Q5. The average age of inventory is viewed as the average length of time inventory is held by the firm or as the average number of day's sales in inventory. Why?

Solution:

Inventory Turnover Ratio: This ratio is computed to ascertain the competence 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.

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

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses - Closing Stock Or Cost of Goods Sold = Net Sales - 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 at which the stock is turned into sales or the number of times the stock is turned into sales during the year. In other words, this ratio reveals the average time for which the inventory is held by the firm.

*********** END **********