

Assignment - 1a

Q.96

Current Ratio of firm increases from 1.5 to 2.5 what would be the response of the company's stock price?

When a company's current ratio increases from 1.5 to 2.5, it indicates a significant improvement in its short-term liquidity. The Current Ratio is calculated as:

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

An increase in this ratio means the company has more current assets [like Cash, Accounts Receivable and Inventory] relative to its current liabilities [like Accounts Payable and Short-Term Debt]

Here's how this change could impact the company's stock price:

Positive Impacts on Stock Price

Improved Liquidity and Solvency

A higher current ratio suggests that the company is more capable of meeting its short-term obligations.

Lower Risk

Improved liquidity lowers the company's financial risk, which can attract more investors, especially those with a low-risk appetite.

Confidence in Operations

If the increase in current ratio reflects better management of working capital [e.g.: faster receivables collection or improved inventory turnover]

Neutral or Negative Impacts on Stock Price

Excessive Liquidity

A current ratio that's too high above 2.0 to 2.5 could signal that the company is holding excessive current assets, which might not be deployed.

Possibly Deteriorating Profitability

If the increase in current ratio is due to a slowdown in operation [e.g.: inventory piling up because of decreased sales], this could be a red flag.

Investor Sentiment and Market Conditions

Broader Market Perception

Stock prices are also influenced by broader market trends and sentiment. This increase in liquidity might be well-received and the stock price could rise.

Sector-Specific Considerations.

Different industries have different norms for current ratios.
[e.g.: Retail, Manufacturing]

Conclusion

While an increase in the current ratio from 1.5 to 2.5 generally indicates improved liquidity, which could have a positive impact on the

Stock price, it depends on the broader context. If the increase is driven by good operational performance, it could be viewed favorably. However, if it results from poor resource utilization or declining sales, it could lead to a neutral or negative market response. Investors would analyze the reason behind the ratio change before reacting.

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