



Section 3.5

Activity 3.5.1

1. a. Capital employed is (non-current assets + current assets) - current liabilities or non-current liabilities + shareholders' equity.
b. Net profit margin is the percentage of net profit earned on each \$1 of sales revenue.

2. Samsung's gross profit:

2012 SKW 201 104 - 126 652 = 74 452

2013 SKW 228 693 - 137 696 = 90 997

3. Samsung's ratios:

	Gross profit margin	Net profit margin	ROCE	Current ratio	Acid test ratio
2012	37.02	14.88	22.30	1.86	1.48
2013	39.79	16.78	23.57	2.16	1.79

4. Samsung's performance 2012–13:

- Gross profit margin has improved
- Net profit margin has improved
- ROCE has improved
- Current ratio shows the business is more liquid
- Acid ratio shows the business is more liquid.

5. Strategies Samsung might use to improve gross profit margin and net profit margin include:

- Increase sales revenue by increasing expenditure on promotion and advertising. The problem with this is that indirect costs rise on promotional spending.
- Increase the price of goods to increase the profit margin on each unit sold. The problem with this is that revenue might fall if the quantity sold decreases.
- Reduce direct costs by cutting spending on raw materials. The problem with this might be reduced product quality.
- Indirect costs could be reduced by cutting administration costs. The problem with this is that the business does not run as efficiently.



Activity 3.5.2

1. a. Current ratio: $98\,475 / 176\,444 = 0.56$
b. Acid test ratio: $83\,007 / 176\,444 = 0.47$
2. Air Mauritius's liquidity position might be described as weak because the acid test ratio (less than 1) and current ratio (less than 1.5) suggest the business does not have the current or liquid assets to cover its current liabilities.
3. Previous years' data might be useful to Mauritius stakeholders because it can:
 - Establish trends
 - Say whether the business's financial position is improving or deteriorating
 - See whether a business strategy is working
 - Promote successful performance if the data is improving.

The weakness of using previous years' data is:

- Enough years need to be considered
- Performance needs to be judged against other businesses in the same industry
- No account is taken of changes in the business environment
- No account is taken of non-monetary factors.

Activity 3.5.3

1. Gross and net profit margins for Ahmed Builders and Flash Builders:

	Ahmed	Flash
Gross profit (2014)	28.57%	25%
Net profit (2014)	5.71%	10%

2. The gross and net profit margin ratios for Ahmed and Flash suggest:
 - Ahmed has a higher gross profit margin and performs better on this basis
 - Flash has a higher net profit margin and performs better on this basis.
3. Two ways in which Ahmed might attempt to increase the net profit margin ratio are:
 - Increase sales revenue by increasing the quality of shop fittings. The problem with this might be that direct costs rise on materials and labour
 - Reduce indirect costs by cutting spending on administration. The problem with this might be that the organisation does not operate as efficiently.



4. The current and acid test ratios for Ahmed and Flash are:

	Ahmed	Flash
Current ratio	2.22	1.25
Acid test ratio	1.11	0.75

5. The current and acid test ratios for Ahmed and Flash suggest the following:

- Ahmed has a relatively secure current ratio (over 2) and acid test ratio (over 1), which implies a relatively safe liquidity position
- Flash has a relatively insecure current ratio (below 1.5) and acid test ratio (below 1), which implies a relatively insecure liquidity position.

6. Two ways in which Flash might attempt to improve its liquidity position might be:

- Take a long-term loan that brings more cash into the business and increases liquidity. The problem is the loan needs to be repaid and interest has to be paid on the loan.
- Sell assets (such as buildings) to generate cash from sales. The problem is assets sold might reduce Flash's ability to generate future revenue.

Exam practice question

- a. Current assets are assets that are likely to be turned into cash before the next balance sheet date.
 - b. Capital employed is (non-current assets + current assets) - current liabilities or non-current liabilities + shareholders' equity.
- One ratio that could measure Karachi Paper's liquidity is the current ratio. This measures the value of current assets the business has to pay its current liabilities.
- Ratios (%) for ROCE, gross profit margin, net profit margin for Karachi Paper:

	31/12/14	31/12/13
ROCE	11.7	12.7
Gross profit margin	70	69.7
Net profit margin	8.75	10

- Karachi Paper's performance over the two years on the basis of the ratios calculated can be summarised as:
 - Fall in ROCE shows poorer performance



- Small rise in gross profit margin is a minor improvement in performance
- Rise in net profit margin shows an improvement in performance.

The weakness of judging performance on the basis of these ratios is that it is:

- Only based on three ratios
- Only based on two years of data
- Not compared with other firms in the same industry.

Key concept question

The importance of financial analysis in developing business strategy might be:

- It provides an assessment of the current financial position
- It gives a guide to a business's strengths and weaknesses, and could be part of a SWOT analysis and developing future strategy
- Trends in financial data can be used to see whether a strategy is working or not
- Comparing financial data between a firm and its competitors shows the relative performance of the firm's strategy.

The weaknesses of financial analysis for business strategy might be:

- Not making allowances for non-monetary factors
- Not making allowances for changes in the business environment
- Looking at the business in the present and past and not considering the future.