Sort out Mark-up from Profit Margin

Description

Because if you set your mark-ups to create negative margins it makes you go broke!

All too often the term “Mark-up” is used interchangeably as “Profit Margin” (or Margin). So here are some Quick Definitions to help you clear this up once and for all!

Profit Margin and **Margin** are generally the same thing when used in accounting, so that is the first part solved.

Margin and **Mark-up** are rooted in the same concept – both are ways of expressing what you get to take home at the end of the day; both can be expressed as either Dollar Values or Percentages. Their difference is the basis used for calculations – so without getting too maths-ey:

In principle:

* **Mark-up** – relates to pricing – it is the amount added on top of production and purchase costs to create your selling price:Â sales – costs = markup ; **as a percentage it is calculated as *markup amount divided by COST***
* **Profit Margin** – relates to profit – it is the proportion of the selling price that is profit:Â sales – costs = profit margin ; **as a percentage it is calculated as *profit margin amount divided by SALES***

In practice:

* **Mark-up** – is mostly used in reference to the profit on individual items, products or product lines – markup will relate to blue t-shirts, or t-shirts in general or tops in general as opposed to a different mark-up being applied to bottoms, trousers, and blue shorts.

* **Profit Margin** – is mostly used to for groups of items and most commonly in reference to the profit of the business as a whole

So, you can’t work out margin without first calculating your mark-up!

Good Mark-up = Getting your Pricing Right

Good Margin =Â Getting your Profit Right

Good Business – Getting both Margin and Mark-Up Right

The problems start when you mix them up, or don't make them high enough and then you may rip yourself off!

Profit Margins and Mark-ups Explained

The easiest way to clarify this is with an example – using something pretty basic to help us work through the maths (don't freak out I promise the maths is easy and if you can master this you will master how to make a profit)…

Let's decide to run a cake stall at the local market – selling 10 cakes each weekend, and 30 cup cakes. OK so it wont make us millionaires, but it will help out the local school…

By adding up the costs of our ingredients, and taking account of admin, rent, time etc weÂ work out the cost.

(Given the process of costing is complex I've skipped over that here; if you need more information see this article)

When you look at the table below each the margin and markup for cupcakes are the same but differ from the markup and margin for cakes.

Which means that overall business margin is a mix of the two.

So in this example if we stick to looking at the dollar values both the margin and the markup of cakes are $4.50Â – the same amount and therefore annoyingly confusing, hence there is so many people who lose the plot at this point!

Note the calculation of the Percentages differ because one is based on cost and one is based on profit – in the case of Cakes the Markup Percentage is 43% markup/cost) but the profit margin is only 30% (margin/sales).

Checking the percentages, and making sure you are using the right method is really important if you have several product lines and are making a change, or adding new products/services – don't get caught out!

	Cup Cakes	**Big Cakes**
Cost	**$1.75 cost per cupcake** (there are 6 cupcakes in a big cake)	**$10.50 cost per cake**
Price	**Sell at $2 per cup cake**	**Sell at $15 per cake**
Mark up $	**$0.25 cupcake mark up** $2.00 sales price – $1.75 cost = $0.25 mark-up	**$4.50 cake mark up** $15.00 sales price-$10.50 cost = $4.50 mark-up
Mark up %	**14% cupcake mark up percentage** $0.25 mark-up Ã· **$1.75 cost** = 14% mark-up	**43% cake mark up percentage** $4.50 mark-up Ã· **$10.50 cost** = 43% mark-up
Item Profit Margin $	**$0.25 item profit margin** $2.00 sales price – $1.75 cost = $0.25 item profit margin	**$4.50 item profit margin** $15.00 sales price-$10.50 cost = $4.50 item profit margin
Item Profit Margin %	**12.5% item profit margin percentage** $0.25 margin Ã· **$2.00 price** = 14% item profit margin	**30% item profit margin percentage** $4.50 mark-up Ã· **$15.00 price** = 30% item profit margin

	Cup Cakes	Big Cakes
Business Income	**$60.00 income from cupcake sales** $2.00 x 30 cupcakes = $60.00 cupcake income	**$150.00 income from cake sales** $15.00 x 10 cakes = $150.00 cake income
Total Income	**$210.00 Business income** $60.00 cupcakes + $150.00 cakes = $210.00 business income	
Business Costs	**$52.50 Cost of cupcake making** $1.75 x 30 cupcakes = $52.50 cupcake costs	**$105.00 Cost of cake making** $10.50 x 10 cakes = $105.00 cake costs
Total Costs	**$157.50 Business costs** $52.50 cupcakes + $105.00 cakes = $157.50 business costs	
Business Profit	**$7.50 Profit from cupcake making** $60.00 – 52.50 cupcakes = $7.50 cupcake profit	**$45.00 Profit from cake making** $150.00 – $105.00 cakes = $45.00 cake costs
Total Profit Margin	**$52.50 business profit margin** $210.00 business Income – $157.50 business cost = $52.50 business profit	

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Total Profit Margin %	**25% item profit margin percentage** $52.50 profit margin Ã· $210.00 income = 25% business profit margin

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Mark-up and Profit Margin Pitfalls

Both Profit Margins and mark-ups can be positive and negative: when the margin is negative the selling price is insufficient to cover the costs of production. So let's quickly look at a few other ways these calculations can go haywire:

1. Using the wrong thing to set your prices

Your Margin is the overall profitability of the business. It is highly likely some products or product lines make more profit than others (i.e your mark-up is not the same dollar amount for each product, and usually also not the same proportion added to each product. Therefore your profit margin is the end combination of all the profits you make on each of your products. Which means you cant work backwards and simply use that average unless you intend to put the same markup on everything (which would probably be bad business).

Don't use: Profit Margin % x Cost Price TO SET THE SELLING PRICE!!

Usign our Cake example again the Profit Margin % x Cost Price will only give a markup $3.15 instead of the $4.50 (ie $10.50 x 30% = $3.15, and $10.50 + $3.15 = $13.65 – not $15.00)

This is why it is so important to understand the difference between markup and margin; *mix them up and you may rip yourself off!*
For more info on where these figures can be found in your P&L see the three-part series Understanding your Income Statement

Tip for Remembering: Markups versus Margins

Doubling your expenses to establish your selling price gives you:
– 100% mark-up
– 50% profit margin

2. Ending up with a mark-down

A Mark-down is the amount a product is reduced below cost to establish a selling price, this may be necessary to clear a backlog of slow-moving stock especially in the case where regaining a portion of costs is preferable to simply discarding the products at -100% mark-down (or zero sales value).

In the cake example above this may mean selling yesterday's cakes at $5.00 which would be a mark-down of $5.50 ($10.50 net cost price – $5.50 markdown = $5.00 selling price).

3. Negative Profit Margins

A Negative Profit Margin can be caused by a) an informed decision (usually involving a mark-down or discount to move older stock) or b) unintentionally which always rapidly leads to a business crisis.

Negative Profit margins most commonly arise when the mark-up is calculated on only Cost of Goods Sold and not Total Costs and consequently pricing doesn't include sufficient to cover overheads and fixed costs.

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