

Understanding profits

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"I'm having trouble figuring out costs. I own a painting company and our expenses are in several groups: sub contractors, office-related such as rent and supplies, equipment for jobs, office staff, myself, credit-card payments, taxes and marketing. Can you give me a quick way to look at expenses?"

One of the big mistakes I see most small businesses making is not separating cost of goods sold – COGS – expenditures from overhead. They don't look at gross profit, overall or by product or service offering. They run blind when it comes to managing costs and pricing items. And that causes the business to have a lot of financial bumps, tumbles and bruises.

Costs of delivering on sales

There should be a fairly constant ratio (percentage) relationship between revenue (sales) and COGS. The goal is to understand and be able to predict costs – both labor and materials – that occur if, and only if, a sale is made. Knowing the money that has to be spent to deliver on sales will help the company plan out how many sales it needs and evaluate if it's efficient enough with the work it produces.

Let's start with a simple model. For each sale, there are two major categories of costs – COGS and overhead. They operate very differently.

COGS is the cost of providing an item that was sold. Whether the item is a product or service, it will probably have both labor and materials in the cost. If volume of sales goes up, so will COGS, and if volume of sales drops, so should COGS.

Next comes the really important number: gross profit. Deducting COGS from revenue yields gross profit. Said another way, as a formula: $\text{income} - \text{COGS} = \text{GP}$. This is the money left over, after the item is delivered to the client. It is also the money that pays for overhead expenses, marketing and sales, debts, taxes and distributions to the shareholders.

Overhead and gross profit

At the same time that the company deals with variable costs related to production and delivery of its products or services, it also has fixed overhead that it has to cover. Rent, lights, telephones, office staff and benefits, and marketing programs all cost money. And then comes debt repayment, taxes, reserve funds and shareholder distributions.

One of the easiest ways to look at these non-COGS expenses is by putting them into categories. General and administrative expenses include things such as rent, lights, office supplies, cleaning services, telephones and office equipment. Marketing and sales costs include all marketing programs, sales payroll and bonuses. If you pay commissions tied directly to sales, that belongs in COGS.

Overhead salaries and benefits include all labor costs not directly related to producing goods and services. Office salaries, carrying cost for field or factory labor when they're not working to produce goods or services, vacation and sick pay all belong in this category. Remember to include officer salaries – you as owner need to get paid a regular wage for the work you do.

Deduct overhead from gross profit and you'll know how much money you have left over for taxes, paying down debts and rewarding shareholders. Shareholder distribution is the reward the owner receives for running a

profitable operation. By this calculation, and in practical fact, the owner is usually the last person to get paid – and that can create problems.

Only by getting enough sales, understanding gross profit, controlling overhead related expenses, and planning for taxes and debt repayment can you, the owner get paid. As sales jump up, money available to the owner will not jump up as fast. At some point, as overhead expenses are covered and stop increasing, the owner starts making more and more money. Knowing when and how that happens is essential to managing a well-run business.

Next week we'll talk about dealing with multiple products or services, and understanding the impact of multiple gross profits.

Looking for a good book? Try "A Simple Guide to Turning a Profit as a Contractor" by Melanie Hodgdon and Leslie C. Shiner.

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