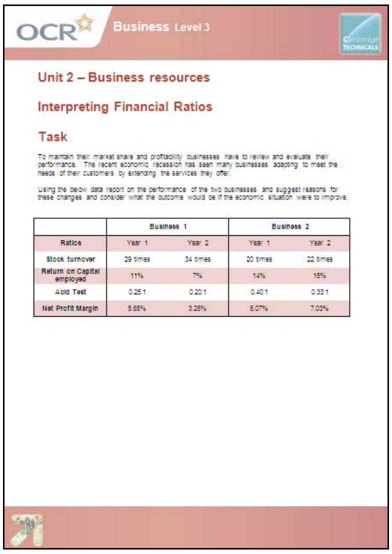
Unit 2 – Business resources

Interpreting Financial Ratios

Instructions and answers for Teachers

These instructions should accompany the OCR resource 'Interpreting Financial Ratios', which supports the OCR Level 3 Cambridge Technical Certificate in Business Unit 2 – Business resources


OCR Business Level 3

Unit 2 – Business resources

Interpreting Financial Ratios

Task

Associated Files:
Interpreting Financial Ratios

Expected Duration:
2 hours

Task

To maintain their market share and profitability businesses have to review and evaluate their performance. The recent economic recession has seen many businesses adapting to meet the needs of their customers by extending the services they offer.

Using the below data report on the performance of the two businesses and suggest reasons for these changes and consider what the outcome would be if the economic situation were to improve.

	Business 1		**Business 2**	
Ratios	Year 1	Year 2	Year 1	Year 2
Stock turnover	29 times	34 times	20 times	22 times
Return on Capital employed	11%	7%	14%	16%
Acid Test	0.25:1	0.20:1	0.40:1	0.33:1
Net Profit Margin	5.65%	3.26%	6.07%	7.03%

Sample answer

Business 1 managed to increase the number of times that it was able to sell its average stock by approximately 17%, whilst Business 2 was only able to increase the number of times that it sold its average stock by 10%. This might suggest that Business 1 was able to attract more customers during the recession, which might indicate that they sell cheaper goods. However, stock turnover is affected by the amount of stock held, so it is possible that both businesses were able to reduce the average stocks held as a way of increasing efficiency during a recession.

Business 2 managed to increase the return obtained from the capital they employed from 14% to 16%, whilst Business 1 saw its return on capital employed fall from 11% to 7%. Whilst this would indicate a better performance by Business 2, it is possible that Business 1 undertook investment during Year 2 which has yet to yield any benefits. It could be argued, however, that this would be unlikely during a recession.

The acid test ratio for both businesses decreased. The importance of this does depend upon the nature of the businesses. For example a retailer can often have a much lower acid test ratio because they handle large amounts of cash. As it stands, though, both of these businesses would be unable to pay off current liabilities using their liquid current assets.

Finally, the net profit margin for Business 2 has increased from just over 6% to just over 7%. At the same time Business 1 has seen its net profit margin fall from 5.65% to 3.26%. Clearly Business 2 has performed better, but it is important to look at the reasons behind this change. Since Gross Profit Margin figures are not provided it is not clear whether the change in net profit margins is due to changes in the cost of sales, or whether it is related to changes in overheads. Nonetheless, both businesses are making a net profit, which in a recession should be considered positively.

This activity offers an opportunity for English and maths skills development.