

Back to basics: profits, markups and margins

Written by Warren Harmer

Small business owners are a pretty amazing bunch of people. You put yourselves out there, week after week, slogging it out and dealing with everything that comes your way. As jack-of-all-trades you have to deal with everything from recruitment, finances, clients and marketing all in the same hour. Your armoury is just the skills that you came in with and those you grew yourself. Such as they are.

Understanding and managing business finances is crucial and the skill set you need takes time to develop and a commitment to educating yourself. From what I have seen in small business there is a big deficient in the skills you all have and what you need. In fact I have commented many times that the level of financial management is so bad it's scary. So many times I hear terms incorrectly used or explanations that warn me the owner is not really on top of what is going on. Looking in your business bank account as an indicator of how your business is going is not sufficient!

There are some very common misunderstandings that I hear when small business owners talk about money. Markup and profit are terms that are used interchangeably, gross profit and net profit are not well understood and ratios are almost never used. Budgets are a foreign concept.

So here we are, I thought I would give a back-to-basics lesson on terminology and concepts for small business owners. Those of you who are on top of this information, please forgive me, but it's worth taking the time for the vast majority. Some terms are used 'forward', such as creating prices; other terms are more often used 'backwards' when you are reviewing your business' financial performance.

Let's look at the whole process:

1.

In your business, you buy a product that you will later sell. In your accounts that is your Cost of Goods Sold.

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Cost of Goods Sold

1.

You may change it in some way to reach your final product. In the process you will have other costs

Cost of Sales

1.

You now add your markup onto the cost to arrive at your final sale price.

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markup. Usually a multiple of your cost, e.g. 2 x Cost of Sales

Whole amount = sale price

1.

You also have other business expenses Overheads that are usually fixed, like rent, insurance and an

overheads

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1.

When you look backwards in reporting, your revenue will be split up into the categories

Net profit – what is left over

Overheads

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Cost of sales

Gross Profit = Revenue – Cost of sales

How to use these numbers

The great thing about using these numbers is that you can very easily check the vitality of your business or from individual product lines. When you do (or get) your financial reports you will obviously look at the Net Profit as that is what is actually left over, but it's very useful to know Gross Profit too. GP easily tells you if you need to take action with pricing, costs or efficiency. Also, by looking at GP each month you can see trends quickly. Knowing percentages gives you very fine control and you can prick trends quickly.

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Margins are usually used to describe your profits as percentages, for example Gross Profit margin of 55% (of revenue) or Net profit margin of 18%.

Case study 1: Service Business.

In the monthly report you see that revenue is \$100,000. In a service business your main Cost of Sales are wages for your staff that provide the service, in this case \$55,000. So GP is \$45,000 or 45%. Your Overheads are \$22,000 so Net Profit is \$23,000 or 23% (which is not bad). Since last month however, GP has decreased from 24.5%, so you will go through your report more closely to see why and whether you need to take action.

Case study 2: Manufacturing business.

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One of my old clients made packaging. When I first met them they said their “margin is 20%”. After I looked more closely at their accounts I soon realised that their Markup was 20%! So for an average monthly material cost of \$50,000 their sales were \$60,000 with GP of 16.7%. Considering overheads were \$15,000 (25%) they were losing 8.3% per month. Prices went up promptly.



Business planner and small business consultant

South Melbourne VIC | www.businessplancompany.com.au

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I am a cultivator of great small businesses. I have a Ph.D in science but fell into the world of small business by accident and discovered my passion. My experience owning and consulting to small businesses now spans over 17 years. I like to solve problems using a scientific approach; looking objectively at businesses to see what is happening and applying first principles. In small business, outcomes reign over theory.

Practical, hands-on advice for small business owners is sorely lacking, since most 'experts' have never owned one. Most business information is targeted to big business and their employees.

My objective is to offer instructive, 'how to' information to make business ownership easier, less stressful and more enjoyable.

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