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शक्तिउत्थानआश्रमलखीसरायबिहार

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Accounting *Ratios*

Illustration 18

From the following information, calculate (*i*) Net Assets Turnover (*ii*) Fixed Assets Turnover and (*iii*) Working Capital Turnover Ratios :

	(Rs.)		(Rs.)
Preference Shares Capital	4,00,000	Plant and Machinery	8,00,000
Equity Share Capital	6,00,000	Land and Building	5,00,000
General Reserve	1,00,000	Motor Car	2,00,000
Profit and Loss Account	3,00,000	Furniture	1,00,000
15% Debentures	2,00,000	Stock	1,80,000
14% Loan	2,00,000	Debtors	1,10,000
Creditors	1,40,000	Bank	80,000
Bills Payable	50,000	Cash	30,000
Outstanding Expenses	10,000		

Sales for the year 2005 were Rs. 30,00,000.

Solution

Sales = Rs. 30,00,000

Capital Employed = Share Capital + Reserves and Surplus + Long-term Debt (or Net Assets)

= (Rs.4,00,000 + Rs.6,00,000) + (Rs.1,00,000 + Rs.3,00,000) + (Rs.2,00,000 + Rs.2,00,000)

= Rs. 18,00,000

Fixed Assets = Rs.8,00,000 + Rs.5,00,000 + Rs.2,00,000 + Rs.1,00,000 = Rs. 16,00,000

Working Capital = Current Assets – Current Liabilities

= Rs.4,00,000 – Rs.2,00,000 = Rs. 2,00,000

Net Assets Turnover Ratio = Rs.30,00,000/Rs.18,00,000 = 1.67 times

Fixed Assets Turnover Ratio = Rs.30,00,000/Rs.16,00,000 = 1.88 times

Working Capital Turnover = Rs.30,00,000/Rs.2,00,000 = 15 times.

Test your Understanding - III

(i) The ________ is useful in evaluating credit and collection policies.

A. average payment period
B. current ratio
C. average collection period
D. current asset turnover

(ii) The __________ measures the activity of a firm's inventory.

A. average collection period
B. inventory turnover
C. liquid ratio
D. current ratio

(iii) The __________ ratio may indicate the firm is experiencing stock outs and lost sales.

A. average payment period
B. inventory turnover
C. average collection period
D. quick

(iv) ABC Co. 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. 47 days
D. 57 days

(v) __________ are especially interested in the average payment period, since it provides them with a sense of the bill-paying patterns of the firm.

A. Customers
B. Stockholders
C. Lenders and suppliers
D. Borrowers and buyers

(vi) The _________ ratios provide the information critical to the long-run operation of the firm

A. liquidity
B. activity
C. solvency
D. profitability

5.9 Profitability Ratios

The profitability or financial performance is mainly summarised in Income statement. Profitability ratios are calculated to analyse the earning capacity of

the business which is the outcome of utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilised. The various ratios which are commonly used to analyse the profitability of the business are:

1. Gross Profit Ratio
2. Operating Ratio
3. Operating Profit Ratio
4. Net profit Ratio
5. Return on Investment (ROI) or Return on Capital Employed (ROCE)
6. Return on Net Worth (RONW)
7. Earnings per Share
8. Book Value per Share
9. Dividend Payout Ratio
10. Price Earning Ratio.

5.9.1 Gross Profit Ratio

Gross profit ratio as a percentage of sales is computed to have an idea about gross margin. It is computed as follows:

Gross Profit Ratio = Gross Profit/Net Sales × 100

Significance: It indicates gross margin or mark-up on products sold. There is no standard norm for its comparison. It also indicates the margin available to cover operating expenses, non-operating expenses, etc. Change in gross profit ratio may result from change in selling price or cost of sales or a combination of both. A low ratio may indicate unfavourable purchase and sales policy. It must be interpreted carefully as valuation of stock also affects its computation. Higher gross profit ratio is always a good sign.

Illustration 19

Following information is available for the year 2005, calculate gross profit ratio:

	Rs.
Cash Sales	25,000
Credit	75,000
Purchases : Cash	15,000
Credit	60,000
Carriage Inwards	2,000
Salaries	25,000
Decrease in Stock	10,000
Return Outwards	2,000
Wages	5,000

Solution

Sales	=	Cash Sales + Credit Sales
	=	Rs.25,000 + Rs.75,000 = Rs. 1,00,000
Net Purchases	=	Cash Purchases + Credit Purchases - Return Outwards
	=	Rs.15,000 + Rs.60,000 - Rs.2,000 = Rs. 73,000
Cost of Sales	=	Purchases + (Opening Stock - Closing Stock) + Direct Expenses
	=	Purchases + Decrease in stock + Direct Expenses
	=	Rs.73,000 + Rs.10,000 + (Rs.2,000 + Rs.5,000)
	=	Rs.90,000
Gross Profit	=	Sales - Cost of Sales = Rs.1,00,000 - Rs.90,000
	=	Rs. 10,000
Gross Profit Ratio	=	Gross Profit/Net Sales × 100
	=	Rs.10,000/Rs.1,00,000 × 100
	=	10%.

5.9.2 Operating Ratio

It is computed to analyse cost of operation in relation to sales. It is calculated as follows:

Operating Ratio = (Cost of Sales + Operating Expenses) / Net Sales × 100

Operating expenses include office expenses, administrative expenses, selling expenses and distribution expenses.

Cost of operation is determined by excluding non-operating incomes and expenses such as loss on sale of assets, interest paid, dividend received, loss by fire, speculation gain and so on.

5.9.3 Operating Profit Ratio

It is calculated to reveal operating margin. It may be computed directly or as a residual of operating ratio.

Operating Profit Ratio = 100 - Operating Ratio

Alternatively, it is calculated as under:

Operating Profit Ratio = Operating Profit/ Sales × 100

Where Operating Profit = Sales - Cost of Operation

Significance: Operating Ratio is computed to express cost of operations excluding financial charges in relation to sales. A corollary of it is 'Operating Profit Ratio'. It helps to analyse the performance of business and throws light on the operational efficiency of the business. It is very useful for inter-firm as well as intra-firm comparisons. Lower operating ratio is a very healthy sign.