

Asset Management Ratios

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WHAT'S COVERED

In this lesson, you will learn about asset management ratios and what they indicate about a business's operations. Specifically, this lesson will cover:

1. Asset Management Ratios

1a. Inventory Turnover Ratio

1b. Day Sales Outstanding Ratio

1c. Fixed Assets Turnover Ratio

1d. Total Assets Turnover Ratio

1. Asset Management Ratios

Asset management ratios are important to the area of financial statement analysis because they give an indication of how well assets are being managed internally in an organization and externally as compared to competitive companies or elsewhere in the industry.

Asset management ratios include:

- Inventory turnover ratio
- Days sales outstanding ratio
- Fixed asset turnover ratio
- Total assets turnover ratio

1a. Inventory Turnover Ratio

Inventory turnover ratio is a ratio that measures the number of times inventory is sold or used in a time period. It is calculated by dividing the cost of goods sold by the average inventory. The average inventory is calculated by taking the beginning and ending inventory for the balance sheet period and dividing that in half. This provides an estimate of the balance for the inventory at any point during the period.



FORMULA TO KNOW

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{\text{Cost of Goods Sold}}{(\text{Beg. Inventory} + \text{End. Inventory}) \div 2}$$

IN CONTEXT

XYZ Company has a cost of goods sold of \$750,000 for the year and an average inventory of \$300,000. What is the inventory turnover?

$$\text{Inventory Turnover Ratio} = \frac{\$750,000}{\$300,000} = 2.5$$

When we divide the cost of goods sold by the average inventory, we get 2.5. This ratio is expressed as “2.5 times” meaning XYZ Company has turned over its inventory 2.5 times.

A low turnover rate may point to overstocking, obsolescence, or deficiencies in the product line or in the marketing effort. However, in some instances, a low rate may be appropriate, such as when higher inventory levels occur in anticipation of prices rising or expected market shortages.

Conversely, a high turnover rate may indicate inadequate inventory levels, which could lead to a loss in business because inventory is too low. This can often result in stock shortages.



HINT

An item whose inventory is sold once a year has a higher **holding cost** than an item whose inventory is sold two or three times a year.

Inventory turnover also indicates the briskness of a business. The purpose of increasing inventory turnover is to reduce inventory for the following reasons:

- Increasing inventory reduces holding costs
- Reducing holding costs increases net income and profitability
- Items that turnover more quickly increase responsiveness to changes in customer requirements and allow the replacement of obsolete items



HINT

The cost of goods sold can be found on the income statement and the average inventory can be found on the balance sheet.



TERMS TO KNOW

Inventory Turnover Ratio

A ratio that measures the number of times inventory is sold or used in a time period.

Holding Cost

Money spent to keep and maintain a stock of goods in storage.

1b. Day Sales Outstanding Ratio

The **day sales outstanding ratio** measures the company's average collection period. It is a measure of their accounts receivable and how long it takes a company to collect the money for purchases that have been made. This ratio is considered an important tool in managing liquidity. Day sales outstanding tends to increase as a company becomes less risk averse, and a higher day sales outstanding can also be an indication of inadequate analysis of credit applicants.

The day sales outstanding ratio can be calculated by dividing the accounts receivable by the average day sales. The average day sales is the total sales for the year divided by 365.



FORMULA TO KNOW

Day Sales Outstanding Ratio

$$\text{Day Sales Outstanding Ratio} = \frac{\text{Accounts Receivable}}{\text{Average Day Sales}} = \frac{\text{Accounts Receivable}}{(\text{Total Sales} \div 365)}$$



HINT

In this calculation, 365 days is used, rather than 360.

IN CONTEXT

LMN Company has an accounts receivable of \$9,750,000 and total sales of \$81,500,000 for the year. What is the day sales outstanding?

First, we need to calculate the average day sales:

$$\text{Average Day Sales} = \$81,500,000 \div 365 = \$223,287.67$$

The average day sales is \$223,287.67 per day. Now we can calculate the day sales outstanding.

$$\text{Day Sales Outstanding Ratio} = \frac{\$9,750,000}{\$223,287.67} = 43.66$$

This ratio tells us that LMN Company has 43.66 days outstanding, which means that it is taking over 43 days to collect a dollar in sales. This is important in the cash conversion cycle. The LMN Company should look at the credit policy to see if it is too easily granting credit or if the collection policy procedures are too slack. The company should know exactly why the ratio is at 43.66 days.



HINT

The accounts receivable can be found on the balance sheet and the total sales can be found on the income statement.



TERM TO KNOW

Day Sales Outstanding Ratio

A ratio that measures the company's average collection period.

1c. Fixed Assets Turnover Ratio

The **fixed assets turnover ratio** is a ratio that measures sales compared to the value of these fixed assets. This ratio indicates how well the business is using its fixed assets to generate sales. Generally, the higher the ratio, the better. A high ratio indicates that the business has less money tied up in fixed assets for each unit of currency of sales revenue.

This ratio is calculated by dividing the total sales by the average fixed assets.



FORMULA TO KNOW

Fixed Assets Turnover Ratio

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Total Sales}}{\text{Average Fixed Assets}}$$



TERM TO KNOW

Fixed Assets Turnover Ratio

A ratio that measures sales compared to the value of these fixed assets.

1d. Total Assets Turnover Ratio

The total assets turnover ratio is a ratio that measures the efficiency of a company's use of its assets in generating sales revenue. Companies with low profit margins tend to have high asset turnover, while those with high profit margins tend to have low asset turnover.

⇒ **EXAMPLE** Companies in the retail industry tend to have a very high turnover ratio mainly due to cutthroat competitive pricing.

This ratio is calculated by dividing the total sales by the average total assets.



FORMULA TO KNOW

Total Assets Turnover Ratio

$$\text{Total Assets Turnover Ratio} = \frac{\text{Total Sales}}{\text{Average Total Assets}}$$



TERM TO KNOW

Total Assets Turnover Ratio

A ratio that measures the efficiency of a company's use of its assets in generating sales revenue.



SUMMARY

In this lesson, we learned about the different types of **asset management ratios**. The **inventory turnover ratio** is a ratio that measures the number of times inventory is sold or used in a time period. The **day sales outstanding ratio** measures the company's average collection period. It is a measure of their accounts receivable and how long it takes a company to collect the money for purchases that have been made. The **fixed assets turnover ratio** is a ratio that measures sales compared to the value of these fixed assets. Finally, the **total assets turnover ratio** is a ratio that measures the efficiency of a company's use of its assets in generating sales revenue.

Best of luck in your learning!

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TERMS TO KNOW

Days Sales Outstanding Ratio

A ratio that measures the company's average collection period.

Fixed Assets Turnover Ratio

A ratio that measures sales compared to the value of these fixed assets.

Holding Cost

Money spent to keep and maintain a stock of goods in storage.

Inventory Turnover Ratio

A ratio that measures the number of times inventory is sold or used in a time period.

Total Assets Turnover Ratio

A ratio that measures the efficiency of a company's use of its assets in generating sales revenue.



FORMULAS TO KNOW

Day Sales Outstanding Ratio

$$\text{Day Sales Outstanding Ratio} = \frac{\text{Accounts Receivable}}{\text{Average Day Sales}} = \frac{\text{Accounts Receivable}}{(\text{Total Sales} \div 365)}$$

Fixed Assets Turnover Ratio

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Total Sales}}{\text{Average Fixed Assets}}$$

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{\text{Cost of Goods Sold}}{(\text{Beg. Inventory} + \text{End. Inventory}) \div 2}$$

Total Assets Turnover Ratio

$$\text{Total Assets Turnover Ratio} = \frac{\text{Total Sales}}{\text{Average Total Assets}}$$