Cost of Goods Sold

Understanding the costs attributed to Cost of Goods Sold (COGS) is a critical piece in the business profitability puzzle. At its core, COGS is the cost of the raw materials used to manufacture products and the cost of items purchased for resale. Other costs that are directly tied to the purchase or sale of a product may be included in COGS as well, such as freight, credit card processing fees, and commissions. COGS are differentiated from other operating expenses, which are categorized as Overhead expenses. Let's explore this further with Joe, our community grocer.

Joe wanted to understand what was really happening in his business; so he organized all the costs he had incurred during the last month. As he sorted through the purchases, he placed the invoices for things he purchased to sell in one stack,

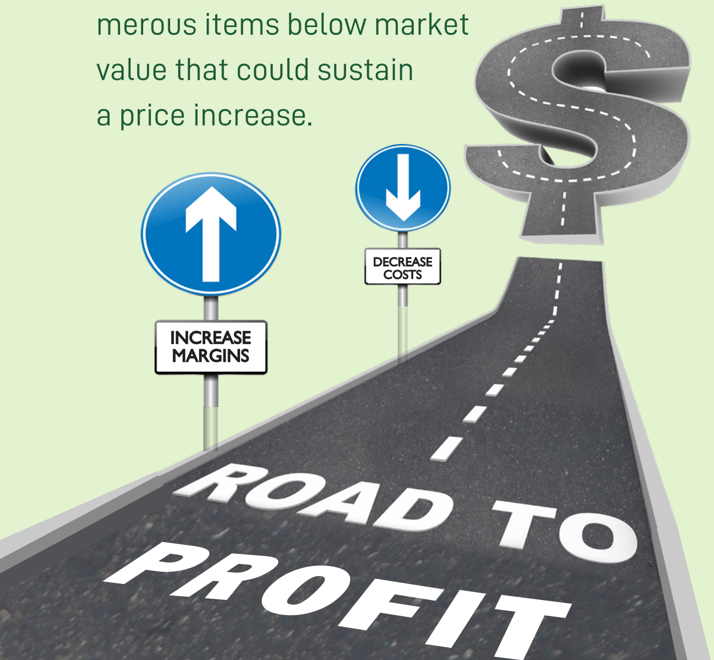
while the other expenses he placed in a separate stack to evaluate later.

The sum of his invoices in the first stack was the COGS for that month. It included fresh fruit purchases, flour, sugar, cereal, eggs, milk, meat, spices, seasonings, snacks, frozen foods, and impulse purchase items for the checkout lane. For some products, Joe paid freight or shipping to get them to his store, so he made sure to include those expenses in his COGS. Since his store accepts credit card payments, he also placed his credit card processing fees in the COGS stack. In short, his COGS were the purchases made for anything he sold in his store, plus his credit card fees. Joe found that his total COGS for that month came to $15,000.

After Joe figured out his COGS, he could calculate the Gross Profit for his company. Without this information, he wouldn't be able to properly file his taxes or know what was truly happening in his business. He subtracted the $15,000 cost from the monthly sales of $20,000, which gave him a $5,000 gross profit or a 25% gross profit margin. This gross profit amount was what

Joe had left to pay the other expenses for his store for the month. Unfortunately, those other expenses (overhead) exceeded his gross profit for the previous month.

Now that Joe recognized this problem, he considered what he could do to correct it. First, he reviewed his purchasing habits. He found several ways to reduce the costs of products by either changing vendors or negotiating with his current vendors. Next, he carefully evaluated all the items in his store to see if he could increase his selling price. He found that some items were price sensitive and would not support a price increase, but he also found numerous items below market value that could sustain a price increase.



Because of his improved buying habits and price increases, Joe increased his Gross Profit Margin from 25% to 30%. This increase meant that every $1,000 of sales in the store would generate $300 Gross Profit instead of $250.

Joe felt a sense of gratification as he realized how much his COGS would be positively impacted because of his persistence to evaluate and adjust his buying and pricing habits. The increased net profit was worth all the effort he had put into understanding his COGS.

—Verlon Miller

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