

Make More Profit by Managing Gross Margin

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The difference between a company's net sales and the related cost of goods sold is gross margin. Gross margin is represented as both a number and a percent. Understanding the differences and relationships between the gross margin as a number and a percent is paramount to understanding the business.

Understanding Gross Margin

Gross margin is both a variable number and percent that changes with the product mix sold. A change in the sales product mix could cause both revenues and gross margin to increase and yet have gross margin decline as a percent. This type of change in gross margin could be the result of the company selling product at a reduced unit price causing overall sales to increase, while the cost of the product in inventory is still valued at the original cost of goods. So, if the company sells more product at the lower unit price, the gross margin number would increase, but the cost of goods percent increases on each item sold, which causes gross margin percent to decline. Business's management needs to understand this cause and effect relationship between sales price and cost for products and services.

Management's Responsibility for Gross Margin

The business's management needs to create a focused business environment that is aware of the importance of gross margin. Sales and marketing departments must be aware of what constitutes profitable sales and the impact that increasing and decreasing sales prices will have on both gross margin as a financial number and percent. Production and manufacturing departments need to be continually seeking new suppliers and materials to assist the business to achieve a better product at a lower cost, especially as a product matures in its product life cycle.

Changes to Gross Margin Impact the Bottom Line

Often gross margin is overlooked by business management in favor of the "bottom line profit" of a company. What business managers may forget is that gross margin is the source used to cover administrative expenses, so changes to gross margin impact the bottom line too. Changes in gross margin are the starting point that will be reflected either positively or negatively on the bottom line profitability of a business. In some cases, there will be an increase in gross margin that coincides with an increase in variable operating expenses related to selling a product or service.

Changes in Pricing Can Permanently Affect Gross Margin

Introduction of new product lines should have a positive result on the business's top and bottom line. The key is understanding the new product's life cycle and the related impact on gross margin. All products have a sales life cycle in the marketplace and as they mature there will be pricing pressures and the related gross margin pressures.

Price reductions on a product line offered by the company should also coincide with reductions in cost of goods sold in an effort to keep the gross margin percent stable. When the sales price and cost of goods prices both decline then the gross margin percent should stay the same, but there will be a reduction in the actual gross margin dollars unless the unit sales price reduction causes an increase in overall gross sales of the product.

Selling slow moving, old, or obsolete inventory at a reduced price is a good business strategy, but businesses also need to understand and be able to identify the short-term impact these types of inventory reduction sales will have on gross margin—especially when it relates to gross margin percent.

Changes in Product Cost Structure

All businesses are aware that increases in manufacturing, labor, or material costs are permanent reductions to gross margin. It is the manner and timeliness in which management responds to these types of changes in product costs that determine the long-term effects on gross margin. Other areas that businesses often pay limited attention to are product development costs. Although initial product development costs should be expensed when incurred, tooling and certain types of development costs are capitalized and amortized over the life of the product. Capitalized costs need to be identifiable and have a reasonable basis for being allocated to gross margin as part of the product's total cost of goods sold.

In addition to capitalized costs, businesses that are licensing a product name or producing a product that pays a royalty need to include these additional costs as part of cost of goods to show the total impact a product being sold has on gross margin. Businesses often want to put tool amortization, licensing and royalties in operations expense. This increases the gross margin and operation expenses, but provides unrealistic financial numbers for both areas of the income statement.

Variable expenses, such as freight in and out can also have an impact on cost of goods sold and gross margin. Freight companies charge surcharges on standard freight as fuel costs vary and these fuel surcharges can cause gross margin to vary. Businesses need to be able to identify and quantify variable expenses and their related effect on gross margin.

Changes in core product and service costs may need to be passed on to customers and, in times of inflation, price increases will need to be taken on a routine basis. Businesses that are unaware of changes in gross margin, or are afraid to pass on the increased cost to customers, will need to reduce other operating costs just to stay in business.

Gross Margin Percentage Should be Stable

Trends in gross margin related to business seasonality and product life cycles change both gross margin as a financial number and as a percent. Businesses that are seasonal may make a majority of their profit during a specific time during the year, so minor increases or decreases in gross margin can have major impacts on the business. Increases in gross margin for a seasonal business are important to understand, especially when the business is budgeting for the next fiscal year. If the gross margin increases were only temporary, then the business should avoid budgeting the gross margin increase in the next fiscal year. The same also applies to temporary decreases in gross margin.

Product line gross margin percent stability provides a business with valuable information related to how certain product lines of the business are performing. The capability to drill down by individual product line level provides management with the data to understand changes on a more micro level and their related effect on the business as a whole.

As a product moves through its product life cycle, businesses need to attempt to keep the gross margin percent stable and understand the changes in the gross margin percent. This is increasingly important, as new products are introduced and older products mature. Their combined effect on the business's gross margin can be planned from both a financial amount and a gross margin percent.

Gross Margin is a Sign of the Business's Financial Health

As this article has discussed, stable gross margin both as a financial amount and percent means that the sales and product costs are in balance. It also means the relationship between the products' sales prices and cost of goods sold is stable. In both cases, a stable gross margin allows a business's management to better predict financial results and allows the business to more accurately budget for the next fiscal period.

Conclusion

Businesses that understand gross margin at all levels of the organization operate their businesses better. Businesses that can plan for variations in gross margin will be able to make smarter business decisions related to pricing, cost of goods sold, and fixed and variable operating costs. When permanent changes in gross margin are identified, the business needs to react timely by adjusting production and operating costs and, as required, increase the sales price of the product.

The Siburg Company, LLC is a boutique consulting firm specializing in the areas of financial and operational consulting, business development, and mergers and acquisitions.

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Dan is the Managing Director of The Siburg Company, LLC and has experience as both a President and Chief Financial Officer. He has helped companies to improve operational functions and organization to manage costs and increase revenue streams, while implementing strategic policies and procedures that focus companies on profitability.

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