LESSON-32
ACCOUNTING RATIOS-1

SUMMARY

Accounting ratios are calculated from the financial statements to arrive at meaningful conclusions pertaining to liquidity, profitability, and solvency. Accounting ratios can be of different types.

OBJECTIVES OF RATIO ANALYSIS

Ratios are regarded as a test of earning capacity, financial soundness and operating efficiency of a business organisation. The advantages derived by an enterprise by the use of accounting ratios are:

- **Useful in Analysis of Financial Statements**
- **Useful in Simplifying Accounting Figures**
- **Useful in Judging the Operating Efficiency of Business**
- **Useful for Forecasting**
- **Useful in Locating the Weak Spots**
- **Useful in Inter-firm and Intra-firm Comparison**

MEANING AND ITS CLASSIFICATION

The ratio is an arithmetical expression i.e. relationship of one number to another. It maybe defined as an indicated quotient of the mathematical expression. It is expressed as a proportion or a fraction or in percentage or in terms of number of times. A financial ratio is the relationship between two accounting figures expressed mathematically.

Broadly accounting ratios can be grouped into the following categories :

(a) Liquidity ratios

(b) Activity ratios

(c) Solvency ratios

(d) Profitability ratios

ACTIVITY OR TURNOVER RATIOS

Activity ratios measure the efficiency or effectiveness with which a firm manages its resources. These ratios are also called turnover ratios because they indicate the speed at which assets are converted or turned over in Revenue from operations (sales). These ratios are expressed as 'times' and should always be more than one. Some of the important activity ratios are :

- Inventory turnover ratio (Stock turnover ratio)
- Trade Receivables turnover ratio (Debtors turnover ratio)
- Trade Paybles turnover ratio (Creditors turnover ratio)
- Working capital turnover ratio

(i) Inventory Turnover Ratio (Stock Turnover Ratio)

Inventory turnover ratio is a ratio between cost of revenue from operation and the average inventory. Every firm has to maintain a certain level of inventory of finished goods. But the level of inventory should neither be too high nor too low. It evaluates the efficiency with which a firm is able to manage its inventory. This ratio establishes relationship between cost of revenue from operation and average inventory.

(ii) Trade Receivable Turnover Ratio (Debtors Turnover ratio)

This ratio establishes a relationship between cost of revenue from operations and average trade receivables i.e. average trade debtors and bill receivables. The objective of computing this ratio is to determine the efficiency with which the trade receivables are managed. This ratio is also known as Ratio of Revenue from Operations (Net Sales) to Average Trade Receivables.

(iii)Trade Payables Turnover Ratio (Creditors Turnover Ratio)

It is a ratio between net credit purchases and average trade payables (i.e creditors and Bill payables). In the course of business operations, a firm has to make credit purchases. Thus a supplier of goods will be interested in finding out how much time the firm is likely to take in repaying the trade payables. This ratio helps in finding out the exact time a firm is likely to take in repaying to its trade payables. This ratio establishes a relationship between credit purchases and average trade payables.

Working Capital Turnover Ratio

Working capital of a concern is directly related to revenue from operations (sales). The current assets like debtors, bill receivables, cash, stock etc, change with the increase or decrease in revenue from operations.

Working capital turnover ratio indicates the speed at which the working capital is utilised for business operations. It is the velocity of working capital ratio that indicates the number of times the working capital is turned over in the course of a year. This ratio measures the efficiency at which the working capital is being used by a firm. A higher ratio indicates efficient utilisation of working capital and a low ratio indicates the working capital is not properly utilised.