Gross Profit Ratio

Gross Profit Ratio can be used to describe the significant relationship between figures shown on a balance sheet.

It simplifies the comprehension of your financial statements. Ratios tell the story of changes in the financial condition of your business.

Gross profit ratio (GP ratio) is the ratio of Gross Profit to net sales expressed as a percentage. It conveys the relationship between gross profit and sales.

> *The calculation of gross profit ratios,* are gross profit and net sales. Gross profit would be the difference between net sales and **cost of goods sold,** also known as <u>direct expenses</u>.

Example: Gross Profit Ratio = (Gross profit / Net sales) × 100]

Total sales = $520,000; Sales returns = $ 20,000; Cost of goods sold $400,000

Gross profit = [(520,000 – 20,000) – 400,000]

= 100,000

Gross Profit Ratio = (100,000 / 500,000) × 100

= 20%

Gross Profit Ratio may be indicated as to what extent the selling prices of goods per unit may be reduced without incurring losses on operations. It reflects efficiency with which a firm produces its products. As the gross profit is found by deducting cost of goods sold from net sales, the higher the gross profit the better it is. There is no standard GP ratio for evaluation. It may vary from business to business. However, the gross profit earned should be sufficient to recover all operating expenses and to build up reserves after paying all fixed interest charges and dividends.

If you have an Increase in the selling price of goods sold without any corresponding increase in the cost of goods sold you will have an increase in your Gross Profit Ratio. Respectively, if you Decrease in cost of goods sold without corresponding decrease in selling price you will also get an increase in the Gross Profit Ratio.

Ratios are simply a statistical yardstick by means of which the relationship between two or various figures can be compared or measured.