

Business Studies

Knowledge Book

Student name:

Form:

Subject:

Year group:

Component 3: Promotion and Finance for Enterprise

Learning Aim C:

Profitability and liquidity

The Big Question

How do I calculate ratios from formulae?

GRADE DESCRIPTORS

To achieve a grade, a learner is expected to demonstrate these attributes across the essential content of the component. The principle of best fit will apply in awarding grades.

Level 1 Pass Learners demonstrate basic knowledge of the elements of promotion and financial records. They can make basic observations about given information and can identify different promotional and financial factors that have positive or negative impacts. They demonstrate a basic ability to interpret information to identify factors that could potentially affect the performance of an enterprise, such as relevant information from cash flow forecasts and statements. Learners are able to make basic recommendations for success.

Level 2 Pass Learners demonstrate knowledge and understanding of the elements of promotion and financial records and apply them in context. They are able to interpret given information to explain factors that could potentially affect the performance of an enterprise, including the impact of specific factors such as information from cash flow forecasts and statements. They can explain how different factors have positive or negative impacts. Learners can produce some realistic recommendations for success.

Level 2 Distinction Learners demonstrate a high level of knowledge and understanding of the elements of promotion and financial records and apply them in context. They demonstrate a high level of ability to interpret given information and can explain, in detail, the factors that could potentially affect the success of an enterprise, and how different promotional and financial factors have positive and negative impacts. Learners can produce clear recommendations for success, with clear, realistic and convincing justifications.

B7 Profitability and liquidity Learners will interpret statements of comprehensive income and of financial position to calculate ratios.

- The difference between cash and profit.
- The difference between liquidity and profitability.
- Calculate profitability ratios from given formulae:
 - gross profit margin percentage (GPM): $(\text{gross profit}/\text{revenue}) \times 100$
 - net profit margin percentage (NPM): $(\text{net profit}/\text{revenue}) \times 100$.
- Calculate liquidity ratios from given formulae:
 - current ratio: $\text{current assets}/\text{current liabilities}$
 - liquid capital ratio: $(\text{current assets} - \text{inventory})/\text{current liabilities}$

Key Terms

Knowledge Phase

Cash is the liquid assets of the enterprise. It is generated from sales/selling.

Liquidity: The ability of an enterprise to pay its debts.

Liquid assets: Cash is the money that an enterprise can access easily to pay its short-term debts. Examples of liquid assets include money in the bank account, money in the till, invoices expected to be paid by customers, products (stock) that can be sold easily.

Profitability: ability of an enterprise to turn revenue into profit. This is known as **profit margin**.

Increasing profitability: Profitability can be increased by raising prices and lowering costs.

Profitability Ratios

GROSS PROFIT MARGIN = gross profit as a percentage of sales turnover

Gross profit margin: $\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100 = \dots\%$

It shows us, for every £1 made in sales, how much is left as **gross profit** after the cost of goods sold has been deducted.

A gross profit of 81 per cent therefore means that, for every £1 of sales made, 81p is left as gross profit.

ANSWER FOR EXAM: If gross profit margin falls from one year to the next or is thought to be too low, an enterprise can reduce the cost of its purchases. This may involve looking for a cheaper supplier. It may try to increase sales without increasing the cost of goods sold.

Activity

Please work out the gross profit margin.

Gross profit margin: $\frac{15,000 \text{ Gross profit}}{100,000 \text{ Sales revenue}} \times 100 = \dots\%$

Please explain what the gross profit margin is indicating for this enterprise.

.....
.....

NET PROFIT MARGIN = net profit as a percentage of sales turnover.

This is calculated using the following formula

$$\frac{\text{NET PROFIT}}{\text{REVENUE}} \times 100 = \dots\%$$

It shows, for every £1 made in sales, how much of it is left as net profit after all expenses have been deducted. A net profit of 31 per cent therefore means that, for every £1 of sales made, 31p is left as net profit.

ANSWER FOR EXAM: If net profit margin falls from one year to the next or is thought to be too low, an enterprise may look to reduce its expenses, for example, by moving to cheaper premises or cutting staffing costs.

Activity

Please work out the net profit margin.

$$\frac{150,000 \text{ NET PROFIT}}{850,000 \text{ REVENUE}} \times 100 = \dots\%$$

Please explain what the net profit margin is indicating for this enterprise.

.....
.....

LIQUIDITY RATIOS

Liquidity ratios measure how solvent (having enough money to pay all the money that is owed) a business is – that is, how able it is to meet short-term debts. There are two liquidity ratios you will look at here:

CURRENT RATIO: $\frac{\text{Current assets}}{\text{Current liabilities}}$

Activity – Current Ratio

Current assets = £56,130

Current liabilities = £30,270

Current ratio = $\frac{\text{£} \dots\dots\dots}{\text{£} \dots\dots\dots} = \text{£} \dots\dots\dots$

Current assets must be higher than current liabilities.

Extension: This means that, for every £1 the business owes in short-term debt (that is, its current liabilities), it owns £..... in current assets.
The business therefore **has/has not** sufficient liquidity to meet short-term debts.

Application Phase

1. What is meant by profitability?

2. What is the formula for gross profit margin?

1 mark

3. What is the formula for net profit margin?

1 mark

4. A snooker hall has revenue/turnover of £820000 per year.

Cost of sales are £120000 and other expenses £388400.

Calculate:

a. Gross profit margin

3 marks

b. Net profit margin

3 marks



Consolidation Phase

Profitability

Total: /14 marks

1. Vince's Vehicle Repairs has a gross profit margin of 60% and a net profit margin of 22%. Turnover was £180000. Calculate:

Cost of sales

3 marks

Other expenses

3 marks

Challenge: Based on question 3 the owners of the snooker hall want to increase the net profit margin to 42%. By how much will they have to lower expenses to achieve this?

2. The following information relates to Angus who has started a business selling burgers.

He bought a:

- BBQ for £200
- Apron and utensils for £50
- 1000 flyers for £50 to promote his business.

In addition to these costs Angus:

- Has to pay £50 rent for his stall per day
- His burgers cost 75p each
- Onions, cheese, sauce and napkins 25p per burger

He has decided to sell his burgers at £3.50 per burger. He sold 300 burgers.

Calculate Angus's **gross profit margin**

Workings:

Calculate Angus's **net profit margin**.

Workings:

Extension: Explain how enterprises can use profitability ratios to inform decision making.

LIQUIDITY

Total: /16 marks

Extract from the statement of comprehensive income and statement of financial position for the Beach View Luxury Resort.

	£000s
Revenue	1185
Cost of sales	387
Expenses	197
Inventory	44
Receivables	123
Cash and cash equivalents	25
Current liabilities	252

Calculate the gross profit margin. 3 marks

Calculate the net profit margin. 3 marks

What is the formula for current ratio? 2 marks

Calculate the current ratio. 3 marks

What is the formula for liquid capital ratio? 2 marks

Calculate the liquid capital ratio. 3 marks

Challenge: The following year current liabilities rise by 10% and inventory increases by 15%. Has liquidity improved or worsened? Use calculations to justify your answer.

LIQUIDITY

Guy finds it difficult to remember the difference between debtors and creditors. Highlight which one is an example of a **debtor** (owes the enterprise money) and a **creditor** (the people that the enterprise owes money to).

- Money Guy owes to a local farmer for vegetables supplied
- Money Guy has borrowed from the bank
- Money Guy has in cash from sales
- The value of Guy's stock
- Money owed to Guy from customers

What is meant by the term liquidity?

Fill in the gaps.

- _____ ratio =
 - Current assets / _____
- Liquid _____ ratio =
 - Current assets - _____ / _____

Malak has started to produce a statement of financial position for his business.

	£
Fixed assets	1000
Current assets	
Stock	700
Cash	200
Current liabilities	
Creditors	500
Overdraft	1000

Calculate 2 liquidity ratios for Malak.

Ratio name		
Calculation		

Extension: Explain why liquidity is crucial to the success of an enterprise.

The Big Question

What are my questions an enterprise needs to ask when it is completing a Cash Flow Forecast?

2.

1.

3.

Next Lesson

I'm greedy for knowledge – I always want more, tell me what is the