Ask Andi

Trusted Advisor to Business Owners

Know your margins, know your profitability

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“Someone recently asked me what is my margin. What immediately comes to mind is what's left over after I pay my taxes. What should I know about margins?“

Margin is a measure of profitability. There are several layers to margins. Knowing which margin to look at, for what purpose, will help this owner stay on top of what's going on.

Profit functions in relation to income. It is rarely a fixed amount each period. Different levels of profit fluctuate according to different variables, including:

- how much is sold
- how profitable are the items that are sold
- how much carrying cost, or overhead, the company has to cover
- how well the company does at keeping customer prices in line with increases in materials and labor needed to produce the good(s) sold.

Before calculating profit, a company has to know its expenses. There are two primary expense categories: cost of goods sold (COGS) and overhead expenses. Coding expenses to the correct section will help to yield a clearer picture of what's going on in the business.

COGS expenditures are those material and labor costs that the company would incur only if it had to produce goods or services for a sale. Overhead expenses are what the company has to pay for, regardless of whether it makes a sale, or not. Classic examples of overhead expenses include rent, lights, phones, computers, research and development, marketing costs and staff payroll. Sales payroll is typically considered overhead, while commissions tied to specific sales are usually considered COGS.

Given that there is more than one type of expense category, a business owner also has more than one margin to look at. Start with the gross profit margin which measures the amount of money left over after the company pays to produce the goods or services it just sold. If the company sells more than one product or service, identifying the detail of which expenses go with which type of sale will help further refine the profit picture.

To determine gross profit, overall or by product, the company needs to know revenue (money coming in from sales to customers) and COGS (the money spent to produce the items or services just sold). Here's the formula: (Revenue $) - (COGS $) = (Gross Profit $). Once you know Gross Profit $, you can calculate (Gross Profit percent) = (Gross Profit $) / (Revenue $).

Gross Profit percent tells an owner how hard the business is working, financially. A low percentage (under 50 percent) means the business has a lot to manage in COGS, before it makes any money to put towards overhead expenses. A high gross profit percent (over 50 percent), means the business doesn't have to work so hard to make money to put towards overhead expenses.

Knowing the gross profit percent and the amount of overhead expenses, means the owner can calculate how much revenue (income from sales) the company needs in order to break even. Knowing what it takes to exceed break even is a good thing, since missing that mark means the owner has to take money out of his or her pocket to keep the company going. Here's the formula for calculating: (Break Even) = (Overhead $) / (Gross Profit %).

Next comes net profit, which is the amount left over after the company pays for overhead expenses. (Gross Profit $) - (Overhead $) = (Net Profit $). This calculation tells the owner how much is left to put towards taxes, savings and debt repayments.

It's important to know the net profit percent as well as dollar amount. (Net Profit %) = (Net Profit $) / Revenue $). A low net profit percent means the company has little room for error, if any of its costs increase or sales drop. A high net profit percent means the company may have room to begin investing in other growth opportunities.

Keep in mind, there is one more way category an owner can code income and expenses in most accounting systems. Other income and other expenses is used to record income that does not come from business operations, for example investment income. Other expenses is used to separate out items such as taxes and shareholder distributions, which fluctuate based on net profit.

If it feels confusing, there are a few actions you can take. Make sure that your chart of accounts is set up properly, in order to correctly code expenses to the right categories. Ask your accountant for advice. Practice with the calculations. Look at, and calculate, your margins monthly. Track how the margins flow over time.

Looking for a good book? Try "Accounting for Non-Accountants, The Fast and Easy Way to Learn the Basics," by Wayne Label.

Business owners regularly turn to Ask Andi and Strategy Leaders for advice on how to grow profitable, successful companies. They find what they need time after time. Specific advice is available at www.AskAndiBlog.com. Ask Andi is also published weekly in the Westchester and Fairfield County Business Journals and Hudson Valley Business. Written by Strategy Leaders President, Andi Gray, the Ask Andi column is a rich source of advice for owners of established, privately held businesses.

If you are a business owner and you have a question or would like to discuss some aspect of your business, call 1.877.238.3535 or send an email to AskAndi@StrategyLeaders.com.

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