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Industry benchmarks

In May 1997, the ATO released the cash economy task force report. The report suggested that the ATO needed to be more open and visible to the business community if it was to increase its effectiveness in dealing with the cash economy.

The task force recommended, amongst other things, that the ATO develop 'tool kits' such as industry profiles and benchmark data, that add value to tax agents' practices and help improve compliance. In response to the report, the ATO worked with industry groups and tax practitioners to produce some benchmarks for selected 'high cash transaction' industries. These were published for the first time in *Taxation Statistics 1996-97*.

This initial benchmark data showed ratios for gross profit, net profit and wages to turnover. These ratios were selected because:

- they are widely used in external publications;
- they can be consistently calculated from ATO return form information; and
- they are useful to tax practitioners, the business community and the ATO.

Industries

Industries selected for benchmarking this year include a mix of primary production industries, service industries and other industries, as follows:

- child care services
- cleaning services
- dairy cattle farming
- grape growing
- liquor retailing
- meat retailing (except poultry or canned meat)
- meat wholesaling
- poultry farming (meat)
- poultry retailing (fresh)
- real estate agents
- sheep-beef cattle farming
- sheep farming

Definitions

Gross profit ratio (GPR): is calculated as total business income minus cost of sales, divided by total business income.

Net profit ratio (NPR): is calculated as total business income minus total expenses, divided by total business income.

Wages to turnover ratio: is calculated as salary and wages paid divided by total business income.

- sheep-grain and beef-grain farming
- smash repairing.

The purpose of benchmarks

Benchmarks help tax advisers to identify businesses which vary significantly from industry averages. Advisers can then use this information to determine why there is such a variance and to identify action that should be taken to correct problems and improve business practices—record keeping in particular.

The general business community and business owners may use the information to compare the performance of their business with industry averages.

For example, a low gross profit ratio may indicate to a business owner that:

- their job quotes or prices are lower than their competitors';
- they are paying too much for their stock purchases;
- there is wastage of materials due to an over estimation of requirements to complete jobs;
- they do not have enough sales in higher profit margin lines (poor sales mix);
- improvements in the way products are merchandised and displayed may need to be considered; and
- their stock level is too high (it may be better to buy stock as it is needed to improve the cashflow of the business).

A low net profit ratio may indicate that some operating expenses are high in comparison to industry averages. A business owner might need to look at:

- the location of their business and rent expenses;

- the level of contractor and subcontractor expenses;
- the number of employees and their effectiveness;
- the cost to the business of motor vehicles; and
- the cost of other major overheads.

For a business owner, a high wages to turnover ratio might suggest that quotes for jobs are too low. This ratio could also be an indicator of the efficiency of the labour used in a business. In particular, an owner may consider:

- the rate at which employees are producing income;
- the time taken to complete jobs; and
- the pay rates of the employees.

The business community may also use the ratios when evaluating tenders submitted for jobs. The gross profit and net profit ratios of a business compared to the industry average may be one factor that is taken into account in deciding whether a particular tender is successful.

For the ATO, the benchmarks are part of a move to be more open and current in its operations. By doing this, the ATO is looking to have a more direct impact on taxpayer behaviour before tax returns are prepared and lodged. The publication of benchmarks forms part of the compliance approach that is being used in the building and construction industry. Feedback from tax professionals indicates that the benchmarks are being considered in the preparation of tax returns.

Once tax returns are lodged, the benchmarks may also be used, together with a range of other information, to identify taxpayers who may require further assistance or monitoring. The wages to turnover ratio, in particular, provides a relevant measure in those industries where cash wages are common. The ATO may also make comparisons between taxpayers and seek further information from those clients whose ratios vary substantially from industry averages.

It is important to understand that the ratios developed are not definitive benchmarks. There will be a range of legitimate reasons why businesses vary from the industry averages. Similarly, businesses whose ratios are close to the industry average may, for various reasons, have

Calculating ratios

Exclusion criteria: when analysing a large population there are cases which, if included, would produce misleading results. For example, there will be cases where income tax return form labels have either not been filled in or not completed correctly, and where the ratios for an individual entity are exceptional and would distort the calculation of a true industry average. In an attempt to remove these cases from the calculation of the ratios and thereby improve the quality of the end product, certain exclusion criteria were developed and used. A full list of the exclusion criteria is available on the CD-ROM attached to this publication.

Ratio calculations: ratios were calculated for each taxpayer in the population and then, using these figures, two sets of average ratio values were determined for each of the sub-groups. The first set includes both profit and loss making entities. It acknowledges there are many taxpayers each year who return losses and provides a benchmark figure for the entire industry population. The second set of ratios excludes those businesses that return a loss and so provide an industry average for 'profitable' businesses. There will be circumstances where one particular benchmark will be more useful than the other. However, in many situations both sets of ratios will be beneficial.

Industry: income tax returns only allow for one industry code to be shown, representing the main business activity of the entity. For entities involved in more than one business, it is not possible to separately identify the amount of income and expenses that can be directly attributed to the major business activity.

Cost of sales: for income tax purposes, cost of sales is defined as the cost of anything produced, manufactured, acquired or purchased for manufacture, sale or exchange in deriving the gross proceeds or earnings of the business. In some cases, other expenses—such as salary and wages and rent, are included in the cost of sales figure. The cost of sales amount is therefore overstated in these cases.

Salary and wage expenses: the total salary and wages expenses label is not used in the calculation of taxable income. It is a non-compulsory information label and is therefore more likely to contain errors.

Population size variations: when using a particular ratio it is important to note the size of the population, as an average ratio calculated using a large population will generally be more reliable than one calculated from a small population. For each entity type and industry, average ratios have been calculated by state, total business income range, market segment and business age. These divisions result in some widely varying population sizes. For industries with small numbers nationally, it was decided not to show separate ratios by state, total business income range, market segment or business age. The population sizes produced by these breakdowns were considered to be too small to provide reliable averages.

compliance problems or other financial difficulties. It would not be appropriate to use the benchmarks in isolation.

However, the benchmarks are useful as a guide when considered over a period of time or in conjunction with other information. For example, while the aim of going into business should be to make a profit, establishment costs can result in significant losses being incurred in early years. Even after a business is established, profits may not be made in every year. Business generally has a cyclical nature—there will be some good years and some bad years. When considering the viability of a business, factors such as the age of the business and its performance over a number of years need to be taken into account.

Ratios

The data show that the net profit ratios of companies and trusts are generally much lower than those of partnerships and individuals. The main reason for this is that the salary and wages income returned to the owners of a company or working beneficiaries of a trust is generally a business expense for the company or trust. However, in a partnership, the income returned to the partners comes in the form of a distribution of net income after business expenses are deducted. A similar situation occurs for individuals. The wages to turnover ratios for individuals and partnerships are lower than for companies and trusts for the same reason.

Although there are some differences in the gross profit and wages to turnover ratios, in many cases the values are similar for all entities. These trends are shown in table 7.1, using the example of the meat retailing (except poultry or canned meat) industry.

Table 7.1: Ratio values by entity—meat retailing (except poultry or canned meat) all established profitable businesses

Entity type	Gross profit ratio	Net profit ratio	Wages to turnover ratio
	%	%	%
Individuals	30.6	9.5	10.8
Partnerships	32.6	9.9	11.3
Companies	33.2	4.7	15.5
Trusts	33.9	6.1	15.3

For most industries the gross profit and net profit ratios tend to decrease as the level of total business income increases. This is likely to be due to higher overheads and a shift in focus towards sales volumes at the expense of profit margins as turnover increases.

However in some industries this trend is not always followed, as shown in Table 7.2. Although net profit ratios decrease as turnover increases, gross profit ratios increase and plateau at the $100 000 to $1 million turnover ranges.

Table 7.2: Ratio values by total business income—dairy cattle, profitable partnerships

Total business income	Gross profit ratio	Net profit ratio
	%	%
$10 000–$49 999	82.8	42.6
$50 000–$99 999	91.5	35.0
$100 000–$299 999	95.1	22.9
$300 000–$499 999	95.6	17.6
$500 000–$999 999	95.4	14.3
$1 000 000–$4 999 999	91.9	10.4

In the majority of industries, there is little difference in the values of the ratios calculated for each state. Most of the larger variations are associated with small numbers and so may not be reliable. However, there are some cases where the population sizes are reasonable and the ratio values show large differences. Table 7.3 shows some of these variations, such as the net profit ratio for profitable smash repair companies in Western Australia.

Although based on a smaller sample, the table also shows companies in the smash repairs industry in Tasmania have a lower net profit ratio. This may indicate that some operating costs are higher in Tasmania than in other states.

Table 7.3: Ratio values by state of lodgment—smash repairing, profitable companies

State	Gross profit ratio	Net profit ratio	Wages to turnover ratio
	%	%	%
NSW	53.2	7.7	30.6
Vic.	53.1	9.2	30.1
Qld	56.2	9.1	28.6
SA/NT	57.8	7.9	29.8
WA	55.3	12.6	27.0
Tas.	53.6	4.1	33.4
ACT	48.3	8.0	28.6

Table 7.4: Ratio values by total business income: liquor retailing, profitable entities

Total business income	Companies		Individuals		Partnerships		Trusts	
	GPR	NPR	GPR	NPR	GPR	NPR	GPR	NPR
	%	%	%	%	%	%	%	%
$10 000–$49 999	46.4	24.9	59.5	39.4	40.2	21.4	26.1	18.9
$50 000–$99 999	38.6	32.0	33.3	34.4	23.6	32.8	58.9	22.0
$100 000–$299 999	41.9	14.8	32.5	12.0	27.5	8.5	30.3	19.3
$300 000–$499 999	33.7	13.2	19.3	5.2	21.1	7.5	21.1	7.2
$500 000–$999 999	21.8	3.2	21.2	3.8	18.6	5.9	20.0	3.7
$1 000 000–$4 999 999	21.1	4.8	18.7	4.8	17.3	5.4	19.8	4.4

An analysis of businesses involved in liquor retailing has been included this year. Table 7.4 summarises gross profit and net profit ratios for profitable liquor retailing businesses by turnover level and entity type. It is noted that while gross profit and net profit ratios trend downwards as turnover increases, a plateau effect is noticeable around the $500 000 to $5 million ranges.

A significant drop in the net profit ratio for liquor retailing companies, individuals and partnerships occurs around the $100 000 to $300 000 mark. For trusts this drop occurs around the $300 000 to $500 000 level.

An unusual concentration in the number of liquor retailing businesses was also noted around the $500 000 to $5 million mark across the range of entity types. In many other small business categories the concentration in numbers occurs lower in the total business income range.

As mentioned in *Taxation Statistics 1997–98*, the comparison of ratios for adjacent years for the same industry generally produces results which are similar. The inclusion of the grape growing industry this year provided an opportunity to compare gross profit, net profit and wages to turnover ratios for 1998–99 with similar details last reviewed in the 1996–97 benchmarking exercise. As can be seen from the details summarised in table 7.5, the tendency for the ratios to remain similar is again apparent.

The future

In view of the similarity in consecutive years' benchmarks for the same industry, the ATO will focus on publishing benchmarks for different industries each year. The approach may be that benchmarks for some industries will be published in five year cycles.

Detailed tables

The following detailed tables on industry benchmarks are available on the CD-ROM attached to this publication.

Table 1: Selected industry by business status
Table 2: Selected industry by market segment
Table 3: Selected industry by state
Table 4: Selected industry by grade of total business income
Table 5: Ratios and exclusion criteria used

Table 7.5: Ratio values by entity—grape growing, all established businesses (comparison of 1997 & 1999 years)

Entity type	Gross profit ratio		Net profit ratio		Wages to turnover ratio	
	1997	1999	1997	1999	1997	1999
	%	%	%	%	%	%
Individuals	76.2	74.6	19.7	20.0	28.9	27.4
Companies	71.9	67.0	8.8	11.9	28.4	26.7
Partnerships	82.8	79.3	18.2	18.5	21.8	20.9
Trusts	79.4	78.8	19.4	16.0	23.8	22.5