Revision Book 2.4 Financial Decisions

Judging performance by using ratio analysis

- Ratio enable businesses to judge success
- They can be based on **performance** = profitability & efficiency
- They can be based on **position** = financial security
- They enable businesses to compare their performance and position over time
- They allow comparison between different companies in similar or different industries
- They enable businesses to see where their strengths and weaknesses and where they should focus

Gross profit margin

- The difference between the selling price and what is cost the business – this is called cost of sales and is the direct or total variable cost, ie what it cost to make the product or service
- Formula

$$\text{Gross profit margin} = \frac{\text{gross profit}}{\text{sales}} \times 100 = \qquad \%$$

How to improve the gross profit margin –

Put prices up	**Cut the price paid to suppliers**

Net profit margin

- Net profit is what is left after all running costs are taken away
- Gross profit may be high BUT that doesn't mean a good net profit will be made, running shops and factories are expensive
- Gross profit may not be enough to cover the running costs of the business

$$\text{Net profit margin} = \frac{\text{net profit}}{\text{sales}} \times 100 = \qquad \%$$

How to improve the net profit margin

Option A – do something about the **gross profit so its higher**

OR

Option B – do something **to reduce the expenses or running costs** of the business but HOW?

Average rate of return

- This compares annual average yearly profit against the capital invested in the project or business
- It gives a % return
- This could be compared to leaving it in a bank – at the moment you would be lucky to get more than 1% return
- It also helps an investor work out whether the risk of investing is worth the potential reward i.e. the profit the investment could generate

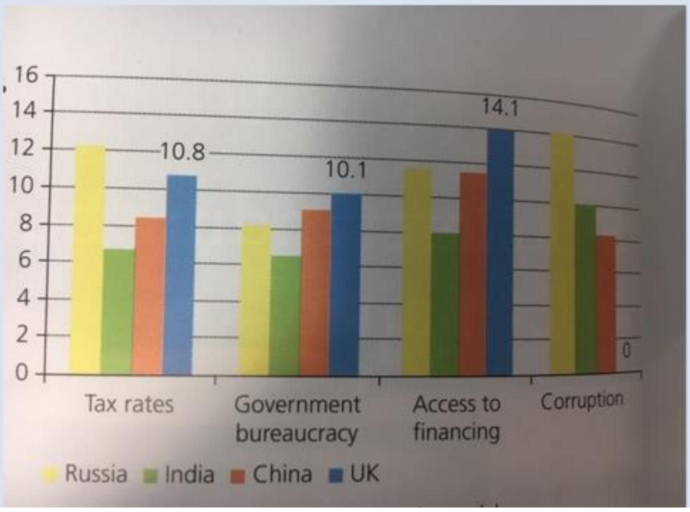
$$\text{Average rate of return} = \frac{\text{average yearly profit}}{\text{initial investment}} \times 100 = \qquad \%$$

- Add up annual profits
- Minus the initial investment
- Divide the total by the number of years life span of the project
- Divide the answer by the initial investment x 100

Uses for quantitative data (statistics)

- Who has generated the most sales and therefore deserves a promotion?
- Which products should be delisted due to low sales
- What is the value of a market? Is it increasing?
- The number of competitors and their market share – shall we enter this market?

Information from graphs and charts – bar graph

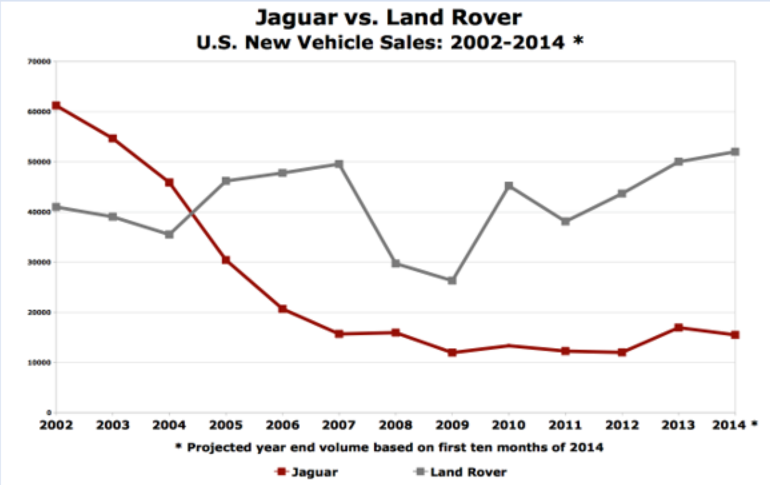


Comparisons are really good in bar charts. Look at this bar chart which shows the biggest barriers to successful business in 4 countries. Which is the biggest barriers for

a. Russia
b. Chine
c. India
d. UK

Are the same?

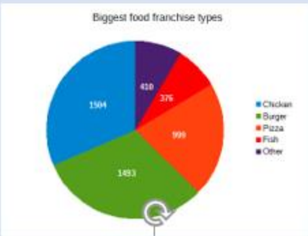
Information from graphs and charts – line graph

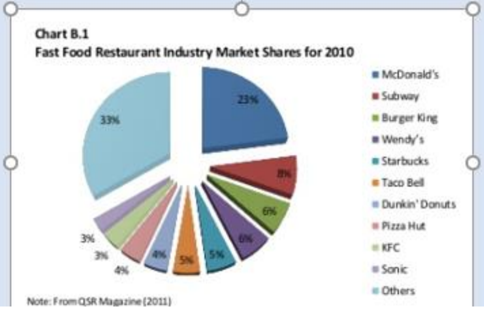


Look at the line graphs for Jaguar/Land Rover sales in the USA. Line graphs are great for displaying trends

What decisions could be made from this?

Information from graphs and charts – pie chart





Pie chart show proportions. Look at the two pie charts

1. What does the market share one tell you about which brands and food dominate the market?

2. Look at the top pie chart – does this agree or conflict with your finding?

Measuring financial data

- As well as gross profit margin, net profit margin and average rate of return, businesses make decisions on

- **Profit or loss of different sections of the business**. Should we focus on one area or even shut a division? E.g. M&S France in the 000s

- **Break even point** – is it worth accepting this order or even carrying on the business
- **Cashflow forecasting** – should we take on this big construction job? Do we have the cash to pay for the resources as it will take a year to get paid

Market data

- It is crucial to know the market size, trends and key players in large businesses.
- There are several companies that provide market intelligence or data as well as newspapers and trade magazine e.g. Euromonitor, Keynote, Mintel
- Businesses can decide on their strategy based on such information

https://www.keynote.co.uk/Market-Sectors

Access a market report summary of your choice

What is the market value?

What are the trends?

How much does this report cost?

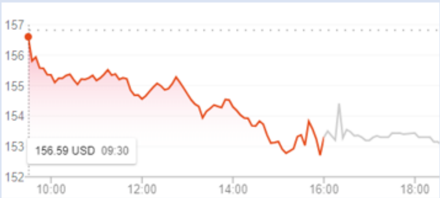
Would it be worth a large business buying it?

Limitations to data

- External factors can affect trends and predictions

https://www.youtube.com/watch?v=Jaw2caLOgNY

- Data may not be valid, biased or out of date
- The presentation of data can skew its appearance – e.g. apple – day, month and 5 years trends on stock values



Limitations to data

- Some data does not tell the whole story – sometimes staff are the only ones that can do that
- Sometimes the results of business decision takes time to come about e.g. launching a new product. Making a decision on sales data in the launch stage of a product would potentially result in product withdrawal, in the longer term the product may be very successful.

VOCABULARY

1. Quantitative – Statistical data
2. Qualitative – data that is based on ideas and opinions
3. Internal data – data produced inside the organisation for example sales data, labour turnover, productivity per employee
4. External data – data from outside the business e.g. newspapers, market reports, ONS
5. Marketing intelligence – information about the market the business operates in including market size, market share, key competitors and products, market trends and market predictions
6. Break even – the point at which total costs = total revenue
7. Cashflow forecast - a prediction of cash flowing in and out of the business
8. Net profit margin – the PROPORTION of sales revenue that end up as net profit after total costs have been taken away (%)
9. Gross profit margin - the PROPORTION of sales revenue that end up as gross profit after the cost of sales (total variable cost) have been taken away (%)
10. Bias- data reflects one factor more than another
11. Validity – how accurate and true data is
12. External factors – factors that may affect the validity of data e.g. changes in the social, legal, economic, political and technological environment
13. Average rate of return – The average net profit generated by a project as compared to its set up costs. This is expressed as a % return on investment.
14. Performance – the ability of a business to generate profit by using its resources effectively
15. Position – the financial position of a business usually measured by assets and liabilities (what the business owns and what the business owes) This is financial stability