CHAPTER 35 LIQUIDITY

Key terms

1. Acid test ration: similar to the current ratio but excludes stocks from current assets. A more severe test of liquidity.
2. Assets: resources that belong to a business.
3. Capital: money put into the business by the owners.
4. Current assets: liquid assets i.e. those assets that will be converted into cash with in 1 year.
5. Current ratio: assess whether or not a business has enough resources to meet any debts that arise in the next 12 months. It is found by dividing current liabilities into current assets.
6. Debt factoring: when a financial institution called a factor takes over the administration of a company's receivables. The factor pays the business the money that suppliers owe to it immediately, in return for a percentage.
7. Intangible assets: non physical assets such as customer lists, franchising agreements and brand names
8. Inventories: stocks of raw materials, finished goods.
9. Liability: debt of the business.
10. Liquidity: the ease with which assets can be converted into cash.
11. Net asset: total assets - total liabilities
12. Non current assets: long-term resources that will be used by the business repeatedly over a period of time.
13. Non current liabilities: money owed by the business for more than 1 year, sometimes called long term liabilities.
14. Shareholders' equity: the amount of money owed by business to the shareholders.
15. Statement of financial position(balance sheet): a summary at a particular point in time of the value of a firm's assets, liabilities, and capital.
16. Trade and other payables: money owed by the business to suppliers and utilities, for example.
17. Trade and other receivables: money owed to the business by customers and any prepayment made by the business.
18. Working capital: the funds left over to meet day-to-day expenses after current debts have been paid. It is calculated by subtracting current liabilities from current assets.

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1. Distinction between cash and profit

1) Some goods are sold oh credit. ⇒ Profit > Cash

Profit = Revenue - Cost

2) Sometimes owners might introduce more cash into the business and this will increase cash balance but it has no effect on profit made.

3) Purchase of fixed assets will reduce cash but it has oh effect on profit.

4) A business may receive cash at the beginning of trading year from sale made in the previous year. This would increase the cash balance but It will not affect profit.

5) Sales of fixed assets will increase cash balance but it will have no effect on profit unless a profit or loss is made on disposal of the assets.

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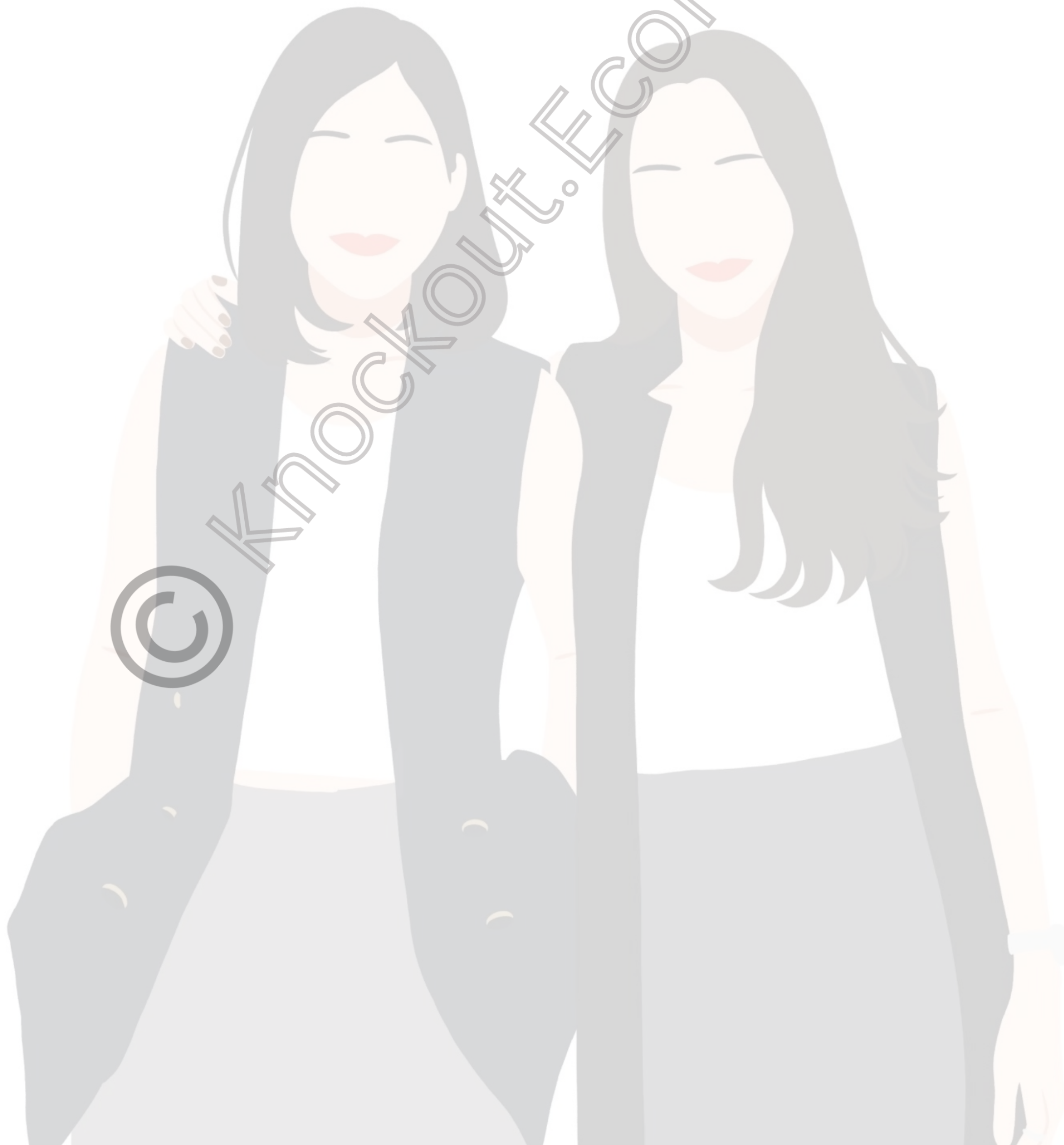

2. Statement of financial position (Balance Sheet)

1) Assets; resources owned by a business which are used to make products or services.

1.1)Non current assets; long-term resources that will be used repeatedly by business overtime.

Fixed assets e. g. equipment, toots, vehicles.

Intangible assets; non physical assets such as customer lists, franchising agreements and brand names

1.2)Current assets; assets that will be changed into cash within 12 months." liquidity assets"

Inventories; stocks of raw materials, finished goods.

Trade and other receivable; money that is owned to the business.

e.g. money receivable from customers prepayment (Where a business paid in advance for a resource e.g. insurance)

Cash or cash equivalents; cash in bank account

2) Liability; debt of the business. It Is sources of funds for business.

2.1)Current liability; sum of money owned by a business that must be repaid within 1year.

Trade and other payable; refer to money owed by the business to suppliers of raw materials "trade creditors"

Current tax liabilities; it includes employees' income tax, VAT, corporation tax

2.2)Non current liability; long term loan and any money owned by the business that does not have to be repaid for at least a year. E.g. pension funds, long term bank loan, mortgages.

2.3) Capital: money put into the business by the owners.

Asset = Liability + Capital(Shareholder Equity)

- **Net asset = total assets - total liabilities = Shareholders' equity**
- Shareholders' equity ⇒ what is owed to the owners of the business.

  ⇒ it includes share capital and retained earnings (retained profit)

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3. Liquidity

- **Liquidity :** the ease with which assets can be converted into cash

Measuring liquidity

1. **Current ratio = Current assets / Current liabilities X 100**

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} \times 100$$

↳ **If current ratio < 1.5**: Business does not have enough working capital / over borrowing

↳ **If current ratio > 2:** too much money, should be repaid debt / invest in some business

2. **Acid test ratio = Current assets - Inventories / Current liabilities**

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

↳ **If Acid test ratio < 1:** current asset minus inventories do not cover current liability. It may have liquidy problems

Ways to improve liquidity

1. Sale of assets or leaseback; selling assets for cash.
2. Supplier credit terms; delay paying suppliers.
3. Factoring; debt factoring is a specialist company or a bank which provides finance against these unpaid invoices.
4. Inventory JIT (just in time); reducing inventories

4. What is working capital?

- Working capital = The amount left over after all current debts have been paid.
- **Working capital = Current assets - Current liabilities**

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