

Liquidity Ratios

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.

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

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

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

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** = $600,000 \div 400,000 = 1.50\times$
- **Quick Ratio** = $(600,000 - 200,000) \div 400,000 = 1.00\times$
- **Cash Ratio** = $120,000 \div 400,000 = 0.30\times$
- **OCF to Current Liabilities** = $300,000 \div 400,000 = 0.75\times$
- **Revenue-to-Cash** = $2,400,000 \div 120,000 = 20\times$

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

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