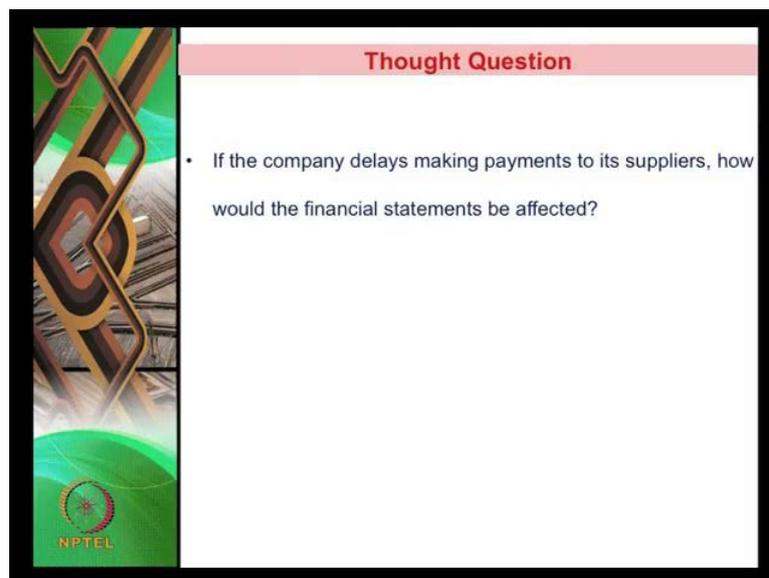


Infrastructure Finance
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Lecture - 7
Analysis of Company Performance – Part 1

Hi, welcome back to this course on infrastructure finance. Today in lecture 7, we are going to talk about analyzing the company's performance. So, far in the earlier lectures we have talked about, how do we actually look at the company's financial statements and what kind of information we find in these financial statements. And taking on from there, today we will talk about how we can use the information in the financial statements and analyze the company's performance, but before that let us get back to the thought questions we put forward in the previous lecture.

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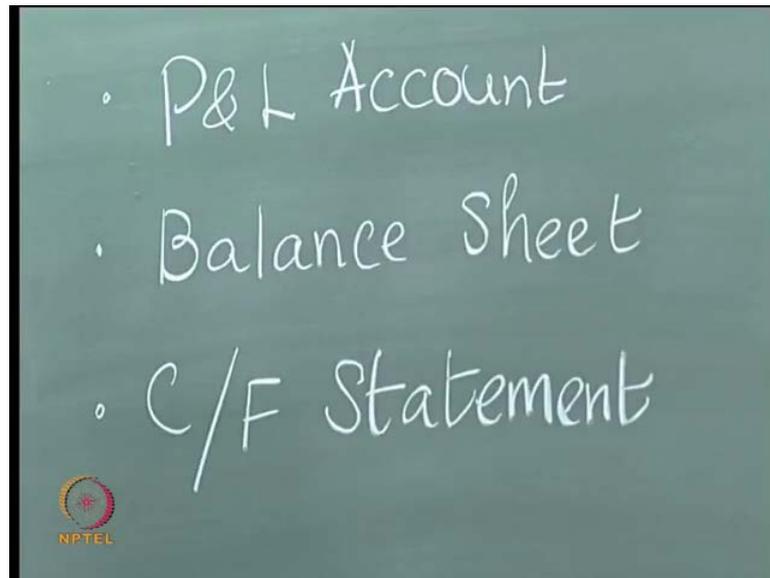
Thought Question

- If the company delays making payments to its suppliers, how would the financial statements be affected?

NPTEL

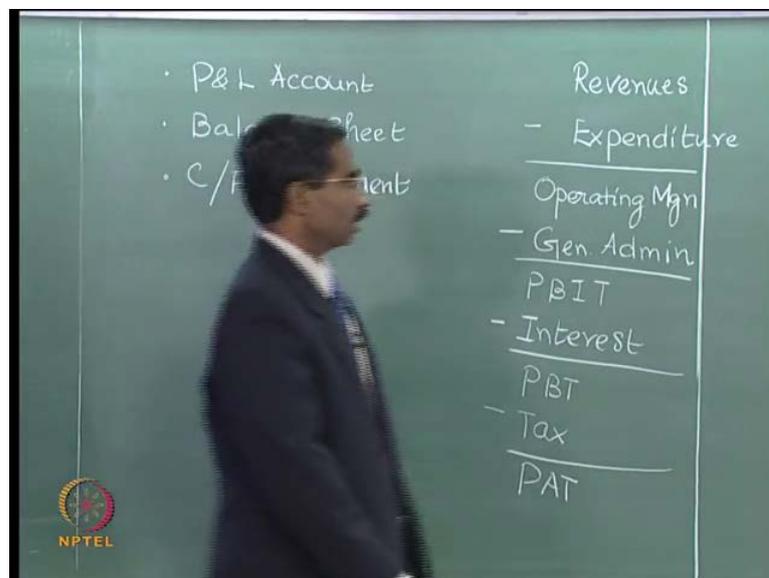
So, question one was, if the company delays making payments to its suppliers, how would the financial statements be affected. So, we will try and discuss this question, but before that, let us try and get a bird's eye view of the entire financial statement we have discussed so far. So, we have looked at 3 kinds of financial statements.

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The profit and loss account, and then we had the balance sheet, and then we had the cash flow statement.

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So, in the profit and loss account we broadly looked at the revenues. Then the company had expenditures in producing these revenues. Then we had what is called as your operating margin, then the company incurred additional expenditures towards general administration. So, this gives what is called as your profit before interest and tax. If the company has borrowed certain amount of capital, it will have to an interest and net of

interest we have profit before tax. A profit making company has to pay tax to the government, then we have tax then we have profit after tax. So, this is the general overall scheme of a profit and loss account.

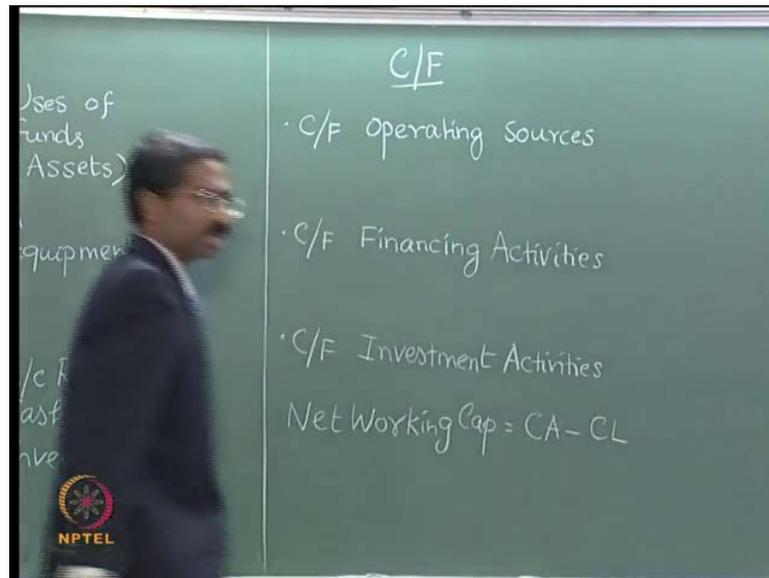
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	Source of Funds (Liabilities)	Uses of funds (Assets)
L.T.	- Equity - L.T. Debt	F.A. - Equipment
S.T.	- Curr. Lia - A/c payables	C.A. - A/c Receivable - Cash - Inventory

Now, let us look at your balance sheet. Balance sheet if you remember it has two components one is we have the source of funds, this is also called as the liabilities. Then we have uses of funds this is also called as your assets. Now, liabilities can be classified into two forms, one is your long term liabilities and you have short term liabilities. So, long term liabilities, we have what is called as your equity. Then you have long term debt short term liabilities are essentially what is called as your current liabilities. Current liabilities contain various items principal among them being accounts payables.

Similarly, if you look at your assets. Assets can be classified in to two categories; one is your fixed assets or long term assets. Then you have your short term assets are current assets. So, fixed assets would involve items like equipment. Any assets, that is going to give benefits for a long duration of time will come under fixed assets. In current assets we have items like accounts receivable. We would have cash and then we would have inventory. Next we will come to the cash flow statement.

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So, cash flow statement we will look at cash flow statements from different sources. One is your cash flow from your operating sources. Then you have cash flow from financing activities and then you have cash flow from investment activities. Now, let us go back to the question, the question is if the company delays making payments to its suppliers how would the financial statements be affected. Now, we have three sets of financial statements the first task for us, now to look at accounts payables. Now, reflected in which of the statement.

So, if you will look at three statements and if you look at the balance sheet, accounts payable is coming under your short term liabilities. Now, the question is if the company is delaying making payments to its suppliers how would the financial statements be affected. So, if the company is delaying payments, there would be a high amount of accounts payable. When a company makes a payment to its suppliers then accounts payables gets reduced and if company's delaying payments, the account payable gets increased.

So, if the account payable increases, then what could be the various impact that could have on the financial statements. Now, we should look at the financial statements as just not the independent statements, but there is a strong inter linkage between all the three statements. For example, if there is an increase in accounts payable, then the first indication we will have is what is called as your net working capital. Net working capital

is nothing but your current assets minus your current liabilities. Now, if the accounts payable is going to increase, that means the current liabilities will also increase.

Now, if the current liabilities increase, then what is actually going to happen to the networking capital. Networking capital is going to reduce so the very act of the company trying to delay payments to the suppliers, is in a way going to reduce the net working capital requirements of the company the company does not need to have a large amount of resources getting tied up in working capital. Now, if the net working capital reduces what is going to happen to the cash flows. Now, in the cash flows we have three different statements, three different parts.

Net working capital would be reflected in which of the parts. So, if you recollect our discussion on cash flow statement you will remember that networking capital will be featured under the cash flow from operations. Now, If there is a reduction in net working capital requirements, then it is also going to have a corresponding effect in the cash flow on operations. An increase in net working capital means a need for more cash, it is treated as cash outflow. A decrease in net working capital is treated as similar to that of a cash inflow.

So, therefore a decrease in networking capital in some sense it is actually going to increase the cash flow from operations. Now, to summarize if there is a delay in making payments to the suppliers, then the first impact is the net working capital will reduce and because of the reduction net working capital, the cash flows from operating sources is going to have an increasing effect.

So, any change in any of the components of each of the financial statements is going to be interlinked. It is actually going to have a corresponding effect over many of the items we will. Now, go to the next question. The next question is, how can we use information in financial statements to analyze the performance of the companies. In fact the crux of the lecture today and the next is going to be how do we elicit the information that we have in financial statements, use that information to analyze to make judgment on the company's performance.

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Now, is to look at how do we really judge a company's performance. When you are looking at an organization, an organization actually has several facets and when you want to talk about performance we will have to really look at performance on which of the facets. It is going to be really difficult to say this is one indicator that reflects the entire performance of the company, whereas we have several indicators looking at each and every aspect of the performance of the company.

So, let us talk about some of the main parameters of performance that we normally use. The first parameter is growth parameter, a growth parameter indicates how much the company has grown. So, we can really look at growth in terms of revenues, we can look at growth in terms of profits, we can look at growth in terms of assets size or whatever parameter we are interested in.

So, it is very important for a business to grow. Understanding and tracking the growth of the company indicates several things about the company's performance. The next parameter of the company's performance is profitability. Profitability is an indication of how much profit the company is making. Similarly, we have other measures of performance such as liquidity, leverage, turnover, valuation. So, what we will do is we will try and look at these main parameters of company's performance in this lecture and subsequent lecture.

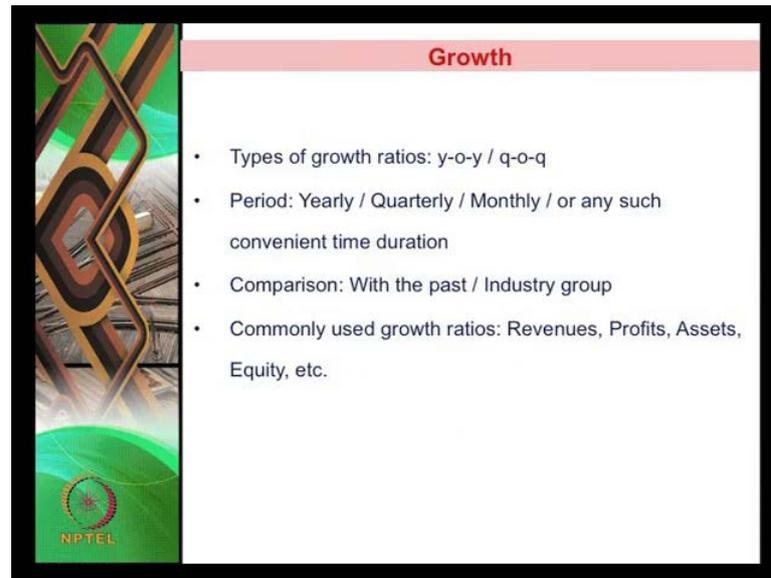
First let us look at growth, it is very important for a business to grow. Growth in the business indicates that the future is very bright and the company is going to be viable company is going to sustain its operations for a long period of time let us look at a simple example of growth. Let us talk about revenue growth to start with. We will always go back to the example of national thermal power corporation's balance sheet. We have used in the previous lectures to understand these various parameters we are talking about. So, if you talk about revenue growth, we will have to really understand how the revenue has grown vis-à-vis the past.

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So, revenues could be obtained from the profit and loss account. So, let us see what is the revenues for NTPC for the financial year 2012. So, in 2012 the profit and loss statement indicates the revenues of NTPC where 64830.65 crores. Now, let us see how much the revenues in 2012 has grown compared to 2011. Revenues in 2011, turns out to be 57407.30 crores. So now, the revenue growth in 2012 happens to be 12.93 percent.

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The slide is titled "Growth" in red text on a pink header. It features a vertical decorative image on the left side showing a green landscape with a circular logo at the bottom that says "NPTEL". The main content is a bulleted list:

- Types of growth ratios: y-o-y / q-o-q
- Period: Yearly / Quarterly / Monthly / or any such convenient time duration
- Comparison: With the past / Industry group
- Commonly used growth ratios: Revenues, Profits, Assets, Equity, etc.

So, 12.93 percent is the yearly growth, that the company has achieved in 2012. Growth ratios can again be looked at it from multiple perspective. What we just now did was what is called as a year on year growth. That is we compare the growth of the revenues from 2011 to 2012. So, there is a growth in revenues over a year. So, this is your year on year growth. We also have something called as a quarter on quarter growth, a company actually has a financial year which can be divided in to 4 quarters.

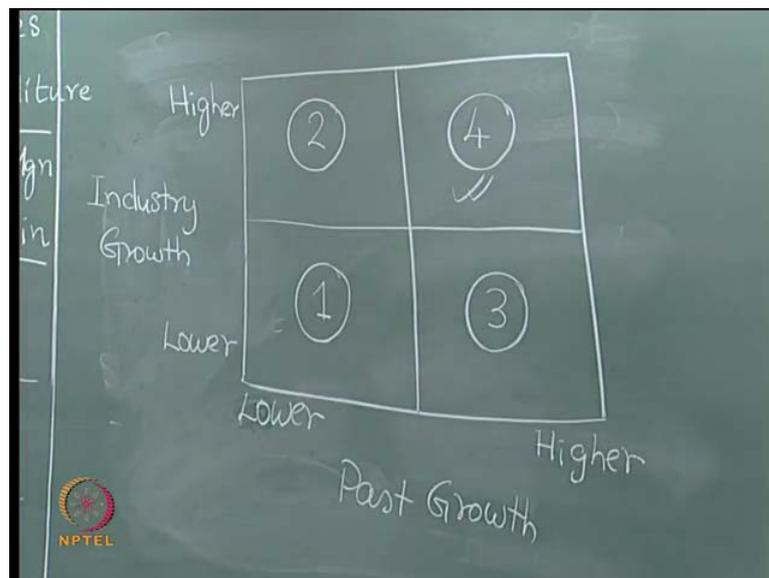
Now, if you compare the growth in revenues of quarter 2 over quarter 1, that is called as quarter on quarter growth. We are comparing the revenue growth from one quarter to the next, but at the same time, if we compare the growth in revenues in quarter 1 of 2012 as compared to quarter 1 of 2011, that is actually a year on year growth, that is we are comparing the growth in revenues of quarter 1 of this year to the quarter 1 of the previous year.

So, that is the year on year growth we are looking at how the growth has changed this year vis-a-vis the revenues of the last year. Now, you are able to understand the difference between quarter on quarter growth and year on year growth. If you are able to compare between two subsequent quarters, then it is a quarter on quarter growth on the other hand if you are able to compare the growth of the same quarters in 2 successive years it your year on year growth.

So, we can look at the growth ratios for any period we are interested in. We can look at the yearly growth, we can look at the quarterly growth, we can look the monthly growth. Whatever period we are interested in we can calculate the growth. So, the most common thing we look at is the yearly growth or your quarterly growth. The example that we talked about in NTPC is your yearly growth. Now, growth number per se might not actually give any meaning. After all if you look at it, a growth rate of 12.93 percent does not really convey a lot. So, for us to really understand what is this growth all about, we will have to essentially do a comparison.

So, a comparison could be in terms of the past. So, how much has a company grown in 2012 as compared to 2011. So, when you are doing that we are trying to compare the past vis-a-vis. The most recent growth rate another comparison could be to look at the company's peers in the industry, how much has the company grown visa, visa the peers in the industry. So, let us try and structure the analysis in a simple 2 by 2 matrix.

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So, let us look at a simple 2 by 2 matrix. So, on the one hand you have what is called as your past growth and on the other hand we have what is called as your industry growth. Now, the growth rate that we have calculated can either be higher or lower as compared to the past growth or as compared to the industry growth. So, let us say that, it is lower and it is higher. Similarly, lower on this scale and higher on this scale.

We divide this into 4 quarters. Now, we can actually map the ratio that we have calculated into any of these 4 quarters to derive meaningful interpretations. So, let us assume that the current growth rate is lower than the past growth rate and it is also lower than the industry growth rate. So, that means we are talking about situation of quadrant 1. So, the company's current growth rate is lower than the previous years, that means the company has not performed well.

Now, this could be because of various reasons. It is possible that the industry itself must be going on a down trend, and this has also affected the company's performance. So, therefore the company's performance rate is lower, but if you look at the growth rate is also lower than the industry growth rate. So, that means this is a problem that is very specific to the company of our interest the industry has grown very high, but the company that we are interested in is not grown as much as the industry.

Therefore, it is a very bad indication of the company's performance. Company is not able to meet its own past performance neither it is able to meet what the other competitors in the industry has achieved. Now, let us look at a situation where the current growth rate is lower, but it is higher than the industry growth rate. So, that means we are talking about the company being present in this quadrant.

So, what does it mean the company's performance is lower than the past it could be because industry itself is going in a down turn. So, therefore company is also affected by this down trend, but if you look at it the company has actually posted a growth rate that is higher than the industry, which is a positive thing. So, that means the company is able to grow much faster than the industry because of its superior management because of its superior ways of posting, better performance as compared to all the others in the industry.

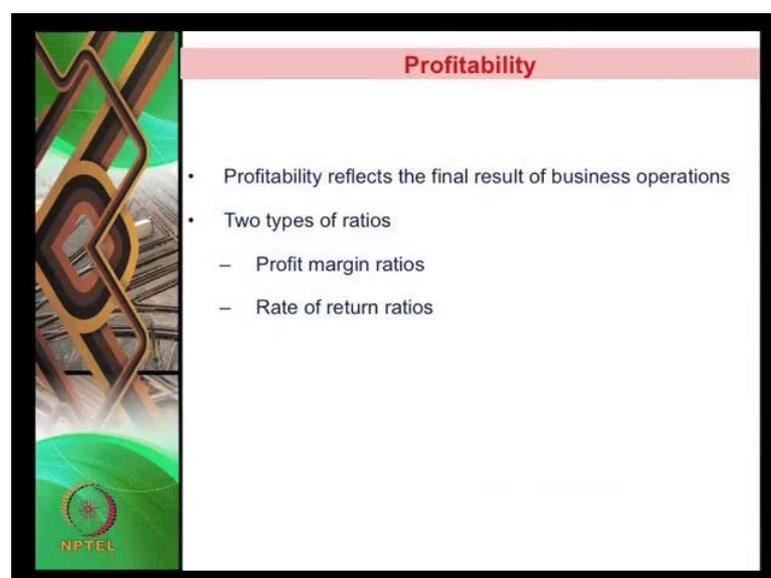
Let us look at a situation where the current growth rate is higher, but it is lower than the industry growth rate. So, we are talking about being in this quadrant. So, it is encouraging to say that the current growth rate is higher than the past, but in a way it is also a disappointment because the growth rate the company has achieved is lower than the industry growth rate. The competitors in the industry other comparable forms in the industry are growing much faster than the company we are interested in and why is the

company not able to meet at least the industry growth rate, is something that needs to be investigated further.

Then we have the 4th quadrant where the company's current growth rate is higher and it is also growing at a rate that is higher than the industry growth rate. So, this is the most ideal situation. The company is beating all the industry peers in terms of growth rate and at the same time it is also posting superior performance as compared to its own past growth rates. This would be the most desirable situation to be in for any company. So, essentially when we are trying to do this analysis and absolute number of 12.93 percent does not really make sense, unless until we are able to compare it with some industry compare it with its own past track record.

Now, let us look at other growth ratios that we normally use. So, we talked about revenues, we can also do for profits, we can also look up for assets, we can also look up for equity. Any of the items that we see in financial statement, whatever is of interest to us we can calculate the growth rates and see how the company has performed for the given period. Next, we look at another important indicator which is your profitability. Profitability is a very important indicator for a business, in fact people even go to the extent of saying that, the very nature of business to exist is to make profits. So, if the business will have to be sustainable, if the business has to be viable as a going concern, then it is very important that the firm is profitable.

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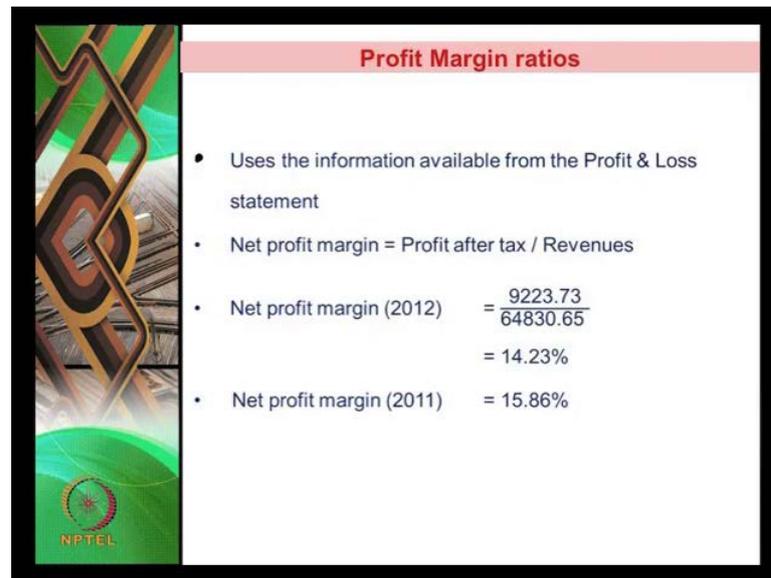
The slide features a decorative left sidebar with a green and gold geometric pattern and the NPTEL logo at the bottom. The main content area has a white background with a red header bar containing the title 'Profitability'.

Profitability

- Profitability reflects the final result of business operations
- Two types of ratios
 - Profit margin ratios
 - Rate of return ratios

So, how do we actually calculate the profitability. So, profitability is nothing but ratio of how much profit the company is making. We have broadly two types of ratios, called as a profit margin ratios and we have what is called as your rate of return ratios. Let us look at this one by one, profit margin ratios.

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The slide is titled "Profit Margin ratios" and contains the following information:

- Uses the information available from the Profit & Loss statement
- Net profit margin = Profit after tax / Revenues
- Net profit margin (2012) = $\frac{9223.73}{64830.65}$
= 14.23%
- Net profit margin (2011) = 15.86%

The slide also features a decorative graphic on the left side with the NPTEL logo at the bottom.

So, if you look at profit margin ratio, this uses the information available from the profit and loss statement. So, you look at the profit and loss statement. You have two items here. We have revenues and then we have profit. So, the profit margin is nothing but the ratio of profit after tax divided by revenues. So, essentially this indicates for every rupee of sale for every rupee of revenue, that the company makes. How much of profit is a company able to make after taking the accounts all the expenditures, after taking in to the account the interest payments, after taking into the account the tax and so on.

So, if you try and calculate the net profit margin for 2012 in the case of NTPC it is 9223.73 which is your profit after tax and then the revenues during the year were 64830.65 crores. So, this works out to a ratio of 14.23 percent. So, during the year 2012 the net profit margin is 14.23 percent, but as I have been discussing earlier, this number of 14.23 percent does not really convey any meaning except to simply state that company is profitable.

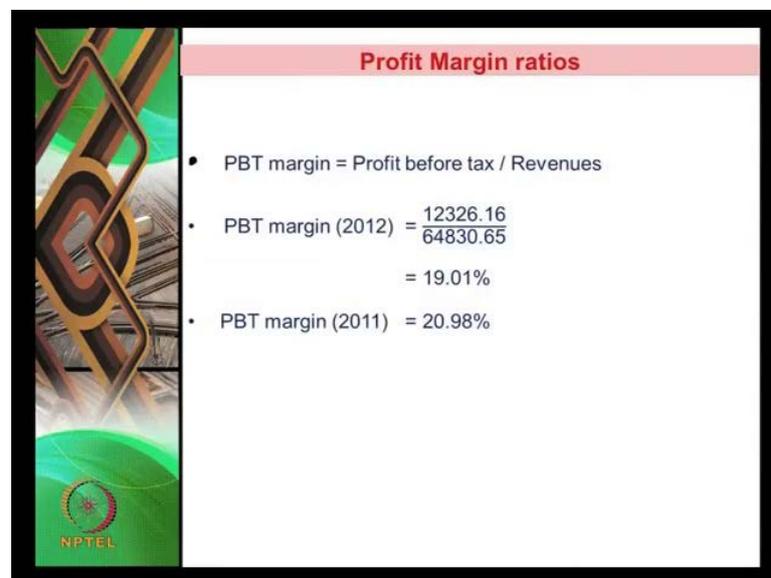
Now, if you have to really find out, whether the profitability has really improved or whether the profitability is in line with the industry standards, we have to do a process of

comparison. So, let us try and compare the net profit margin for 2011. So, if you look at the net profit margin for 2011 it is 15.86 percent. So, what does it indicate, it indicates that the profit margin in 2012 has come down by 12 percent to 1.5 percent as compared to what it was in 2011.

So, this immediately alerts us, to why could this profitability decline in 2012 as compared to 2011. As far as an investor is concerned, the company is not actually making as much profit the company is not as profitable as it was in 2011. For the company's management this will help us to focus on those areas and help us to improve the profitability. The reduction could be due to various reasons, the reduction could be increasing cost, the reduction could be due to reduction in sale prices.

Whatever it is, but the trend of decline in profitability alerts us to the fact that, we will have to understand the reasons behind this decline and rectify this situation, and the company bounces back to its original profitability. It is also important for us to understand, whether the industry trend is also behaving in the same direction. That is a profit margin of comparable industry firms also reduced in 2012 as compared to 2011.

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The slide, titled "Profit Margin ratios", features a decorative left sidebar with a green and gold geometric pattern and the NPTEL logo at the bottom. The main content area lists the following:

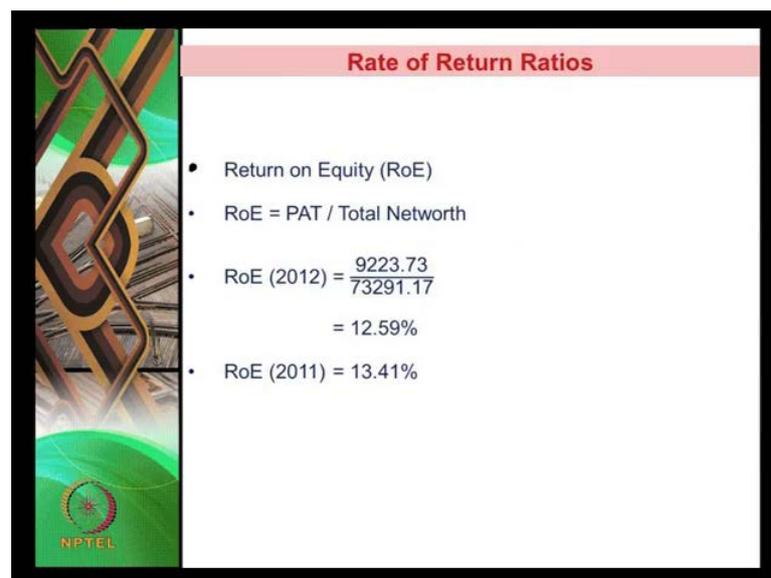
- PBT margin = Profit before tax / Revenues
- PBT margin (2012) = $\frac{12326.16}{64830.65}$
= 19.01%
- PBT margin (2011) = 20.98%

We look at another indicator of profit margin, which is your PBT margin. If you look at it the company has profit before tax and then the company pays the tax from the profit that it has made after payment of interest. Now, this tax is dependent on various aspects. For example, if a company has a high amount of debt in the balance sheet, then it will

also have a higher amount of interest payment. If the interest payment is high, then the profit before tax will be lower and it will lead to a correspondingly low amount of tax payment.

On the other hand if the company is completely funded by equity, then there will not be any interest payment and therefore, the tax to be paid is going to be very high. Therefore, since tax is a subject that is managed by the company's financial managers and useful indicator is to look at, profit before tax as a percentage of revenues. So, in the case of NTPC, the profit before the tax margin works out to be 19.01 percent in 2012, the same indicator in 2011 is 20.98. So, the trend that we saw in net profit margin is also evident in case of profit before tax margin. Another indicator of profitability is rate of returned ratios.

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The slide, titled "Rate of Return Ratios", features a decorative graphic on the left with the NPTEL logo at the bottom. The main content is a list of bullet points:

- Return on Equity (RoE)
- $\text{RoE} = \text{PAT} / \text{Total Networth}$
- $\text{RoE (2012)} = \frac{9223.73}{73291.17}$
= 12.59%
- $\text{RoE (2011)} = 13.41\%$

So, in profitability ratio analysis, the profit margin analysis talks about revenues and profit after tax. So, both of these are taken from the profit and loss account, but in a rate of return ratio we are going to take one item from profit and loss account and we are going to take one item from the balance sheet. So, rate of return could be on various aspects. So, we could have rate of return on the total capital employed in the business, we could calculate the rate of return on the shareholders funds. So, on any of these case we are going to take one item from the profit and loss statements, we are going to take one item from balance sheet.

Now, let us calculate rate of return on equity. Rate of return on equity is again very common indicator used in financial analysis. For a shareholder it is very important to calculate how much return that he is getting, how much return the company is able to generate on the shareholders funds that the company has on its balance sheet.

So, return on equity is nothing but ratio of profit after tax divided by total net worth. So, profit after tax is obtained from your profit and loss account and the total net worth is obtained from the balance sheet. So, if we calculate return on equity for 2012 it is nothing but 9223.73 crores. So, which is profit after tax divided by 7329.17 crores, which is actually the total share holders funds that we can see form the balance sheet.

So, this gives return on equity of 12.59 percent. Now, let us calculate the return on equity on 2011, return on equity in 20 11 13.41 percent. So, in a sense, what we saw in the profit margin ratio, is also to a certain extent reflected in your return on equity ratio. The return on equity has reduced in 2012 as compared to it was in 2011. Now, I will leave it to you as short assignment to calculate other rate of return ratios for example, you can calculate rate of return on capital employed and try and compare the numbers that you get with return on equity. Try and compare it with the net profit margin ratio as well. Also kind of try and understand which of the ratios will be better whether the return on equity will be higher or the return on total capital employed will be higher. Let us look at the next performance parameters, which is liquidity what is liquidity.

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Liquidity

- Refers to the ability of the firm to meet its short-run obligations
- Important liquidity ratios are: Current ratio and Quick ratio
- Current ratio = Current assets / Current liabilities
- Current ratio (2012) = $\frac{38912.52}{17238.64}$
= 2.26
- Current ratio (2011) = 2.57

The slide features a decorative graphic on the left side with a green and gold color scheme, including a circular logo with the text 'NPTEL' at the bottom.

So, liquidity refers to the ability of the firm to meet its short term obligations. Obligations of the firm are generally classified as liabilities. The company has obtained capital from various sources and the company is obliged to give return on the capital as well as return the capital to the investors. So, liquidity refers to the ability to pay or meet short term obligations. So, where do we actually find information about the firm's short term obligations in the financial statements.

So, we find it in the company's balance sheet because the balance sheet is an indication of the company's liabilities as well as assets. So, short term liabilities information about it could be obtained from the balance sheet. So, short term liabilities essentially are classified under the current liabilities. When you want to calculate the liquidity we use the short term assets current assets and the short term liabilities. The current liabilities an important liquidity ratio is called as the current ratio. Current ratio is defined as the current assets by current liabilities.

So, both the information is available in the balance sheet. If you have to calculate the current ratio for 2012 it is nothing but 38912.52 divided by 17238.64 . So, this gives a number of 2.26 current ratio for 2011 turns out to be 2.57 . So, again if you will look at it the current ratio has decreased in 2012 as compared to 2011. So, what does it indicate what can be inferred from this change. We could infer that the company's ability or the safety level that it can meet the current obligations in 2012 is lower as compared to what it was in 2011.

Now, unlike profitability, where when we find that when the profitability reduces or the rate of return reduces, then it is seen as a matter of concern, but in the case of liquidity reduction in liquidity may not necessarily be a very bad thing. Sometimes, reduction in liquidity can also be seen as a way of efficiently managing the working capital requirements. So, if the current ratio reduces from 2.57 to 2.26 , it can be seen as a very efficient way of managing the company's working capital. There is no absolutely the basis that, if the current ratio reduces, it is actually going to affect the company's ability to meet the company's short term obligations.

On an average it is expected that the current ratio will always have a number that is more than 1 because it is good prudent management practice that, the level of current assets is higher than the level of current liabilities. So, that in the case of any unfortunate

circumstances, the company can liquidate the current assets and then meet its short term obligations, but how much the current ratio be more than 1, it is entirely dependent on the management style and preference. If the current ratio is substantially higher than 1, let us say for example, if it is a ratio of 5 6 or in those ranges. It is considered that the company has very conservative working capital management policy.

The company has adequately preferred with a good amount of buffer to meet any short term liability that could arise. On the other hand, if the company has another ratio only slightly more than 1, that indicates company has a very aggressive working capital management policy. In case of any contingencies, the company is confident that it is in a position to raise resources to meet any of the short term liabilities.

So, the companies that are very confident of meeting the short term liabilities have a very aggressive or a ratio that is very close to 1. So, what is the appropriate ratio is entirely dependent on, the company's management style and the company's willingness to take short term risks. On an average you will find most of the companies having a current ratio of around 3. So, if you are talking of a current ratio 2.57 or 2.26 that more or less in that range and we could kind of say that the company is actually operating in a range that is considered to be safe and optimal.

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Liquidity

- Quick ratio
- Quick ratio = Quick assets / Current liabilities
= (Current assets – Inventories) / Current liabilities
- Quick ratio (2012) = $\frac{(38912.52 - 3702.85)}{17238.64}$
= 2.04
- Quick ratio (2011) = 2.32

Another indicator of liquidity is what is called as quick ratio. Quick ratio is a more conservative estimate of a company's liquidation ability. So, when we look at current assets, current assets consists of many items it consist of accounts receivables, it consists of cash, it consists of inventory, it consists of certain loans and advances made to the employees and so on and. So, now liquidity ratio indicates that should there be an exigency the company should be able to liquidate the current assets. Then meet the obligations of the short term lenders.

Now, the question is are all the current assets are easily liquefiable. Some assets may not as liquid as the other, for example, cash is a current asset that is liquid. You can use cash for any purpose, but current assets such as accounts receivables or inventories may not be as liquid as cash. If the company has inventory or it to meet the current liabilities the inventory should be, first liquefied and then it will have to be used to meet the obligations. If there are difficulties in liquidating the inventories, then you may not be able to meet all your current term liabilities.

So, to take that into consideration to take into consideration that, inventories may not be liquidated so easily. There is another indicator of liquidity which is your quick ratio. Quick ratio is nothing but the ratio of quick assets to current liabilities. How do we calculate quick assets. We remove the inventories from the current assets and that is called as your quick assets.

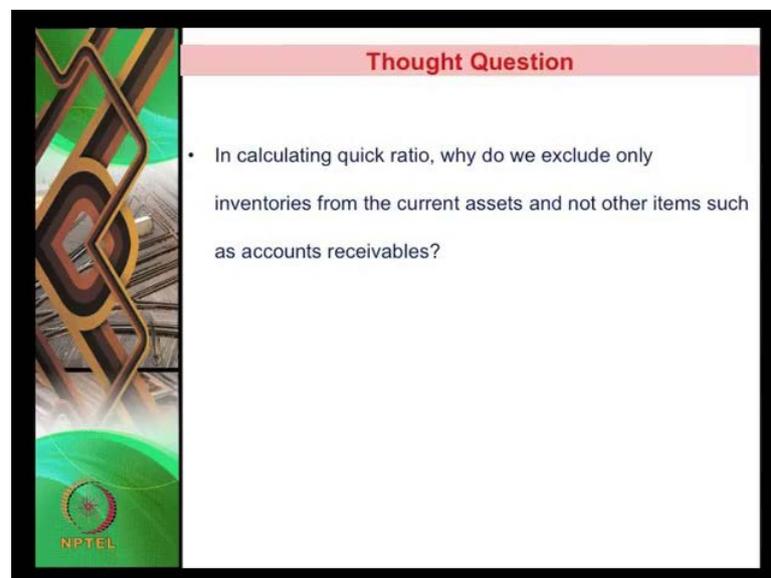
So. quick assets divided by current liabilities gives you quick ratio. So, let us calculate the quick ratio of NTPC for 2012. So, the quick ratio is quick assets by current liabilities quick assets is nothing but 38912.52 crores, which is the total current assets. From that we subtract the inventories which is 3702.85. Then we divide the amount we obtained by current liabilities. So, the quick ratio turns out to be a number 2.04. So, as you may note because of the fact that we have removed inventories from the current assets. Quick ratio is a lower number as compared to the current ratio. The quick ratio for 2011 turns out to be 2.3 2.

In organizations that do not have any inventory the current ratio and the quick ratio will have a similar value. Since the quick ratio has a lower value when there is an inventory, it is considered as a more conservative estimate of the organization's liquidity. So, from an analyst's perspective, if you want to really look at under the worse circumstances

what will be the liquidity position of the company then a quick ratio will be a better indicator as compared to a current ratio.

So, to sum up we have looked at three parameters of performance in this lecture. We talked about growth, we talked about profitability. In profitability we looked at two types of profitability ratios. We looked at profit margin ratio and we looked at the rate of return ratio. The third parameter that we looked at was liquidity and in liquidity we looked at two types of ratios. We looked at the current ratio and we looked at the quick ratio. So, the remaining parameters of performance we will try and discuss in the next lecture, but before we close a quick thought question for you.

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A presentation slide with a black border. On the left is a vertical decorative panel with a green and gold geometric pattern and the NPTEL logo at the bottom. The main area has a white background with a pink header bar containing the text "Thought Question". Below the header is a bulleted question.

Thought Question

- In calculating quick ratio, why do we exclude only inventories from the current assets and not other items such as accounts receivables?

Then we calculate quick ratio, why do we exclude inventories from the current assets and not other items such as accounts receivables. So, as we have seen current assets contain apart from cash other items such as loans and advances, accounts receivables and inventories. We excluded only inventories when we calculated the quick ratio, but we kept the accounts receivables and the other items in the current assets in doing the quick ratio. Why did we not include the accounts receivables, should we also exclude the accounts receivables along with the inventory in calculating the quick ratio. So, think about it and we will discuss in the next class.