Profitability Ratios

Please click on the link and watch the video on profitability ratios (3rd video from the top)

https://www.tutor2u.net/business/reference/financial-ratios-explained

Gross profit margin

- This shows how much gross profit is made per £ of sales
- Formula: $$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$
- If it is too low, there may not be enough gross profit to cover expenses.
- To improve it you could increase your prices or try to lower your cost of sales.

Operating profit margin

- Shows operating profit per £ of sales
- Formula: $\dfrac{\text{operating profit}}{\text{Sales revenue}} \times 100$
- If it is too low, there may not be enough operating profit to invest in the business and so get growth.
- Ways to improve it:
  - Boost gross profit margin
  - Cut overheads per £ of sales
  - Increase sales

Challenge:
Capital employed can also be calculated as total assets minus current liabilities. Can you explain why?

Profitability

- **Return on Capital Employed (ROCE)**
  - A measure of how efficiently a business is using capital employed to generate profits
  - Capital employed = total equity + non-current liabilities i.e. all the money invested in the business from:
    - Share capital
    - Reserves
    - Long term loans
  - Formula:

$$\frac{\text{Operating profit}}{\text{Total equity + non-current liabilities}} \times 100$$

Return on capital employed

Balance Sheet		£m
Non-current assets		19550
Inventories	2375	
Receivables	1170	
Cash & cash equivalents	2300	
Total current assets		5845
Current liabilities		(8160)
Net current liabilities		(2315)
Non-current liabilities		(6000)
Net assets		11235
Share capital		6000
Reserves & retained earnings		5235
Total equity		11235

Income Statement		£m
Revenue		35400
Cost of sales	(30100)	
Gross profit	5300	
Expenses		(720)
Operating profit		4580
Finance income		300
Finance cost	(260)	
Profit before tax		4620
Taxation		(1109)
Profit for the year		3511

$$\frac{\text{Operating profit}}{\text{Total equity} + \text{non-current liabilities}} \times 100$$

$$\frac{4580}{11235 + 6000} \times 100$$

$$\frac{4580}{17235} \times 100 = \underline{\mathbf{27\%}}$$

Interpretation of ROCE

Why would it be meaningful to compare this to the current rate of interest?

Why might a high street retailer compare ROCE between individual stores?

Return on capital employed

$$\frac{\text{Operating profit}}{\text{total equity + non-current liabilities}} \times 100$$

$$\frac{4580}{17235} \times 100 = \mathbf{27\%}$$

For every £1 of capital employed in the business 27 pence is generated in operating profit.

Complete the following:

Flippin' Pancakes!

To be able to complete a profit & loss account and calculate profitability.

Use this information to complete the activity

Pancakes Sale Price: £2.59

Cost to Make £0.28 *per portion!*

Monthly Sales 7800 Portions!

Monthly Expenses (Gas, Electricity, Rent)
Gas: £124.00 Rent: £740.00
Electricity: £87.00

Calculate the following (show working)

Sales Turnover

£

Cost of Sales

£

Extra Challenge!! Calculate the following (show working):

Gross Profit Margin

Net Profit Margin

Complete this business's Profit & Loss account.

	£	£
Expenses		

Complete the following revision quiz

- https://www.tutor2u.net/business/reference/income-statement-revision-quiz