Assessing Current Ratio

By BNET Editorial

published on BNET.com 12/12/2007

Current ratio is a measure of liquidity, which compares a company's current assets with its current liabilities.

Current ratio is a favored test among banks and lenders because it reveals whether a company is generating enough cash to pay its short-term creditors.

What to Do

The ratio divides current assets by current liabilities. "Current assets" (or "liquid assets") are cash and other items that can be converted into cash over the next year, such as inventory and accounts receivable. Current liabilities are bills that have to be paid in the next 12 months.

The formula is:

current assets / current liabilities = current ratio

Example:

Suppose a company's current assets are $2 million, and its current liabilities are $1.4 million. Current ratio is therefore 2 / 1.4 = 1.43. This suggests that for every dollar it owes, the company will be able to raise $1.43.

What You Need to Know

- In general, the higher the ratio, the greater a company's liquidity. Typically, current ratio lies between 1 and 1.5, although it varies between industries. Lenders may require at least 1.5.
- A low ratio is not always a sign of trouble—for example, restaurants and supermarkets can operate successfully with ratios that would cause concern in other sectors.
- Excessively high ratios could suggest that a company is not making best use of its assets, or that receivables and/or inventory are diminishing.
- Ratios of less than 1 indicate serious difficulties with generating enough cash to pay short-term creditors.
- Managers, as well as lenders, find current ratio useful. For example, it might reveal problems with liquidity that could be addressed by re-balancing short and long-term debt.

- Current ratio does not distinguish between cash and less easily convertible assets (like inventory). Some analysts prefer to use the “quick” or “acid test” ratio, which focuses on liquid assets.
- Current ratio provides a snapshot of liquidity when a particular balance sheet is issued. Figures may appear favorable at this moment, but for a more accurate picture it makes sense to look at other measures too.
- If current ratio remains much the same, but quick ratio begins to fall, it suggests that a company is neglecting its liquid assets in favor of other assets.

Where to Learn More

Web Site:

A toolkit for small businesses: www.toolkit.cch.com

Copyright © 2007 CNET Networks, Inc. All Rights Reserved.