

MISMEASUREMENT OF THE FINANCIAL HEALTH OF COMPANIES

ROLE OF THE CONCEPT OF CURRENT RATIO

ANALYSIS of the financial position of companies can sometimes give a misleading picture if it is not properly applied and correctly interpreted. For example, performance of companies in terms of profitability may appear to be quite satisfactory and yet their financial viability or soundness may remain questionable. In fact, financial judgments have to be based not only on the earning capacity of concerns but also on the proportion between assets and liabilities so that a reasonable conclusion may be drawn about their strength to sustain the ups and downs of business fluctuations. That is why, it is now recognised that a company is not only an earning concern but also an institution with a primary obligation for instilling confidence in the minds of its creditors, shareholders and the community in general. One important test by which the financial health of a company can, with reasonable reliability, be judged as a going and as a gone concern is the concept of current ratio.

CURRENT RATIO—MEANING AND CONTENTS

Financial analysts adopt the practice of taking out current assets and current liabilities from the balance-sheet and of dividing the former by the latter in order to obtain the measure of business health, colloquially known as the current ratio. Current assets are such as in the ordinary course of business would move onward, through the various processes of production, distribution and payment for goods, until they become cash or its equivalent, by which debts may be readily and immediately paid. For instance, cash, stocks, temporary investments, bills receivables,¹ etc., can be termed as current assets. However, they do not include the surrender value of life insurance policy as such an item is regarded more in the nature of a semi-permanent investment. Besides, it is not used in the normal operation of business, nor does it represent working capital.²

A crucial item in current assets is the inventory meant for sale. It can be valued on the basis of cost price, market price, fifo, average and so on. Hence, its valuation must give rise to some differences when the return ratio is compared with that of other companies of the industry. How such differences should be adjusted or what allowance, if any, should be made

for comparative purposes is difficult to resolve. Further, if an inventory valuation reserve is used, the question arises as to whether or not the inventory should be used as net of the reserve. Again, as between different kinds of businesses, the character or liquidity of the current assets will vary. For instance, articles such as women's fashionable cosmetics are very much more likely to vary in value and salability than groceries. Harry G. Guthmann observes that, "As goods are sold, the inventory is replaced by customers' receivables, while cash is diminished by the expenses of operation. The cycle is completed when the collections from the customers permit the liquidation of current indebtedness."³

From the standpoint of an analyst, current liabilities are the short-term obligations due and payable within one year and must be paid on definite dates. All maturities due within one year should be included, as otherwise the current liabilities, the net working capital, the ratio of current assets to current liabilities and the ratio of current liabilities to the tangible net worth will become distorted.

Over a period of time or because of certain factors, changes in the value of assets and liabilities may take place. In times of falling prices, for example, the book value of current assets could shrink to say 50 per cent when the firm is finally liquidated but current creditors would still receive payment of their obligations in full. In this connection, the distinction between an economist's balance-sheet and the accounting balance-sheet as envisaged by Joel Dean is worth noting. "An economist's balance-sheet has quite a different interpretation, since it is an attempt to aggregate the future earnings of the firm's properties now on hand. Each asset has earning power by itself. The value of this earning power is hard to compute, but it is certainly not less than the price the asset can bring in the current market."⁴ The important point is that an economic balance-sheet derives entirely from income expectation, while an accounting balance sheet can be viewed as the basic tool for computing accounting income. In other words, to the economist, sunk costs are irrelevant whereas they are not scorned by the accountant.

One writer visualizes the possibility of dividing current assets and current liabilities into a further dichotomy as (i) liquid assets and (ii) deferred assets, and (i) liquid liabilities and (ii) deferred liabilities.⁵ All assets and liabilities that are expected to be paid within a month are grouped in the first category and the rest in the second one. This categorization can be availed of in a situation where the power of the concern to pay off its immediate debts is in question. Whether to adopt this classification for computing the current ratio will also depend upon the purpose for which the current ratio is to be used.

FINANCIAL STRENGTH

The current ratio is now most commonly used as an index of financial strength, although it is still a rather crude measure. The basic question underlying this ratio is the ability of the business to meet its obligations with a margin of safety to allow for a possible shrinkage of value in its various current assets like inventories and receivables. This implies a liquidation approach rather than a judgement on the going concern, for it does not explicitly take into account the revolving nature of current assets and current liabilities. In its computation the analyst must always include contingent liabilities for bills discounted, otherwise the ratio will be incorrect and misleading. He should find out if there is a window-dressing of the current ratio. The following balance-sheets containing items for current ratio give an indication of the type of window-dressing that can be perpetrated in order to mislead.

BALANCE-SHEET A

Current Liabilities		Current Assets	
	Rs.		Rs.
Bill Payable	10,000	Cash	5,000
Working Capital	8,000	Bills Receivable	10,000
		Inventories	3,000
	<u>18,000</u>		<u>18,000</u>

BALANCE-SHEET B

Current Liabilities		Current Assets	
	Rs.		Rs.
Bills Payable	6,000	Cash	5,000
Working Capital	8,000	Bills Receivable	6,000
		Inventories	3,000
	<u>14,000</u>		<u>14,000</u>

The bills receivable have been discounted in Balance-Sheet B and the cash realised was used in the payment to current debts. Now, if the bills are not paid at maturity by their drawees, the company will have to pay them. As such, a contingent liability has arisen but it has not been shown in the balance sheet. The current ratio as per the first balance-sheet is 9:5 while for the second one it is 7:3. The latter ratio is higher and as such, shows a better financial position when actually the position is worse in view of the contingent liability not included in the balance-sheet. Therefore, if the current ratio is low or high enough, the analyst must

ascertain the reasons for that. In a period of favourable business activity, the desire for expansion grips the management and it may be carried too far by purchasing fixed assets at the expense of working capital. For example, if all the retained profits are absorbed in an increased holding of stock, then further fixed assets can be bought only at the expense of cash or by short-term credit. Good management will keep this fact under constant examination and take decision on investments in the light of resources available. In this context, purchase of stock is just as much an investment as is purchase of plant. If both are purchased at the same time when extra resources are sufficient to cover only one such investment, it will only weaken the financial prospects of the business by making it more difficult to meet the immediate demands of its short-term creditors.

It follows that a proper ratio between current assets and current liabilities must always be maintained. A generally popular rule of thumb for the current ratio is considered to be a 2:1 relationship. A "Two for One" ratio has indeed become the alpha and omega of balance-sheet analysis. Businessmen are legion who believe this single ratio to be the one infallible guide to balance-sheet interpretation⁶. However, a 2:1 or even 10:1 current ratio does not of itself guarantee reserve assets (especially inventories) into cash as needed (liquidity). Therefore, the ratio has to be interpreted with great caution. Besides, the ratio for a well-established firm may not be safe for a new or poorly managed business concern. "How large this margin will be will depend very much upon the type of business. Size is of less importance because the comparison will be on a relative or percentage basis. Much more significant is whether sales are on a cash or a credit basis or, if mixed, the relationship between the two."⁷ Therefore, the implicit efficacy of a current ratio can be questioned. As a generality, it can be said that if the ratio is 2:1, the balance-sheet gives double assurance of creditworthiness.⁸

WORKING CAPITAL RATIO

Here it may be mentioned that because of its link with working capital the current ratio is sometimes referred to as the 'working capital ratio'. It assumes that working capital is defined as the excess of current assets over current liabilities. Still, however, the amount of working capital may not truly depict the inherent strength or weakness of a concern. There may be cases where the ratio is somewhat less than "Two for one" but the balance-sheet shows a healthy state. It might be that current ratio analysis reflects static conditions, giving as it does the relationship between two variables on a particular date. It means that the ratio may change daily as a concern enters its busy season, increases its inventory, collects its receivables, etc. The following tables give some interesting phenomena

regarding working capital and the current ratio.

TABLE I

	1968 Rs.	1969 Rs.
Current Assets	6,00,000	1200,000
Current Liabilities	2,00,000	8,00,000
Working Capital	4,00,000	4,00,000
Current Ratio :	3:1	1.5:1

TABLE II

	1968 Rs.	1969 Rs.
Current Assets	4,00,000	8,00,000
Current Liabilities	2,00,000	8,00,000
Working Capital	2,00,000	Nil
Current Ratio :	2:1	1:1

In Table I the net working capital in both the years is the same but the current ratio is different. In 1969 the ratio is less than two but the working capital is the same as was in 1968 when the ratio was more than two. Table II shows diminution in the value of current assets in both the years compared with that of Table I but the amount of liabilities remains the same. The result is that the concern is less vulnerable in 1968 than in 1969 as a consequence of smaller liabilities in 1968. Further, the working capital in 1969 is completely wiped out in spite of the fact that current assets are twice in value than those of 1968. This is a bad enough situation as working capital should always be adequate in relation to the needs of the business. Whether this is a dangerous situation or not depends very much upon the extent and the precise details of current assets increase. The real danger in such a situation would be when the increase in current assets takes the form of a larger investment in stock which in turn will mean greater delay in meeting the claims of creditors.

The amount of working capital also represents the limit of credit that may be held for current creditors. With a given working capital and a current ratio of two-to-one, the size of the stock of goods that may be carried will be determined by the need for carrying cash balances and for extending credit to customers. On this matter, James L. Lundy has this to say: "Vendors on finding that a customer has a weak current ratio, are likely to refuse to grant credit to that particular customer in order to minimize their bad debt losses."* The maximum line of credit can be derived by subtracting one unit from the

minimum current ratio and dividing the amount of working capital by the result. The quotient will represent the maximum line of credit. It is, however, said that this is a theoretical computation as creditors generally act independently or oblivious of the ratio to which they may not attach as much importance as to other factors. However, when current ratio becomes a basis for credit, it may be that a second comparison is required to be made for testing the financial strength in a fool-proof manner.

ACID TEST

The second comparison which is called the "acid test" is more severe in that an attempt is made in it to eliminate some of the disadvantages of the current ratio by concentrating on strictly liquid assets whose value is fairly certain. Therefore, it excludes inventories from the current assets and as such, bills receivables as a realisable asset is given an added prestige. It is believed that a concern whose current assets consist largely of inventory can very easily become technically, if not actually, insolvent within a short period of time. That is why, this test yields the "quick ratio" on the basis of realisability. By excluding inventories from consideration the question can in fact be: "If the business were to stop selling today, what are its chances for paying off its current obligations with the readily convertible funds on hand."¹⁰ Generally, a 1:1 ratio is applied in this test. To be on the safer side, J. Batty has suggested that "If the quick ratio is to be of some value then the nature of the assets and liabilities included should be appreciated. Thus, for example, if some of the debtors are slow payers this fact should be allowed for in the calculation of the ratio. In addition, when there is the possibility of bad debts, a provision should be created, the debtors being reduced by the amount involved."¹¹

From the standpoint of time, it is suggested that if the fiscal year ends at a time when operations and inventories are at a low seasonal ebb, it will show the best current ratio. Actually, with different financial years, the ratios of different companies will not be comparable. The suitability of a ratio varies from industry to industry and from time to time. Therefore, for properly evaluating the current ratio of a concern, the analyst must have recourse to the typical ratios of similar concerns in respect of different times. Used independently, without relationship to other analytical ratios, the effectiveness of the current ratio is impaired.¹² Gerstenberg rightly observes that the current ratio demonstrates only the quantity coverage of current assets against current liabilities. It gives no indication of the quality of these assets and liabilities, apart from it being a static concept.

In the context of the foregoing analysis, certain limitations with respect to the overall significance of the concept of current ratio as a measure-

ment of business health deserve attention. For example, the concept becomes relevant depending upon (i) the seasonal influence, (ii) the extent to which the balance-sheet reflects the current realisable values at the end of the balance-sheet, (iii) the proportions of the different current assets and liabilities and (iv) the degree of risk of possible value fluctuations. So far as the weightage to be assigned to these constraints is concerned, it is a matter of judgment for the particular line of business.

Concluding, it must be recognised that the current ratio is just one of the several ratios that can be computed for measuring financial soundness of companies. In fact, each of the several ratios tells its own story, and each ratio, in conjunction with some other ratio and other relevant facts, tells a supplemental story. In the light of the above discussion, the utility of the concept of current ratio may or may not go unchallenged. Studied from the point of view of the make-up of the various items of a balance-sheet and the acid test applied to it, the current ratio does give a fair idea of the solvency of a going concern. "It is certain that whatever the limits of ratio analysis, its use in a moderate degree induces, familiarity with statements and a realisation of component relationships that may escape scrutiny of the absolute amounts. Nevertheless, it must be kept in mind in the use of ratios that they are derived data and have their source in the statement figures."¹³ There is no doubt that in the process of financial analysis, a simultaneous computation of various ratios is more desirable than a single ratio which is liable to be misinterpreted.¹⁴ The device of the current ratio must be taken as a useful tool in the hands of analysts who should not judge a company's strength merely from the criterion of its profitability or growth.

REFERENCES

1. Values used for receivables should either be at gross or net of the allowance for uncollectible accounts. *Vide Cost Accountancy* by Matz, Curry and Frank, Prentice-Hall of India Pvt. Ltd., New Delhi. 1964. p. 919.
2. What are known as current assets today were called as circulating capital by Adam Smith long ago in 1776 in 'The Wealth of Nations' when he said, "The goods of the merchant yield him not revenue or profit till he sells them for money, and the money yields him as little till it is again exchanged for goods. His capital is continuously going from him in one shape, and returning to him in another, and it is only by means of such circulation, or successive exchanges, that it can yield him any profit. Such capital, therefore, may very properly be called circulating capital." *Vide How to Evaluate Financial Statements* by Wall Alexander, Harper and Bros., New York, p. 11.
3. Harry G. Gunthmann, *Analysis of Financial Statements*, Prentice-Hall of India Pvt. Ltd., New Delhi. 1964. p. 103.
4. Joel Dean, *Managerial Economics*, Prentice-Hall of India Pvt. Ltd., New Delhi, 1968. p. 15.
5. J. Batty, *Management Accountancy*, Macdonald & Evans Ltd., London. 1966. p. 397.

6. "In any given instance, however, the appropriate value of the ratio depends on the nature of the firm's business and the rigour with which the monetary measures of the several components of current assets are obtained." Cf. R.J. Chambers, *Financial Management*, University of Sydney, 1967. p. 244.
7. Magee, C.C., *Financial Accounting and Control*, George Allen and Unwin, London. 1968. p. 81.
8. "Whereas public utilities are often considered to be in sound financial condition with current ratios of one, a current ratio of less than two or three probably would be taken as a sign of weakness for a manufacturing concern." Cf. *Essentials of Industrial Management* by James L. Lundy, Eurasia Publishing House Pvt. Ltd., New Delhi. 1968. p. 57.
9. *Ibid.* p. 57.
10. The acid test backs away from the assumption of a going concern by not considering future funds flow of the business. See *Techniques of Financial Analysis* by Erich A. Helfert. Richard D. Irwin, Inc., Illinois, 1967.
11. *Op. cit.*, p. 397.
12. Gerstenberg, Charles W., *Financial Organization and Management of Business*, Prentice-Hall, Inc., New York. 1959. pp. 377-78.
13. M.E. Murphy, *Managerial Accounting*, D. Van Nostrand Company, Inc., New Jersey, 1968. p. 75.
14. "Variations expressed only as absolute amounts are not always satisfactory because the absolute amount is frequently not indicative of the significance of the variation." *Vide: Budgeting—Profit Planning and Control* by G.L. Welsch, Prentice-Hall, Inc., New Jersey, 1967. p. 375.