

Assignment - 12

current Ratio of firm increases from 1.5 to 2.5, what would be the impact 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 receivable 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.

Investors Sentiment and market condition

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

it depends on the borders context. If the
increase is driven by good operational performance,
it could be viewed favorable. However if it stems
from poor resource utilization or declining sales,
it could lead to a rational or negative market
response. Investors would analyze the reasons for
the ratio change before reacting.

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