

# Liquidity Ratio Analysis



As a business owner, you understand the importance of having access to accurate financial statements. But the typical financial statements which include income statements and balance sheets only tell a portion of the story.

To get a better handle on how your business is performing financially, consider using accounting ratios. With dozens of ratios available to choose from, you can obtain detailed metrics and KPIs on things like company profit margin, working capital, accounts receivable turnover, and inventory movement.

You can also get some much-needed insight into the liquidity of your business by using a series of specialized ratios which can show you how well you can meet your short-term financial obligations, such as payroll, rent, and taxes.

Liquidity ratios concentrate on current assets and liabilities, not concerned with long-term assets that cannot be converted into cash quickly, nor long-term liabilities that are not payable within the year's time. Liquidity ratios are important for a variety of reasons, including the following:

- Ability to pay bills - If all of your current obligations came due today, do you have enough current assets in place to pay them without resorting to credit? Liquidity ratios will tell you if you have enough cash to pay your bills.

- Reassure creditors and financial institutions - Are you applying for credit from a vendor, or trying to obtain a business loan? If so, one of the first things that they'll look at is your liquidity. The number one thing that a potential creditor wants to know is whether your business can repay a loan, while a vendor will want to know that your business can pay its bills on time and in full.
- Attract investors - Like creditors, potential investors will want to see that your business can pay its bills on time. But investors also look at high liquidity ratios with caution as well, since a higher-than-normal result can point to the possibility that cash is not being used properly.

These are just a few of the reasons why calculating your company's liquidity ratio and understanding the results of that calculation are so important for both small businesses and global enterprises.

While a large corporation may want a good liquidity ratio to attract quality investors, small business owners want to know that they have enough assets on hand to pay any bills that may come due in the short term.

Luckily, calculating liquidity ratios is a quick and easy process, giving you the information you're looking for in minutes. There are numerous types of liquidity ratios, with three common liquidity ratios used most frequently. Though each of these ratios is similar, they offer differing levels of detail.

## Current Ratio

The current ratio is the most inclusive of the liquidity ratios, providing you with detailed information on the liquidity of your business by measuring the ability of your business to pay current liabilities only using current assets.

Common current assets that should be included in the current ratio calculation include the following.

- Cash and cash equivalents such as marketable securities
- Accounts receivable
- Prepaid expenses
- Inventory

When calculating the current ratio, you'll only use current liabilities or liabilities

that are due and payable within a year. These liabilities can include the following.

- Accounts payable
- Employee payroll
- Taxes
- Accrued liabilities
- Any short-term debt (due within 12 months)

## How to calculate the current ratio

The current ratio formula is simple. Simply take your current asset total and divide the total by your current liability total.

The simplest ratio to complete; the current ratio calculation is:

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

Because the current ratio includes ALL of your company's current assets, there is no need to take individual totals of your current assets such as cash or inventory. You can simply use the current assets and current liabilities totals that can be found on your balance sheet to calculate the current ratio.

When reviewing results, a good current ratio is usually anywhere between 1.2 and 2, with 1.2 indicating that you have an equal amount of current assets and current liabilities, while a current ratio of 2 indicates that you have twice as much in current assets.

## Quick Ratio

The quick ratio is also known as the acid-test ratio and looks at your ability to pay off short-term liabilities with quick assets; or assets that can be converted to cash within 90 days.

But unlike the current ratio, the quick ratio does not include certain assets such as real estate, inventory, and prepaid expenses, because they are unlikely to be converted into liquid assets quickly.

Many companies choose to use the quick ratio over the current ratio because it provides a more accurate depiction of a company's true liquidity.

## How to calculate the quick ratio

You can calculate the quick ratio by adding cash and cash equivalents, current accounts receivable, and short-term investments and dividing that total by your current liabilities.

$$\text{Quick Ratio} = (\text{Cash} + \text{Cash Equivalents} + \text{Accounts Receivable} + \text{Short-Term Investments}) / \text{Current Liabilities}$$

1 is considered a good quick ratio, though creditors prefer a quick ratio of at least two, which increases the likelihood that they will be paid on time.

## Cash Ratio

The cash ratio is just as it sounds, using cash or cash equivalents such as marketable securities to measure liquidity.

All other current assets such as accounts receivable, inventory, and prepaid expenses should not be included in the cash ratio calculation.

Because the cash ratio focuses on cash and its equivalents, it can provide the most realistic results of any of the liquidity ratios.

## How to calculate the cash ratio

The cash ratio uses only cash and equivalents, dividing your cash totals by your current liabilities. The calculation is:

$$\text{Cash Ratio} = (\text{Cash} + \text{Marketable Securities}) / \text{Liabilities}$$

A cash ratio will normally be lower than both the current or the quick ratio because the parameters are much narrower. Most businesses should strive for a cash ratio between .5 and 1, although creditors may want to see it higher.

*A good liquidity ratio can vary from industry to industry, making it important to always compare the results of your company to those of similar companies.*

# Differences between the liquidity ratios

While all of the liquidity ratios are designed to measure how easily your business can pay off short-term liabilities with current assets, they all provide a different level of measurement.

Using the following balance sheet, we'll calculate the Current Ratio, the Quick Ratio, and the Cash Ratio for JNB Manufacturing.

	<b>JNB Manufacturing 2020 Balance Sheet</b>	
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash		\$125,000.00
Marketable Securities		\$30,000.00
Accounts Receivable		\$31,000.00
Prepaid Expenses		\$10,000.00
Inventory		\$111,000.00
<b>Total Current Assets</b>		<b>\$307,000.00</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Accounts Payable		\$66,000.00
Salary/Wages Payable		\$14,000.00
<b>Total Current Liabilities</b>		<b>\$80,000.00</b>

## Current ratio calculation

For example, in December of 2020, JNB's balance sheet had total current assets of \$307,000 and total current liabilities of \$80,000.

Because the current ratio uses all current assets in the calculation, you can use the entire current assets total to calculate the current ratio.

$$\mathbf{\$307,000 / \$80,000 = 3.84}$$

This shows that for every \$1 that JNB has in current liabilities, they have \$3.84 worth of current assets, giving them a current ratio of nearly 4.

## **Quick ratio calculation**

The quick ratio calculation includes only liquid assets such as cash and accounts receivable, so you'll need to include only JNB's cash total, marketable securities total, and accounts receivable total found on the balance sheet.

$$\mathbf{(\$125,000 + \$30,000 + \$31,000) / \$80,000 = 2.32}$$

When removing prepaid expenses and inventory, you'll notice that JNBs liquidity drops from nearly a 4 to 1 ratio to a 2 to 1 ratio. The result above indicates that for every dollar in liabilities, JNB has \$2.32 in assets.

## **Cash ratio calculation**

Used most frequently by creditors and financial institutions, the cash ratio is considered the most stringent of the three liquidity ratios, using only cash and marketable securities in its calculation.

$$\mathbf{(\$125,000 + \$30,000) / \$80,000 = 1.93}$$

The result of 1.93 means that for every dollar in liabilities, JNB has \$1.93 in assets.

Based on the above calculations, you can see that the results dropped from a high of 3.84 when calculating the current ratio to a low of 1.93 for the cash ratio, depending on what current assets were included in each of the calculations. A low cash ratio can also pinpoint an issue with company cash flow.

## **What is a good liquidity ratio?**

Calculating liquidity ratios is a fairly simple task. But liquidity ratio analysis can

be more complicated for a variety of reasons.

First, a good liquidity ratio can vary from industry to industry, making it important to always compare the results of your company to those of similar companies.

For example, the industry standard for the current ratio usually falls between 1.2 and 2, with a higher result considered better.

A good current ratio is 2, meaning that you have twice as much in assets that can pay off any liabilities due. A business with a current ratio of less than 1 indicates that your business may have difficulty paying any short-term financial obligations.

But higher isn't always better. Too high of a liquidity ratio can also be problematic; signifying possible issues with cash management.

For example, potential investors will likely view a liquidity ratio between 1 and 3 favorably.

However, a ratio higher than 3 can raise a red flag with investors, who may view a company with a higher liquidity ratio as too cautious or unable to properly use its resources.

It's important to remember that each industry will have its own standard. For example, a retail business that needs to stock large amounts of inventory will have a much different liquidity ratio than a service business.

As an example, let's take a look at Amazon.com's liquidity ratios and what they mean. As of December 2020, Amazon.com had a current ratio of 1.05, meaning that it has equal amounts of both short-term assets and liabilities. Their quick ratio was 0.83, while their cash ratio was 0.67.

However, Amazon's business model like Walmart and Target is based on inventory, which means a much higher accounts payable liability total. Their business model does not typically offer credit to customers, eliminating an accounts receivable balance.

Their current ratio of 1.05 means that they have just about the same amount of current assets as they have current liabilities, while their quick ratio and cash ratios are a bit lower. But because of their inventory-heavy business model, these

totals are actually within the range that they should be.

## **Liquidity vs. Profitability**

With all this talk of liquidity, you might be wondering what the difference is between liquidity and profitability. To make things even more confusing, a company can be profitable but not liquid.

For example, considering Amazon's liquidity ratios, when you look at their profit margin, you'll see that their relatively low liquidity does not impact their profit margin. As of December 2020, their profitability ratio was 39.57%. So, what is the difference between liquidity and profitability?

Profitability is the ability of a company to make a profit after all business expenses have been deducted from revenue earned. On the other hand, liquidity refers to a company's ability to pay short-term debt with its current assets.

Companies like Amazon.com remain profitable even when liquidity is at a minimum since the majority of their assets are tied up in inventory. While profitability is more important for the long-term success of any business, liquidity is a short-term measurement of a business's ability to pay the short-term debt at any given time.

## **Should you calculate liquidity ratios?**

Though primarily used by credit analysts and potential investors, liquidity ratios can also provide useful metrics for business owners and managers who want to check on their company's solvency.

This is particularly important when applying for a loan or credit terms from a vendor since they will likely calculate the ratios themselves to determine the ability of your company to pay its short-term debt.

But financial ratios can also provide you with some much-needed insight, offering insight into whether you're able to meet current financial obligations including employee salaries, utility bills, rent, and taxes.

Easy to calculate and easy to analyze, there is no good reason not to

calculate liquidity ratios for your business.

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