Chapter 2

Liquidity Ratios

Using current ratio and acid-test ratio to assess liquidity

A business is liquid when it has enough cash – or current assets that it can quickly turn into cash - to pay its bills when they are due.

An organisation needs to monitor and evaluate its liquidity to be confident that it can pay its bills and avoid bankruptcy. Cash must be able to flow where it is needed.

Liquid – when a business has enough cash, or current assets that it can quickly turn into cash, to pay its bills when they fall due.

Even if an organisation's assets greatly outweigh its liabilities, it may still face a liquidity problem if most of its assets are fixed, and yet its liabilities are current.

This is different from insolvency, which occurs when a business' assets are simply not enough to cover its liabilities, giving its net assets a negative value. Even if that business could sell its assets immediately, it still would not be able to pay all of its debts.

A temporary loan might help a business that is illiquid, but it won't help an insolvent one.

Insolvent – when assets are not enough to cover liabilities. Net assets are negative.

The balance sheet will tell us how much working capital or net current assets a business has. However, to assess whether this is sufficient to cover its current liabilities or not, we need to calculate the current - or working capital - ratio.

Current (working capital) ratio

The current ratio is a business' current assets, divided by its current liabilities.

Current assets		£
Stock		4 000 000
Debtors		2 500 000
Investments (short-term)		1 000 000
Cash		500 000
Total current assets		8 000 000
Total assets		10 000 000
Current liabiities		
Creditors: amounts failing due within a year		5 000 000

In X-AMPLE's case, this is £8m divided by £5m, giving a current ratio of 1.6.

		£
Total current assets		8 000 000
Current liabilities		5 000 000

8 000 000 / 5 000 000 = 1.6

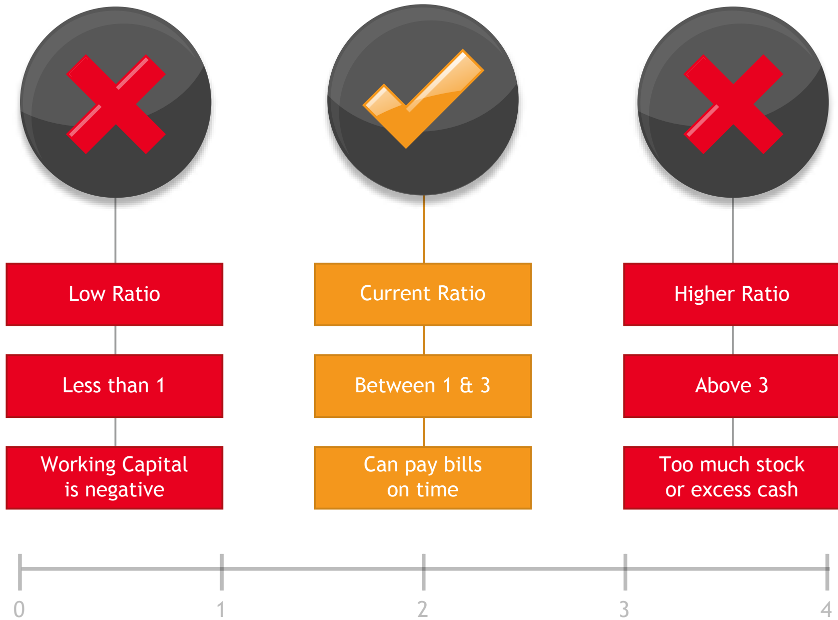
This means that for every £1 of current liabilities that X-AMPLE owed on 30th September 2016, it had £1.60 of current assets available to cover this debt.

A current ratio of between 1 and 3 is usually a good indicator that a business can pay its bills on time.

A low ratio, of less than one, reveals that the business does not have enough current assets to cover current liabilities. Therefore, its working capital is negative.

However, a high ratio above 3 can also be a concern, because it might suggest that the business is not using its current assets efficiently or managing its working capital well. It may have too much stock or excess cash - which it would be better to invest elsewhere.

Current Ratio



But can the business sell its stock in time?

One criticism of using the current ratio to indicate liquidity is that it assumes that the business will be able to sell its stock quickly enough to pay its bills on time. However, this is not always the case, especially during difficult periods when the business is in most need of cash and least able to secure a loan.

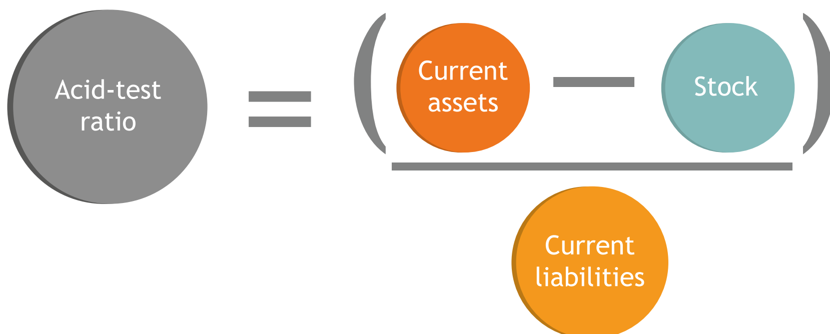
Therefore, we also calculate the acid-test or quick ratio to assess liquidity.

Acid-test (quick) ratio

This test assumes that the business will not be able to sell any of its stock, and has to meet its short-term obligations using only its most liquid assets: cash, short-term investments and debtor sums. The acid-test ratio is calculated by first subtracting the value of a business' stock from the sum of its current assets, and then dividing that total by the sum of its current liabilities.

Current assets		£
Stock		4 000 000
Debtors		2 500 000
Investments (short-term)		1 000 000
Cash		500 000
Total current assets		8 000 000
Total assets		10 000 000
Current liabilities		
Creditors: amounts falling due within a year		5 000 000

In X-AMPLE's case, this is £8m, minus £4m, divided by £5m. This gives an acid-test ratio of 0.8.



$$(8\,000\,000 - 4\,000\,000) / 5\,000\,000 = 0.8$$

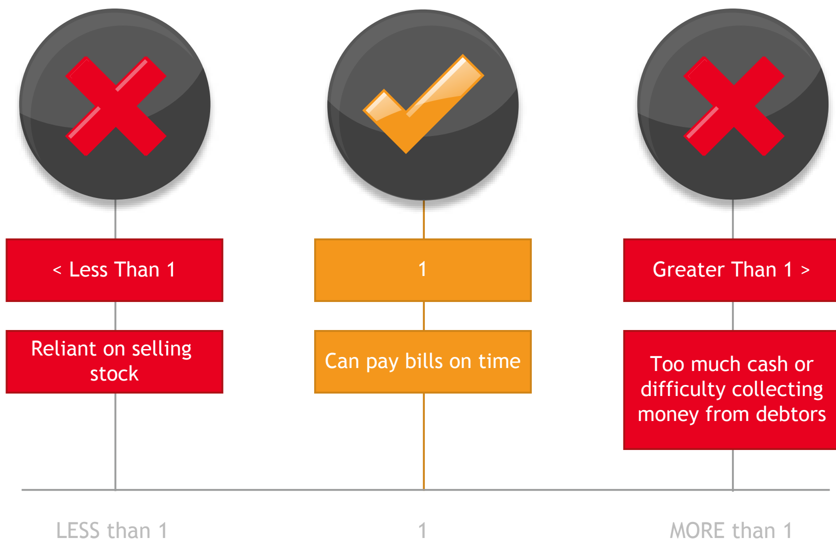
This means that for every £1 of current liabilities that X-AMPLE owed on 30th September 2016, it had 80p of liquid current assets (excluding stock) to cover this debt.

Businesses will aim to have an acid-test ratio of 1. An acid-test ratio much lower than 1 indicates that the business might be too reliant on selling stock to meet its current liabilities.

An acid-test ratio significantly greater than 1 might mean that the business has too much cash and is failing to invest profitably - or that it has difficulty collecting money owed by debtors.

When the business has trouble obtaining short-term finance, a high acid-test ratio is needed. The acid-test ratio assumes the business cannot sell its stock.

Acid-Test Ratio:



"The Acid-test (quick) ratio assumes that the business will not be able to sell any of its stock, and has to meet its short-term obligations using only its most liquid assets"