EDGE INITIATIVES

SOLUTIONS FOR BUSINESS OWNERS

Gross Margin

The Gross margin is probably the most important in any business, and yet many people fail to measure it. Part of the reason for this is that the Gross margin is radically different for different businesses and in many cases it is not a well understood concept.

The driver behind the concept is that it should be revenues on an accrual basis (see article ***Key Performance Indicators – Revenues***) less all the costs directly associated with delivering those revenues. The best way of deciding what should or should not be included in the cost side of that equation is to ask whether the cost would go away if the product or service that produces the revenues did not exist.

Direct labor should always be included in the cost side of the equation even if the people involved are employed on a salaried basis. If they do not work full time on the revenue-generating side of the business, their appropriate costs should be pro-rated based on the time they do spend there and put in the equation. When calculating this number, all the expenses connected with the employee must be included…not just payroll, FICA etc, but all medical, 401(k) and other costs borne by the company.

Salespeople are more of a judgment call, and I lean towards measuring that component separately outside the Gross margin calculation by looking at sales as a percentage of revenues as a separate Key Performance Indicator.

One key thing to remember is that it is perfectly acceptable to use “guestimates” when allocation is difficult. Nobody is going to audit these numbers and they are for your benefit only. If an allocation number is 10% out, it is better than not having it at all.

The payoff from creating this measurement for the business is that it tells you how much you are generating from revenues to cover overhead expenses. This will give you information and ammunition in raising prices and cutting expenses and help you manage the business.

More importantly, it will also help you understand your business model better and identify whether different potential acquisitions and expansion strategies make financial sense or not.

Product Sales

In a business that resells or distributes product, the Gross Margin calculation is simple and well-understood and it is calculated by taking revenues and subtracting the cost of goods sold. Any shipping costs incurred in connection with the sale (both inbound and outbound) should be included in the calculation and the revenue side should include any shipping charges levied.

The gross margin and gross margin percentage calculation is as follows:

Gross Margin – Product Sales

Revenues for month

$100,000

Cost of goods sold

$60,000

Shipping costs

$1,000

Outside commissions

$2,500

Gross Margin

$36,500

%

36.5%

The question as to whether to include sales costs in the gross margin calculation is a complex one, and as already mentioned, I generally prefer to measure sales expenses as a percentage of revenues in a separate calculation. I do strongly believe, however, that any specific outside commissions that would not exist if the sale was not made should be included in the Gross Margin calculation – matched, of course, in the same period.

Manufacturing

The Gross Margin in manufacturing businesses follows the same principle, with cost of raw materials replacing the cost of goods sold in the previous example. In addition, direct labor costs should be brought into the equation.

Direct labor costs are all those costs directly associated with producing the product. In line with the main definition, they should be included if they are costs that would go away if the product to which they directly relate was not being manufactured. It does not matter whether the employees are salaried or hourly paid, their entire cost should be recorded here. If you are not utilizing them fully, then that will start to show up in the gross margin percentage.

Gross Margin - Manufacturing

Revenues for month

$100,000

Cost of raw materials

$45,000

Direct labor

$15,000

Other direct costs

$5,000

Gross Margin

$35,000

%

35.0%

In some manufacturing operations it is appropriate to measure the Gross Profit after raw materials as one number and the Gross Profit after raw materials and direct labor as a separate calculation. Either way is fine, and you can create as many subtotals within your Gross Margin calculation as seems to make sense based on how you want to measure and manage the business.

Service Companies

The gross margin for a service company can be difficult to put together, but it is an absolutely essential number to measure and to manage.

The cost of goods used is typically quite small as a percentage of revenues – spare parts or incidental expenses – and it is meaningless to look at the business and think that it has a 90% or better Gross Margin as it tells you effectively nothing.

The largest expense component in most service companies is the payroll of the people providing the service. In putting together the Gross Margin calculation it is important to go back to the definition shown earlier and include all the costs that would go away if the service that produces the revenues was not being performed. This includes not only payroll and associated fringe costs but also travel, entertainment and training costs for those personnel.

The template for a Gross Margin in a service company looks like this:

Gross Margin - ServiceCompanies

Revenues for month

$100,000

Cost of goods used

$10,000

Direct labor - Salaries

$40,000

Direct labor - Overtime

$5,000

Direct labor - Travel

$2,000

Direct labor - Entertainment

$1,750

Other direct costs

$2,000

Gross Margin

$39,250

%

39.3%

As with a manufacturing company, you may choose to create a number of different sub-totals to measure Gross margin after cost of goods used, Gross Margin after cost of goods sold and direct labor etc. Either way is fine, and you can create as many subtotals within your Gross Margin calculation as seems to make sense based on how you want to measure and manage the business.