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What is a Current Ratio?

What does it mean? Why would you, as a business owner, be concerned about your company's Current Ratio?

A Current Ratio is much more that just one of those fancy terms that your accountant or a financial "type" might talk about. It's something that can easily be computed, but can tell you a number of things about your business. Banks, Investors and even creditors use it to tell how "liquid" you business is – how easily your business will be able to pay off the current debt. It can also point to possible problems that you may not even know exists.

A Current Ratio is a comparison of your current assets (what you have like your Cash, Accounts Receivable and Inventory) to your current liabilities (what you owe). The term current is used to describe the easy conversion of cash to relieve your incurred debt within a 12-month period. This is also referred to as your "liquidity" factor (or how liquid your business is).

To compute your Current Ratio, you would divide your current assets by your current liabilities. For example, if a business reports $10,000 in current assets and $5,000 in current liabilities, the current ratio would be 2:1 (10,000/5,000 = 2). Although ratios may vary from industry to industry a ratio of 2:1 is considered the norm. In other words, your assets are twice what your liabilities are.

Ok, so your curiosity got the best of you. You grabbed your most recent balance sheet and calculated your Current Ratio. But now what? As you see it, it's just a number. But let's explore this a little more..

Since your current ratio is dictated in part by your current assets, you will want to determine what makes up your current assets. Is the majority value of your current assets in Cash? Accounts Receivables? Or Inventory?

As the current ratio approaches or falls below 1, you will want to take a close look at your business and make sure there aren't any liquidity issues. For instance, if you are in a manufacturing business and your current assets are made up, in large part, by inventory, this could over-inflate your assets, or if your assets are mainly raw materials, this cannot easily be converted into cash.

On the opposite side of the spectrum, if the current ration is 3 or 4, then you may have potential funds that could be used to expand your business.

Another way to analyze your business through the current ratio is to look at the ratio over a period of time, such as annually. This will allow you to compare the ratios, which could signal growth or potential "concerns" you may not be aware of. Compare the ratios from year to year. Again look at what makes up the ratio (assets and liabilities) and determine why the ratio has changed. A declining ratio could signal some potential financial problems, like not enough assets to cover your debts. An improving ratio could signal a brighter financial picture, as long as the reason it's improving is an increase in your assets along with a reasonable amount of debt. Look at your inventory. Has your inventory increased without incurring additional debt? This would mean that perhaps you've elected to use your cash to fund your growth, as opposed to using the leverage of OPM (Other People's Money).

For a deeper analysis of your current ratio and other financial tools, or if you need financial statements generated or updated, please give us a call.