How to Calculate Gross Profit

Know whether your business is making money.

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One of the most important financial concepts you'll need to learn in running your new business is the computation of gross profit, and the tool you use to maintain gross profit is markup.

The gross profit on a product is computed as follows:

Sales – Cost of Goods Sold = Gross Profit

To understand gross profit, it is important to know the distinction between variable and fixed costs.

Variable costs are costs that change based on the amount of product being made – and that are incurred as a direct result of producing the product. They include:

1. Materials used
2. Direct labor
3. Packaging
4. Freight
5. Plant supervisor salaries
6. Utilities for a plant or a warehouse
7. Depreciation expense on production equipment
8. Machinery

Fixed costs are generally more static in nature. They include:

1. Office expenses such as supplies, utilities and office telephones
2. Salaries and wages of office staff, salespeople, officers and owners

3. Payroll taxes and employee benefits
4. Advertising, promotional and sales expenses
5. Insurance
6. Automotive expenses for salespeople
7. Professional fees
8. Rent

Variable expenses are recorded as cost of goods sold. Fixed expenses are counted as operating expenses (sometimes called selling and general administrative expenses).

While the gross profit is a dollar amount, the gross profit margin is expressed as a percentage. That’s equally important to track, since it allows you to keep an eye on profitability trends. This is critical because many businesses have gotten into financial trouble with an increasing gross profit that coincides with a declining gross profit margin.

The gross profit margin is computed as follows:

Gross Profit / Sales = Gross Profit Margin

There are two key ways for you to improve your gross margin. First, you can increase your prices. Second, you can decrease the costs to produce your goods. Of course, both are easier said than done.

An increase in prices can cause sales to drop. If sales drop too far, you may not generate enough gross profit dollars to cover operating expenses. Price increases require a very careful reading of inflationary rates, competitive factors and basic supply and demand predictions for the product you’re producing.

The second method of increasing gross profit margin is to lower the variable costs to produce your product. This can be accomplished by decreasing material costs or making the product more efficiently. Volume discounts are a good way to reduce material costs: The more material you buy from a

supplier, the more likely they are to offer you discounts. Another way to reduce material costs is to find a less costly supplier, but you might end up sacrificing quality if the purchased goods aren't made as well.

Whether you're starting a manufacturing, wholesaling, retailing or service business, you should always be on the lookout for ways to deliver your product or service more efficiently. However, you also must balance efficiency and quality.

Let's look at the gross profit of ABC Clothing Inc. as an example of the computation of gross profit margin. For Year One, sales were $1 million, and the gross profit was $250,000 — resulting in a gross profit margin of 25 percent ($250,000 / $1 million). For Year Two, sales were $1.5 million, and the gross profit was $450,000 — resulting in a gross profit margin of 30 percent ($450,000 / $1.5 million).

It is apparent that ABC Clothing earned not only more gross profit dollars during Year Two but also a higher gross profit margin. The company either raised prices, lowered variable material costs from suppliers or found a way to produce its clothing more efficiently (which usually means fewer labor hours per product produced). ABC Clothing did a better job in Year Two of managing its markup on the clothing products it manufactured.

Many business owners often get confused when relating markup to gross profit margin. They are first cousins in that both computations deal with the same variables. The difference is that gross profit margin is figured as a percentage of the selling price, while markup is figured as a percentage of the seller's cost.

Markup is computed as follows:

(Selling Price – Cost to Produce) / Cost to Produce = Markup Percentage

Let’s compute the markup for ABC Clothing for Year One:

($1 million – $750,000) / $750,000 = 33.3%

Now, let’s compute markup for ABC Clothing for Year Two:

($1.5 million – $1.05 million) / $1.05 million = 42.9%

While computing markup for an entire year for a business is very simple, using this valuable markup tool daily to work up price quotes is more complicated. However, it’s even more vital. Computing markup on last year’s numbers helps you understand where you’ve been and gives you a benchmark for success, but computing the markup on individual jobs will affect your business going forward and can often make the difference in running a profitable operation.

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