

5.19: Liquidity Ratios

Learning Objectives

By the end of this section, you will be able to:

- Calculate current, quick, and cash ratios to assess a firm's liquidity and make informed business decisions.
- Assess organizational performance using liquidity ratios.

Liquidity refers to the business's ability to manage current assets or convert assets into cash in order to meet short-term cash needs, another aspect of a firm's financial health. Examples of the most liquid assets include cash, accounts receivable, and inventory for merchandising or manufacturing businesses. The reason these are among the most liquid assets is that these assets will be turned into cash more quickly than land or buildings, for example. Accounts receivable represents goods or services that have already been sold and will typically be paid/collected within 30 to 45 days.

Inventory is less liquid than accounts receivable because the product must first be sold before it generates cash (either through a cash sale or sale on account). Inventory is, however, more liquid than land or buildings because, under most circumstances, it is easier and quicker for a business to find someone to purchase its goods than it is to find a buyer for land or buildings.

Current Ratio

The current ratio is closely related to working capital; it represents the current assets divided by current liabilities. The current ratio utilizes the same amounts as working capital (current assets and current liabilities) but presents the amount in ratio, rather than dollar, form. That is, the current ratio is defined as current assets/current liabilities. The interpretation of the current ratio is similar to working capital. A ratio of greater than one indicates that the firm has the ability to meet short-term obligations with a buffer, while a ratio of less than one indicates that the firm should pay close attention to the composition of its current assets as well as the timing of the current liabilities.

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

5.19.1

The current ratio in the current year for Clear Lake Sporting Goods is

$$\text{Current Ratio} = \frac{\$200,000}{\$100,000} = 2 \text{ or } 2:1$$

5.19.2

A 2:1 ratio means the company has twice as many current assets as current liabilities; typically, this would be plenty to cover obligations. A 2:1 ratio is actually quite high for most companies and most industries. Again, it's recommended that ratios be used in conjunction with one another. An analyst would likely look at the high current ratio and low accounts receivable turnover to begin asking questions about management performance, as this might indicate a trouble area (high inventory and slow collections).

Link to Learning

Target Corporation

As we have learned, the current ratio shows how well a company can cover short-term liabilities with short-term assets. Look through the balance sheet in the [2019 Annual Report for Target](#) and calculate the current ratio. What does the outcome mean for Target?

Quick Ratio

The quick ratio, also known as the *acid-test ratio*, is similar to the current ratio except current assets are more narrowly defined as the most liquid assets, which exclude inventory and prepaid expenses. The conversion of inventory and prepaid expenses to cash can sometimes take more time than the liquidation of other current assets. A company will want to know what it has on hand and can use quickly if an immediate obligation is due. The formula for the quick ratio is

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Short-Term Investments} + \text{Accounts Receivable}}{\text{Accounts Payable}}$$

5.19.3

The quick ratio for Clear Lake Sporting Goods in the current year is

$$\text{Quick Ratio} = \frac{\$110,000 + \$20,000 + \$30,000}{\$100,000} = 1.6 \text{ or } 1.6:1$$

5.19.4

A 1.6:1 ratio means the company has enough quick assets to cover current liabilities. It's again key to note that a single ratio shouldn't be used out of context. A 1.6 ratio is difficult to interpret on its own. Industry averages and trend analysis for Clear Lake Sporting Goods would also be helpful in giving the ratio more meaning.

Link to Learning

Target Corporation

As we have learned, the quick ratio shows how quickly a company can liquidate current assets to cover current liabilities. Look through the financial statements in the [2019 Annual Report for Target](#) and calculate the quick ratio. What does the outcome mean for Target?

Cash Ratio

Cash is the most liquid asset a company has, and cash ratio is often used by investors and lenders to assess an organization's liquidity. It represents the firm's cash and cash equivalents divided by current liabilities and is a more conservative look at a firm's liquidity than the current or quick ratios. The ratio is reflected as a number, not a percentage. A cash ratio of 1.0 means the firm has enough cash to cover all current liabilities if something happened and it was required to pay all current debts immediately. A ratio of less than 1.0 means the firm has more current liabilities than it has cash on hand. A ratio of more than 1.0 means it has enough cash on hand to pay all current liabilities and still have cash left over. While a ratio greater than 1.0 may sound ideal, it's important to consider the specifics of the company. Sitting on idle cash is not ideal, as the cash could be used to earn a return. And having a ratio less than 1.0 isn't always bad, as many firms operate quite successfully with a ratio of less than 1.0. Comparing the company ratio with trend analysis and with industry averages will help provide more insight.

$$\text{Cash Ratio} = \frac{\text{Cash and Cash Equivalents}}{\text{Current Liabilities}}$$

5.19.5

The cash ratio for Clear Lake Sporting Goods in the current year is:

$$\text{Cash Ratio} = \frac{\$110,000}{\$100,000} = 1.1$$

5.19.6

A 1.1 ratio means the company has enough cash to cover current liabilities.



Figure 5.19.1: Cash is the most liquid asset a company has and is often used by investors and lenders to assess an organization's liquidity. (credit: "20 US Dollar" by Jack Sem/flickr CC BY 2.0)

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