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Current Ratio or Net Working Capital?

BY HAROLD S. BENJAMIN

WHAT is the proper means by which to compare the financial strength of business enterprises at various dates? Is it the ratio which current assets bear to current liabilities (current ratio), or is it the excess of current assets over current liabilities (net working capital)? Two well known economists recently were engaged in a dispute about that question. Professor Gerhard Colm, in an article on "The Revenue Act of 1938"[1] cites an increase in the net working capital of the leading American industrial corporations to support his contention that these corporations were at least as well equipped in 1938 as they were in 1935, to finance, out of their own resources, an increase in plant and equipment, if business conditions made such an increase advisable. His interpretation has been vigorously assailed by another economist, who points to the lowered current ratio, the reduced cash, and the increase in current liabilities. The figures on which both sides base their arguments, Standard Statistics "Composite Balance-sheets of Leading American Industrial Corporations,"[2] are shown on the following page.

Before attempting to decide what the correct interpretation of these figures is, let me illustrate by means of a more simple example the meaning of both current ratio and net working capital.

A client of mine, for whom I had to prepare an accountant's report, had not been very successful during the year ended June 30, 1938. His volume of sales had declined, and his net loss had exceeded the depreciation charges so as to impair the working capital. At the beginning of the year, cash, inventories, and accounts and notes receivable had amounted to $80,000, and current liabilities to $40,000. At the end of the year, current assets were only $50,000 and current liabilities had been reduced to $17,000. The only favorable fact I could find was that the current ratio had improved from two to one to approximately three to one. But was there any real improvement? The working capital had been reduced from $40,000 to $33,000. An ensuing upswing in business would probably raise receivables to the previous year's level, and the client would probably like to increase his inventory to what it had been one year before. But he could do so only by reducing his cash or increasing his liabilities beyond the prior year's level, unless profits appeared quickly enough to compensate for the loss suffered. The higher current ratio was a result of the depression, and would disappear with returning prosperity. The decisive factor was the reduced working capital. This impairment could be recouped only through new capital contribution, through future profits, or through liquidation of fixed assets.

For the leading American corporations, from the end of 1934 up to the summer of 1937, a development took place exactly opposite to the one which my client experienced in 1937–1938. Inventories and receivables of those corporations were low in 1934, current liabilities accordingly small, and cash holdings very substantial. But if we want to determine how much the corporations had available in 1934 for investment in plant and equipment, we have to subtract from cash the amount

[1] *Social Research*, Sept. 1938, p. 270.

[2] *Standard Corporation Records*, Vol. 15, No. 3342, Aug. 13, 1937, and *Standard Trade and Securities*, Vol. 88, No. 19, June 3, 1938. The sample comprises 399 corporations in 1934 and 385 corporations in 1937. This decrease in the number of corporations reduces the total assets and total liabilities by less than 2 per cent so that the comparability of the figures is not materially affected.

All amounts in millions of dollars	1934		1937	
Assets:				
Property account (less depreciation reserve)		13,765		14,256
Investments		2,481		2,371
Intangibles		679		573
Other fixed assets		474		418
Cash and equivalent	3,136		2,816	
Receivables	1,642		2,212	
Inventories	4,442		5,914	
Total current assets		9,220		10,942
Total assets		26,619		28,560
Liabilities:				
Funded debt		2,769		2,478
Preferred stock		3,352		3,217
Common stock and surplus		17,256		18,785
Capital reserves		995		730
Other liabilities		585		649
Total current liabilities		1,662		2,701
Total liabilities		26,619		28,560
Net working capital (excess of current assets over current liabilities)		7,558		8,241
Current asset ratio (ratio of current assets to current liabilities)		5.5		4.1

which, in case of the hoped-for upswing in business, would be converted into receivables and inventories. If we deduct from the corporations' cash holdings as of the end of 1934 the amount which would be required if inventories and receivables were to be brought back to their level of 1928, we find that current liabilities exceed cash, whereas at the end of 1937, when inventories and receivables taken together were beyond the high level of 1928 so that no such earmarking of funds was necessary, cash was in excess of current liabilities. Professor Colm, therefore, is right. The leading American industrial corporations were better equipped at the end of 1937 than they were at the end of 1934 to finance a limited period of prosperity by their own means.

We have arrived at our conclusion by comparing amounts which we computed by deducting from the excess of cash over current liabilities, the amounts by which receivables and inventories were below normal or prosperity level. This is, in effect, nothing but a comparison of the amounts of net working capital of the corporations.

The current ratio is a valuable expedient for comparing the financial position of enterprises engaged in the same line of business as of the same date, or of the same enterprise at various times of similar business conditions. However, to trace the changes in the financial strength of enterprises through the various phases of the business cycle, we must use the amount of net working capital, or, if the size of the enterprise has changed, the ratio which net working capital bears to total assets.