

# Entrepreneurship

## Quarter 2 – Module 8 Computation of Gross Profit



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**Development Team of the Module:**

<b>Author:</b>	<b>Joel Y. Yacas</b>	<b>Janice B. Dominguez</b>
	<b>Naneth M. Valdehuesa</b>	<b>Ronee D. Quicho</b>
	<b>Mary Cris A. Maquilan</b>	<b>Marylinda T. Puzon</b>
	<b>Charity E. Parel</b>	<b>Denver E. Neri</b>
	<b>Lorena Fe S. Anub</b>	<b>Ethel Lalaine B. Morales</b>
<b>Evaluators:</b>	<b>Cherryl F. Descallar</b>	
	<b>Eddy Lou T. Hamak</b>	
	<b>Sherriemae V. Reazol</b>	
<b>Illustrator:</b>	<b>PSSg Edzel M. Dominguez</b>	
<b>Management Team:</b>		
<b>Chairperson:</b>	<b>Dr. Arturo B. Bayocot, CESO III</b> Regional Director	
<b>Co-Chairpersons:</b>	<b>Dr. Victor G. De Gracia Jr., CESO V</b> Asst. Regional Director	
	<b>Mala Epra B. Magnaong</b> CES, CLMD	
	<b>Dr. Bienvenido U. Tagolimot, Jr.</b> Regional ADM Coordinator	
<b>Members:</b>	<b>Elson C. Jamero</b> EPS-Designate-TLE	

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## What I Need to Know

As we all know that profit is a financial gain from a transaction or from a period of investment or business activity, usually calculated as income in excess of costs or as the final value of an asset in excess of its initial value.

It is a total revenue minus total expenses, **profit** is the amount of money a business "makes" during a given accounting period. The more profit you make, the better, as profit can be re-invested into the business or retained by the business owners. Being able to accurately determine your business's profit is an essential part of being able to judge its financial health. It can also help you decide how to price your goods and services, how to pay your employees, and more.

To make your business gain more profit, begin by adding up all of the money your business has made in a set period of time (either, quarterly, yearly, monthly, etc. Other sources, like products sold, services rendered, membership payments, or, in the case of government agencies, taxes, fees, the sales of resource rights, and so on.

Note that you will need to subtract any amount of cash refunded to customers for returns or disputes in order to find an accurate figure for your total income.

It's easier to understand the process of calculating a business's profit by following along with an example.

Let's say that we own a small publishing business. In the last month, we sold P20,000 worth of books to retailers in the area. However, we also sold the rights to one of our intellectual properties for P7,000 and received P3,000 from book retailers for official promotional materials. If these represent all of our revenue sources, we can say that our total income is  $P20,000 + P7,000 + P3,000 = P30,000$ .

This module is divided into two lessons:

*Lesson 1 – Compute for profits CS\_EP11/12ENTREP-0h-j-16*

*Create the company's five (5) year projected financial statements*

*-CS\_EP11/12ENTREP-0h-j-17*

To be able to successfully complete this module, previous knowledge in adding & multiplying numbers will best help.

After carefully studying the contents of this module, you should be able to:

- compute for profits
- define profitability, liquidity & solvency
- identify commonly used profitability ratios.



### **What I Know**

Let us see what you already know about forecasting revenues and costs. Answer the questions below.

Write **True** if the statement is correct & write **False** if you think the answer is not correct.

- \_\_\_\_\_ 1. The gross profit rate of the entrepreneurial venture is computed by dividing the cost of goods sold by net sales.
- \_\_\_\_\_ 2. The gross profit rate provides information on the cost ratio of the business.
- \_\_\_\_\_ 3. In evaluating the profitability of the entrepreneurial venture, the evaluation must focus on the information reflected on the face of the balance sheet.
- \_\_\_\_\_ 4. The operating profit margin rate indicates information on the percentage of operating expenses on the net sales.
- \_\_\_\_\_ 5. Mr. Q is a practicing Doctor of Medicine. During the month of March 2019 he received Professional Fees amounting to P 1,000,000 and total expenses of P250,000. The net income of Mr. Q is P 750,000.

- \_\_\_\_\_ 6. Profit is the money received from customer in exchange of products given to customer.
- \_\_\_\_\_ 7. The gross profit rate of the entrepreneurial venture is computed by dividing the cost of goods sold by net sales.
- \_\_\_\_\_ 8. The gross profit rate provides information on the cost ratio of business.
- \_\_\_\_\_ 9. One of the objectives in evaluating the gross profit rate of the business is to determine whether the amount of the gross profit is sufficient to cover the operating expenses.
- \_\_\_\_\_ 10. The operating profit margin rate indicates information on the percentage of operating expenses to net sales.
- \_\_\_\_\_ 11. The government is not interested in financial statements since it is not a party to any of the transactions of the business.
- \_\_\_\_\_ 12. The net profit margin rate presents the general perspective of the operating performance of the business.
- \_\_\_\_\_ 13. The amount of income per peso investment can be determined by computing the net profit margin rate.
- \_\_\_\_\_ 14. In normal situation, it is favorable for the business to have high inventory
- \_\_\_\_\_ 15. Preparation & presentation of the financial statements of the entity is the primary responsibility of an accountant.

# Lesson

## 1

# Computation of Gross Profit



### What's In

Let's review of what is revenue of the business. This is an important tool and materials needed in the operation of the business. It is said that revenue is the result when sales exceed the cost to produce or manufacture goods/merchandise as well as costs incurred in selling.

Forecast is advance information that could help us prepare and ready for any incoming event. Forecasting is the tool used in planning that aims to support management or a business owner in its desire to adjust and cope up with uncertainties of the future. If anyone of us can predict that we can be rich so it means all of us will be rich. This fantasy is played out every day in boardrooms across the globe with the practice of business forecasting.

It is important to have a good organization in the business to easily grow and expand in the future.



### What's New

#### Activity 1

Read and understand the given problem.

Rodrigo is engaged in a buy-and sell business of perfumes. He bought 10 boxes of perfumes. Each box costs 12,000.00 and contains a dozen of perfume bottles. He is planning to sell one perfume bottle at P1,500. What is his expected profit on the 10 boxes of perfumes?

The ultimate goal of any business whether a retail or wholesale is to earn a profit. Getting the difference between the amount of money earned from the selling 10 boxes containing a dozen of perfume bottles and the cost of those 10 boxes gives the profit.

In the example that I gave, answer the following questions:

1. How much does Rodrigo earned profit?
2. Is it good to engage in a business? Yes or No?
3. What do you think of Rodrigo's business? Is it good for a beginner?



## What Is It

### Compute the Gross Profit

The profitability ratios are a group of financial statement that primarily determine the profitability of the business operation.

The gross profit rate on a product is computed as:

Net Sales	xxxxxxx
Less: Cost of sales	<u>xxxxxxx</u>
Gross profit	<b>xxxxxxx</b>

By using the formula, the gross of XYZ Trading in the year 2017

Net Sales	P 734, 000.00
Less: Cost of Sales	<u>577, 000.00</u>
Gross Profit	<b><u>157, 000.00</u></b>

**Profit** is the gross income. The amount of gross profit provides information to the entrepreneur about revenue earned from sales.

The term **cost** refers to the purchase price of the product including of the product including the total outlay required in producing it.

The gross profit margin is computed as follows:

$$\text{gross profit rate} = \frac{\text{gross profit}}{\text{net sales}}$$



The gross profit rate measures the percentage of gross profit to sales, indicating the profit that the business realizes from the sale of the product.

The gross profit rate of XYZ Trading for the year computed as follows:

$$\text{gross profit rate} = \frac{46,900.00}{734,000.00}$$

**gross profit rate = 21.39%**

The gross profit rate may signal to the entrepreneur that the amount of margin on sales is 21.39%. This rate will be used to determine whether the amount of gross profit can cover the operating of the business. Since the gross profit rate of XYZ Trading is 21.39%, the cost ratio to sales will be 78.61%. This information will help the entrepreneur in assessing whether the cost is too high or too low. Any product with a very high cost will not become competitive in the market.

The gross profit rate will also help the entrepreneur set the selling price.

### **Operating Profit Margin Rate**

The *operating the profit margin* is the excess of gross profit from operating expenses.

Gross profit	xxxxx
Less: Operating Expenses	<u>xxxxx</u>
Operating profit margin	<u>xxxxx</u>

The operating profit margin is the second level of revenue in the income statement. At this stage, not only the cost of buying or making the product that has been deducted is included but also the operating expenses. These are expenses incurred during a particular period only, and are not expected to provide benefits to any future period. The operating expenses are also period costs.

In case there are no financing charges like interest, expenses, and income tax, the amount of the operating profit margin is equal to the net income.

Gross profit	P 157,000.00
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Less: Operating expenses	<u>90,000.00</u>
Operating profit margin	<b><u>P 67,000.00</u></b>

This information that the business realized an income of P 67,000.00 during the year after deducting the cost and operating expenses from the sales made.

$$\text{Operating profit margin rate} = \frac{\text{Operating Profit Margin}}{\text{Net Sales}}$$

By applying

$$\text{Operating profit margin rate} = \frac{67,000.00}{734,000.00}$$

$$\text{Operating profit margin rate} = 9.13\%$$

The operating profit margin of the business measures the percentage of profit available after deducting the cost of sales & operating expenses of the business. A higher operating profit margin is favorable to the business.

### **Net Profit Margin Rate**

Operating profit margin		xxxxxxx
Add: Interest Income		xxxxxxx
Total		
Less: Interest Expense	xxxxxxx	
Income Tax	<u>xxxxxxx</u>	<u>xxxxxxx</u>
<b>Net Profit margin</b>		<b><u>xxxxxxx</u></b>

The Income statement is the net profit margin & the third level in the revenue. The business is only given consideration like interest expense and income tax.

Operating profit margin	P67,000.00
Less: Income tax	<u>20,000.00</u>
Net profit margin	<b><u>P46,900.00</u></b>

The income statement of XYZ Trading does not reflect any data on interest expense. Only income tax has been deducted from the operating profit margin.

$$\text{Net profit margin rate} = \frac{\text{Net Profit}}{\text{Net Sales}}$$

By applying the formula, the profit margin of XYZ

$$\text{Net profit margin rate} = \frac{46,900.00}{734,000.00}$$

$$\text{Net profit margin rate} = 6.39\%$$

XYZ Trading appears to have earned 6.39% of its total sales of P734,000 during the year. This profits rate must be compared with those of other similar businesses within the industry.

### **Analyse the Liquidity Status of the Business**

#### **Liquidity Ratios**

Current ratio = Current assets / Current liabilities

Quick ratio = (Current assets – Inventories) / Current liabilities

= (Cash and equivalents + Marketable securities + Accounts receivable)  
/ Current liabilities

The **quick ratio** measures its short-term obligations with its most liquid assets and therefore excludes inventories from its current assets.

. Financial statements are important in a company management as a means of communicating past successes as well as future expectations. The financial statement records all the operating results such as sales, expenses and profits or losses.

#### **Return of Investment (ROI)**

The **Return of investment (ROI)** measures the amount of net income per peso invested to the business.

The formula to compute ROI is as follows

$$\text{Return of Investment} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

The average total assets are by dividing the sum of the total assets at the beginning and end of the period.

Table 1

**Projected Five Year Balance Sheet**

Fit Mo'to Ready to Wear Online Selling Business

	Year 1	Year 2	Year 3	Year 4	Year 5
<b>ASSET</b>					
Cash	337,398.56	686,417.05	1,052,886.47	1,437,679.36	1,841,711.89
Total Assets	337,398.56	686,417.05	1,052,886.47	1,437,679.36	1,841,711.89
Liability	-	-	-	-	-
Owners' equity	337,398.56	686,417.05	1,052,886.47	1,437,679.36	1,841,711.89
Total Liabilities and Owner's Equity	337,398.56	686,417.05	1,052,886.47	1,437,679.36	1,841,711.89

Table 1

**Projected Five Year Income Statement**

Fit Mo'to Ready to Wear Online Selling Business

	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Revenue</b>	1,545,673.95	1,622,957.64	1,704,105.53	1,789,310.80	1,878,776.34
<b>Cost</b>	1,213,275.38	1,273,939.15	1,337,636.11	1,404,517.91	1,474,743.81
<b>Gross Profit Before tax</b>	332,398.56	349,018.49	366,469.42	384,792.89	404,032.53

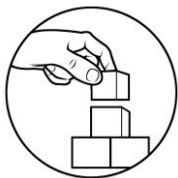
Yearly increase in revenue is assumed at 5%

Yearly increase in cost is assumed at 5%

As a future entrepreneur, one should always remember that nothing is permanent in the field of entrepreneurship. What is applicable to one entrepreneur may not be applicable to another. Certain things may happen to one entrepreneur but may not happen to another.

Entrepreneurship should be practiced not as a science but as an art. Creativity should always be applied to entrepreneur by regularly evaluating the market and the environment and responding to the changes in them.

The owner of an ordinary small business has the freedom to manage and operate. Ideally, he/she prefers business activities which are done easily. However, the entrepreneur has to perform the entrepreneurial activities correctly regardless of whether they are undertaken easily or not. The important in entrepreneurship is that the business activities are performed correctly.



### **What's More**

#### **Compute the Gross Profit**

Answer the given problem.

1. Annie bought one dozen smartphones for P200,000.00 with a discount of 5%. She sold half dozen at a price of P18,000.00 per unit. However, a new model of smartphone became available in the market, so she sold the remaining half dozen @ P12,000.00 each unit. What was her profit or loss?

Compute the following requirements:

- a. Gross profit rate
- b. Operating profit margin rate
- c. Net profit margin rate
- d. Return on Investment

Now ask yourself the following questions:

1. Is creativity present in the operation of ordinary small businesses along the streets and highways and in your neighborhood? Why do you say so?

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2. Will you consider the daily business practices of the small owner within the concept of entrepreneurship? Why?

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### **What I Have Learned**

The profitability and ratios are a group financial statement ratios that primarily determine the profitability of the business operation. They provide information on the efficiency of resource utilization.

The gross profit represents the difference between net sales and cost of sales of the entrepreneurial venture during a given period. It is computed as follows:

Net Sales	xxxxxx
Less: Cost of Sales	<u>xxxxxx</u>
<b>Gross Profit</b>	<b><u>xxxxxx</u></b>

By using the formula, the gross profit of XYZ Co., in the year 2017 is computed as follows :

Net Sales	P734,000.00
Less: Cost of Sales	<u>577,000.00</u>
Gross profit	<u><b>P 157,000.00</b></u>

**Profit** is determined by:

- the money you get from sales
- the cost of stock – if you're selling a product
- all the expenses you incurred

Income earned by the business are sales & gross profit. Commissions, discounts, fixed expense are business expenses.

### **How to Increase your Sales**

- ❖ Improve profit by looking at the money you earn from sales, and increase:
  - The number of customers
  - The volume of goods or services existing customers to buy
  - The sales price



### **What I Can Do**

Conduct an interview of at least three (3) successful business people in your locality, use the following questions as your guidelines:

1. What made him motivate to start a business?

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2. What is the nature of his business?

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3. How much capital involved?

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4. How many years of existence?

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5. Did you consider the population of the community?

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6. How much gross profit did you earn for the first year of operation?

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### **Assessment**

How did you understand the lessons that you have studied in this module? Answer the following questions.

Write **True** if the statement is correct & write **False** if you think the answer is not correct.

\_\_\_\_\_ 1. The gross profit rate of the entrepreneurial venture is computed by dividing the cost of goods sold by net sales.

\_\_\_\_\_ 2. The gross profit rate provides information on the cost ratio of the business.

\_\_\_\_\_ 3. In evaluating the profitability of the entrepreneurial venture, the evaluation must focus on the information reflected on the face of the balance sheet.



- \_\_\_\_\_ 4. The operating profit margin rate indicates information on the percentage of operating expenses on the net sales.
- \_\_\_\_\_ 5. Mr. Q is a practicing Doctor of Medicine. During the month of March 2019 he received Professional Fees amounting to P 1,000,000 and total expenses of P250,000. The net income of Mr. Q is P 750,000.
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- \_\_\_\_\_ 15. Preparation & presentation of the financial statements of the entity is the primary responsibility of an accountant.



### **Additional Activities**

After learning how to compute the gross profit at least you have learned now how to do it by your own. Solve and compute the following:

1. A watch store owner decided to offer 20% discount for a particular brand of watch that sells at P35,000.00. By doing so, his average sales increased from 5 watches to 12 watches a day. If he bought one watch at a price of P22,000.00 from the supplier, by how much was his daily profit increased or decreased by offering such discount on the watch?
2. Michelle went to Baguio and bought 20 jars of strawberry jam for P3,500.00 with 1 5% discount. When she got back to Manila, she sold 10 of the jars for a total of P1,800.00 and the rest as P185.00 each. How much profit did Michelle again?



## Answer Key

### What I Know

1. F
2. T
3. F
4. F
5. T
6. F
7. F
8. T
9. F
10. F
11. F
12. T
13. F
14. T
15. F

### Assesment

1. F
2. T
3. F
4. F
5. T
6. F
7. F
8. T
9. F
10. F
11. F
12. T
13. F
14. T
15. F

### What's New

#### Activity 1

Solution:

Given of 10 boxes of perfumes contain a dozen of bottles

120 bottles bought by Rodrigo

Cost of each box = P12,000.00

Selling Price of each perfume =P1,500.00

To solve the problem, we compute first the cost of  $10 \times 12 = 120$  bottles

Since each box costs P12,000.00 & Rodrigo bought 10 boxes, we get

Cost =  $P12,000.00(10) = P120,000.00$

Rodrigo can expect that the net sales he will get upon selling 10 boxes consisting of 120 bottles

Net Sales =  $1,500 (120) = P180,000.00$

Thus, has

Profit = Net Sales – Costs

=  $180,000.00 - 120,000.00$

= P60,000.00



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For inquiries or feedback, please write or call:

Department of Education - Bureau of learning Resources  
Zone 1, DepEd Building Masterson Avenue, Upper Balulang,  
Cagayan de Oro City, 9000

Telefax: (088) 880 7072

E-mail address: [region10@deped.gov.ph](mailto:region10@deped.gov.ph)

