RATIO ANALYSIS

(Lecture-3)

SEMESTER – 6

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Classification of Ratios

Liquidity ratios should be examined taking relevant turnover ratios into consideration.

Liquidity Ratios

The terms 'liquidity' and 'short-term solvency' are used synonymously. Liquidity or short-term solvency means ability of the business to pay its short-term liabilities. Continuous default on the part of the business leads to commercial bankruptcy. Eventually such commercial bankruptcy may lead to its sickness and dissolution. Both lack of sufficient liquidity and excess liquidity is bad for the organization.

Various Liquidity Ratios are:

(a) Current Ratio
(b) Quick Ratio or Acid test Ratio
(c) Cash Ratio or Absolute Liquidity Ratio
(d) Basic Defense Interval or Interval Measure Ratios
(e) Net Working Capital Ratio

Current Ratio

It addresses the answer to the question that "Does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets?"

Interpretation to this ratio:

A generally acceptable current ratio is 2:1. But whether or not a specific ratio is satisfactory depends on the nature of the business and the characteristics of its current assets and liabilities

Where,

Current Assets = *Inventories + Sundry Debtors + Cash and Bank Balances + Receivables/Accruals + Loans and Advances + Disposable Investments + Any other current assets.*

Current Liabilities = *Creditors for goods and services + Short-term Loans + Bank Overdraft + Cash Credit + Expenses + Provision for Taxation + Proposed Dividend + Unclaimed Dividend + Any other Current Liabilities*

Quick Ratio

The Quick Ratio is sometimes called the **"acid-test"** ratio and is one of the best **measures of liquidity**

$$\text{Quick Ratio or Acid Test Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

Where,

Quick Assets = Current Assets + Inventories + Prepaid expenses

Current Liabilities = Same as mentioned under Current Ratio

The Quick Ratio is a much more conservative measure of short-term liquidity than the Current Ratio. It will help to determine "If all sales revenues should disappear, could my business meet its current obligations with the readily convertible quick funds on hand?"

Quick Assets consist of only cash and near cash assets. Inventories are deducted from current assets on the belief that these are not 'near cash assets' and also because in times of financial difficulty inventory may be saleable only at liquidation value. But in a seller's market inventories are also near cash assets.

Interpretation to this Ratio:

An acid-test of 1:1 is considered satisfactory unless the majority of "quick assets" are in accounts receivable, and the pattern of accounts receivable collection lags behind the schedule for paying current liabilities.

Cash Ratio/ Absolute Liquidity Ratio

The cash ratio measures the absolute liquidity of the business. This ratio considers only the absolute liquidity available with the firm. This ratio is calculated as:

$$\text{Cash Ratio} = \frac{\text{Cash and Bank balances + Marketable Securities}}{\text{Current Liabilities}}$$

Or,

$$\frac{\text{Cash and Bankbalances + Current Investments}}{\text{Current Liabilities}}$$

Interpretation to this Ratio:

The Absolute Liquidity Ratio only tests short-term liquidity in terms of cash and marketable securities/ current investments.

Basic Defense Interval/ Interval Measure

$$\text{Basic Defense Interval} = \frac{\text{Cash and Bank balances + Marketable Securities}}{\text{Opearing Expenses} \div \text{No. of days (say 360)}}$$

Or

$$\text{Interval Measure} = \frac{\text{Current Assets - Inventories}}{\text{Daily Operating Expenses}}$$

Daily Operating Expenses

(Cost of GoodsSold+Selling Administartion and other General expenses - Depreciationand other non cash expenditure)/No. of Days

Interpretation to the Ratio:

If for some reason all the company's revenues were to suddenly cease, the Basic Defense Interval would help determine the number of days for which the company can cover its cash expenses without the aid of additional financing.

Net Working Capital Ratio

Net working capital is more a measure of cash flow than a ratio. The result of this calculation must be a positive number. It is calculated as shown below:

Net Working Capital Ratio = Current Assets-Current Liabilities
(Excluding short-term bank borrowing)

Interpretation to the ratio:

Bankers look at Net Working Capital over time to determine a company's ability to weather financial crises. Loans are often tied to minimum working capital requirements