Benefits of computing gross profit on sales in contrast to contribution margin

Business

The computation of gross profit on sales, which can be derived under the absorption costing approach, is a profitability measure normally conducted under financial analysis. This accounting ratio outlines the gross profit generated from every $100 of sales. Such measure is highly useful in financial analysis, because it provides indications on the profitability potential and cost efficiency of the company. For instance, if there was an increase in sales of 10%, but the gross profit margin declined by 4%.

This indicates that the cost efficiency of the organization deteriorated during the period. Such analysis cannot be conducted under the contribution margin approach, because gross profit is not present. However, under the contribution margin approach one can calculate the contribution to sales ratio which indicates the contribution determined from every $100 of sales. This would also provide indications on the control of variable costs once compared over time.

Difference in Net Income arising from different approaches. In the example of ABC Company the profit under the two methods is the same. However, this is not always the case. Profits under the two methods differ whenever there is movement in inventory. This is due to the fact that since under the absorption costing technique fixed manufacturing costs are included in the cost of goods sold, a proportion of fixed costs will be included in inventory leading to such a difference.

Contribution margin approach not allowable for external reporting. The contribution margin approach, despite being highly useful to provide valuable information for decision making, is not acceptable for external reporting. This is due to the fact that it does not comply with the Generally

Accepted Accounting Principles (GAAP). For example, under the GAAP the income statement layout should clearly outline the gross profit made by the company. Under the contribution margin method this is not highlighted.

Another important reason why the absorption approach is allowable for external reporting and not the contribution approach is due to the way in which the income statement is classified. The GAAP state that the income statement is classified by function, like under the absorption method. In the contribution approach it is classified by cost behavior. Indeed separation between fixed and variable costs is made under such method. This conflicts with another requirement of the GAAP. Reference: Drury C. (1996). Management and Cost Accounting. Fourth Edition. New York: International Thomson Business Press.