

## Gross profit, anyone?

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**"Our painting company has commercial and residential clients. The commercial projects last longer and use up more resources. Forecasting profits can be a real challenge. Can you help?"**

*Note: Last week's column looked at separating cost of goods sold expenses from overhead. This is the second half of the reader's question.*

If the owner separates revenue and cost of goods sold expenses into two categories - commercial and residential jobs - she'll also be able to calculate gross profit dollars and percentages for each category. By sampling work over a period of time the owner should be able to establish a percentage of gross profit for each category.

The owner can then model cost, revenue and profit for this year. Here's a practical example.

- The average commercial project sells for \$100 and costs \$70 to produce and deliver to the customer, yielding \$30 gross profit from the sale.
- The average residential project sells for \$50 and costs \$25 to deliver, yielding \$25 gross profit.

The gross profit can be calculated as a percentage of revenue:

- commercial gross profit/revenue =  $\$30/\$100$ , or 30%; and
- residential gross profit/revenue =  $\$25/\$50$ , or 50%.

### Now comes the strategy

Two sources of income, commercial and residential, make the company stronger. If sales from one source fall off, the company can turn to the other source as backup. For example, in a recession, typically commercial work drops off first, then residential drops off as commercial starts to recover.

The company can focus on commercial sales, using smaller, more profitable residential jobs to fill in holes in the schedule and boost profits. Or, the company can focus on selling mostly higher profit residential work, with a few commercial jobs throughout the year to keep the crews steadily employed and paid.

Whatever strategy the company decides to pursue, it needs to forecast the individual and combined gross profit of the two business lines. The owner wants to ensure that the combined gross profit exceeds the funds needed to run the business. The gross profit must cover all the expenses of the business, or the business will lose ground financially.

### Add it up

Figuring out how many jobs the company needs to sell is relatively straightforward. Add up the value of principal repayment and desired shareholder distributions and reinvestment funds. These items are all paid out of profits. Multiply this profit total by the company's likely tax rate, and add that in, along with the cost of overhead, marketing and sales. This is the amount of gross profit the company needs.

For example, let's say that principal repayment, shareholder distributions and funds to reinvest in the business add up to \$120. Multiply by the company's tax rate, let's say it's 30 percent, which equals \$36. Then add in overhead of \$60 and marketing and sales of \$40:  $\$120 + \$36 + \$60 + \$40 = \$256$  of gross profit needed for the year.

The owner can now use the average gross profit percentage per residential and commercial job, and the ratio of residential sales to commercial sales to estimate how many of each must be sold during the year.

Calculate the number of residential jobs needed by dividing \$256 by gross profit of 50 percent for residential, which equals \$512 in residential sales. At an average residential job size of \$50, it would take 10 to 11 residential jobs to meet the gross profit goal. Alternately, at 30 percent commercial gross profit, the company would need \$853 in sales ( $\$256/30$  percent). At an average job size of \$100, it would take eight commercial jobs. Or, work out a mix of both.

Granted, it will take a little bit of math and patience to work out the details. However, having a set of goals to pursue, and a clear understanding of what it will take to be profitable is just plain smart business.

Looking for a good book? Try "Found Money: Simple Strategies for Uncovering the Hidden Profit and Cash Flow in Your Business" by Steve Wilkinghoff.

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