**APPLICATION EXERCISE 11 – SUGGESTED SOLUTION**

**Discuss** whether the profitability of Watson’s Windows has improved or worsened in 2019.

Profitability measures how the business has earned a profit compared to a base figure such as sales, assets or owner’s equity.

The decline in the Gross Profit Margin initially indicates that the profitability of Watson’s Windows has worsened as for every $1 of sales in 2019 the business retained only 45 cents to cover Other Expenses compared to 55 cents in 2018. However, this may be due to Watson’s Windows reducing their selling prices resulting in the increase in Sales.

Further to this, the Net Profit Margin has also decreased unfavourably to 7% in 2019 compared to 8% in the previous reporting period. This means that for every $1 of Sales the business has made 7 cents of Net Profit. This would indicate that the profitability of Watson’s Windows has not improved.

However, given that the Sales have increased by 50%, both the Gross Profit and Net Profit actually increased. The owner would view these increases as favourable. But in order to assess profitability, these increases in Sales and Net Profit need to be compared to the Assets needed to generate them.

As Sales have increased by a greater percentage than the percentage increase in Assets, the Asset Turnover profitability indicator has improved. In addition to this, as the actual Net Profit has increased by a greater percentage than the percentage increase in Assets, the Return on Assets profitability indicator has also improved.