The Distinctions Between Profitability and Liquidity

Specification requirement— the distinction between profitability and liquidity and their relative importance.

We all from our studies understand profits, whether Gross Profit, Net Profit or the ways of measuring profit margins (GPM and NPM), But what is liquidity and how can we compare profits and liquidity?

Liquidity is a measure of the availability of money for use in the day to day running of a business. A liquid asset is one that is cash or can easily be turned into cash, for example a debtor, someone who owes a business money, is likely to pay soon, so this is a liquid asset. Stocks that will be sold in the near future—another liquid asset.

Working Capital

Working Capital is a measure of liquidity. If a firm has large amounts of working capital, it can be described as having good levels of liquidity. Low or even negative working capital = low levels of liquidity. Working capital is calculated by using figures on a firms balance sheet, Current Assets take away Current Liabilities gives us Working Capital.

Profits and Liquidity Compared

There does seems to be a clear relationship between profits and liquidity, after all profits are calculated by taking costs from sales revenue, and liquidity is measured by taking current liabilities which include creditors (created by purchases) from Current Assets (which includes cash and bank balance, the money that comes from selling goods and services).

But there are important differences between the two. These differences include;

Capital Inflows. If a business receives an injection of capital that has not arisen from its trading activities (sales) then this improves availability of cash. So if a firm borrows money for investment, this increases the amount of working capital available —liquidity is improved. But this borrowing is obviously not an increase in profits, and repayments on the loan will be shown as a business expense, reducing profitability.

Depreciation. As depreciation is a paper accounting transaction, not involving actual spending of money, this loss in value of assets does not affect liquidity. But depreciation is shown as a business expense, reducing profits.

Sales or revenue. How sales and revenue is shown on accounts also causes differences between measurement of profits and liquidity. Sales are applied to the accounting period in which the sale occurs. So if a good sold in one period on credit, is entered as a sale for that period and adds to the profit in that period, The payment may not be due or received until the next accounting period (maybe 60 days later), so liquidity does not benefit until maybe 60 days after the sale. Even though the sales has created a debtor (which is a current asset) it is not the same as having cash, and will not become cash until the debtor pays . In fact the sale may have for a short period made liquidity worse, as the costs of sales will have to be paid before the money is recived from the buyer of the goods.

This problem of costs and payments being incurred well before money received from the buyer is a real problem for small firms, and is one of the main causes of lack of liquidity.

The Importance of Profits and Liquidity.

Liquidity

If managers of a business say they have a liquidity or working capital problem, this means that they will have a problem meeting all their immediate or near future expenditure demands. That is they do not have enough cash in hand, or do not expect enough cash to be flowing into the business and cannot convert enough assets into cash in the short term to be able to pay all their bills, wages, debts etc.. Without liquidity firms can go bust very quickly. Cash is needed to keep the wheels of business turning, to pay bills, wages, suppliers etc. In the short run liquidity is more important than profit, but in the longer term, there is no point in having available cash, if this cash has not come from profits made.

Profits

Profits are the reason why businesses exist, it is the potential of making profits that encourage entrepreneurs to take risks to invest in a business, so the first role of profits is to reward owners for risks taken when investing in a business. Apart from rewarding enterprise / risk taking, profits have other uses.

- Providing money for investment. Profits kept within the firm and reinvested, help firms grow.
- Profits attract new investors, therefore making raising capital easier.
- Growing profits increase the value of a business, giving the owners 'capital gain'.
- Profits allow the repayment of loans made to a firm, reducing gearing and reliance on lenders.

Notes