What Is A Liquidity Ratio, And How Might It Affect Your Company’s Ability To Borrow?

What is a liquidity ratio?

A liquidity ratio is a financial metric used to determine a company’s liquidity. Liquidity refers to the ability to convert current assets into cash to cover current liabilities and day-to-day business expenses.

The importance of liquidity ratios

Liquidity ratios measure how well you manage your assets and liabilities and can help you make informed decisions about your company. They can also be compared to industry averages or competitors' ratios to assess your relative performance. As they point to your ability to pay short-term debt, liquidity ratios help investors and creditors assess the risks of doing business with you.

What are the three liquidity ratios?

The three most commonly used liquidity ratios include current, quick and cash. When used together and in the right context, these ratios can give you a clearer picture of your financial position.

Current ratio

The current ratio determines your ability to pay your current liabilities with total current assets such as cash accounts receivable and inventories.

Quick ratio

The quick ratio or acid test ratio measures your ability to meet short-term obligations with your most liquid assets and therefore excludes inventories.

Cash ratio

The cash ratio is the most stringent measure of your liquidity— it uses only cash and cash equivalents.

How are liquidity ratios calculated?

The **current ratio** includes all current assets and is calculated by dividing total current assets by current liabilities.

The **quick ratio** includes cash equivalents and accounts receivable and is calculated by subtracting inventory from current assets and dividing the answer by current liabilities.

The **cash ratio** includes cash on hand and is calculated by adding total cash reserves and marketable securities and dividing the answer by current liabilities.

What is a good liquidity ratio?

A good liquidity ratio is anything greater than one, anything less than one could signal that a company may have liquidity issues and struggle to meet its short-term obligations. As a general rule, if you have both a current ratio of at least two and an acid test ratio of at least one, you have adequate liquidity. It is, however, important to note that optimal liquidity ratios vary across businesses and industries.

How liquidity ratios affect your company’s ability to borrow

Lenders use liquidity ratios to determine if you can meet your short-term obligations, and to what degree. They may consider industry averages or analyse your liquidity over a period to see if your financial position is improving or deteriorating.

Generally, higher ratios are more favourable as they point to greater financial health and less risk. This increases your company's ability to borrow at favourable terms, while low liquidity ratios can make it more challenging.

While it’s good to have a high degree of liquidity, liquidity ratios don’t tell the full story. Lenders also consider other factors and financial ratios to get a better understanding of your financial position.

For example, your solvency or ability to generate sufficient cash flow to meet your obligations over the long term might be considered as well. Together, liquidity and solvency ratios could paint a more complete picture of your company's financial health.

The bottom line

Liquidity ratios provide a snapshot of your company's ability to honour its short-term obligations. If you're intending to borrow, having great liquidity may count in your favour. However, it is important not to analyse liquidity ratios (or any other financial ratios) in isolation. Always consider context and additional metrics for a more accurate depiction of your financial standing.