

# **Liquidity Ratios**

by Sophia

₩HAT'S COVERED
In this lesson, you will learn about ratios that measure short-term financial strength. Specifically, this lesson will cover:
1. Current Ratio 2. Quick Ratio

## 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.

#### L FORMULA TO KNOW

#### **Current Ratio**

Current Ratio = Current Assets 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.

ABC Company Inc.		
		Dec. 31, 201)
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	t	14,442
(Less accumulated depreciatio	n)	(2,200)
Intangible assets		
	Total fixed assets	14,552
Other Assets		STOCKS STOCKS
Deferred income tax Other		
	Total Other Assets	-
Total Assets	Total Other Assets	27,426
Total Assets Liabilities and Owner's Equ		27,426
		27,426
Liabilities and Owner's Equ		
Liabilities and Owner's Equ Current Liabilities		
Liabilities and Owner's Equ Current Liabilities Accounts payable		<b>27,426</b> 9,060 3,349
Liabilities and Owner's Equ Current Liabilities Accounts payable Short-term loans		9.060
Liabilities and Owner's Equ Current Liabilities Accounts payable Short-term loans Income taxes payable		9.060
Liabilities and Owner's Equ Current Liabilities Accounts payable Short-term Ioans Income taxes payable Accrued salaries and wages	uity	9.060
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Liabilities and Owner's Equ Current Liabilities Accounts payable Short-term Ioans Income taxes payable Accrued salaries and wages Unearned revenue Current portion of long-term de To Long-Term Liabilities	<b>Jity</b>	9,060 3,349 12,409
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Liabilities and Owner's Equ Current Liabilities Accounts payable Short-term Ioans Income taxes payable Accrued salaries and wages Unearned revenue Current portion of long-term de Current por	a <b>ity</b> ebt etal current liabilities	9,060 3,349 12,409 3,450 3,450 6,000
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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.

#### E 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.

### 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.



#### **Quick Ratio**

Quick Ratio = Current Assets – Inventory 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.

		ec. 31, 201X
Assets		
Current Assets		
Cash		7,314
Accounts receivable		
Inventory		5,560
Prepaid expenses		
Short-term investments		
	Total current assets	12,874
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Intangible assets		
	Total fixed assets	14.55
Other Assets		
Deferred income tax		
Other		
	Total Other Assets	
Total Assets		27,426
		27,426
Liabilities and Owner's	Equity	27,426
Liabilities and Owner's Current Liabilities	Equity	
Liabilities and Owner's Current Liabilities Accounts payable	Equity	
Liabilities and Owner's Current Liabilities Accounts payable Short-term loans	Equity	9,060
Liabilities and Owner's Current Liabilities Accounts payable Short-term loans Income taxes payable		9,060
Liabilities and Owner's Current Liabilities Accounts payable Short-term loans Income taxes payable Accrued salaries and way		9,060
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Liabilities and Owner's Current Liabilities Accounts payable Short-term loans Income taxes payable Accrued salaries and way Unearned revenue Current portion of long-to Long-term Liabilities Long-term debt Deferred income tax Other Owner's Equity Owner's investment	ges erm debt Total current liabilities	9,060 3,349 12,409 3,450 3,450 6,000
Liabilities and Owner's Current Liabilities Accounts payable Short-term Ioans Income taxes payable Accrued salaries and way Unearned revenue Current portion of long-te Long-Term Liabilities Long-term debt Deferred income tax Other Owner's Equity Owner's investment Retained earnings	ges erm debt Total current liabilities	9,066 3,349 12,409 3,456 3,456 6,000 5,566
Liabilities and Owner's Current Liabilities Accounts payable Short-term Ioans Income taxes payable Accrued salaries and way Unearned revenue Current portion of long-te Long-Term Liabilities Long-term debt Deferred income tax Other Owner's Equity Owner's investment Retained earnings	ges Frm debt Total current liabilities Total long-term liabilities Total owner's equity	27,426 9,060 3,349 12,409 3,450 3,450 6,000 5,567 11,567 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.



#### **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!

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#### 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**

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#### 工 FORMULAS TO KNOW

#### **Current Ratio**

Current Ratio = Current Assets Current Liabilities

**Quick Ratio** 

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