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Accounting *Ratios H.W*

Question 5:

The average age of inventory is viewed as the average length of time inventory is held by the firm for which explain with reasons.

ANSWER:

Inventory Turnover Ratio: This ratio is computed to determine the efficiency with which the stock is used. This ratio is based on the relationship between cost of goods sold and average stock kept during the year.

$$\text{Inventory / Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

$$\text{or, Cost of Goods Sold} = \text{Net Sales} - \text{Gross Profit}$$

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$\text{Average Age of Inventory} = \frac{\text{Days in a year}}{\text{Inventory Turnover Ratio}}$$

It shows the rate with which the stock is turned into sales or the number of times the stock in turned into sales during the year. In other words, this ratio reveals the average length of time for which the inventory is held by the firm.

Question 1:

What are liquidity ratios? Discuss the importance of current and liquid ratio.

ANSWER:

Liquidity ratios are calculated to determine the short-term solvency of a business, i.e. the ability of the business to pay back its current dues. Liquidity means easy conversion of assets into cash without any significant loss and delay.

Short-term creditors are interested in ascertaining liquidity ratios for timely payment of their debts.

Liquidity ratio includes

1. Current Ratio

2. Liquid Ratio or Quick Ratio

1. **Current Ratio**- It explains the relationship between current assets and current liabilities. It is calculated as:

$$\text{CurrentRatio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Currents Assets are those assets that can be easily converted into cash within a short period of time like, cash in hand, cash at bank, marketable securities, debtors, stock, bills receivables, prepaid expenses. etc.

Current Liabilities are those liabilities that are to be repaid within a year like, bank overdraft, bills payables, Short-term creditors, provision for tax, outstanding expenses etc.

Importance of Current Ratio

It helps in assessing the firm's ability to meet its current liabilities on time. The excess of current assets over current liabilities provide a sense of safety and security to the creditors. The ideal ratio of current assets over current liabilities is 2:1. It means that the firm has sufficient funds to meet its current liabilities. A higher ratio indicates poor investment policies of management and low ratio indicates shortage of working capital and lack of liquidity.

2. **Liquid Ratio**- It explains the relationship between liquid assets and current liabilities. It indicates whether a firm has sufficient funds to pay its current liabilities immediately. It is calculated as:

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

$$\text{Liquids Assets} = \text{Current Assets} - \text{Stock} - \text{Prepaid Expenses}$$

Importance of Liquid Ratio

It helps in determining whether a firm has sufficient funds if it has to pay all its current liabilities immediately.

It does not include stock, since it takes comparatively more time to convert the stock into cash. Further prepaid expenses are also not included in liquid assets, since these cannot be converted into cash. The ideal Liquidity Ratio is considered to be 1:1. It means that the firm has a rupee in form of liquid assets for every rupee of current liabilities.