Liquidity

A firm must be in a position to meet short-term financial commitments and obligations once due. Whether it can actually do so, may be answered by analyzing its state of liquidity.

A firm´s financial commitments and obligations may arise from its indebtedness (e.g. meeting principal and interest payments related to bank loans or bonds) or payments due to shareholders (e.g. dividends). Of course, such commitments also extend to payments related to a firm´s production process, such as payments to its suppliers of raw materials, goods and services, not least to its personnel, but also payments of taxes or fees, as there may be.

For this purpose, firms have to have sufficient liquidity, either by holding cash or by having quick access to it: Latter could be achieved by divesting liquid assets (e.g. securities, even receivables) or by drawing cash from credit lines provided by one of the firm´s creditors, such as its house banks.

Financial analysts at commercial banks and credit rating agencies have developed a broad set of parameters to assess a firm´s state of liquidity. These parameters, often ratios, are also found in loan documentations (i.e. financial covenants). The most relevant ones among them are the current ratio, the quick ratio and the cash ratio.

The current ratio addresses the relation of a firm´s current assets vis-à-vis its current liabilities. Current assets are those that a firm intends to hold for a short period only (usually less than a year), such as cash, cash equivalents, securities, receivables and inventory. Current liabilities include payables as well as short-term debt and such soon to mature. According to the concept of the current ratio, a firm should hold sufficient liquid, current assets to be in a position to cover its current liabilities. Often literature suggests that the current ratio should exceed 1 (i.e. current assets exceeding current liabilities). - However, this view ignores that there are various alternatives for a firm to maintain sufficient levels of liquidity, such as accessing credit lines, for instance, aside from holding enough liquid assets. (Having said this, current assets may be required as collateral, though, when accessing such funding). Besides, like any other ratio, also the current ratio should not be treated as an absolute threshold. Instead, it may rather be viewed as a relative benchmark in a peer-to-peer context or be observed along trends (stable, improving or deteriorating).

The quick ratio excludes the inventory from a firm´s current assets, with this diminished position then divided by current liabilities: In most cases, inventory (composed of raw material, semi-finished and finished goods) will be less liquid than cash or receivables. Whilst often true, one could argue, though, that such depends on the type and quality of an inventory: Commodities, such as oil or timber could probably be converted into cash swiftly, perhaps in a matter of days. On the other hand, the same process may take much longer if specialty machinery components or similar were involved.

Finally, the cash ratio excludes - next to inventory - also receivables from current assets. As a matter of fact, in most cases receivables - depending upon size and quality – can be liquidated swiftly, often within days. As a matter of fact, factoring is an important part of liquidity management for many firms, whereby receivables are sold to factoring specialists on an ongoing basis. These financial institutions instantly pay in cash for a certain percentage of the claims, perhaps some eighty, even ninety per cent (depending upon the quality of a firm´s customer base), with the remainder split between the factor and the firm upon collection. - Nevertheless, receivables are not regarded to have the same quality of liquidity, such as cash or equivalents. - The cash ratio is therefore defined as the firm´s cash position plus highly liquid securities (i.e. cash equivalents) divided by current liabilities.

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BALANCE SHEET

CASH	PAYABLES
CASH EQUIVALENTS	SHORT-TERM DEBT
RECEIVABLES	OTHER CURRENT LIABILITIES
INVENTORY	
OTHER CURRENT ASSETS	
NON-CURRENT ASSETS	NON-CURRENT LIABILITIES
	EQUITY

CASH RATIO — CASH, CASH EQUIVALENTS

QUICK RATIO — CASH, CASH EQUIVALENTS, RECEIVABLES

CURRENT RATIO — CASH, CASH EQUIVALENTS, RECEIVABLES, INVENTORY, OTHER CURRENT ASSETS

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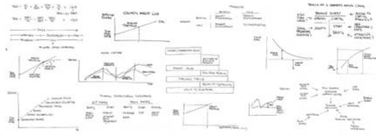

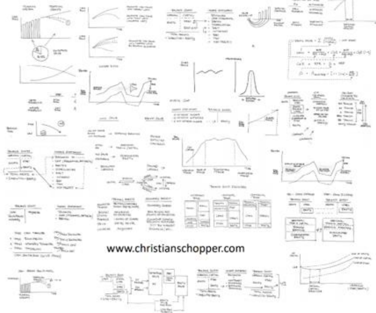

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