

Improving Your Small Business Skills

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Information to Increase both the Wealth and Lifestyle of Your Family

Why Is Gross Profit Important to Your Small Business?

Does Gross Profit Relate to Your Business?

It relates to businesses which sell products or goods they buy or manufacture. E.g.: Retailers and Manufacturers of Jewellery, Hardware, Food, Plumbers, Electricians and Builders. It does not relate to service businesses such as consultants, accountants, and lawyers.

What is Gross Profit?

It is the excess of sales over costs incurred in buying goods which have been sold and preparing them for sale. For a retailer this would include freight costs in buying the goods and packaging. It would not include delivering the goods once sold as this would be a selling expense.

Example: Joan Flower runs a Local Nursery Retail Business. Below is her Profit & Loss Statement for the year ended 30 June 2016.

<u>Profit & Loss Statement</u>	<u>\$</u>	<u>\$</u>
Sales		625,000
Less: Cost of Sales		
Opening Stock on Hand	85,000	
Add: Purchases	382,000	
Add: Freight Inwards	12,000	
Less: Closing Stock	(90,000)	<u>389,000</u>
GROSS PROFIT		236,000
<u>Expenses</u>		
Selling Expenses		80,000
Administrative Expenses		106,250
Finance Expenses		<u>31,250</u>
TOTAL EXPENSES		217,500
NET PROFIT		\$18,500

Explanation of Terms

Gross Profit Margin - This reflects Gross Profit as a Percentage (%) of Total Sales. That is, $(\$236,000/\$625,000 = 37.76\%)$. This is one of the

most important key performance indicators used in the retailing and manufacturing sectors.

Difference Between "Price Mark-Ups" and Gross Profit

Purchase of a Plant in the Nursery: \$15; Sale Price: \$30. The "Price Mark-Up" is 100% ($\$15 \times 2$). This is the price increase from the Purchase Price.

The Gross Profit is \$15 and the Gross Profit Margin is 50% ($\$30 - \$15 = \$15/\30). Gross Profit is the difference between Sale and Cost Price. This is often, initially, misunderstood by retailers who talk and think about "marking-up" from cost. *The \$15 Gross Profit is used to pay the expenses of the business and pay profits to the small business owner.*

Example of Improving your Gross Profit Margin: The above Nursery's Gross Profit Margin is 37.76%. That is, for each dollar sold, the business makes 37.76 cents. *The nursery has recently made two changes to improve its profits:*

1. Joined a "Nursery Buyers Group" which has as members 100 Retail Nursery stores. Through this bulk buying power, they have reduced their purchase costs. This has improved their gross profit by 3.5% to 41.26%.
2. They now grow a number of their plants themselves using existing staff during their idle times. This has also reduced their purchase costs and has grown their Margin by another 2% to 43.26%.

What is the effect on Net Profit?

Sales and Expenses are still the same. Gross Profit is now $\$625,000 \times 43.26\% =$ **\$270,375, an increase of \$34,375 which has improved Net Profit by the same amount from \$18,500 to \$52,875 - an improvement of 185%.**

This information is for the benefit of our clients and interested parties. The commentary contained does not purport to be comprehensive advice. Please contact David Chambers if specific assistance is required in this area.