## **Liquidity Ratios**

A business requires liquid funds in order to meet its short-term commitments. Liquidity is the ability of an organization to pay the amount as and when it becomes due, to the [stakeholders](https://www.toppr.com/guides/accountancy/financial-statements/stakeholders-and-their-information-requirement/).

Thus, we need to calculate the Liquidity ratios to measure liquidity. These ratios are short-term in nature. The creditors always want to know the liquidity position of the entity because of their financial stake.

When an organization is unable to fulfill its short-term commitments it adversely affects its credibility as well as the credit rating.

Also, this may result in bankruptcy or closure. It is noteworthy here that excess and insufficient liquidity both are not good for the organization.

### **Types of Liquidity Ratio**

* Current Ratio
* Quick Ratio or Acid test Ratio
* Cash Ratio or Absolute Liquidity Ratio
* Net Working Capital Ratio

#### **Current Ratio**

It is one of the most common [ratios](https://www.toppr.com/guides/accountancy/accounting-ratios/activity-or-turnover-ratios/) for measuring the short-term solvency or the liquidity of the firm. It is the ratio between the Current Assets and Current Liabilities.

In other words, it [measures](https://www.toppr.com/guides/physics/units-and-measurement/measurement-of-length-mass-and-time/) whether there are enough current assets to pay the current debts with a margin of safety for potential losses in the realization of the current [assets](https://www.toppr.com/guides/accounting-and-auditing/preparation-of-final-accounts-of-sole-proprietor/classification-of-assets-and-liabilities/).

Usually, the ideal current ratio is 2:1. However, the ideal ratio depends on the [nature](https://www.toppr.com/guides/business-studies/nature-and-purpose-of-business/nature-of-business-risk/) of the [business](https://www.toppr.com/guides/business-studies/nature-and-purpose-of-business/concept-and-characteristics-of-business/) and the characteristics of its current assets and current liabilities. Thus,

Current Ratio=Current Assets ÷ Current Liabilities

Where,

**Current Assets** = Sundry Debtors + Inventories + Cash-in-hand + Cash-at-Bank + Receivables + Loans       and Advances + Disposable Investments + Advance Tax

**Current Liabilities** = Creditors + Short-term Loans + Bank Overdraft + Cash Credit + Outstanding expenses + Provision for Taxation + Dividend payable

#### **Quick Ratio**

It is also known as Acid-test Ratio. Quick Ratio measures the relationship between Quick Assets and Current Liabilities. It measures whether there are enough readily convertible quick [funds](https://www.toppr.com/guides/business-studies/sources-of-business-finance/classification-of-sources-of-funds/) to pay the current debts.

Thus, it is better than the Current Ratio. Quick assets include only cash and near cash assets. It does not include inventories as they are not readily convertible into cash.

The ideal Quick Ratio or Acid-test Ratio is 1:1. Thus,

Quick Ratio or Acid-test Ratio=Quick Assets÷Current Liabilities

Where,

**Quick Assets** = Current Assets – Inventories – Prepaid Expenses

#### **Cash Ratio or Absolute Liquidity Ratio**

It measures the absolute liquidity of the firm. It measures whether a firm can pay the current debts by using only the cash balances, bank balances and marketable securities.

We do not include Inventory and Debtors because there is no guarantee of their realization. Thus,

Cash Ratio=Cash and Bank Balances + Marketable Securities + Current Investments÷ Current Liabilities

#### **Net Working Capital Ratio**

It is a measure of cash flow. The answer to this ratio should be positive. Usually, the bankers keep an eye on this ratio to see whether there is a financial crisis or not. Thus,

**Net Working Capital Ratio** = Current Assets – Current Liabilities (exclude short-term bank borrowing)

Above given formulas are very important to solve the sums of ratios.(green coloured)

## Question.1

**From the following particulars calculate current Ratio, quick ratio ,cash ratio and net working capital ratios:**

|  |  |
| --- | --- |
| Particulars | Amount |
| Inventory | 140000 |
| Sundry Debtors | 280000 |
| Cash | 50000 |
| Bills receivable | 20000 |
| Creditors | 300000 |
| Bank Overdraft | 50000 |

Ans.

1. Current Ratio=Current Assets÷Current Liabilities=490000÷350000=1.4:1

Current Assets = Sundry Debtors + Inventories + Cash-in-hand + Bills Receivable

= 280000 + 140000 + 50000 + 20000

= 490000

Current Liabilities = Creditors + Bank Overdraft

= 300000 + 50000

= 350000

1. Quick Ratio or Acid-test Ratio=Quick assets ÷ current Liabilities

=350000÷350000=1:1

Quick Assets = Current Assets – Inventories

= 490000 – 140000

= 350000

Current liability=350000

1. Cash Ratio=Cash Balance ÷ Current Liabilities

=50000 ÷ 350000=0.14:1

1. Net Working Capital Ratio = Current Assets – Current Liabilities (exclude short-term bank borrowing)

= 490000 – 300000

= 190000