

Ratio Analysis—Liquidity Ratios

Specification requirement—Liquidity ratios - current and acid-test ratios. The calculation, interpretation and importance of these ratios.

The Balance Sheet on its own does not present a great deal of opportunity for Ratio Analysis, but we can use it to produce two important ratios. These are:

- **Current Ratio**
- **Acid Test Ratio.**

Both of these ratios are **Liquidity Ratios**. Liquidity is a measure of the firm's ability to pay its short term debts, it is therefore also a measure of the availability of **working capital**.

Liquidity refers to how quickly an asset can be converted into cash. Money in the bank, or held in cash is the most liquid asset. Other liquid assets are stock and debtors; of these two it is likely that stock is the least liquid.

Working Capital is calculated by totalling Current assets minus current liabilities. Working capital measures how much in liquid assets a company has available. The number can be positive or negative, depending on which is the larger Current Assets or Current Liabilities

It is important that firms have a good level of liquidity (I explain what good means below). If firms are unable to pay their credi-

tors the owner may find that the supplies of stock or raw materials are stopped, or he/she may find that the bank stops their cheques. In this sort of situation the business may be forced to stop trading. So management of liquidity is very important.

Current Ratio

This ratio tells us about the relationship between Current Assets and Current Liabilities. The formula is given below.

$$\text{Current Assets} : \text{Current Liabilities}$$

The Current Ratio is always shown as :
something : 1

So if :-

Current Assets

Stock	4,700	
Debtors	1,200	
Cash at Bank	950	
Total Current Assets	6,850	6,850

Current Liabilities

Creditors	3,700	
Overdraft	0	
Total Current Liabilities	3,700	3,700

Net Current assets **3,150**

Step 1. Take the figures from the balance sheet.

$$\pounds 6,850 : \pounds 3,700 = \text{Current Ratio.}$$

Step 2. Divide the Current Liabilities figure into the Current Assets Figure.

£6,850 divided by £3,700 = 1.85

Step 3. Place the answer before the colon in the ratio and 1 after the colon.

1.85 : 1

We now have the Current Ratio.

So what does this tell us?

The answer we have is **1.85:1**. So for every £1.85 of Current Assets the firm owns, it owes £1.00p of Current Liabilities. Looking at this ratio we can see that if all the creditors of the business demanded their money, the business would have enough resources in the form of Current Assets to meet these demands. We can say then that as indicated by the Current Ratio the liquidity of the firm is good, and it is managing its working capital effectively

As a guide to liquidity, if the Current Ratio figure is:

- above 1.5:1, we can say that liquidity is good
- between 1.5:1 and 1:1, we can say it is reasonable
- below 1:1, we can say it is poor

But do not treat the above figures as a fixed rule. Some firms happily survive on low current ratios. These are businesses with a high level of stock turnover, who deal in cash. Good examples of this type of firm are supermarkets, Tesco survives on a current ratio of about 0.5:1

Also, the Current Ratio can be regarded as being too high. For example a current Ratio of 3:1, may indicate that the business is holding a great deal of cash or stock that could be better used by the business if it was turned into some form of fixed asset.

The Current Ratio has one main failing as a tool of analysis, that is it includes stock in the calculation. In many cases stock may not be a very liquid asset. This means it may not be easy to turn into cash. A fireworks manufacturer may build up its stock over the year ready for the October sales boom. But if the firework maker needed to dispose of large amounts of stock in March to meet the demands of creditors, it is likely to have problems in selling its stock at anything near the price it could get later in the year. Other businesses may have a great deal of raw materials or work-in-progress (part completed products), each of these would be difficult or impossible to sell.

We therefore refine the Current Ratio by removing stock from the calculation. **We call this new ratio, the Acid Test Ratio.**

The Acid Test Ratio.

The Acid Test Ratio is the second liquidity ratio. It also measures the ability of the firm to meet likely short term demands for cash.

The method of calculation of the Acid Test Ratio is almost the same as the Current Ratio, and the answer is in the same format, the only difference is that we remove stock from the equation.

So the formula is;

**Current Assets - Stock : Current Liabilities
= Acid Test Ratio**

Step 1. Take the figures from the balance sheet.

$$\text{£6,850} - \text{£4,700} : \text{£3,700} \\ = \text{Current Ratio.}$$

Step 2. Divide the Current Liabilities figure into the Current Assets Figure.

$$\text{£2,150 divided by £3,700} = 0.58$$

Step 3. Place the answer before the colon in the ratio and 1 after the colon.

$$0.58 : 1$$

We now have the Acid Test Ratio for the firm.

So what does this acid test ratio figure tell us?

The answer we have is **0.58 :1**. For every £0.58p of Current Assets less Stock the firm owns, it owes £1.00p of Current Liabilities. Looking at this ratio we can see that if all the creditors of the business demanded their money and the business had problems in selling its stock quickly, the business would have not have enough resources in the form of other types of Current Asset to meet these demands. We might now say that the firm's management of it's liquidity is poor or working capital is low.

As a guide to liquidity, if the Acid Test Ratio figure is:

- above 1:1, we can say that liquidity is good
- between 0.8:1 and 1:1, we can say it is reasonable
- below 0.8:1, we can say it is poor

But as with the Current Ratio do not treat these figures as a fixed rule. Some firms happily survive on low Acid Test ratios. Again these are businesses with a high level of stock turnover, who deal in cash and those with good financial management of the other current assets and current liabilities. For the firm in our example it is best to compare the two liquidity ratios. From an examination of these, would could say :

" The firms liquidity as indicated by it's Current Ratio looks good. A figure of 1.85:1 indicates sufficient Current Assets to meet Current Liabilities. But we should also consider stock. If we look at the Acid Test Ratio, we see a figure of 0.58:1, this tells us that liquidity is poor, and the business may have problems if creditors demanded the money they are owed. The firm should try to reduce stock holdings in an attempt to improve its liquidity."

A final note on liquidity. As with the Current Ratio, the Acid Test Ratio can be regarded as being too high. For example a Acid Test Ratio of 2:1, may indicate that the business is holding a great deal of cash that could be better used by the business.

Notes