

Chapter 6

Operating Performance Ratios

How can I use operating performance ratios to assess how efficiently my organisation uses its resources?

Operating performance ratios include the fixed assets turnover ratio, Debtor days, and the stock turnover ratio.

They help us to judge how well a business is using its resources to generate value for shareholders. This could be in terms of how efficiently assets are used to make sales, or how quickly these sales are then turned into cash.

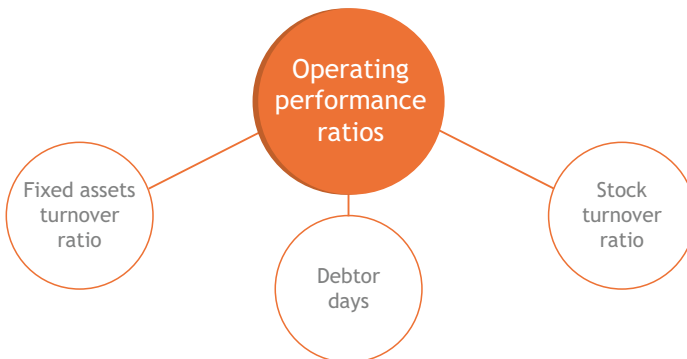
Operating performance ratios measure how efficiently:

Resources generate shareholder value

Assets are used to make sales

Sales are turned into cash

Once a problem is identified, targeted action can then be taken to improve the efficiency of the organisation.



Fixed Assets Turnover Ratio

Fixed assets turnover ratio measures how much sales revenue is generated for every £1 of fixed assets the business has.

The fixed assets turnover ratio equals a business' sales revenue, divided by its fixed assets.

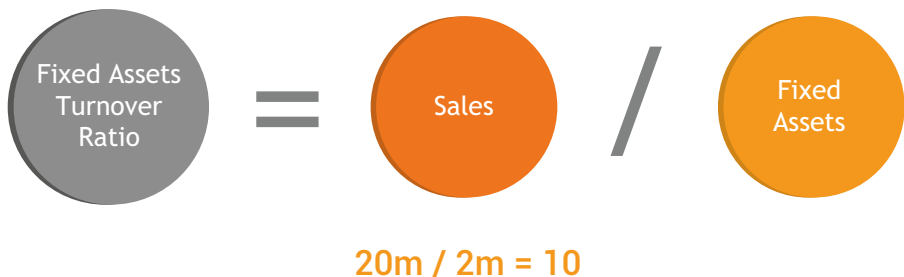
Using X-AMPLE's profit and loss account and balance sheet, this is £20m divided by £2m, giving a fixed assets turnover of 10.

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016

	£	£
Sales		20 000 000
Cost of sales		(8 000 000)

Balance sheet for X-AMPLE Ltd as at 30th September 2016

	£	£
Fixed assets		
Tangible		1 000 000
Intangible		500 000
Investments		500 000
Total fixed assets		2 000 000



This means that for every £1 of fixed assets that the business has, it manages to generate £10 of sales revenue in a year.

A high fixed assets turnover ratio indicates that a business is using its assets effectively, with little downtime or inefficiency.

As with all financial ratios, this can be compared with previous years' performance and with competitors across the industry.

Higher fixed assets turnover ratios generally occur in service industries with less fixed capital than heavy industry or manufacturing.

A high fixed assets turnover ratio – the business is sweating its assets effectively, with little downtime or inefficiency

Debtor Days

Debtor days measure how long it takes, on average, for the business to receive cash payments for its sales.

A business 'debtors' days equal its figure for debtors, divided by sales, then multiplied by 365. This gives us how long it takes, on average, for the business to receive cash payments for sales it has made.

Balance sheet for X-AMPLE Ltd as at 30th September 2016 £

Fixed assets		
Tangible		1 000 000
Intangible		500 000
Investments		500 000
Total fixed assets		2 000 000
Current assets		
Stocks		4 000 000
Debtors		2 500 000

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016

	£	£
Sales		20 000 000

Using X-AMPLE's balance sheet and profit and loss account, this is £2.5m, divided by £20m, multiplied by 365, giving X-AMPLE debtor days of 45.6.

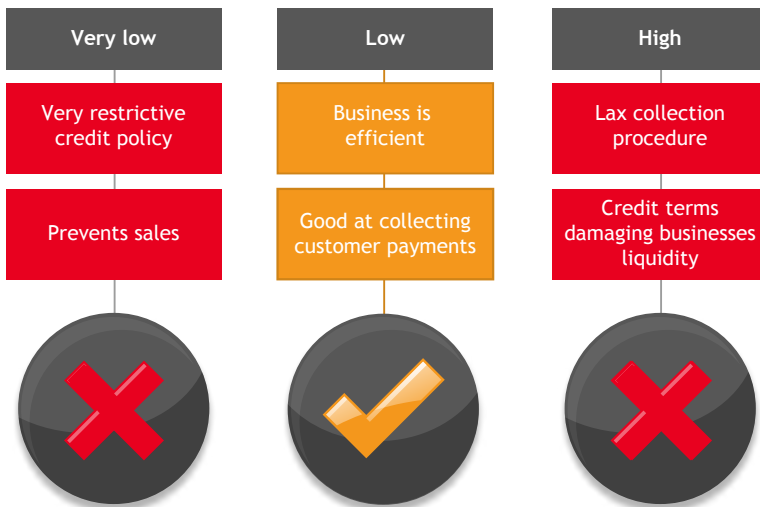
$$\text{Debtor Days} = \left(\frac{\text{Debtors}}{\text{Sales}} \right) \times 365$$

$$(2.5 / 20) \times 365 = 45.6$$

This means that it takes X-AMPLE 45.6 days, on average, to turn its sales into cash.

A low figure for debtor days means that a business is efficient at collecting payments from its customers. However, if the figure is too low, it may indicate a very restrictive credit policy that prevents sales.

A high figure for debtors' days means that the business is too lax in its collection procedures, or offers credit terms that are too liberal. This delay in collecting cash will damage its liquidity.



Stock Turnover Ratio

Stock turnover ratio measures how many times the business sold its inventory of stock during the year.

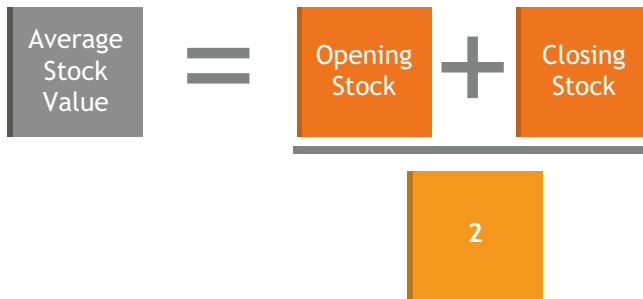
The stock turnover ratio equals a business' cost of sales, divided by its average stock value over the year.



We can get X-AMPLE's cost of sales from its profit and loss account.

We calculate the average stock value by adding the opening stock value at the beginning of the year (to be found on the previous year's balance sheet) to the closing stock value at the end of the year (found on this year's balance sheet) and then dividing the sum by 2.

If X-AMPLE ended 2015 with £5m of stock, our calculation is £5m plus £4m, divided by 2, giving us an average stock value of £4.5m.



$$= (5m + 4m) / 2 = £4.5m$$

We can now calculate X-AMPLE's stock turnover ratio.

£8m, divided by £4.5m, gives a stock turnover of 1.8.

Stock turnover ratio = cost of sales / average stock value

$$= 8\text{m} / 4.5\text{m} = 1.8$$

This means that X-AMPLE managed to sell its entire inventory of stock 1.8 times during the year. This gives us an indication of how long the business holds onto stock, before turning it into sales revenue.

A low stock turnover means that significant funds that could otherwise be earning interest are tied up in stock – and the costs of storage will be high. However, the company does avoid any production problems associated with having too little stock available, and is likely to benefit from greater purchasing discounts by buying in bulk.

A high stock turnover means that less working capital is tied up in stock. Therefore, liquidity increases, and there is less chance of the business holding damaged or obsolete stock.

