Liquidity: asset and acid test ratio assignment

Business

Liquidity Liquidity is vital to the survival of a business for there to be sufficient liquid resources available to meet maturing obligations. Liquidity refers to the ease with which assets can be converted to cash in the normal course of business. The current ratio compares the ‘ liquid’ assets of a business with the current liabilities. The higher the ratio, the more liquid the business is considered to be. Some people seem to suggest there is an ‘ ideal’ current ratio (usually 2: 1) for all businesses however this fails to take into account the fact that different types of businesses require different current ratios.

For example, a manufacturing business will often have a high current ratio because it is necessary to hold raw materials and will normally sell goods on credit, thereby incurring debtors. A supermarket chain, on the other hand, will have a low current ratio, as it will only hold fast-moving stock and will generate mostly cash sales revenue. For Keith Alison, the current ratio fell significantly from 9. 41 in 2006 to 3. 09 in 2007. As liquidity is vital to the survival of a business, a higher current ratio is preferable to a lower one.

The acid test ratio is very similar to the current ratio, but it represents a more stringent test of liquidity. It can be argued that, for many businesses, stock cannot be converted into cash quickly. The acid test ratio is a variation of the current ratio, but excluding stock because stock takes time to sell. Also, the inventory may be sold to debtors, who will often take at least a month to settle their debt. In this case, the acid test decreased from 6. 59 in 2006 to 1. 72 in 2007.

The current assets cover the current liabilities, so the business will not experience any liquidity problems for this period with regards to the ‘ ideal’ 2: 1 ratio, but the rapid decline in this ratio should lead to steps being taken, at least, to stop further decline. The Inventory Turnover period measures the period for which stocks are being held. The inventory ratio is only a crude measure of the rate at which stocks are sold. Different marketing situations face different industries and trades.

A butchery will clearly have a much higher stock turnover rate than a firm selling luxury goods and have a lower turnover period as it shifts all its goods fast because they can go off and he will lose money. The inventory turnover period may give a useful indication of trading difficulties facing a particular firm by comparing it with those of the previous years. The holding of inventory is expensive as many costs can be incurred such as warehouse overheads like heat, light, rent, rates and insurance.

A business will normally prefer a short turnover period to a long one, as funds tied up in stocks cannot be used for other purposes. When judging the amount of stock to carry, the business must consider things such as the likely demand for the stick, the likelihood of price rises, the perishability of the stock and the amount of storage space available. For Keith Alison, the turnover period increased dramatically from 29 days in 2006 to 77 days in 2007. This indicates a drop in the sales and the net profit, which we explained earlier.