Liquidity

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

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

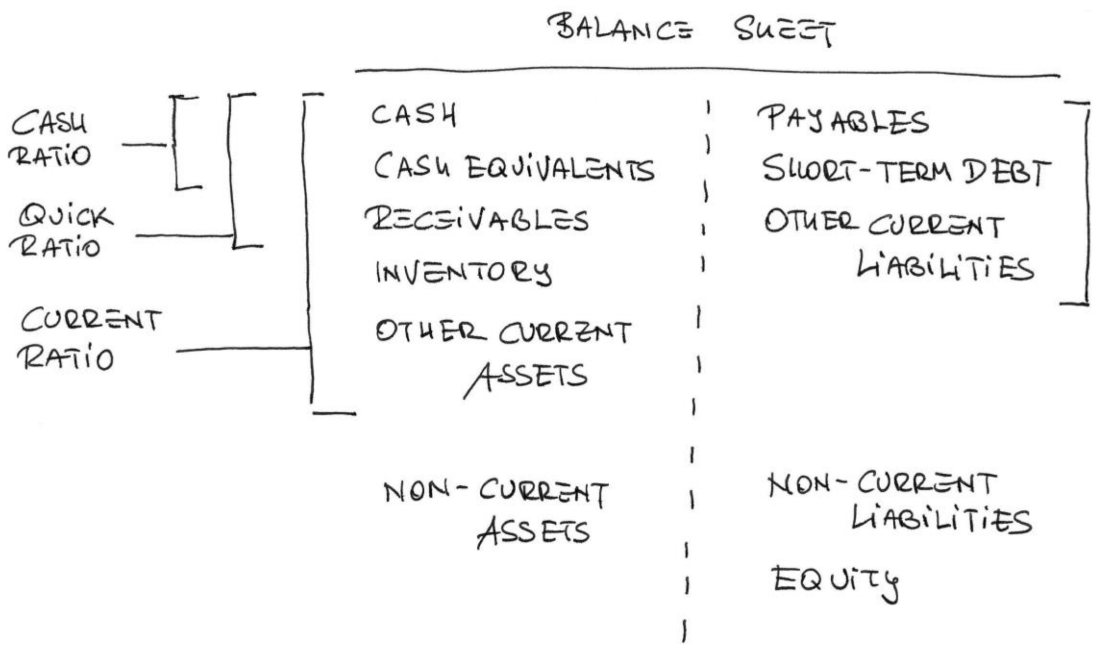
For this purpose, firms require access to sufficient liquidity, either by holding adequate cash or by having quick access to it: Latter could be achieved by divesting liquid assets (e.g. securities or receivables) or by drawing cash from credit lines provided by one of the firm´s house banks.

Financial analysts at commercial banks and credit rating agencies have developed a broad set of parameters and ratios to assess a firm´s financial health as far as its liquidity is concerned. These parameters, often ratios, typically also find themselves in loan documentations (i.e. financial covenants). Among them, the most relevant ones are the current ratio, quick ratio and cash ratio.

The current ratio addresses the relationship 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 of time only, such as cash, cash equivalents, securities, receivables and inventory. Current liabilities include payables as well as short-term debt and any other 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, whereby literature often suggests that the current ratio should exceed 1 (i.e. current assets exceeding current liabilities). - However, this view ignores that there are various means for a firm to ensure a sufficient level of liquidity, such as drawing on credit lines, aside from just holding sufficient liquid assets. (Admittedly, current assets may be required as collateral when accessing such funding). Further, as far as any ratio is concerned, also the current ratio has to be either seen in a relative, peer-to-peer context (rather than serving as an absolute benchmark) or to be assessed along trends which may be stable, improving or deteriorating.

The quick ratio excludes the firm´s inventory from the current assets, whereby this diminished position is then divided by current liabilities: In most cases, inventory (composed of raw material, semi-finished and finished goods) is regarded as being less liquid than cash or receivables. Whilst often true, one could argue, though, that this actually depends upon the type and quality of inventory: Commodities, such as oil or timber could be converted into cash easily and fast, maybe within 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, receivables - depending upon size and quality – can be sold fairly easily, often within days. Also, there are firms whose liquidity management heavily relies on factoring, whereby receivables are sold to factoring specialists on an ongoing basis. These financial institutions immediately pay in cash for a certain percentage of the claims, 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. - Despite all that, receivables do not have the liquidity quality of cash or its equivalents. - The cash ratio is therefore defined as the firm´s cash position plus highly liquid securities (cash equivalent) divided by the firm´s current liabilities.


BALANCE SHEET
CASH RATIO
QUICK RATIO
CURRENT RATIO
CASH
CASH EQUIVALENTS
RECEIVABLES
INVENTORY
OTHER CURRENT ASSETS
NON-CURRENT ASSETS
PAYABLES
SHORT-TERM DEBT
OTHER CURRENT LIABILITIES
NON-CURRENT LIABILITIES
EQUITY

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