

## Maximize Your Bottom Line

Some basic accounting functions, such as determining gross profit, can be intimidating or frustrating to small business owners. While the time spent managing financial records and performing tax related tasks can seem like a burden, a savvy owner can use these records to improve their business. In particular, using available financial records to determine gross profit can help small businesses determine optimal pricing, prioritize customers, and/or establish advertising budgets.

Before we look at how the information in your financial records can be used to improve your bottom line, let's make sure that we're all on the same page. Exactly what is gross profit?

### Calculate Gross Profit

Gross profit is the difference between the amount of money you can sell a product or service for (revenue) and the cost of making that product or providing that service. Let's say your business, Canine Cooking, makes and sells gourmet dog treats. If it costs you \$25 to make each batch of treats, and you can sell those treats for \$100, then your gross profit on each batch of treats will be \$75.

In determining the cost, it's important to include only those expenses that go directly into producing the product. Accountants have a specific term for this – it's called "Cost of Goods Sold". For this particular calculation, when we look at cost, we're not going to include expenses for business operations such as marketing, rent/lease, salaried management, etc. There are some subtleties in this calculation, so if you have questions, consider running them past your accountant the next time you meet.

You can look at gross profit for your entire business or you can break it down by unit. In our example, the gross profit per unit would be the price you can sell one batch of dog treats for, less the cost of producing the batch. Once you have the gross profit per unit, you can use that figure in a number of ways. Let's walk through some possible benefits of determining gross profit, from prioritizing categories of products, to determining a marketing budget, to establishing prices.

### Using Gross Profit for Decision Making

Determining what products to push is often challenging. Many small business owners focus their attention on what sells the best, rather than on what is most profitable. Using their financial records – receipts and expenses – is critical to building their business. It's easy for business managers to prioritize products based on which ones bring in the most revenue. For example, once they have a store stocked with products, many business owners prioritize the product that generates the most revenue or sales dollars. However, they should take a step back and prioritize the products or services that bring in the highest gross profit.

Following our dog treat example, Canine Cooking, a small business manufacturing dog treats, has two great products – both selling at about the same pace, about 20,000 units per year. The fancy liver biscotti treat, priced at \$40, brings in twice as much revenue (\$800,000) as the chicken biscuit, priced at \$20 (\$400,000). The owner is thinking of focusing marketing efforts on the liver biscotti. Is this the right decision? I would recommend using the owner's books and records to determine what each of the treats costs to make. In this case, the liver treat costs \$30, while the chicken only \$5. Armed with the

information that the business can quickly determine that the profit is \$200,000 on the liver treats, but \$300,000 on the chicken. Now, it's clear that marketing should focus on the chicken treats.

### **Using Gross Profit for Marketing Decisions**

Another good use of gross profit is to help determine a marketing budget. Many companies spend high amounts on marketing and see a good boost in revenue from it. However, it is important to ensure that the additional amount of money you generate from that boost in customers actually covers the cost of marketing. For example, if the gross profit on our dog treat business is \$10 per unit, then a marketing campaign that costs \$400 would need to sell 40 extra units to cover the marketing costs. If we only sell an additional 25 units in the long term, than we've just spent \$400 to make \$250 – not a good tradeoff! (If we expect the marketing campaign to pick up additional long term customers, then a short term loss could be a good strategy).

### **Using Gross Profit for Pricing Decisions**

Pricing decisions can become much easier once you understand gross profit. Owners can find the optimal price/quantity trade-off when they have a full understanding of their cost of goods sold. Using our Canine Cooking example, if the more expensive dog treat actually produces less gross profit, the owner may decide to raise the price per treat, knowing that the amount sold will be less. Again, this strategy can seem counterintuitive. But if the owner can raise the gross profit per batch of treats significantly, the business will be more successful!!! In other words, sometimes selling less means earning more!

Further, informed owners can manipulate their price according to competitive factors. For example, if their business operates in a highly competitive market, they may decide to drop their price below the competition to a level that reduces your gross profit to a minimal amount. This strategy might be pursued on a temporary basis or as a permanent solution for companies seeking to boost sales quantities and gain market share. The bottom line is clear: successful competitive pricing strategies work when they're implemented by informed owners who have a solid understanding of how many additional sales they will need to make at a lower price.

Prioritizing products, determining marketing budget, and setting pricing are three ways that informed business owners can use a business' gross profits to benefit their business. The goal of tracking these numbers is ultimately to make better business decisions. By generating the proper reports and understanding how to use the results, managers can make better choices and significantly improve their net income.

Business owners and managers should be aware of these financial tools when making strategic decisions. Most accountants are equipped to work with their clients to set up reports that will allow tracking gross profits and other numbers that may be useful as benchmarks.

To learn more about how to use these strategies and other business management concepts, [click here](#), or call (303)517-6342, and contact Two Hills.