**MEANING AND IMPORTANCE OF LIQUIDITY**
Liquidity is the ability of a company to meet the short term obligations. It is the ability of the company to convert its assets into cash. Short term, generally, signifies obligations which mature within one accounting year. Short term also reflects the operating cycle: buying, manufacturing, selling, and collecting.

A company that cannot pay its creditors on time and continue not to honor its obligations to the suppliers of credit, services, and goods can be declared a sick company or bankrupt company. Inability to meet the short term liabilities may affect the company’s operations and in many cases it may affect its reputation too. Lack of cash or liquid assets on hand may force a company to miss the incentives given by the suppliers of credit, services, and goods. Loss of such incentives may result in higher cost of goods which in turn affect the profitability of the business. So there is always a need for the company to maintain certain degree of liquidity. However, there is no standard norm for liquidity. It depends on the nature of the business, scale of operations, location of the business and many other factors.

Every stakeholder has interest in the liquidity position of a company. Supplier of goods will check the liquidity of the company before selling goods on credit. Employees are also have interest in the liquidity to know whether the company can meet its employees’ related obligations: salary, pension, provident fund etc. Shareholders are interested in understanding the liquidity due to its huge impact on the profitability. Shareholders may not like high liquidity as profitability and liquidity are inversely related. However, shareholders are also aware that non-liquidity will deprive the company from getting incentives from the suppliers, creditors, and bankers.

**Liquidity and Business Decisions**
One can understand the liquidity position by analyzing the financial statements of a company. Following financial items are required to understood to understand the liquidity position of a company:
- Current Assets
- Current Liabilities

Liquidity position of a company can examined through financing decisions or investment decisions. A company can finance its investment by different combination of current and long term sources. In other words, a company can invest the money, raised through short term source or long term sources, in the current assets or non-current assts. Some of the relevant business strategies are as follows:
- Financing the current assets by current sources
- Financing the current assets by the long term sources
- Financing non-current assets by the short term sources
- Financing non-current assets by long term sources

One can get an idea about the above mentioned decisions by seeing the balance sheet or determining the working capital of a company.

**Liquidity and Working Capital**
As mentioned in the previous section, working capital helps in understanding the liquidity position of a company. It also shows the financing or investment decisions of a company.

Working capital is the excess of current assets over the current liabilities. So working capital of a company can take one of the following directions:

- **Positive working capital**: When current assets are more than the current liabilities
- **Negative working capital**: When the current liabilities are more than the current assets
- **Zero working capital**: when the current assets are equal to the current liabilities

Conventionally, it is accepted that higher the positive working capital, better is the liquidity position. The rationale of this position is that it is easier to sell off the current assets and make the payment towards the current liabilities.

Let us see the relationship between the working capital and other components of the balance sheet.

- **Sources = Assets**  
  Or  
  **Owners fund + Long Term borrowings + Current Liabilities = Current Assts + Non-Current Assets**  
  Or  
  **Long Term funds + Current Liabilities = Current Assets + Non-current assets**  
  Or  
  **Long Term funds = Current Assets + Non-Current Assets - Current Liabilities**  
  Or  
  **Long term funds – Non Current Assets = Current Assets – Current Liabilities**  
  Or  
  **Long Term Funds – Non-Current Assets = Working Capital**

So managing working is not just managing current assets and current liabilities. One can manage the working capital by managing the long term funds and non-current assets. In other words, liquidity of a company can be managed by managing current assets, current liabilities, non-current assets, and long term funds.

Therefore, one can also explain the working capital from the financing angle as follows:

- **Positive working capital**: When current assets are partly financed by the long term funds.
- **Negative working capital**: When the non-current assets are partly financed by the current liabilities.
- **Zero working capital**: when the current assets fully financed by the current liabilities and the non-current assets are fully financed by the long term funds.

Table 15.1 shows the working capital of some of the well known companies of India.
<table>
<thead>
<tr>
<th>Industry</th>
<th>WC</th>
<th>%</th>
<th>Industry</th>
<th>WC</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Satyam Computer Services Ltd.</td>
<td>3760</td>
<td>74%</td>
<td>I T C Ltd.</td>
<td>1427.26</td>
<td>11%</td>
</tr>
<tr>
<td>Sun Pharmaceutical Inds. Ltd.</td>
<td>2334</td>
<td>65%</td>
<td>Indian Petrochemicals Corpn. Ltd.</td>
<td>1128.26</td>
<td>11%</td>
</tr>
<tr>
<td>Reliance Energy Ltd.</td>
<td>8213</td>
<td>56%</td>
<td>Reliance Industries Ltd.</td>
<td>8094.97</td>
<td>9%</td>
</tr>
<tr>
<td>Suzlon Energy Ltd.</td>
<td>2435</td>
<td>54%</td>
<td>Grasim Industries Ltd.</td>
<td>753.39</td>
<td>9%</td>
</tr>
<tr>
<td>Dr. Reddy’S Laboratories Ltd.</td>
<td>1743</td>
<td>45%</td>
<td>Videsh Sanchar Nigam Ltd.</td>
<td>603.69</td>
<td>8%</td>
</tr>
</tbody>
</table>

Prowess: CMIE Database