Liquidity Ratios

by Sophia

WHAT'S COVERED

In this lesson, you will learn about ratios that measure short-term financial strength. Specifically, this lesson will cover:

1. Current Ratio

Recall that the concept of liquidity represents the ability of a company to repay its short-term creditors out of the cash that it has available. This liquidity can be represented by a ratio that compares assets to liabilities. There are a couple of ways to do this:

- Current ratio
- Quick ratio

The **current ratio** measures whether or not a firm has enough resources to pay its debts over the next 12 months. It compares the current assets to the current liabilities. These current assets comprise assets that can be converted to cash or used to pay current liabilities within the coming year. Current assets usually include cash, cash equivalents, short-term investments, accounts receivable, and inventory. Current liabilities are often represented by all of the liabilities that an organization has to be settled in cash within the next year.
The current ratio is found by dividing the current assets by the current liabilities.

FORMULA TO KNOW

Current Ratio

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

Acceptable current ratios vary from industry to industry but they are generally between one and a half and three for a healthy business. If a company has a ratio in this range, it generally indicates good short-term financial strength.

EXAMPLE Here is the balance sheet of our fictitious ABC Company.

Balance Sheet
ABC Company Inc.

		Dec. 31, 201X
Assets		
Current Assets		
	Cash	7,314
	Accounts receivable	
	Inventory	5,560
	Prepaid expenses	
	Short-term investments	
	Total current assets	12,874
Fixed (Long-Term) Assets		
	Long-term investments	2,310
	Property, plant, and equipment	14,442
	(Less accumulated depreciation)	(2,200)
	Intangible assets	
	Total fixed assets	14,552
Other Assets		
	Deferred income tax	
	Other	
	Total Other Assets	-
Total Assets		**27,426**
Liabilities and Owner's Equity		
Current Liabilities		
	Accounts payable	9,060
	Short-term loans	
	Income taxes payable	3,349
	Accrued salaries and wages	
	Unearned revenue	
	Current portion of long-term debt	
	Total current liabilities	12,409
Long-Term Liabilities		
	Long-term debt	3,450
	Deferred income tax	
	Other	
	Total long-term liabilities	3,450
Owner's Equity		
	Owner's investment	6,000
	Retained earnings	5,567
	Other	
	Total owner's equity	11,567
Total Liabilities and Owner's Equity		**27,426**

The total current assets are $12,874, while the total current liabilities are $12,409. If we divide the current assets by the current liabilities, we get 1.05, which seems a little bit low. The company can barely repay its current liabilities from its current assets.

Now, can a current ratio be too high? If you are a shareholder and the current ratio is 4, are you happy because they are so liquid? Most likely, you would want that number to be lower, because that higher number means there is cash sitting there that is not being invested in growth or paid out in dividends.

TERM TO KNOW

Current Ratio

A ratio that measures whether or not a firm has enough resources to pay its debts over the next 12 months.

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2. Quick Ratio

The **quick ratio**, or the acid test, measures the ability of a company to use its cash or quick assets to retire its liabilities immediately. It is calculated by dividing the current assets minus the inventory by the current liabilities.

FORMULA TO KNOW

Quick Ratio

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

Cash and cash equivalents are the most liquid assets found in the current asset portion of the balance sheet and among the ones that could be most quickly converted; we can include accounts receivable among those as well. However, inventory is something that could take a bit longer to convert, so it would not be immediately available to repay the current liabilities. Because of this, inventory is excluded in the quick ratio formula.

EXAMPLE Let's take a look at the balance sheet for ABC Company again.

Balance Sheet
ABC Company Inc.

	Dec. 31, 201X
Assets	
Current Assets	
Cash	7,314
Accounts receivable	
Inventory	5,560
Prepaid expenses	
Short-term investments	
Total current assets	12,874
Fixed (Long-Term) Assets	
Long-term investments	2,310
Property, plant, and equipment	14,442
(Less accumulated depreciation)	(2,200)
Intangible assets	
Total fixed assets	14,552
Other Assets	
Deferred income tax	
Other	
Total Other Assets	-
Total Assets	**27,426**
Liabilities and Owner's Equity	
Current Liabilities	
Accounts payable	9,060
Short-term loans	
Income taxes payable	3,349
Accrued salaries and wages	
Unearned revenue	
Current portion of long-term debt	
Total current liabilities	12,409
Long-Term Liabilities	
Long-term debt	3,450
Deferred income tax	
Other	
Total long-term liabilities	3,450
Owner's Equity	
Owner's investment	6,000
Retained earnings	5,567
Other	
Total owner's equity	11,567
Total Liabilities and Owner's Equity	**27,426**

We said that ABC Company has current assets of $12,874, but if we subtract the inventory of $5,560, then we only have the cash of $7,314. If we divide that by the current liabilities of $12,409, then we arrive at a quick ratio of 0.58. This shows we do not have nearly enough coverage to take care of our current liabilities in the short term.

TERM TO KNOW

Quick Ratio

A ratio that measures the ability of a company to use its cash or quick assets to retire its liabilities immediately.

SUMMARY

In this lesson, you learned that liquidity is the ability of an organization to pay its current liabilities with its current assets. We can measure this with the **current ratio**, which is current assets divided by current liabilities. Generally, this should be between 1.5 and 3 for healthy businesses. The second measure that you looked at was the **quick ratio**, which subtracts the inventory from the current assets. The quick ratio should be one or higher, but this can vary.

Best of luck in your learning!

TERMS TO KNOW

Current Ratio

A ratio that measures whether or not a firm has enough resources to pay its debts over the next 12 months.

Quick Ratio

A ratio that measures the ability of a company to use its cash or quick assets to retire its liabilities immediately.

FORMULAS TO KNOW

Current Ratio

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

Quick Ratio

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