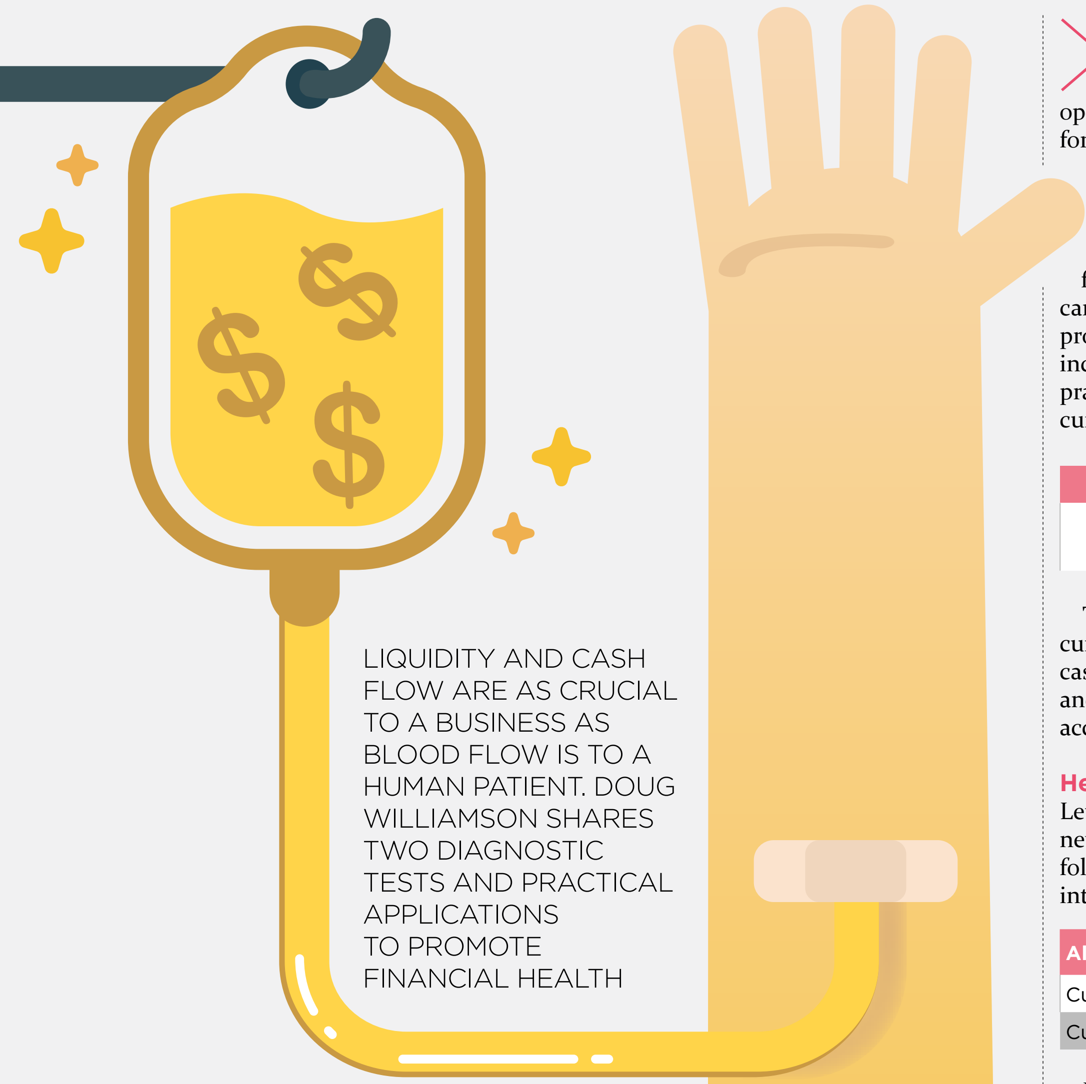

LIQUIDITY AND CASH FLOW ARE AS CRUCIAL TO A BUSINESS AS BLOOD FLOW IS TO A HUMAN PATIENT. DOUG WILLIAMSON SHARES TWO DIAGNOSTIC TESTS AND PRACTICAL APPLICATIONS TO PROMOTE FINANCIAL HEALTH

LIFE BLOOD

Our organisation's liquidity is its ability to pay its obligations when they fall due, and so safeguard continuing operations. As treasurers, we are responsible for ensuring liquidity at all times. Failures can be expensive, even fatal.

Diagnosis

Happily, a number of diagnostic tests for liquidity have been developed. These can give us early warning of any growing problems. Among others, these tests include liquidity ratios. Let's explore two practical liquidity ratios, starting with the current ratio.

Current ratio
Do we have enough current assets in hand to pay our current liabilities?

This simple assessment assumes our current assets could all be converted into cash in time to pay the current liabilities, and without loss compared with their accounting, or 'book', values.

Health check

Let's assume we work for OpCo. Our new assistant Alex has provided the following data, extracted from OpCo's internal accounts.

Alex's data (€m)	
Current assets	23
Current liabilities	11

Let's calculate our current ratio, using this information. Then we'll explore what this number is telling us about our liquidity.

A simple formula for the current ratio is:

Current assets / Current liabilities
= 23 / 11
= 2.09 times

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Vanessa Harwood-Whitcher, ACT director of learning, shares her tips at https://blogs.treasurers.org/how-to-get-the-best-from-learning-online

The current ratio is just over 2.0. This indicates that our current liabilities would be covered, more than twice, by our current assets.

What else does the current ratio mean?

A higher current ratio is usually associated with stronger liquidity, but it may also be a symptom of inefficient working capital management.

Comparison of the current ratio over time, and with similar organisations, can give a useful early-warning indicator of matters that need investigation, and potential improvement. The current ratio can be especially useful for analysing financially distressed companies.

Is OpCo's current ratio optimal?

There's no such thing as an ideal, or optimal, level for a financial ratio. An appropriate level depends on many factors, including the maturity of the business, the sector and any regulation. A typical current ratio for a manufacturing firm might be between 1.5 and 2.0. By contrast, supermarkets tend to have current ratios well below 1.0.

All tests and ratios are best used as elements within a comprehensive toolkit of investigations. We should never rely on the results of any single test to give a clean bill of financial health.

How liquid is the inventory?

The current asset least likely to be fully liquid in practice is our inventory (stock). It can be difficult to turn inventory into cash quickly, for its full book value.

To take this potential lack of liquidity into account, the 'quick ratio' excludes inventory from current assets. The quick ratio is also known as the 'acid test', or the 'acid test ratio'.

Quick ratio
Do our current assets, excluding inventory, cover our current liabilities?

Both the current ratio and the quick ratio should be treated with caution. In cases of financial distress, debtors may not pay their potentially insolvent supplier, and the recoverable values of receivables (debtors) might turn out to be much less than their book values.

OpCo's quick ratio

Turning back to OpCo, Alex helpfully investigates further, and now gives us the following split of total current assets.

Current assets split (€m)	
Inventory	14
Other current assets	9
Total current assets	23

A simple formula for the quick ratio is:

Current assets excluding inventory / Current liabilities
= 9 / 11
= 0.82 times

OpCo's quick ratio is less than 1.0. This indicates that current liabilities are not covered by the more liquid of our current assets. This is a warning sign. We decide to investigate further, starting with our liabilities.

Should we include our overdraft?

Alex asks us whether our €20m overdraft counts as a current liability. It was not included in the €11m figure for liabilities reported earlier.

Yes. Overdrafts are indeed a current liability. They're repayable to our bank on demand. We can't ignore them for liquidity assessments, so we need to correct Alex's earlier figure for current liabilities, to include our overdraft.

With this correction, our current liabilities are:
11 + 20 = €31m

You have a go

Using this updated information, recalculate the current ratio and the quick ratio. (*Check your answer.)

Can we improve liquidity?

Yes. It's important to make sure that receivables are collected promptly, and that payables are not paid too quickly, subject, of course, to maintaining relationships with customers and suppliers. Inventory should also be maintained at appropriate levels, and managed efficiently.

Any short-term simplistic responses to liquidity problems may have adverse consequences, temporarily masking symptoms while the underlying condition deteriorates.

Side effects

In business, as in physics, every action is met with an opposite reaction. For example, delaying payments to vendors may reduce working capital needs over the short term, but any benefit is likely to disappear over time, as vendors adjust their pricing accordingly.

Restriction of cash is like restricting blood flow as the patient 'withers on the vine'. Severance of cash is like a blood clot or severing a major artery; it quickly becomes terminal. Successful recovery needs both speed of repair and identifying exactly where the restriction or severance occurs.

John Mardle, managing director, CashPerform Ltd

Financial health insurance

A further response could be to replace some of our overdraft funding with longer-term borrowings. This would stabilise our funding base by converting short-term liabilities into longer-term ones. A related benefit would be to provide more flexibility and time to engage successfully with any future crises.

Take a learning health check

The best test of your learning is whether you can answer questions under time pressure. Take a learning health check now, by attempting the quizzes or assessment papers on your learning website.

Will it hurt?

Testing yourself in this way will provide you with an accurate measure of the areas where you need more learning and practice. Realistically, any further learning you do won't be entirely pain-free. But it will bring predictable and healthy added value to your organisation and your career.

With many thanks to John Mardle for his valued guidance.

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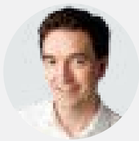

***Answers:** Current ratio: 23 / 31 = 0.74; quick ratio: 9 / 31 = 0.29