

Topic 2.4 Knowledge Organiser

Making financial decisions

What is gross profit margin

- Gross profit margin is gross profit as a percentage of sales revenue.
- Or, for an individual item, gross profit as a percentage of the selling price.
- It is the difference between the selling price and how much it cost.
- The gross profit margin formula is:

$$\text{gross profit margin} = \frac{\text{gross profit}}{\text{revenue}} \times 100$$

- **Example:** If a Superdry jacket's gross profit is £65 with £100 selling price, what is the gross profit?

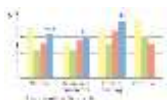
$$\text{gross profit margin} = \frac{£65}{£100} \times 100$$
$$\text{gross profit margin} = 65\%$$

Average rate of return (ARR)

- Average rate of return (ARR) is the average yearly profit as a percentage of the sum invested.
- This shows the profitability of a business and can be compared with the interest rates available on bank deposit accounts.
- For example, if a business wants to know the ARR of an investment of £50,000 in a lift truck which results an extra £5,000 per year.

$$\text{ARR} = \frac{£5,000}{£50,000} \times 100$$
$$\text{ARR} = 10\% \text{ per year}$$

- The 10% ARR can then be compared to other investments, or even just leaving the money in the bank
- The higher the percentage the better the profitability.



A **line graph** is data presented as lines, making it easy to identify trends, especially if time is on the horizontal axis.

A **bar chart** is data presented so that the height of the bar represents the quantity involved.

A **pie chart** is data presented in a circle, with each slice of the pie representing a proportion of the whole.

What is net profit margin?

- Net profit is what is left after taking all fixed costs away, e.g. rent
- Net profit margin is net profit as a percentage of sales revenue
- Or, for an individual item, net profit as a percentage of the selling price.
- The formula is:

$$\text{net profit margin} = \frac{\text{net profit}}{\text{revenue}} \times 100$$

- For example the fixed costs for the Superdry jacket such as renting the store may be £50 when the gross profit is £65 and the selling price £100. Net profit is £65 - £50 = £15.

$$\text{net profit margin} = \frac{£15}{£100} \times 100$$
$$\text{net profit margin} = 15\%$$

Gross and net profit margins and average rate of return can help businesses make decisions.

Looking at the actual or expected profit or loss from the business or a specific deal helps make decisions.

Working out the breakeven point for a product or business, e.g. whether more advertising needs to be done to create more sales.

Forecasting cash flow to look at whether expansion can be funded from retained profits or will need some form of short or long term finance.

Marketing data includes the business's own sales figures and spend on marketing as well as primary market research.

As launching products can be very expensive, the business needs to be able to look at the risks of success and failure.

Primary market research will help the business see if the product is likely to be wanted by potential customers.

Limitations

Data is only as good as the person interpreting it. Businesses can often be overly optimistic.

Calculations can be misinterpreted, leading to poor decision making.

Raw figures may be unreliable or biased

Talking to staff may give details into business situations that data cannot reveal.

Data is not always the best predictor of good business decisions.

Tier 3 words

Average rate of return (ARR)

- Average yearly profit as a percentage of the sum invested. This shows profitability and can be compared with the interest rates available on bank deposit accounts.

Gross profit margin

- Gross profit as a percentage of sales revenue (or, for an individual item, gross profit as a percentage of the selling price)

Net profit margin

- Net profit as a percentage of sales revenue (or, for an individual item, net profit as a percentage of the selling price)

Sum invested

- The cash put at risk when investing in new equipment or a new product

Bar chart

- Data presented so that the height of the bar represents the quantity involved; good for making comparisons

Line graph

- Data presented as lines, making it easy to identify trends, especially if time is on the horizontal axis

Pie chart

- Data presented in a circle, with each slice of the pie representing a proportion of the whole; good for proportions of a total, e.g. market share