

Short-term Liabilities

Author: Rickard Carlsson 2008-09-30

Short-term liabilities are an important aspect of a company's financial performance. Although they can be considered a fairly easy notion to explain, they cannot be fully understood without knowledge of the context in which this specific concept arises. For this reason, the following pages will not only offer an explanation of what short-term liabilities are and what they mean for a company, but also an introduction to the concepts of balance sheet and liability in general.

The Balance Sheet

The balance sheet presents a company's financial state at a specific point in time. For this reason, some might describe the balance sheet as a "snapshot" of the company's financial position on a specific date. As an example, on December 31st, 2008 the balance sheet of a specific company will show all transactions that have been accounted for by the firm up to that specific date.

Assets, liabilities and owners' equity are the three components that make up a company's balance sheet, usually represented in the following equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

In simple terms, assets represent what the company owns, while liabilities stand for what the firm owes. The result from the difference between the first two elements of the equation is the net worth of the company, generally referred to as owners' equity. On the balance sheet, assets are presented on the left side, while liabilities and equity are always on the right.

The balance sheet is a very important document in the administration of a firm, as it gives valuable information to any stakeholder who might want to determine the company's financial state at any point in time. The name of such a document itself refers to the equation previously presented, highlighting the importance of balancing the three items.

Example of a balance sheet for company X.

Assets		Liabilities	
Current assets:		Short-term liabilities:	
Cash	10,000	Debt due within 1 year	15,000
Inventory	20,000	Payables	10,000
Total current assets	30,000	Total short-term liabilities	25,000
Fixed assets:		Long-term liabilities:	
Property, plants, equipment	50,000	Shareholders equity	30,000
		Long-term debt	25,000
Total fixed assets	50,000	Total long-term liabilities:	55,000
Total assets:	80,000	Total liabilities:	80,000

Liabilities

As briefly mentioned above, liabilities are a company's obligations to transfer assets or provide services to other entities as a result of past transactions or events. They have often the word payable in their account title, because it is often an already used service or product that remains to be paid.

Some examples of liabilities that can be found on a company's balance sheet:

- Wages payable;
- Accounts payable;
- Income taxes payable;
- Notes payable;
- Interest payable;
- Accrued liabilities.

Liabilities are generally important to investors, financial analysts, management, creditors and anyone who wishes to know the level of indebtedness of the firm. In the balance sheet, liabilities are normally divided into two sections, which are short-term liabilities and long-term liabilities. The difference might be obvious: short-term liabilities are liabilities due within one year, while long-term liabilities have a longer due date. While long-term liabilities will be covered in another chapter, we will focus our attention now on short-term liabilities.

Short-term liabilities

As stated above, short-term liabilities are a company's debts or obligations that are to be repaid or performed within one year. Often referred to as *short-term debt*, *current liabilities* or *current debt*, they appear on the right side of the company's balance sheet and include items such as accounts payable, accrued expenses payable, taxes payable, unearned revenues, product warranty liabilities, the current portion of long-term debt, notes payable and commercial paper. Understanding what does and does not represent, a short-term liability makes it easier to manage the financial affairs of a company, as it is a great indicator of the overall financial stability of the organization.

In practical terms, when defining short-term liabilities, it is important to think of them in terms of recurring expenses that are generally handled within thirty to ninety days as a part of normal operations. These examples of short-term liabilities would include raw materials used in the production process, products and services that are used in the process of operating the company on a day-to-day basis, and equipment purchases that will require only a short time to be paid in full. Short-term loans that also will be paid off during the current fiscal year may be considered as short-term liabilities. Essentially, these are bills that are due to creditors, suppliers and other stakeholders within a short period of time.

The ability to meet short-term debts can be estimated via three specific ratios: current ratio, quick ratio and cash ratio.

Current Ratio

The current ratio is an indication of a company's ability to meet short-term debt obligations, i.e. the measure of a company's ability to pay short-term debt and have enough money to finance its day-to-day business. The way to calculate current ratio is as follows:

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

The rule of thumb evaluating the result of such an equation is that the higher the ratio, the more liquid the company is. That means: if the current assets of a company are more than twice the current liabilities, then that company is generally considered to have good short-term financial strength – ie, 2 euros of current assets for every euro of current liabilities. On the other hand, if current liabilities exceed current assets, then the company may have problems meeting its short-term obligations.

However, one should be careful in considering other aspects related to this ratio. For instance, a current ratio of 3 to 1 might at first seem extremely favourable. In contrast, such a large disparity indicates that the company has a high amount of cash available, which could be put to better use.

An example of Current Ratio

Company X has 150,000 euros in current assets and 100,000 euros in current liabilities. The current ratio in this case would therefore be:

$$\text{Current Ratio} = 150,000 / 100,000 = 1.5$$

In other words, for every euro of debt or liability, company X has 1.5 euros of cash. This means the current liabilities of the company are covered 1.5 times.

Quick Ratio

The quick ratio is very similar to the current ratio, with the only difference being that it eliminates inventory from the calculation of current assets. In other words, the quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets. Just as in the case of the current ratio, the rule of thumb remains that the higher the quick ratio, the better the position of the company. The quick ratio is calculated as follows:

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Also known as the "acid-test ratio" or the "quick assets ratio", the quick ratio is a very strict test that indicates if a company has enough short-term assets to cover its current liabilities without selling inventory. The choice of excluding inventory is related to the difficulty of some companies in turning their inventory into cash.

Compared to the current ratio, this is a more familiar measure of liquidity with investors. However, one should consider that in the event that short-term obligations need to be paid off immediately, there are situations in which the current ratio would overestimate a company's short-term financial strength.

A Quick Ratio example

Company X has 200,000 euros in current assets and 150,000 euros in current liabilities. In addition, of the 200,000 euros in current assets, 110,000 euros is inventory. What is the result of the quick ratio?

$$\text{Quick Ratio} = (200,000 - 110,000) / 150,000$$

$$\text{Quick Ratio} = 90,000 / 150,000$$

$$\text{Quick Ratio} = 0.6 \text{ euros}$$

In this case, a quick ratio of 0.6 is not a good result for the company, as it shows a sign of too much inventory being held up and not getting sold. Furthermore, if all of the creditors of the company would demand their money at this time, company X would not have sufficient funds to pay off its short-term debt. It has only 0.6 Euro of accessible cash for every Euro in short-term debt.

Cash Ratio

The cash ratio, also called liquidity ratio or cash asset ratio, measures the extent to which a corporation or other entity can quickly liquidate assets and cover short-term liabilities. For this reason, it is of great interest to short-term creditors.

The cash ratio is calculated as follows:

$$\text{cash ratio} = \frac{\text{cash} + \text{short-term securities}}{\text{current liabilities}}$$

The cash ratio measures only the most liquid of all assets against current liabilities, and is therefore seen as the most conservative of all the three liquid ratios. The formula is an indicator of the extent to which a company can pay current liabilities without relying either on the sale of inventory or on the receipt of accounts receivable.

In comparison with the current ratio, the cash ratio excludes both inventory and accounts receivable. As in the case of current ratio and quick ratio, an excessive cash ratio should be discouraged, because the company should rather be using its extra cash to seek greater returns. Moreover, when using the cash ratio formula one should keep in mind that it ignores the timing of both cash received and cash paid out.

A Cash Ratio Example

Company X has 50,000 euros in cash and 50,000 euros in marketable securities. If the current liabilities are 75,000 euros, what is the cash ratio of the firm?

$$\text{Cash Ratio} = (50,000 + 50,000) / 75,000$$

$$\text{Cash Ratio} = 100,000 / 75,000$$

$$\text{Cash Ratio} = 1.33 \text{ Euros}$$