Liquidity Ratios

1. Introduction

Liquidity ratios measure a company's ability to meet its short-term obligations using cash and other current assets. They provide insight into financial flexibility, the adequacy of cash reserves, and the company's capacity to manage day-to-day operations without financial strain. When combined with profitability and solvency analysis, they form a comprehensive assessment of overall financial health. These ratios are a key indicator of short-term financial health and operational stability.

2. Why These Ratios Matter

Liquidity ratios are important because they:

- Assess the company's ability to meet short-term obligations on time
- Provide early warning signs of potential cash flow constraints
- Highlight operational stress before it impacts profitability
- Evaluate reliance on short-term borrowing or external financing
- Enable comparison of liquidity across periods and peer groups
- Measure resilience during revenue fluctuations or economic downturns

3. Key Metrics

Common liquidity ratios include:

- Current Ratio
- Quick Ratio (Acid-Test Ratio)
- Cash Ratio
- Operating Cash Flow to Current Liabilities
- Revenue-to-Cash Ratio

4. Core Formulas

- **Current Ratio** = Current Assets ÷ Current Liabilities
- **Quick Ratio** = (Current Assets − Inventory) ÷ Current Liabilities
- **Cash Ratio** = Cash & Cash Equivalents ÷ Current Liabilities
- **Operating Cash Flow to Current Liabilities** = Operating Cash Flow ÷ Current Liabilities
- **Revenue-to-Cash Ratio** = Annual Revenue ÷ Cash Balance

5. Computation Example

Sample Financial Data

- Current Assets = $600,000
- Inventory = $200,000
- Cash = $120,000
- Current Liabilities = $400,000
- Operating Cash Flow = $300,000
- Annual Revenue = $2,400,000

Calculated Ratios

- **Current Ratio** = 600,000 ÷ 400,000 = **1.50×**
- **Quick Ratio** = (600,000 − 200,000) ÷ 400,000 = **1.00×**
- **Cash Ratio** = 120,000 ÷ 400,000 = **0.30×**
- **OCF to Current Liabilities** = 300,000 ÷ 400,000 = **0.75×**
- **Revenue-to-Cash** = 2,400,000 ÷ 120,000 = **20×**

6. Interpretation Guidance

Liquidity Position Insights

- Higher ratios → stronger short-term financial flexibility and liquidity buffer
- Current Ratio above ~1.0 → indicates ability to cover short-term obligations
- Quick Ratio around or above 1.0 → reflects efficient working capital management without reliance on inventory

Cash & Working Capital Quality

- Low Cash Ratio → indicates reliance on receivables, inventory, or supplier credit
- Strong OCF-to-Liabilities → suggests obligations are supported by actual cash generation rather than accounting earnings

Trend & Efficiency Signals

- Declining liquidity ratios → potential early indicator of cash flow stress or increased financing needs
- Excessively high liquidity → may indicate inefficient capital allocation or underutilized resources
- High Revenue-to-Cash → signals lean cash levels relative to business scale, requiring careful cash management

7. How This Supports Decision-Making

For Management

- Identifies potential short-term funding gaps or liquidity constraints
- Supports optimization of cash reserves and working capital
- Informs decisions on credit policies, inventory management, and supplier payments

For Investors

- Evaluates short-term financial health and operational resilience
- Assesses the company's ability to withstand revenue volatility

For Creditors and Lenders

- Determines short-term repayment capacity
- Supports credit approvals and working capital financing decisions

For Planning & Operations

- Strengthens budgeting and cash flow forecasting
- Enhances short-term financial planning and risk management
- Ensures adequate liquidity during business cycles or downturns