

Understanding Business Liquidity And How To Improve It



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Small businesses and large multinational corporations are both tasked with maintaining the financial health of their business.

While robust sales can certainly help, if a business doesn't have the cash on hand to take care of its financial obligations, it risks failure.

That's why business owners need to understand business liquidity, including how

to measure liquidity, what the results tell you, why good liquidity matters, and how you can improve your liquidity.

What Is the Meaning of Liquidity in Business?

Business liquidity refers to a company's ability to cover all of its short-term obligations including wages, rent, operational costs, loans, and taxes.

When a business has strong liquidity, it simply means that it can cover all of these costs without having to make internal adjustments such as staff layoffs, shortened operations, or incurring additional debt by taking out a business loan.

How Is Liquidity Different From Solvency?

Both liquidity and solvency address the financial health of a business, with liquidity determined by focusing on current assets and current liabilities while solvency addresses long-term financial issues such as if a business will be able to meet all of its debts as they come due, not just those that need to be paid in the next ninety days.

How is Liquidity Different From Solvency?

COMPARISON	LIQUIDITY	SOLVENCY
Definition	Refers to the ability to pay off current liabilities using its current assets	Refers to the ability of a business to cover debts as they become due
Purpose	Considers short-term responsibilities	Considers long-term debt obligations
Ratios to Calculate	Current ratio, quick ratio, and cash ratio	Debt-to-equity ratio, interest coverage ratio, and fixed asset ratio
Why is it Used?	To see how quickly current assets can be converted into cash	To know whether a business can sustain operations long-term
Balance Sheet Accounts Used	Current assets and current liabilities with some variations	Shareholders' equity, debt, long-term assets

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Comparison	Liquidity	Solvency
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Why Is Liquidity Important in a Business?

Being able to cover your short-term liabilities is the earmark of a successful business.

Common short-term liabilities include:

- Common expenses such as rent, utilities, wages, and supplies
- Short-term loans
- Other short-term liabilities due within 12 months
- Taxes
- Interest

When determining company liquidity, you'll need to take a look at how quickly you can convert assets to cash.

▪ Cash and Cash Equivalents

These include current bank balances or any short-term government bonds or money market funds that can be quickly sold for cash.

• **Accounts Receivable (AR)**

Your accounts receivable balance represents funds owed to you by your customers.

Generally, your AR balance is considered liquid because in most cases, payment is collected from customers in a brief period.

• **Securities**

Marketable securities such as common stock, treasury bills, and other short-term securities that mature in 12 months or less are considered liquid since they can usually be sold within a short period.

• **Inventory**

You may or may not want to include inventory in your list of current assets since inventory, particularly raw materials and unfinished goods is not as liquid as the other three current assets, though finished goods can usually be sold within a short period if necessary.

What Financial Ratios Can You Use To Determine Business Liquidity?

You can determine the liquidity of your business by calculating several common ratios.

The results of these metrics provide you with keen insight into your current liquidity and help determine if improvements are needed.

The three most common ratios used to measure liquidity include the following:

What Financial Ratios Can You Use To Determine Business Liquidity?

1 Current Ratio

The Formula For Calculating The Current Ratio Is:

Current Assets	Current Liabilities	=	Current Ratio
\$110,000	\$51,000	=	2.16%

2 Quick Ratio

The Formula To Calculate The Quick Ratio Is:

Cash Equivalents	Accounts Receivable	Marketable Securities	Current Liabilities	=	Quick Ratio
\$62,000	\$25,000	\$10,000	\$51,000	=	1.98%

3 Cash Ratio

The Formula To Calculate Your Cash Ratio Is Simple:

Cash Equivalents	Marketable Securities	Current Liabilities	=	Current Liabilities
\$62,000	\$10,000	\$51,000	=	1.41%

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1. Current Ratio

The current ratio, also known as the working capital ratio, is the easiest ratio to calculate and determines the number of times a business can use its current assets to pay for its current liabilities.

The formula for calculating the current ratio is:

Current Assets / Current Liabilities = Current Ratio

Let's say your business balance sheet shows current assets that total \$110,000 and current liabilities of \$51,000:

$$\$110,000 / \$51,000 = 2.16$$

The above result means that you can cover your current liabilities at least twice, with some funds left over.

Businesses should always strive to have a current ratio of at least 1 which indicates that you have as much in current assets as you have in current liabilities.

A current ratio below one can indicate liquidity issues, though this can vary from business to business, depending on the industry.

2. **Quick Ratio**

The quick ratio, also known as the acid test ratio is similar to the current ratio, but does not include inventory totals in the measurement.

The quick ratio also excludes prepaid expenses because it's unlikely that prepaid expenses can be converted to liquid assets quickly.

The formula to calculate the quick ratio is:

$$(Cash\ Equivalents + Accounts\ Receivable + Marketable\ Securities) / Current\ Liabilities = Quick\ Ratio$$

Using the example above, we'll want to remove inventory totals, which totaled \$13,000, while including \$62,000 in cash equivalents, a \$25,000 accounts receivable balance, and marketable securities of \$10,000, with current liabilities totaling \$51,000.

We would calculate the quick ratio as follows:

$$(\$62,000 + \$25,000 + \$10,000) / \$51,000 = 1.98$$

The quick ratio calculation result is less than the current ratio, but not significantly so. This would change if your inventory totals were much

higher.

With a result of 1.98, you can nearly cover your current liabilities twice with your current assets.

When calculating the quick ratio, it's important to take accounts receivable collections methods into account when analyzing your quick ratio results, since a fast AR turnover means that the funds will be available if necessary while slow AR turnover can result in a higher quick ratio but less actual liquidity.

Again, most businesses should strive for a minimum quick ratio of at least 1, even though there are occasions when it may drop below 1 without lasting damage.

3. **Cash Ratio**

The final liquidity ratio useful for determining business liquidity levels is the cash ratio.

The cash ratio includes only the most liquid assets like cash equivalents and marketable securities, while excluding both inventory and accounts receivable, which may take longer to convert to cash.

The formula to calculate your cash ratio is simple:

(Cash Equivalents + Marketable Securities) / Current Liabilities

Using the numbers from the example above, let's run the cash ratio for the business.

$$(\$62,000 + \$10,000) / \$51,000 = 1.41$$

You can see that using the most conservative calculation method, your liquidity has dropped considerably, from being over 2 to less than 1.5.

While the result is still within the acceptable range, it can be helpful to calculate liquidity using all three ratios to see exactly what liquidity level your business is at when removing inventory and accounts receivable totals.

How Can I Improve My Liquidity?

If your calculation results indicate low liquidity, there are some things you can do to improve it.

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Reduce Overhead Costs



Reassess Your Payment Cycles



Reduce Inventory



Consider Raising Prices



Refinance Debt Obligations

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• Reduce Overhead Costs

One of the easiest ways to improve liquidity is to reduce overhead expenses.

Common overhead costs that you may be able to reduce include rent, utilities, insurance, advertising, and incidentals like subscriptions.

• Reassess Your Payment Cycles

Both your accounts payable and accounts receivable cycles have a direct impact on your liquidity.

If you need to pay vendors promptly, it leaves little opportunity to use that money for other things.

Liquidity issues can also arise if your customers take a long time to pay you.

Try negotiating a discount with your vendors for paying early or provide your customers with a discount for early payment.

▪ **Reduce Inventory**

Do you often have a surplus of inventory that doesn't sell as quickly as other products?

Try reducing your reorders or even consider discontinuing products that don't sell to eliminate the cost of producing and storing them.

▪ **Consider Raising Prices**

If you haven't raised prices in a while, you may want to reassess your cost of goods sold to make sure that you're selling your products at the most optimal price.

▪ **Refinance Debt Obligations**

If you have a lot of short-term debt, consider refinancing it to long-term debt, which can reduce your monthly payments.

If you have multiple short-term debt obligations, you may also want to consider consolidating all of your loans which can also reduce your monthly debt payment.

What Is Liquidity Planning?

Liquidity planning is another word for cash flow planning and is the act of creating a cash flow forecast for future accounting periods.

Liquidity planning can help businesses avoid cash flow problems and take better control of the cash flow process.

Liquidity planning requires you to implement a liquidity strategy that should include the following:

- Cash flow from operations which looks at short-term cash flows for up to six months
- Cash reserve analysis for up to one year
- Strategic cash flow which is designed for long-term planning, estimating

revenues and expenses well into the future

How Do I Create a Liquidity Plan?

The best way to create both a short-term and a long-term liquidity plan is to use a template that provides estimated cash flow projections for 12 months.

This template should include the following:

Cash Inflows

1. Your beginning cash balance as of the end of the previous accounting period.
2. Estimated cash sales for each month. Do not include sales that you expect to be made on credit.
3. Your estimated accounts receivable for the period. If the majority of your sales are made on credit, it should be easy to estimate your AR totals.
4. Estimated cash inflows from other sources such as investments should be included in your liquidity planning template as well.
5. Inventory totals for the month which should include material costs as well as the value of any unsold inventory.
6. Add up your cash inflows to obtain your estimated cash inflows for the month.

Cash Outflows

1. Fixed costs which include rent or mortgage payments, subscriptions, maintenance plans, and leasing fees will need to be tallied and added.
2. Personnel costs should include wages and salaries for all employees including any associated payroll expenses such as insurance and employment tax.
3. Cost of goods sold includes material expenses as well as the purchase of complete products for resale.
4. Income tax, corporate tax, and VAT will need to be included in the liquidity plan.
5. Always make allowances for unplanned costs since there will always be unexpected expenses incurred. Regularly planning for them will keep your

business on track financially.

6. Add up your cash outflows to determine estimated cash outflows for the month.

When this is complete, you'll subtract your cash outflows from your cash inflows to determine your level of liquidity and if you have enough cash on hand for the upcoming month.

What Is Liquidity Risk and How Is It Managed?

Liquidity risk refers to the risk that a business will not be able to meet upcoming financial obligations.

There are two types of liquidity risk that companies may need to deal with.

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Funding Liquidity Risk

Funding liquidity risk is the biggest issue facing most businesses today, as it deals with the inability to fund short-term liabilities. Businesses that are less liquid face consequences such as a drop in creditworthiness and difficulty in finding lenders willing to invest in your business.



Market Liquidity Risk

Market liquidity risk refers to a temporary drop in an asset's value. This can happen when a store goes out of business and must sell its remaining inventory at a loss. Real estate is another area where market liquidity risk is increased.

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2. **Market Liquidity Risk**

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The best way to manage liquidity risk is to prepare a cash flow forecast that is updated regularly.

Having cash reserves on hand is also a necessity since one unexpected expense can quickly undermine the stability of a business.

Another way to mitigate liquidity risk is to create multiple income streams. This can be accomplished by introducing new products or diversifying investments.

Regularly assessing overhead costs and the cost of goods sold can also help with liquidity risk.

How Does Liquidity Tie In With Procurement?

Procurement plays an important part in liquidity. When businesses have sufficient liquidity, they can pay suppliers on time.

In turn, this creates stronger vendor and supplier relationships and opens the door to negotiating discounts for early payment or extended payment terms.

Liquidity can also play a role in supply chain management, as a shortage of materials or an unexpected rise in prices can leave unprepared businesses without materials or available cash.

Maximize Business Liquidity Through

Automation

Investing in technology through an automated solution like PLANERGY can reduce labor costs, eliminate human error, and improve invoice processing times.

Automation allows for faster payment processing, the ability to capture vendor discounts timely, and helps build healthy vendor and supplier relationships while helping you better manage liquidity now and for the future.

What's your goal today?

1. Use PLANERGY to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

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