Teaching Note
Firm Liquidity Ratios

<https://wrds-wwwww.wharton.upenn.edu/classroom/financial-ratios/>

A. Case Overview: presents a synopsis of the exercise that is being taught.

Financial ratios measuring a company’s liquidity are important metrics because investors, bankers, other lenders, auditors, and company management often use these measures to help assess a company’s ability to meet financial obligations as they come due. Additionally, industry-specific factors can affect the comparability of these metrics. The WRDS Financial Ratios Visualization tool is an interactive application that enables students to learn about financial ratios in a visually engaging format that contains both firm and industry-level ratio data.

In the assignment, students will be introduced to a set of financial ratios commonly used to determine a company’s ability to meet its short-term obligations: (1) the cash conversion cycle; (2) cash ratio; (3) current ratio; and (4) quick ratio (acid-test). Students will be asked to select companies from three different industry sectors (Consumer Staples, Financials, and Information Technology), note any significant differences between the values, and consider how factors such as the industry’s typical operating cycle affect these metrics. Students will also compare the financial ratios for each chosen company with the median value of its corresponding industry-sector.

An alternative assignment is also available, asking students to compare the liquidity of two companies of their choosing for the same fiscal year. Students are directed to select two companies from the same industry for this comparison. Using the Simplified Financial Statements query form, they then generate the data necessary for their own calcluations of the cash ratio, current ratio, and quick ratio.

B. Learning Objectives: after this lesson the following objectives should be met.

Students will learn about four ratios commonly used to assess a company’s ability to meet short-term financial obligations, as well as some important considerations regarding the industry sector’s impact upon these measures:

* Cash Conversion Cycle (Days)
* Cash Ratio
* Current Ratio
* Quick Ratio (Acid-test)

C. Teaching Approach/Pedagogy: an explanation of how the lesson will be taught, and who the target audience is.

Undergraduates are the primary target audience for the case. Although this exercise is designed as part of an introduction to the fundamentals of financial accounting, it is also appropriate for students studying investment strategies. Students should come to this assignment with some basic understanding of the three financial statements and the information that each provides. Assignment instructions are found in the accompanying PowerPoint slide deck, which you may distribute to students.

D. Assignment and Discussion Questions: provides questions that stimulate thought and facilitate understanding of the lesson.

1. Provide specific examples, using actual companies, of why values for liquidity ratios could vary significantly from industry to industry.
2. If a company’s quick ratio is low but it’s current ratio is high, what might this discrepancy say about the company in regards to its inventory?
3. What two financial statements provide the information used to calculate the Cash Conversion Cycle?
4. Explain why a ratio such as the Cash Ratio should fall within a certain range. In other words, why would extremely high liquidity not necessarily be a good thing?

E. Conclusion and Feedback: assesses whether learning objectives were met and solicits feedback from students about the effectiveness of the assignment.

Were the learning objectives met? Be sure to solicit feedback from students in order to ascertain what worked and what didn’t work with the assignment.

**YOUR FEEDBACK IS VITAL TO THE WRDS CLASSROOM INITIATIVE. PLEASE USE THE FOLLOWING LINK TO SEND COMMENTS AND SUGGESTIONS:**

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