

Knockout.Economics by Kru P'Eve & Kru P'Da

IGCSE -Business studies

Profitability ratio



- Executive summary IGCSE Business studies
- Series of exam questions each chapter
- Exam Strategies and exclusive tips to achieve A* from Knockout.Economics
- Exclusive Key Terms for IGCSE Business studies exam



Overviews

1. Profitability ratio



1. Profitability ratio

Profitability ratio: assess how well a company generates profit

Profitability ratio

1. Gross Profit Margin(%)

$$GPM = \frac{GrossProfit}{SaleRevenue} \times 100$$

Gross profit = sales revenue - cost of goods sold

e.g. GPM = 30% The company made \$30 gross profit on every \$100 of revenue.

2. Net Profit Margin(%)

$$NPM = \frac{NetProfit}{SaleRevenue} \times 100$$

Net profit = Gross profit - operating expense

e.g. NPM = 15% on every \$100 on revenue, The company made \$15 net profit.

3. Return on capital employed (ROCE)(%)

$$ROCE = \frac{NetProfit}{CapitalEmployed} \times 100$$

Capital employed = shareholders' equity + non current liability

e.g. ROCE = 10% The company made a return on capital employed 10%.

1. Profitability ratio

Profitability ratio	Gross Profit Margin(%)	Net profit margin(%)	Return on capital employed (ROCE)(%)
Formular	$GPM = \frac{GrossProfit}{SaleRevenue} \times 100$ <p>Gross profit = Revenue - COGS</p>	$NPM = \frac{NetProfit}{SaleRevenue} \times 100$ <p>Net profit = Gross profit - Expense</p>	$ROCE = \frac{NetProfit}{CapitalEmployed} \times 100$ <p>Capital employed = Shareholders' equity + non current liability</p>
Analysis	<ul style="list-style-type: none"> • It shows how successful a business can <i>convert revenue into gross profit</i>. • It shows the ability to <i>control cost of goods sold and increase price of products by more than cost</i>. 	<ul style="list-style-type: none"> • It shows how successful a business can <i>convert sales into net profit</i>. • It shows the <i>ability to control the overhead cost</i> such as advertising and marketing. 	<ul style="list-style-type: none"> • It shows how <i>efficient a business can generate net profit from capital</i> used in the business. • It shows the <i>ability to generate net profit by the amount of investment</i>.

1. Profitability ratio

Income Statement	
Sales revenue	\$65,000
Cost of goods sold	\$23,000
Gross profit (Sales revenue - Cost of goods sold)	\$42,000
Other income	<u>\$5,000</u>
Less expense:	\$31,000
Net profit (Gross profit + Other income - Expense)	\$16,000

1. Calculate gross profit margin, net profit margin, return on capital employed, given \$30,000 on shareholders' equity and \$20,000 on non current liability.

◆ **Gross profit margin**

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◆ **Net profit margin**

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◆ **Return on capital employed**

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Liquidity ratio



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Overviews

1. Liquidity ratio



1. Liquidity ratio

Liquidity ratio: assess ability to pay its short-term debt.

Liquidity ratio

1. Current Ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liability}}$$

Current assets include cash, account receivable, inventory, and raw material.

2. Acid test ratio or Liquid Ratio

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liability}}$$

1. Liquidity ratio

Liquidity ratio	Current Ratio	Acid test ratio
Formular	$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liability}}$	$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liability}}$
Save raito	1.5 - 2.0	1
Analysis	<ul style="list-style-type: none"> • If <i>current ratio</i> < 1; it cannot pay off its short term debt from current assets. • If <i>current ratio</i> > 2 ; it has opportunity cost from holding too much liquid asset or working capital. 	<ul style="list-style-type: none"> • If <i>acid test ratio</i> < 1; it cannot pay off its short term debt from its most liquid assets. It needs to reduce inventories and increase cash. • The <i>great difference between current ratio and acid test ratio</i> means the business holds <i>a high level of inventories</i>.

1. Liquidity ratio

Knockout company - 2021 Account Summary	
Current Assets	\$6,500
Inventories	\$3,800
Current Liability	\$3,500

1. Calculate current ratio and acid test ratio. Analyse the liquidity of Knockout company

◆ **Current ratio**

◆ **Acid test ratio**

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Exercise: Analysis account



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Exercise

John is CEO of a private limited company called Mellow. It produces and sells pens in Thailand. The company's sales revenue has fallen although economy is growing so fast. A summary of the financial statement is shown below.

	2019	2020
Revenue	\$50,000	\$35,000
Gross profit	\$20,000	\$11,000
Net profit	\$15,000	\$5,000
Current assets	\$3,400	\$2,900
Current liabilities	\$1,400	\$1,900

(a) Calculate gross profit margin and net profit margin in 2019 and 2020? [4]

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(a) Calculate gross profit margin and net profit margin in 2019 and 2020? [4]

	2019	2020
Gross profit margin	40%	31%
Net profit margin	30%	14%

Exercise

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	2019	2020
Gross profit margin	40%	31%
Net profit margin	30%	14%

(b) Do you think John should be concerned about the change in the profitability ratio? [4]

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Exercise

John is CEO of a private limited company called Mellow. It produces and sells pens in Thailand. The company's sales revenue has fallen although economy is growing so fast. A summary of the financial statement is shown below.

(b) Do you think John should be concerned about the change in the profitability ratio? [4]

• Gross profit margin decreased from 40% in 2019 to 31% 2020

- ***The business is not successful in converting revenue into gross profit.***
- ***It shows the business is unable to increase price by more than cost in 2020***
- ***It shows the business is unable to control cost of goods sold in 2020***

• Profit margin decreased from 30% in 2019 to 14% in 2020

- ***The business is not successful in converting revenue into net profit in 2020***
- ***It shows the business is unable to control expense in 2020***

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(c) Calculate current ratio in 2019 and 2020, and analyze the liquidity position of Mellow in two years[4]

	2019	2020
Current ratio		
Analysis		

Exercise

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(c) Calculate current ratio in 2019 and 2020, and analyze the liquidity position of Mellow in two years[4]

	2019	2020
Current ratio	2.4	1.52
Analysis	<p><u>Too much liquidity/working capital</u> - Too much working capital is tied up in unprofitable current asset.</p>	<p><u>Acceptable</u> - The business has enough current assets to pay off all short term debt and also has enough working capital to run the business.</p>

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