3.6 Efficiency ratio analysis (HL)

Strategies to improve efficiency

Businesses can use a combination of strategies to improve efficiency ratios.

Strategies to improve the stock turnover ratio

Different strategies used to improve stock turnover ratio, along with their benefits and limitations, are outlined in **Table 1**.

Table 1. Benefits and limitations of strategies used to improve the stock turnover ratio.

Strategies	Benefits	Limitations
Supplying a narrower range of goods	Simplifies the stock, increases the control over stock and can reduce stock quantities.	Simplifying the product portfolio and offering reduced choice to customers may negatively affect sales revenues.
Selling obsolete stock, stocking goods in high demand	Reducing unpopular stock items can reduce stocks. Selling goods in high demand will increase sales of stocks. This can also save on storage costs.	

Strategies	Benefits	Limitations
Just-in-time stock control ([Subtopic 5.6 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39337)](/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39337))	Stock could be ordered only when needed for the production process. This ensures that there is no excess stock.	Delays in supply chains, as seen during the COVID-19 pandemic for example, can cause the business to run out of stock, reducing sales revenues and causing customer dissatisfaction. This increases risk.

Case study

Rahman Auto Repairs is an automobile spare parts business in Lucknow, India that was started by two sisters, Saba and Samina. The business supplies spare parts to major auto manufacturers in Lucknow. It has a huge inventory of spare parts. Some of the spare parts belong to old models of cars.

Figure 1. Rahman Auto Repairs supplies spare parts to major auto manufacturers in Lucknow.

Credit: Fertnig, Getty Images

The cost of sales is 120 000 INR. The business started the trading year with stocks valued at 100 000 INR. It had closing stock at the end of the trading year valued at 40 000 INR.

Questions

- Calculate Rahman Auto Repairs' stock turnover ratio. [2 marks]
- Explain one way in which Rahman Auto Repairs can improve its stock turnover. [2 marks]

Strategies to improve debtor days

Different strategies used to improve debtor days, along with their benefits and limitations, are outlined in **Table 2**.

Table 2. Benefits and limitations of strategies used to improve debtor days.

Strategies	Benefits	Limitations

Strategies	Benefits	Limitations
Having customers pay in cash	The business could offer discounts for cash payments, charge interest on credit payments or have a cash-only policy. This would reduce the amount of outstanding purchases on credit.	These strategies may upset some customers leading to a decline in sales revenue. A business needs to balance its own need to reduce debtors with its customers' needs for flexible payment options.
Shortening the credit period	Shortening the credit period from 90 days to 60 or 30 days would mean debtors paying sooner, decreasing the debtors' figure and lowering the debtor days.	
Improving credit control	The business could give trade credit only to customers with a record of paying on time. They could also use stricter criteria for buying on credit, reducing the number of customers who take this option.	
Refusing to do business with customers who pay late	Stopping deliveries to customers who have not yet paid for the product should also bring faster payment, reducing the debtor figures.	

Strategies	Benefits	Limitations
Threatening legal action or imposing a penalty	The business could threaten legal action against customers who do not pay for delivered products. The business could also charge interest on overdue amounts.	

Strategies to improve creditor days

Different strategies used to improve creditor days, along with their benefits and limitations, are outlined in **Table 3**.

Table 3. Benefits and limitations of strategies used to improve creditor days.

Strategies	Benefits	Limitations
Negotiating longer credit periods	Businesses can develop close relationships with their suppliers (creditors), helping them negotiate longer credit periods.	Asking for longer credit periods can threaten relationships with suppliers, who themselves need payment for their own working capital cycles.
Good stock control system (just-in-time)	Stock could be ordered only when needed for the production process. This ensures that there is no excess stock.	Delays in supply chains, as seen during the COVID-19 pandemic, can cause the business to run out of stock, reducing sales revenues and causing customer dissatisfaction. This increases risk.

Strategies	Benefits	Limitations
Looking for different suppliers	Working with different suppliers might help businesses get better credit terms and might extend credit periods.	Working with different suppliers might help businesses get better credit terms and might extend credit periods.

Activity

Learner profile: Knowledgeable
Approaches to learning: Thinking skills (transfer)

Dunkin' Express's cost of sales is valued at $240 000 in 2020. The restaurant has creditors valued at $25 000.

Questions

1. Calculate Dunkin' Express's creditor days ratio. [2 marks]
2. Explain how an increase in the value of Dunkin' Express's trade creditors is likely to affect its creditor days ratio. [2 marks]

Strategies to improve the gearing ratio

Different strategies used to improve creditor days, along with their benefits and limitations, are outlined in **Table 4**.

Table 4. Benefits and limitations of strategies used to improve the gearing ratio.

Strategies	Benefits	Limitations
Paying off liabilities	Businesses can pay their long-term liabilities to reduce the gearing ratio.	Paying off long-term liabilities will mean less cash for daily operations, which can reduce sales revenue.

Strategies	Benefits	Limitations
Increasing retained profit	This can be achieved through cost minimisation and increasing revenue. This increases the value of the denominator in the formula, thereby decreasing the gearing ratio.	This strategy could mean reducing dividends to shareholders and may make them unhappy.
Selling more shares	This will increase the denominator and consequently decrease the gearing ratio. The value of equity will increase.	Selling more shares will dilute ownership of the company and reduce dividends to shareholders.

Activity

Learner profile: Knowledgeable
Approaches to learning: Thinking skills (transfer)

West End Supermarket has a few branches across Sri Lanka. It has an existing mortgage of $4.5 million. The business has equity valued at $2.5 million.

1. Calculate the gearing ratio for West End Supermarket. [2 marks]
2. Explain one strategy West End Supermarket can use to improve its gearing ratio. [2 marks]