Current Ratio & Quick Ratio

What is Current Ratio?

It is a liquidity ratio that measures a company’s ability to pay short-term obligations. It is also known as "Liquidity Ratio", "Cash Asset Ratio" and "Cash Ratio".

The Current Ratio formula is: \( \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \)

The ratio is mainly used to give an idea of the company’s ability to pay back its short-term liabilities with its short-term assets (cash, inventory, receivables). The higher the current ratio, the more capable the company is of paying its obligations.

A ratio under 1 suggests that the company shows the company is not in good financial health, it does not necessarily mean that it will go bankrupt.

Companies that have trouble getting paid on their receivables or have long inventory turnover can run into liquidity problems.

The components of current ratio (current assets and current liabilities) can be used to derive working capital (difference between current assets and current liabilities).

Acceptable current ratios vary from industry to industry and are generally between 1.5 and 3 for healthy businesses.

What is Quick Ratio?

The Acid-Test or Quick Ratio measures the ability of a company to use its near cash or quick assets to extinguish or retire its current liabilities immediately. Quick assets include those current assets that presumably can be quickly converted to cash at close to their book values.

Quick (Acid Test) Ratio = \( \frac{(\text{Cash} + \text{Marketable Securities} + \text{Receivables})}{\text{Current Liabilities}} \)

OR

\( \frac{\text{Current Assets} - \text{Inventory} - \text{Prepayments} }{\text{Current Liabilities}} \)

The quick ratio is more conservative than the current ratio because it excludes inventories from current assets. If a business has large amounts in accounts receivable which are due for payment after a long period, and essential business expenses and accounts payable due for immediate payment, the Quick Ratio may look healthy when the business is actually about to run out of cash. In contrast, if the business has negotiated fast payment or cash from customers, and long terms from suppliers, it may have a very low Quick Ratio and yet be very healthy.

Generally, the acid test ratio should be 1 or higher; however this varies widely by industry. In general, the higher the ratio, the greater the company’s liquidity (i.e., the better able to meet current obligations using liquid assets).
For example: Firm A has the following balance sheet:

Cash INR 5 million, Marketable Securities INR 10 million, Accounts Receivable INR 15 million, Inventories INR 20 million & Current Liabilities of INR 20 million.

The Quick Ratio in this case is 1.5 (Cash INR 5 million + Marketable Securities INR 10 million + Accounts Receivable INR 15 million) / Current Liabilities INR 20 million.

- The Current Ratio in this case is 2.5 (Cash INR 5 million + Marketable Securities INR 10 million + Accounts Receivable INR 15 million + Inventories INR 20 million) / Current Liabilities INR 20 million.

Mutual fund investments are subject to market risks, read all scheme related documents carefully.