

# WHAT DOES THE GROSS PROFIT % TELL ME?

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*Researched and compiled by Garry Stephens*

***What Does the Gross Profit % Tell Me?***

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**WHAT HAPPENS TO THE GP % IF YOUR SALES DOUBLE?**

Gross Profit is what is left when Directly Variable Expenses are taken away from Sales.

Sales	\$10,000
Less Directly Variable Expenses <i>(cost of sales)</i>	\$6,000
= Gross Profit	\$4,000

And Directly Variable Expenses are those that move in line with Sales (such as purchases to replace stock, or Sales Tax, discounts, commissions, etc.)

The GP % to Sales is found by:  
 $4,000 / 10,000 \times \% = 40\%$

So, to get back to the question, what would happen to the GP % if sales doubled. Think about it.

The answer is that the GP % should remain the same. So if sales went to \$20,000 twice as much stock would need to be replaced, twice as much discounts would be allowed and commissions paid, etc. Therefore the Directly Variable Expenses would also double, and the new figures would be

Sales	\$20,000
Less Directly Variable Expenses	\$12,000
= Gross Profit	\$8,000

GP % to Sales would now be  
 $8,000 / 20,000 \times \% = 40\%$

***It stays the same.***

In reality the GP % will not be exactly the same from month to month. Some months will be higher and others lower. But over a period of say four months, the figures should average out.

**IF YOUR MONTHLY GP % IS GOING DOWN, WHAT DOES THIS MEAN?**

Say that you have been keeping a record for some months and the GP % to Sales look like this

July	41.3%	August	40.7%
September	38.9%	October	37.6%
etc...			

Obviously something is wrong, because the GP % is supposed to stay roughly the same from month to month, even if the Sales double, or halve.

Before reading on, see how many reasons you can think of to explain this drop in the GP %.

The GP % to Sales could drop because of the following:

- i Cost increases. Purchase costs have gone up and you have not increased your prices.

- i Pilferage or theft. Someone is stealing your stock. You have to replace it, but no extra sales result.
- i Wastage, scrap and spoilage. increases in scrap means higher material costs for the same sales.
- i Extra discounts or commissions. You are giving away more discounts or commissions than normal.
- i Change in sales mix. You have sold more low-profit lines than normal.
- i Jobs wrongly recorded. If your workers are not booking enough hours to jobs, or are not recording materials or parts used, you may be under-charging your customers.
- i Drop in productivity. If your work is not properly organised or efficient, or your workers are not pulling their weight, the jobs will cost more but the sales will stay the same.

So you can see that the GP % to sales is a very powerful tool that you can use to control your business.

It is like measuring the pulse of the business. If it is going up, the business is improving. If it is going down, you may be heading for trouble.

**INDUSTRY AVERAGES - HOW DOES YOUR BUSINESS COMPARE?**

The GP % will vary greatly from one type of business to another. But within an industry group, it stays much the same. So if you are a newsagent, you should expect your GP % to come out at about 24.7%. This is the industry average for newsagents. And it still applies whether you are a small newsagent or a large newsagent.

This is because within any one industry all businesses buy the same sorts of material at about the same costs. And they are forced by competition to sell their products or services at much the same prices.

Attached is a list of GP % for different types of small businesses. These figures were prepared by the Financial Management Research Centre at the University of New England in Armidale, NSW They obtained actual sales and cost figures from hundreds of small businesses throughout Australia. The Business Enterprise Centre has other businesses 'benchmarked'.

How does your business compare? If your GP % is lower than the industry average you should search a bit deeper to find out why. It may be that you should be charging a bit more or that ways can be found of improving efficiency.

If your GP % is higher than average, try and keep it that way.

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**BUYING A BUSINESS - USING THE GP % TO CHECK IT OUT**

Knowing what the GP % should be can be used to great advantage when buying a business.

First, calculate the GP % for the prospective business over the last three years.

If the GP % is higher than the industry average,

- i It could be an exceptionally well-run business.
- i There may be some factor that makes this business different - what is it?

OR.....

- i The owner may be cheating on the figures.

If the GP % is lower than the average,

- It could be a poorly-run business. If you can improve things it could be a good buy.
- It could be a sick business - make sure you can 'cure' it.
- The owner may be putting money in his pocket.

Watch out as well for large variations in the GP % from year to year or big changes in the figures either upwards or downwards. Get explanations, especially if the figures have increased dramatically over, say, the past 6 months!

**GROSS MARGIN PERCENTAGES**

<b>RETAIL</b>	<b>GP %</b>
Butchers	30.0
Men's Fashions	36.8
Delicatessens	27.7
Milk Bars	42.3
Electrical	56.0
New Car Dealers	16.1
Flower and Garden	45.8
Newsagents	24.7
Footwear	35.9
Record and Music	29.2
Fruit and Vegetables	37.1
Service Stations	21.5
Giftware	37.2
Sporting Goods	30.4
Hardware	30.7
Tyre and Battery Dealers	35.2
Jewellers	42.9
Women Fashions	39.3
Liquor	21.3

<b>SERVICE</b>	<b>GP %</b>
Building Contractors	23.4
Hotels	44.0
Commercial Printers	38.2
Private Hospitals	30.1
Credit Unions	81.9
Restaurants	59.0
Dry Cleaners	71.3
Smash Repairers	57.5
Electrical Contractors	56.0
Single Truck Operators	54.6
Hairdressing Salons	83.6
Travel Agents	50.0

<b>PROFESSIONS</b>	<b>GP %</b>
Accountants	66.2
Pharmacies	36.3
Architects	65.0
Real Estate Agents	57.0
Legal Practices	66.5
Surveyors	67.3

<b>MANUFACTURING</b>	<b>GP %</b>
Bakers	45.4
Wooden Furniture	23.4

*Source: Financial Management Research Centre, University of New England, Armidale, NSW*