Analysing a business' gross profit margin

from

businessbankingcoach.com

in association with

International
Training
Solutions

Probably the most revealing measure of a business' profitability is the gross profit margin

If a business doesn't perform well at that level of its income statement, it has little chance of delivering bottom-line profit - so a good gross profit margin is key

On an income statement, gross profit is the first profit figure that we come across

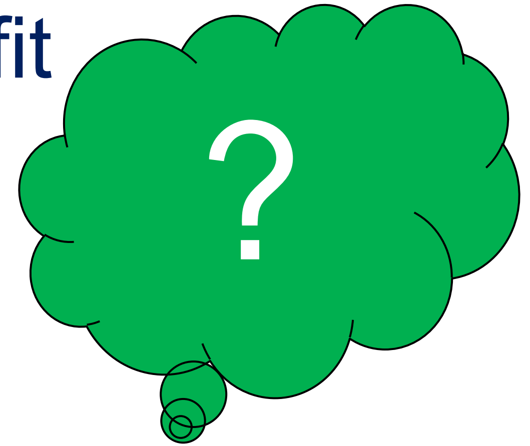
So what does it tell us?

Example Business Limited

Income Statements for the year ended 28 February

	2013	**2012**
Turnover	32,076,796	28,161,327
Cost of goods sold	(22,293,812)	(19,283,781)
Gross profit	**9,782,984**	**8,877,546**
Operating expenses	(6,896,393)	(4,143,044)
Depreciation & amortisation	(705,610)	(607,658)
Operating profit/(loss)	**2,180,981**	**4,126,844**
Interest expense	(340,863)	(522,759)
Net profit before tax	**1,840,118**	**3,604,085**
Tax	(460,400)	(867,448)
Profit for the year	**1,379,718**	**2,736,637**

As you can see from the income statement, it's the profit made from turnover (sales or revenue) after deducting the direct expense incurred in making those sales.



But, I hear you ask, what are direct expenses?

Direct expenses are those that ***have*** to be incurred in order to make the sale.

The most common direct expense is the cost of the stock that was purchased and then sold.

Let's talk about an example

Let's assume that we're in business as retailers of chairs and we buy them from a manufacturer.

We buy them for 200 and we sell them for 500.

If we sell one chair, our income statement will look like this;

Turnover	500
Cost of Goods Sold	200
Gross Profit	300

If we sell five chairs, our income statement will look like this;

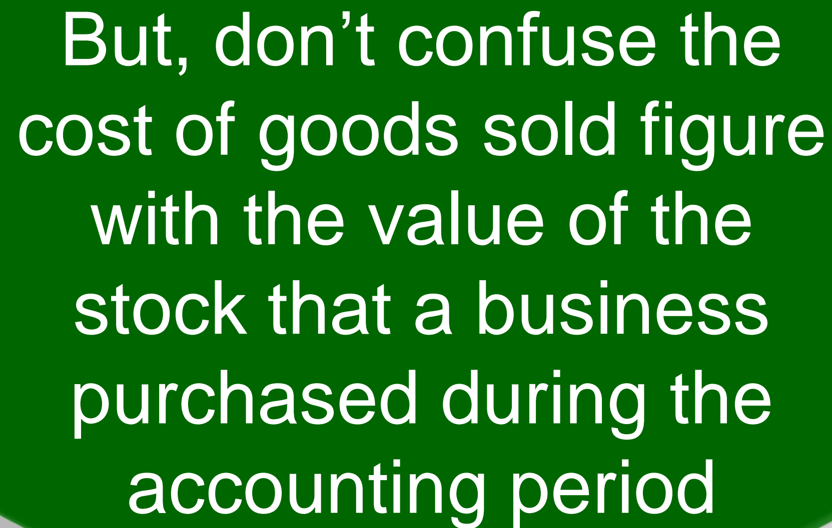
Turnover	2,500
Cost of Goods Sold	1,000
Gross Profit	1,500

So, our turnover multiplied by 5 but so did our cost of goods sold figure because we had to buy 5 chairs from our suppliers in order to sell them to our customers.

In this simple example, our direct expense is the cost of the chairs that we sold.

Notice the direct correlation between the turnover and the cost of goods sold figure – that gives us another name for these expenses; *variable expenses*

We call them variable because as the level of turnover changes, so does the level of the cost of goods sold figure.


But, don’t confuse the cost of goods sold figure with the value of the stock that a business purchased during the accounting period

For those businesses that trade with stock there is a basic formula for the calculation of the cost of goods sold figure;

Opening stock

Plus purchases

Less closing stock

For some businesses, though, the direct expenses can also include other expenses.

For example, if we had covered our chairs in paper or cardboard to protect them in transit to our customers, that would be a direct expense because the more chairs we sold, the more paper or cardboard we would have to use.

If we paid for the transportation of the chairs to our customers, that would also be a direct expense.

Get the idea?

An understanding of what constitutes the direct (or variable) expenses for a business is central to being able to properly analyse the gross profit margin.

Let’s see why that is......

In that income statement that we saw earlier, the gross profit for the latest year was 9,782,984 and the turnover was 32,076,796 which is nice to know but it doesn’t help us very much in our analysis.

What we have to do to make this information more meaningful is to convert those figures to a percentage.

So, we express the gross profit as a percentage of the turnover as follows;

$$\frac{\mathbf{9{,}782{,}984}}{\mathbf{32{,}076{,}796}} \quad \mathbf{= 30.50\%}$$

That tells us that the gross profit margin is 30.50%.

To put it another way, 30.50% of its turnover is gross profit

How does that help us?

Not very much actually!

To learn anything from it, we have to compare it to the previous year’s margin.

Let’s do that, then

If we apply the same calculation to the previous year's gross profit and turnover figures we see that the margin in that year was 31.52% so the latest year's margin is ***lower*** than it was the previous year.

This is not a good sign

Okay....
.....but why not?

What we are measuring here is the percentage of gross profit made from turnover. If that percentage reduces, only one of two things could have happened;

The cost of goods sold figure could have increased without a corresponding increase in turnover

or

Turnover could have reduced without a corresponding reduction in the cost of goods sold figure

In either event, the problem is that the cost of goods sold (the basic input costs into the business) are not in the same proportion to the turnover figure.

That probably implies an increase in the costs that could not be passed on to the business' customer, possibly because of competition in the market, the existence of substitute products that customers might buy in preference or simply that customers wouldn't perceive value in the product at the higher price.

The problem for the business is that it still has to meet its operating expenses from its gross profit so, if gross profit falls because of a reducing gross profit margin, it can have a very negative effect on the business' ability to make that bottom-line profit.

From an analyst's perspective, there are two issues when analysing a gross profit margin

Is the gross profit margin sufficient to cover all the remaining expenses of the business to leave a reasonable return for shareholders? The margin differs between industries so a comparison with other businesses in the same industry can be a useful guide.

and two

If the gross profit margin is falling, what caused it to fall and can the situation be rectified to get it back to where it was? If not, the business may be in long-term trouble.