22. Business Liquidity and the Operating Cycle

As was noted above, careful examination of the balance sheet is essential to analysis of a company's financial health, and the classified balance sheet helps in that analysis. Investors and creditors must be mindful of a company's liquidity. Liquidity is the ability of a firm to meet its near-term obligations as they come due. Inadequate liquidity can spell doom, even for a company with bright long-term prospects and significant noncash assets.

22.1 Working Capital

Working capital is the difference between current assets and current liabilities. The illustration for Classy Company revealed current assets of $450,000 and current liabilities of $150,000. Thus, working capital is $300,000 ($450,000 - $150,000). For obvious reasons, one would hope to find a positive amount of working capital. If not, it may be an indication of financial stress.

Of course, care should be taken in drawing blanket conclusions about a firm's condition based solely upon an examination of a single number. Could a firm have negative working capital, and still be in great shape? Yes! For instance, the firm may have a standby letter of credit at a bank that enables it to borrow money as needed to meet near-term obligations. Or, some companies are in great shape even though they have negative working capital. Consider a fast food restaurant that has virtually no receivables (most sales are for cash) and a very low inventory (you know bread and milk don't store well). The only current assets may consist of cash, nominal inventories, and some prepaid items. Nevertheless, they may have current liabilities in the form of significant accounts payable and short term debt. How do they survive? The velocity of their cash flow may be very fast, as they hopefully turn large volumes of business at high profit margins. This enables the spinning of enough free cash flow to pay obligations as they come due and have money left over to reinvest in growing other business locations. So, you see that working capital is important to monitor. Just be careful about blanket conclusions based on any single measure.

22.2 Current Ratio

Is $1,000,000 of working capital a lot? Maybe, maybe not. $1,000,000 is but a drop in the bucket to a corporate giant, and that amount of working capital could signal the end. On the other hand, a "mom and pop" business could be doing grand with far less than $1,000,000. So, it really depends on the ratio of current assets to current liabilities. The current ratio is used to express the relative amount of working capital. It is calculated by dividing current assets by current liabilities:

$$\text{Current Ratio} = \text{Current Assets}/\text{Current Liabilities}$$

Classy Company has a current ratio of 3:1 ($450,000/$150,000). Be advised that ratios can be manipulated. If Classy wished to increase their current ratio, they could just pay off a little debt. For instance, if they paid off $50,000 of accounts payable with cash, then current assets and current liabilities would each decline by $50,000, and the revised current ratio would "improve" to 4:1 (($450,000 -$50,000)/($150,000 - $50,000)).

22.3 Quick Ratio

A company could possess a large amount of inventory that is not easily sold. Thus, the current ratio (which includes inventory) could signal no problem, all the while the company is struggling to pay its bills. A tougher ratio is the quick ratio. This ratio provides a more stringent test of debt-paying ability by dividing only a firm's quick assets (cash, short-term investments, and accounts receivable) by current liabilities:

Quick Ratio = (Cash + Short-term Investments + Accounts Receivable)/Current Liabilities

Classy Company has a quick ratio of 1.5:1 (($100,000 + $50,000 + $75,000)/$150,000).