



Which Products Really Drive Your Business's Profits?

Robust sales don't always translate into strong profits. A popular product could produce disappointing returns when you account for discounts, shipping, returns and support costs. At the same time, a lower-volume product could quietly generate an attractive profit margin.

How can you tell what's working? The solution may be product-level analysis that shows where you're generating profit and where strong revenue might be masking weak performance. This holds true whether your business manufactures, distributes or sells products through sales reps, online channels or brick-and-mortar stores.

Calculating the full cost

Start by identifying each of your product's direct costs, such as materials, inventory purchases, production labor and packaging. Then consider expenses that might be easier to overlook, including:

- Freight, warehousing and inventory carrying costs,
- Sales commissions,
- Payment-processing charges,
- Promotions and discounts,
- Returns, spoilage and shrinkage, and
- Customer service and technical support.

Overhead expenses — including rent, insurance, technology and administrative salaries — also affect product profitability. However, allocating them solely by sales volume can distort results.

A product that requires, for example, customized packaging or extensive customer support should receive a greater share of those costs. Activity-based costing can provide a more realistic view by assigning expenses according to the activities that generate them.

Beyond gross margin

No single measurement tells the whole story. Gross margin shows how much revenue remains after covering cost of goods sold. Meanwhile, contribution margin subtracts variable costs from revenue. A positive contribution margin generally means a product helps cover fixed expenses and generate profit.

So if a product appears unprofitable after allocated overhead, don't automatically discontinue it. Because many fixed costs will remain, eliminating the product could reduce your business's overall profit. Instead, consider whether the product attracts new customers or supports sales of more profitable items.

Also evaluate product profitability by sales channel and customer segment. The same item may be profitable in a store but lose money through an online marketplace because of commissions, fulfillment expenses and returns. In a similar vein, a large customer's discounts could erase the benefit of high sales volume.

Turn findings into action

Reliable product data can support better pricing, purchasing, marketing and inventory decisions. It can also help you negotiate supplier terms, adjust sales and distribution channels, and evaluate new products.

Product-level analysis shouldn't be a one-time exercise. Market and economic conditions often change, so you should review margins regularly and investigate major variances.