Liquidity Ratios

Liquidity Ratios…

Liquidity: the ability for a company to access cash quickly!

Liquid Assets: cash, and those things that can be converted to cash in a short period of time in order for a company to pay its bills on a regular (and not too stressful) basis!

- Cash (i.e., savings or checking account): yes, very “liquid”
- Accounts Receivables: pretty much, you’ll have cash in 30 or 60 days
- Inventory: not so liquid, it depends on how quickly you sell it
- Buildings and Land: not liquid at all; could take years to sell

Liquidity Ratios…

Liquidity Ratios are indicators of the company's ability to pay its bills coming due in the short term (within a year).

Current Ratio: a measure whether the company has enough "liquid" assets to cover its short-term debt obligations.

Quick Ratio: similar to the current ratio, but without the complicating issue of inventories.

The Current Ratio…

Compares the Current Assets to the Current Liabilities (Balance Sheet):

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

Current Assets: things you can turn into cash quickly

Current Liabilities: the bills you need to pay quickly

Ideally, a company would like this ratio to be > 1

A company needs enough cash on hand to keep all the bills paid.

The Current Ratio…

While a Current Ratio < 1 indicates liquidity problems, a value >> 1 doesn't really tell us too much.

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

$$\text{Current Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivable} + \text{Inventory}}{\text{Accounts Payable} + \text{Short-Term Debt} + \text{Accrued Liabilities}}$$

Too much cash?

Too much tied up in the market

Too generous with credit terms

Too much inventory

The Current Ratio…

What should it be?

How much cash do you need to pay the bills?

How much inventory do you need to serve the marketplace without having “too much”?

What credit terms should be offered to incentivize customers without being overly generous?

What is the Current Ratio for the “Best in Class” company within the industry?

The answers to these questions determine whether a current ratio between 1 and 2 is adequate, or something else is more appropriate.

The Quick Ratio…

Also known as the "Acid-Test" Ratio

Same as Current Ratio, but without the questionable Inventory issue

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\begin{array}{l}\text{Cash} \\ + \text{ Marketable Securities} \\ + \text{ Accounts Receivable}\end{array}}{\begin{array}{l}\text{Accounts Payable} \\ + \text{ Short-Term Debt} \\ + \text{ Accrued Liabilities}\end{array}}$$

Why is this important?

- Accts Receivables are very liquid – you'll get paid in 30 or 60 days
- Inventory – not easily controlled, and therefore not very liquid

The Quick Ratio…

Also known as the "Acid-Test" Ratio

Same as Current Ratio, but without the questionable Inventory issue

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

What should this be?

It will obviously be less than the Current Ratio

A Quick Ratio > 1 is ideal, but something close is ok

Note: A Services Business, with no inventory:
Current Ratio = Quick Ratio

Main Takeaways…

Liquidity Ratios are measures of a company's ability to pay its bills coming due in the short-term (within a year).

Current Ratio relates the current assets to the current liabilities; if the ratio if greater than 1, the company has enough assets to cover its short-term debt obligations.

Quick Ratio is similar to the current ratio, but excludes inventory from current assets, making it a true acid test of the company's ability to pay its bills in the very near term!

Next Time…

Working Capital Management Ratios

Credits & References

Slide 1: Liquidity Ratios – Statistics/Business by MQ-Illustrations, Adobe Stock (335905242.jpeg).

Slide 10: Businessman working data document graph chart report marketing research development planning management strategy analysis financial accounting by Chaosamran_Studio, Adobe Stock (296141290.jpeg).