Financial Accounting
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Lecture – 82
6.12 Practice Problem: Liquidity Position

Let us do a practice problem on the liquidity position of the business, the short-term financial position of the business.

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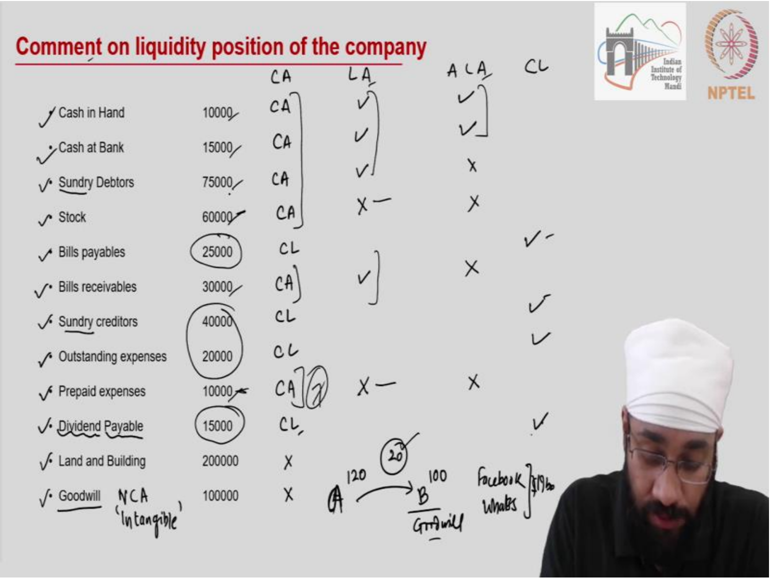

On the screen I have a list of account balances. These are picked from the financial statements of a company and we have to comment on the liquidity position of this company.

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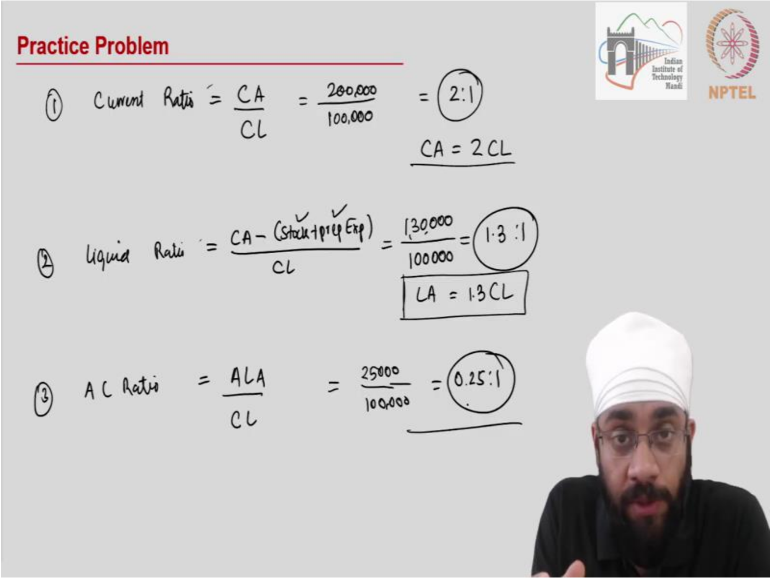

In order to comment on the liquidity position of the company, there are three indicators that we use. First is the current ratio, second is the liquid ratio and third is the absolute liquid ratio. Let us look at the contents of these.

In the current ratio, we take current assets and divide them by current liabilities. In the liquid ratio, we take only the liquid assets (which is equal to current assets minus stock and prepaid expenses) and divide them by current liabilities. In the absolute liquid ratio, we take absolute liquid assets which are cash and cash equivalents and divide them by current liabilities. What we are trying to do is to comment on the position or the ability of the business to pay off its current liabilities using its current assets, its liquid assets and its absolute liquid assets. Let us look at these terms and see if there is something which we do not know.

Cash in hand is a current asset, we know it very well. Cash at bank is also a current asset. Sundry basically means a large number of small customers clubbed together. Debtors, money to be recovered falls under current assets; the stock is also a current asset. Bills payable is a current liability, bills receivables are current assets, sundry creditors (again sundry means the same, various small vendors to whom you have to pay) current liability. Outstanding expenses are also current liability, prepaid expenses are expenses paid in advance so they are current assets and dividend payable is a current liability.

Now, this is something that we have not discussed before. Dividend payable refers to the equity dividend which the company has declared, but the shareholder has not claimed yet. There is a process through which the dividend is finally paid to the shareholders. After deciding that this much amount is to be paid as dividend, the company keeps that amount in a separate bank account so that it is not used for other purposes. This amount has to be claimed by the shareholders. Shareholders have to provide some information to receive this amount. Until the time this money or dividend is distributed, this amount is treated as a liability on the company. This is so because the company does not have a claim on this dividend, the shareholders have the claim and shareholders are a separate legal entity of the business. So, when it says payable, we treat it as a current liability and you expect to pay it off as soon as possible, within the next 1 year. Land and building is not a current asset, not a current liability. So, we are not going to consider this here and you have goodwill. Goodwill is a long-term asset and we are not going to consider it in the current assets; however, we need to discuss what goodwill is. When business A purchases business B the value of which is 100, but business A agrees to pay 120 for it. In the negotiations, maybe B convinced A to pay this much or A saw the benefit in paying more and closing the deal; otherwise, another company C would have bought B. By buying B, A hopes to make more money in the future; benefit from the existing business of B and make more sales. This additional 20 which has been paid; why has this been paid? This has been paid because B had some goodwill in the market, B had a reputation in the market, B had a customer base in the market. So, this additional 20 is regarded as the purchase of reputation. This is something which is going to benefit company A in the long run. It will help it in the generation of revenue in the long run. Therefore, goodwill is treated as a non-current asset and also it is an intangible asset; you cannot see it. For example, Facebook purchased WhatsApp. I think the transaction happened for about 19 billion dollars. And the actual value of WhatsApp must have been much lower. But what Facebook saw was a benefit in the user base that WhatsApp had. And after the purchase if you have noticed, if you have somebody on your WhatsApp list, then you see a friend suggestion of that person in your Facebook feed also. Facebook gives you a friend suggestion of that person on Facebook as well. So, they are utilising the user base of WhatsApp to increase their network, the subscribers on the Facebook platform. That in short is goodwill. Anyway, goodwill is not being used in this question at all. So, this is the current assets and current liabilities. We also need to figure out if some of these items are going to fall under liquid assets and absolute liquid assets or not. So, cash in hand certainly falls under the current asset category and cash in hand is also going to be treated as the liquid asset and absolute liquid asset. Bank balance also has the same treatment; debtors are going to be treated here, but not here; stock is not going to be included neither here nor here; bills payable are current liability; so, maybe I will have a column for current liabilities. So, I will check here.

Bills receivable are liquid assets yes, not absolute liquid assets, creditors are current liabilities, outstanding expenses are current liabilities. Prepaid expenses are not included in the liquid assets nor in the absolute liquid assets, dividend payable are current liabilities. There you go.

Current liabilities have four items and absolute liquid assets have 2 items, liquid assets have four items and current assets have actually more than all of these, seven items in total. So, all we have to do is sum these up and calculate the numbers.

The total of the current asset is 200000. So, the current assets are 200000, divide them by current liabilities; current liabilities which are equal to 85000 (i.e., 25000+40000 +20000) and 100000 is current liability total. There you go. The current ratio comes out to be 2:1 which means the current assets are twice the size of current liabilities. It means you can afford to lose half of your current assets and still be able to pay your current liabilities. It is a good situation to be in. Again we do not have the industry standard here, but its double the current liabilities. The current assets have enough cushion to pay off the current liabilities done.

Let us go to liquid ratio and liquid ratio stock and prepaid expenses are going to be excluded; so, only liquid assets are going to be used. So, 1 and 2; these two terms go out; so, 10000 and 60000. So, 70000 should be reduced which means 130000 should be the total for liquid assets; divide this by current liabilities which is 100000 and you have 1.3:1 as the liquid ratio. This means if the stock and prepaid expenses are ruled out, because they do not give you cash; still, you will have current liquid assets which will be 1.3 times the current liabilities. It means you can afford to lose 30 percent of your liquid assets and still be able to pay off your current liabilities; good position to be in. Let us look at the 3rd ratio which is absolute liquid assets; it is going to include only these two. This is 25000. So, 25000 divided by 100000 gives us a ratio of 0.25:1; which means if you were supposed to pay your current liabilities right away within a couple of days using the cash and bank balance and the marketable securities that you had, you will not be able to meet them. You only have sufficient money to pay one-fourth of the current liabilities, you will not be able to pay off 75 percent of the current liabilities. So, that is the short-term position of the business.

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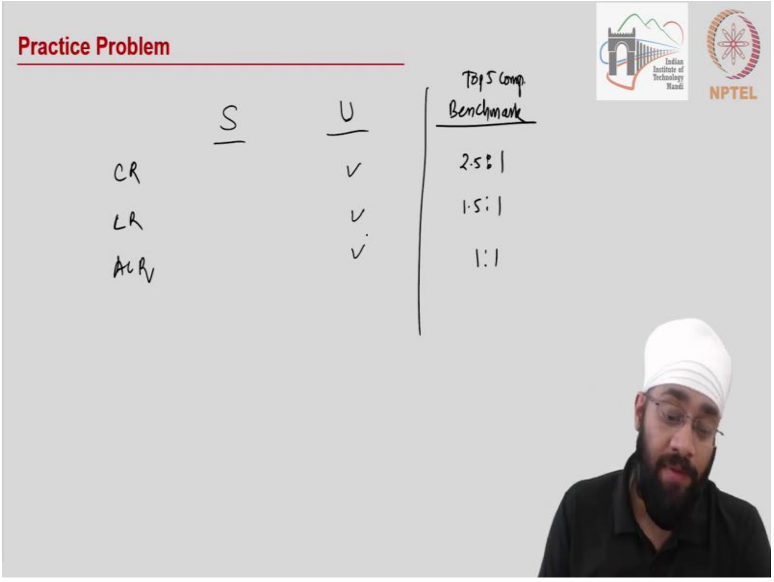

How would you come to a conclusion? If you have to comment in terms of satisfactory or unsatisfactory, would you click on satisfactory or unsatisfactory? Well, in order to do that you need a benchmark, you need to say what am I comparing against? You have current ratio, liquid ratio and absolute liquid ratio. For the benchmark, let us say the top 5 competitors have an average current ratio of 2.5:1. The liquid ratio on the other hand is 1.5:1 and absolute liquid ratio is 1:1. If these were the numbers, then you would say unsatisfactory; the short-term financial position is unsatisfactory compared to the industry, compared to our top 5 competitors. There you go, that is how you comment on the short term financial position of a company.

I will see you in the next video.