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Profitability Recipes for Food and Beverage Companies

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In a previous article I discussed the importance of tracking gross to net sales, deduction management systems and how 80% of a company's profits are generated by 20% of its customers and 20% of its products. While much about these concepts may be clear, the methodology to analyze profitability is not commonly known or utilized by many companies. Most companies focus on gross profit, synonymous with 'margin,' which is the classic way accountants track sales less the cost of goods sold. Some companies even erroneously equate margin with mark-up, when a mark-up will not generate the same percentage gross profit. For example, a 20% mark-up will only yield a 17% gross profit.

The problem with gross profit is that cost of goods sold often includes fixed expenses, such as rent, which don't change incrementally with sales. Because of the distortion caused by fixed expenses, companies often make poor profitability decisions using a gross profit percentage. Therefore, utilizing contribution margin is the preferable method in analyzing profitability of a customer, product or distribution channel. Contribution margin is defined as sales less all variable expenses. You won't see contribution margin in a published financial statement, as gross profit still rules, but it should be a part of every internal financial statement when management has to make financial decisions.

Contribution margin reflects the profit generated from sales of products after all variable costs are deducted. So if a company's contribution margin percentage is 30%, it would mean for every net sales dollar, 30 cents is left to cover fixed expenses. And fixed expenses, by their very nature, remain constant regardless of sales volume or if you're open for business that day.

The exercise of calculating contribution margin is quite simple. Extract from cost of goods sold all fixed expenses and then add to your analysis all variable expenses, such as sales

commissions, broker fees, and distribution costs. You would apply this formula to overall sales and determine the percentage contribution margin. By taking this contribution margin percentage and dividing it into fixed expenses, you will have calculated your breakeven sales. This term is used to define the amount of sales necessary to cover all fixed expenses with no profit, hence 'breakeven.' For example, if all fixed expenses amount to $2,000,000 annually and your contribution margin percentage is 30%, your annual breakeven sales would be $6,666,666 ($2,000,000 divided by 30%).

So why is this so important? Applying the formula to determine your breakeven sales won't help with customer or product profitability. That's where the analysis starts to get interesting. You will notice as you drill into customer data that promotional costs, or slotting fees, or rebates affect the profitability of that customer. You will also notice that certain costs might vary more with some customers than others such as demo costs, commissions, broker fees or distribution costs. You don't have to analyze what impact fixed expenses have because they aren't relevant to that one customer. Many companies are lured into customer relationships because they generate more sales but they don't take the next step of looking at what profits are generated by that customer. Analyzing the contribution margin of each customer or product is essential to overall profitability. Beware if you calculate a negative contribution margin, which would mean that, for every dollar of sales from that customer, you are losing the negative contribution margin amount. Don't be that company that's lured into products or customers who are unprofitable, because the bottom line for all businesses is a profitable bottom line.

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