Liquidity Ratios (SL/HL)

Current Ratio formula:

$$\boxed{Current\ Ratio = \frac{Current\ Assets}{Current\ Liabilities}}$$

Definition

The current ratio is a financial metric that evaluates a company's short-term liquidity and ability to meet its immediate obligations. It is calculated by dividing the total current assets by the total current liabilities. This ratio provides insight into the company's capacity to cover its short-term debts with its readily available assets, indicating the proportion of assets available for every dollar of current liabilities. It serves as a key indicator for assessing a company's short-term financial health and its ability to meet its near-term financial obligations.

Example

For example, if a business makes \$20,000 by selling machines. It costs \$8,000 to manufacture those machines. The gross profit would be \$12,000. To calculate the Gross profit margin:

$$Current\ Ratio = \frac{\$12{,}000}{\$20{,}000} = 0.6$$

Acid test (quick) formula:

$$\boxed{NPM = \frac{current\ assests - stock}{current\ liabilities}}$$

Definition

The acid-test ratio, also known as the quick ratio, measures a company's ability to meet its short-term liabilities with its most liquid assets, excluding inventory. It is calculated by dividing the sum of cash, marketable securities, and receivables by the total current liabilities. This ratio provides a more stringent assessment of a company's immediate liquidity position, focusing on assets easily convertible to cash.

Example

For example, if a business sales are $1,000,000 from computers, and your profit before interest and tax is $100,000 the net profit margin is:

$$Acid\ Test\ Ratio = \frac{\$100{,}000}{\$1{,}000{,}000} = 0.10$$