7.3 PROFITABILITY

AN INSIDER'S INSIGHTS

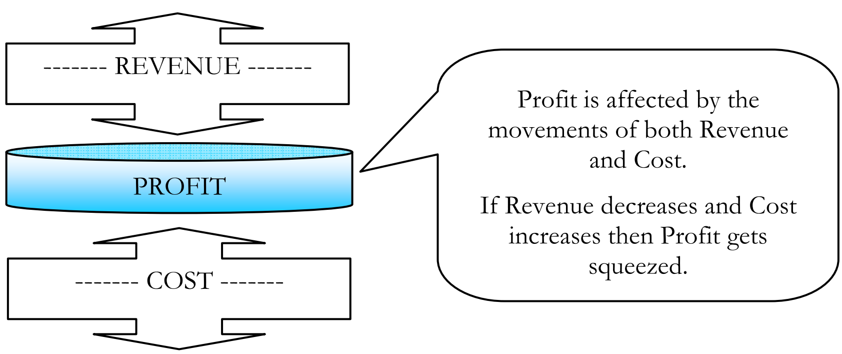
Profit is the most important factor you need to consider even if it is not the first thought that crosses your mind when you initially develop an exciting idea.

Running a company's finances shares the same bottom line principles as managing personal finance; you want to make more than you spend. The key to doing this is to understand the basic terminologies and how to manage them.

RELATIONSHIP BETWEEN COST, REVENUE, AND PROFIT

Calculating profit is fairly simple and straightforward, but managing the relationship of these three elements is anything but straightforward. Take a look at this diagram below. Each element is dynamic, and can move up or down (increase or decrease) at anytime.

As cost increases, if revenue is fixed because of a price ceiling, then your profit gets squeezed. To maintain profit margin, companies raise prices in times of inflation.



Toys and luxury products, especially non-essential entertainment (some people would rather starve than to give up their cable service) tend to be the most vulnerable to inflation, recession, and other economic swings.

The key point is that you must understand where your product lies relative to the need vs. want and essential vs. non-essential scale. You also must look out for any foreseeable cost increases in its production cycle and possibly sales cycle. Having awareness allows you to be better prepared when your profit margin is reduced even if it does not insulate you from the impacts.

Some Definitions

It is a fairly common practice to use a product's gross profit margin (**GM**) to assess whether it is a good business to be in, and how well it is positioned amongst other products in its industry sector.

To calculate gross profit margin you will need to know the gross profit, which is calculated with this formula:

Gross Profit = Revenue – COGS

For SnapIt! the 2010 gross profit is $255,831, which equals to revenue ($568,512) minus COGS ($312,681).

Contrast the gross profit to net profit (net income), which is $13,504. Net profit is gross profit minus all the other expenses and adding all other income, then subtracting any interest expenses and taxes owed. This figure is the true profit for the business. It is the amount that is equivalent to the money put into a personal savings account after all the bills have been paid.

Gross profit margin is gross profit expressed as a percentage of revenue.

GM = gross profit / revenue

In this case it is 45% (255,831 as a percentage of 568,512)

This is not to be confused with the other two types of accounting profit margins, namely operating margin and net profit margin. For the purpose of this evaluation we will focus on using the gross profit margin to assess the health of a potential concept turned business. If you are curious about the other two types, one good source of explanations is www.investopedia.com.

How Gross Margin Affects Pricing

Here is a table that illustrates how an item's cost is marked up through the food chain. It includes the gross margins of the players and how they in turn affect the retail price. The cost information corresponds to the sample income statement in Appendix 5.

	COGS	Cost %	Price	Profit	GM
consumer	$ 49.95	-	-	-	-
retailer	$ 24.98	50%	$ 49.95	$ 24.98	50%
distributor	$ 16.23	65%	$ 24.98	$ 8.74	35%
manufacturer	**$ 8.93**	55%	**$ 16.23**	$ 7.31	45%
factory	$ 6.25	70%	$ 8.93	$ 2.68	30%