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Liquidity

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What is Liquidity

Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.

Market liquidity refers to the extent to which a market, such as a country's stock market or a city's real estate market, allows assets to be bought and sold at stable prices. Cash is considered the most liquid asset, while real estate, fine art and collectibles are all relatively illiquid.

Accounting liquidity measures the ease with which an individual or company can meet their financial obligations with the liquid assets available to them. There are several ratios that

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Why Is Liquidity Important?

BREAKING DOWN Liquidity

Cash is considered the standard for liquidity, because it can most quickly and easily be converted into other assets. If a person wants a $1,000 refrigerator, cash is the asset that can most easily be used to obtain it. If that person has no cash but a rare book collection that has been appraised at $1,000, she or he is unlikely to find someone willing to trade them the refrigerator for their collection. Instead, she/he will have to sell the collection and use the cash to purchase the refrigerator. That may be fine if the person can wait months or years to make the purchase, but it could present a problem if the person only had a few days. She/he may have to sell the books at a discount, instead of waiting for a buyer who was willing to pay the full value. Rare books are an example of an illiquid asset.

that, for all intents and purposes, it does not exist. The stock market, on the other hand, is characterized by higher market liquidity. If an exchange has a high volume of trade that is not dominated by selling, the price a buyer offers per share (the bid price) and the price the seller is willing to accept (the ask price) will be fairly close to each other. Investors, then, will not have to give up unrealized gains for a quick sale. When the spread between the bid and ask prices grows, the market becomes more illiquid. Markets for real estate are usually far less liquid than stock markets.

Accounting Liquidity

For an entity such as a person or a company, accounting liquidity is a measure of ability to pay off debts as they come due. In the example above, the rare book collector's assets are relatively illiquid and would probably not be worth their full value of $1,000 in a pinch. In practical terms, assessing accounting liquidity means comparing liquid assets to current liabilities, or financial obligations that come due within one year. There are a number of ratios that measure accounting liquidity, which differ in how strictly they define "liquid assets."

Current Ratio

The current ratio is the simplest and least strict ratio. Current assets are those that can reasonably be converted to cash in one year.

Current Ratio = Current Assets / Current Liabilities

Acid-Test or Quick Ratio

The acid-test or quick ratio is slightly more strict. It excludes inventories and other current assets, which are not as liquid as cash and cash equivalents, accounts receivable and short-term investments.

Acid-Test Ratio = (Cash and Cash Equivalents + Short-Term Investments + Accounts Receivable) / Current Liabilities

A variation of the acid-test ratio simply subtracts inventory from current assets, making it a bit more generous:

Acid-Test Ratio (Var) = (Current Assets - Inventories) / Current Liabilities

Cash Ratio