ensure flexible access to debt markets during

economic shifts, aligning with the observed contingent approach.

8. Future Research:

Future studies should extend this analysis to include the post-pandemic period to assess how extreme liquidity shocks impact the liquidity-leverage nexus. Additionally, comparative research involving Small and Medium Enterprises (SMEs) or emerging markets would provide deeper insights into how institutional environments moderate these financial decisions.

9. Conclusion

This study set out to investigate the relation between liquidity and capital structure decisions among a sample of 40 firms listed on the UK's FTSE 100 between 2011 and 2019. This period was specifically chosen for its financial stability, allowing the analysis to isolate the fundamental relation from the extreme volatility caused by the 2020 global pandemic. By employing Panel Data Regression across six models that link liquidity proxies (Current Ratio and Quick Ratio) to various leverage measures. The results reveals that the capital structure decisions of FTSE 100 firms are highly sensitive to asset-based leverage measures, which were all statistically significant. In contrast, models measuring leverage against equity were statistically insignificant, confirming that investment decision policies are basically sensitive to the firm's asset structure, not its equity composition.

The findings provide compelling evidence that a single firm's financing behavior cannot be wholly categorized under one theoretical framework; rather, FTSE 100 managers appear to adopt a contingent approach to capital structure, at the same time exhibiting characteristics of both the POT and the TOT. The results indicate that greater current liquidity reduces the need for external debt, which is compatible with the POT. In sharp contrast, other finding suggests that while managers prefer to use internal resources for funding, they also strategically utilize the liquid assets (QRatio) to support higher debt levels and maximize the tax shield benefit. This distinction implies that financial managers treat different classes of liquid assets as having distinct signaling capabilities and funding preferences, contributing significantly to the literature on capital structure decisions.

One limitation of this study is the diverse nature of sectors within the FTSE-100 index. Although the research controls for firm-specific heterogeneity through panel data techniques, the varying nature of liquidity across different industrial sectors (e.g., manufacturing vs. services) remains an area for future exploration. Thus, the results should be interpreted within the context of large-cap non-financial firms.

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