ACCOUNTING RATIO | ACTIVITY / TURNOVER RATIO

BY- ANUJ JINDAL
• Rapidity with which the resources available to the concern are being used to produce revenue from operations

• To measure how well companies utilize their assets to generate income
1. Inventory Turnover Ratio
2. Trade Receivables Turnover Ratio
3. Trade Payables Turnover Ratio
4. Working Capital Turnover Ratio
INVENTORY TURNOVER RATIO

How effectively inventory is managed by comparing cost of goods sold with average inventory for a period

Inventory turnover ratio = cost of goods sold/ average inventory

COGS = Opening stock + Purchases + Direct Expenses – Closing Stock

COGS = Sales - Gross Margin. or Sales + Gross Loss

Average stock = (Opening stock + Closing stock)/ 2
## Inventory Turnover Ratio

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Implication</th>
</tr>
</thead>
</table>
| **Low** | Inventory lying in the Godown  
- Increased storage costs  
- Blocking of funds |
| **High** | Inventory is selling quickly  
Goods can be sold at low margin of profit and even then the profitability may be quite high. |
How many times a business can turn its accounts receivable into cash

Trade receivable turnover ratio = Net credit sales / average Trade receivable
Net credit sales = credit sales – sales return
Average debtors = (opening debtors + opening bills receivable + closing debtors + closing bills receivable) / 2
<table>
<thead>
<tr>
<th>Ratio</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Inefficient credit sales policy of the firm</td>
</tr>
<tr>
<td>High</td>
<td>Less risk of bad debts</td>
</tr>
</tbody>
</table>
Average collection period is calculated after calculating debtors turnover ratio.

The formula is:

Debt collection period (number of months) = \( \frac{12}{\text{debtors turnover ratio}} \)

Debt collection period (number of days) = \( \frac{365}{\text{debtors turnover ratio}} \)
Creditor’s Turnover Ratio = Net Credit Purchases/ Average Payables

Average Payables = (Opening creditors + Opening bills payable + Closing creditors and Closing bills payable)/ 2

The higher the ratio – The better it is – Trade Payables are being paid more quickly – Increases credit worthiness of the firm.
Working Capital Turnover Ratio = Net Sales / Working Capital

Net Working capital = Current Assets – Current Liabilities

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Efficient use of working capital</td>
</tr>
<tr>
<td>Low</td>
<td>Underutilization of working capital</td>
</tr>
<tr>
<td>Very High</td>
<td>Over trading (Doing business with too little working capital)</td>
</tr>
<tr>
<td>Very Low</td>
<td>Under trading (working capital in excess of requirements)</td>
</tr>
</tbody>
</table>
Q) Which of the following is useful in evaluating credit and collection policies?

[a] Average Payment Period

[b] Average Collection Period

[c] Current Ratio

[d] Inventory Turnover Ratio
[b] Average Collection Period
Q) Which of the following ratios measures the speed with which various accounts are converted into sales or cash?

[a] Activity
[b] Liquidity
[c] Debt
[d] Profitability
[a] Activity
Q) Calculate Creditors Turnover Ratio from the following information:

- Total Purchases: 840,000
- Cash Purchases: 70,000
- Purchase Returns: 40,000
- Creditors at end of the year: 120,000
- Bill Payable at the end of year: 20,000
- Provision for Discount on Creditors: 7500

[answered]
- [a] 4.81 times
- [b] 4.67 times
- [c] 5.21 times
- [d] 5.34 times
[c] 5.21 times
Q) Calculate Working Capital Turnover Ratio from the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>6,00,000</td>
</tr>
<tr>
<td>Trade Receivables</td>
<td>5,00,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,00,000</td>
</tr>
<tr>
<td>Trade Payables</td>
<td>2,00,000</td>
</tr>
<tr>
<td>Bank Overdraft</td>
<td>1,20,000</td>
</tr>
<tr>
<td>Cost of Revenue from Operations</td>
<td>52,80,000</td>
</tr>
</tbody>
</table>
[a] 6 times

[Hint: Net sales are not mentioned. Thus, Cost of Revenue from Operations has been taken]
A company extends credit terms of 45 days to its customers. Its credit collection would be considered poor if its average collection period was:

[a] 30 days  
[b] 36 days  
[c] 40 days  
[d] 57 days
[d] 57 days
Q) The total sales (all credit) of a firm are Rs.640,000. It has a gross profit margin of 15% and a current ratio of 2.5. The firm’s current liabilities are Rs.96,000; inventories Rs.48000 and cash Rs.16,000. Inventory turnover ratio is 5 times. Determine the average collection period if the opening balance of debtors is intended to be of Rs.80,000.(Assume 360 days in a year)

[a] 66 days  
[b] 68 days  
[c] 75 days  
[d] 72 days
PRACTICE QUESTIONS

[d] 72 days
Q) Calculate the Average Collection Period from the following details by adopting 360 days in a year.

- Average Inventory: 3,60,000
- Average Debtors: 2,30,000
- Inventory Turnover Ratio: 6
- Gross Profit Ratio: 10%
- Credit sales to total sales: 20%

[a] 175.5 days
[b] 165 days
[c] 172.5 days
[d] 160 days
PRACTICE QUESTIONS

[c] 172.5 days
Q) From the following data related to PQR company, Calculate the value of stock:

[a] 108.45  
[b] 104.65  
[c] 105.55  
[d] 110.65

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and marketable securities</td>
<td>100</td>
</tr>
<tr>
<td>Sales</td>
<td>1000</td>
</tr>
<tr>
<td>Average collection period</td>
<td>40 days</td>
</tr>
<tr>
<td>Quick ratio</td>
<td>2 times</td>
</tr>
<tr>
<td>Current ratio</td>
<td>3 times</td>
</tr>
</tbody>
</table>
[c] 105.55
Q) Find out Inventory Turnover from the following information:

[a] 6.25 times  
[b] 7.36 times  
[c] 8.43 times  
[d] 7.21 times

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit</td>
<td>20% on cost</td>
</tr>
<tr>
<td>Revenue from operations</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Opening Stock</td>
<td>42500</td>
</tr>
<tr>
<td>Closing Stock</td>
<td>37500</td>
</tr>
</tbody>
</table>
[a] 6.25 times
Q) Determine the sales of the firm given the following information:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>1.5</td>
</tr>
<tr>
<td>Acid Test Ratio</td>
<td>1.2</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>8,00,000</td>
</tr>
<tr>
<td>Inventory Turnover Ratio</td>
<td>5 times</td>
</tr>
</tbody>
</table>

[a] 11,00,000  
[b] 10,00,000  
[c] 12,00,000  
[d] 11,50,000
[c] 12,00,000