A Firm Has Net Working Capital Of $6,800 And Current Assets Of $21,800. What Is The Current Ratio?.69.601.451.67.92

Understanding the Current Ratio: A Key Indicator of a Firm's Liquidity

A Firm Has Net Working Capital Of $6,800 And Current Assets Of $21,800. What Is The Current Ratio?.69.601.451.67.92 This question introduces an essential aspect of financial analysis: the current ratio. For investors, creditors, and management, the current ratio provides insights into a company's ability to meet its short-term obligations. In this article, we will explore what the current ratio is, how to calculate it, and why it matters, using the provided data to illustrate these concepts.

What Is the Current Ratio?

The current ratio is a liquidity ratio that measures a company's ability to pay short-term liabilities with its short-term assets. It is expressed as:

Current Ratio = Current Assets / Current Liabilities

This ratio indicates whether a firm has enough resources to cover its upcoming financial obligations without needing to secure additional funding. Generally, a higher current ratio signifies better liquidity, but an excessively high ratio might also suggest inefficient asset management.

Interpreting Net Working Capital and Current Assets

Before calculating the current ratio, it's important to understand key financial metrics involved:

Net Working Capital (NWC)

- Defined as: NWC = Current Assets - Current Liabilities
- Represents the short-term liquidity of a company.
- Indicates the amount of liquid assets available after covering short-term liabilities.

Current Assets

- Assets expected to be converted into cash within one year.
- Includes cash, accounts receivable, inventory, and other liquid assets.

Given Data:
- Net Working Capital (NWC) = $6,800
- Current Assets = $21,800

From these, we can infer the company's short-term liquidity position.

Calculating the Current Liabilities

Since the current ratio requires current liabilities, we need to determine this value first. Using the relationship:

NWC = Current Assets - Current Liabilities

Rearranged:

Current Liabilities = Current Assets - NWC

Plugging in the numbers:

Current Liabilities = $21,800 - $6,800 = $15,000

This means the company's current liabilities amount to $15,000.

Calculating the Current Ratio

Now, using the formula:

Current Ratio = Current Assets / Current Liabilities

Substituting the known values:

Current Ratio = $21,800 / $15,000 ≈ 1.45

This ratio signifies that for every dollar of current liabilities, the firm has approximately $1.45 in current assets.

What Does a Current Ratio of 1.45 Indicate?

- Liquidity Position: A current ratio of 1.45 suggests the company has a healthy liquidity position.
- Industry Standards: While ideal ratios vary by industry, generally, a ratio above 1 indicates the firm can meet its short-term obligations.
- Potential for Improvement: Although satisfactory, some analysts prefer ratios closer to 2 for a more conservative liquidity cushion.

Factors Affecting the Current Ratio

Several factors influence a company's current ratio, including:

Asset Management

- Efficient inventory management reduces excess inventory, improving the current ratio.
- Faster collection of receivables enhances liquidity.

Liability Management

- Extending the maturity of short-term debt can improve the current ratio temporarily.
- Managing payables effectively ensures better cash flow.

Industry Norms

- Some industries, like retail, tend to operate with lower current ratios.
- Others, like manufacturing, often maintain higher ratios for safety.

Limitations of the Current Ratio

While useful, the current ratio has some limitations:

- Does Not Account for Asset Quality: It treats all current assets equally, regardless of liquidity.
- Ignores the Timing of Cash Flows: It doesn't measure when liabilities are due within the current period.
- Can Be Manipulated: Companies might delay payments or accelerate receivables to improve the ratio temporarily.

Alternative Liquidity Ratios

To gain a comprehensive view of liquidity, consider other ratios:

1. **Quick Ratio (Acid-Test Ratio):** Excludes inventory and other less liquid assets from current assets.

2. **Cash Ratio:** Focuses solely on cash and cash equivalents.

These ratios offer more conservative measures of liquidity, especially in industries where inventory isn't easily liquidated.

Conclusion: Putting the Calculation into Context

Based on the provided data:

- Current Assets: $21,800
- Net Working Capital: $6,800
- Current Liabilities: $15,000
- Current Ratio: approximately 1.45

This indicates the firm is in a reasonably healthy liquidity position, capable of covering its short-term obligations with its assets. However, it's essential to compare this ratio with industry benchmarks and consider other financial metrics to assess overall financial health comprehensively.

Final Thoughts

Understanding and analyzing the current ratio is vital for stakeholders to evaluate a company's liquidity.

While a ratio of 1.45 suggests adequate short-term financial health, firms should continually monitor and improve their liquidity positions and consider industry standards. Proper management of current assets and liabilities ensures the firm remains resilient against unforeseen financial challenges.

Remember: Financial ratios are tools that, when used together, provide a clearer picture of a company's financial stability. Always consider multiple indicators and industry context for a comprehensive analysis.

Frequently Asked Questions

What is the current ratio of a firm with net working capital of $6,800 and current assets of $21,800?

The current ratio is approximately 1.62.

How can I calculate the current ratio given net working capital and current assets?

You can find the current ratio by dividing current assets by current liabilities, where current liabilities equal current assets minus net working capital.

If a firm has current assets of $21,800 and net working capital of $6,800, what are its current liabilities?

Current liabilities are $15,000, calculated as $21,800 minus $6,800.

Why is the current ratio important for assessing a firm's liquidity?

The current ratio indicates a firm's ability to cover short-term obligations; a higher ratio suggests better liquidity.

Based on the given data, which of the following options is closest to the current ratio: 0.69, 1.45, 1.67, 2.0?

The closest current ratio is approximately 1.67.

If a firm's current assets increase while net working capital remains the same, how does that affect the current ratio?

The current ratio increases because the numerator (current assets) increases while current liabilities stay constant.

Can a firm have a high net working capital but a low current ratio?

Yes, if current liabilities are very high relative to current assets, the current ratio can be low even with high net working capital.

Additional Resources

A firm has net working capital of $6,800 and current assets of $21,800. What is the current ratio? This question touches on fundamental concepts in financial analysis, specifically relating to liquidity and short-term financial health. Understanding how to interpret net working capital and current assets to determine the current ratio provides valuable insights into a company's ability to meet its short-term obligations. In this guide, we'll explore these key financial metrics, their significance, how to compute the current ratio, and what the resulting figure reveals about a firm's liquidity position.

Understanding Key Financial Metrics

Before diving into the calculations, it's essential to understand what each term means:

Net Working Capital (NWC)

- Definition: Net Working Capital is the difference between a company's current assets and current liabilities.
- Formula:
Net Working Capital = Current Assets - Current Liabilities
- Significance:
NWC indicates the firm's short-term liquidity and operational efficiency. A positive NWC suggests that the company can cover its short-term liabilities with its short-term assets.

Current Assets

- Definition:
Current assets are assets that are expected to be converted into cash or used up within one year or within the operating cycle, whichever is longer.
- Examples: Cash, accounts receivable, inventory, marketable securities.

Current Liabilities

- Definition:
Current liabilities are obligations due within one year.
- Examples: Accounts payable, short-term debt, accrued expenses.

Calculating the Current Ratio

What is the Current Ratio?

The current ratio is a liquidity ratio that measures a company's ability to pay short-term obligations with its short-term assets.

- Formula:
Current Ratio = Current Assets / Current Liabilities

How to Derive the Current Ratio from Given Data

Given:
- Net Working Capital (NWC) = $6,800
- Current Assets = $21,800

We need to find:
- Current Liabilities (CL)
- Then, compute the current ratio.

Step-by-Step Calculation

Step 1: Find Current Liabilities

Recall the relationship:

NWC = Current Assets - Current Liabilities

Rearranged:

Current Liabilities = Current Assets - NWC

Substituting the known values:

Current Liabilities = $21,800 - $6,800 = $15,000

Step 2: Calculate the Current Ratio

Using the formula:

Current Ratio = Current Assets / Current Liabilities

Plugging in the numbers:

Current Ratio = $21,800 / $15,000 ≈ 1.45

Interpreting the Current Ratio

A current ratio of approximately 1.45 indicates that the firm has $1.45 in current assets for every dollar of current liabilities. This suggests a comfortable liquidity position, with sufficient assets to cover short-term obligations.

What Do Different Current Ratio Values Mean?

Current Ratio	Interpretation
Less than 1.0	The company may struggle to meet short-term debts, indicating liquidity issues.
Exactly 1.0	The company's current assets equal current liabilities, signaling just enough liquidity.
Between 1.0 and 2.0	Generally considered healthy, indicating the company has enough assets to cover its liabilities comfortably.
Greater than 2.0	Might suggest the company is holding excessive current assets, possibly indicating inefficient asset utilization.

In this context, a ratio of 1.45 is generally viewed as healthy, implying the company is well-positioned to meet its immediate financial obligations.

Additional Insights and Considerations

Why Is the Current Ratio Important?

The current ratio provides a quick snapshot of liquidity, which is vital for:

- Creditors: To assess the risk of lending.

- Management: To ensure operational stability.
- Investors: To evaluate financial health.

Limitations of the Current Ratio

While useful, the current ratio has its limitations:

- Doesn't account for the quality of assets: Not all current assets are easily liquidated.
- Ignores timing of cash flows: It doesn't consider when liabilities are due.
- Can be manipulated: Companies might hold large inventories or receivables that are difficult to convert to cash quickly.

Complementary Ratios and Analyses

To get a comprehensive view of liquidity, consider examining:

- Quick Ratio (Acid-Test Ratio): Excludes inventory and other less liquid assets.
- Cash Ratio: Focuses solely on cash and cash equivalents.
- Working Capital Trends: Changes over time indicate improving or deteriorating liquidity.

Practical Applications

Understanding how to analyze and interpret financial ratios like the current ratio empowers stakeholders to make informed decisions. For instance:

- Financial Managers: Adjust working capital strategies based on liquidity needs.
- Investors: Evaluate the firm's short-term financial health before investing.
- Creditors: Determine creditworthiness and set lending terms.

Summary

In conclusion, given that a firm has net working capital of $6,800 and current assets of $21,800, the current liabilities can be calculated as:

Current Liabilities = $21,800 - $6,800 = $15,000

Then, the current ratio is:

Current Ratio = $21,800 / $15,000 ≈ 1.45

This indicates a firm with a healthy liquidity position, capable of meeting its short-term obligations with its current assets. Understanding these metrics and their interrelationships is fundamental for effective financial analysis and strategic decision-making.

Final Notes

- Always compare ratios to industry benchmarks for more meaningful insights.
- Monitor ratios over time to identify trends.
- Use a combination of liquidity ratios for a comprehensive analysis.

By mastering these concepts, you'll be better equipped to assess a company's financial health and make strategic business or investment decisions with confidence.

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