Norrish and Associates

Business Management Consultants

For any further information regarding this article please contact Michael Norrish on 0408 914 051

PRICING FOR PROFIT (NOT MARK-UP)!!

Do you know the difference between mark-up pricing and profit margin pricing?

A lot of businesses are of the view that if they mark-up a product cost price by (say) 55% that they will achieve a gross profit of the same amount!..... **Incorrect!!**

As Julius Sumner Miller once said….”Why Is It So”!

I will explain below so please read on.

Mark-Up Pricing

A product costing $4.00 is “marked up” by 55%. On that basis the “sale price” would be $6.20 ($4.00 x 155%). However the gross profit margin is only 35.48%!!!

The gross profit margin is calculated by the following formula: -

$$\frac{\text{Sale Price minus Cost of Goods Sold} \quad \text{x} \quad \text{(multiply by) 100}}{\text{divided by Sales Price}}$$

i.e.

$$\frac{\$6.20 - \$4.00 \ \text{x} \ 100}{\$6.20} = 35.48\%$$

Thus a 55% “mark-up” equates to a 35.48% gross profit margin!

Therefore, there needs to be a mechanism to “price for profit margin” and there is!!!!

Profit Margin Pricing

As for the above example the product cost is $4.00.

Your goal is to achieve a 55% gross profit margin. (“GP Margin”)

If you want to achieve a 55% gross profit margin, the Cost of Goods Sold must therefore equal 45% as the sum of both components (Cost of Goods Sold and required Profit Margin) must equal 100% which is the Sale Price.

To calculate a sale price on a gross profit margin basis the calculation is: -

$$\frac{\text{Cost of Goods Sold x (multiply by) 100}}{\text{(divided by) 100 minus desired GP Margin}}$$

i.e. (using the above cost price of $4.00)

$4.00 x (multiply by) 100 = $400.00
(divided by) 100 minus 55 = 45

Therefore: - $400 divided by 45 = $8.89

A further way of expressing the formula is: -

$4.00 (Cost Price)
(divide by) 0.45 (1.00 minus 0.55) = $8.89

Let's calculate the gross profit margin using the same methodology as per the foregoing example: -

$8.89 minus $4.00 = 55.00%
(divided by) $8.89

Thus, to achieve a 55% profit margin the equivalent "mark-up" (in the example) would need to be 222.25%!!! ($4.00 multiplied by 222.25% = $8.89)

You need to be aware of the difference so that you always use the most appropriate pricing mechanism for your business.

Once having determined your correct pricing structure you then need to incorporate that information into a budget and cash flow forecast so that you can see the result.

These outcomes can then be included into your written business plan.

Cash Flow Projections

A Cash Flow Projection is a very important business tool. When completed, it shows the flow of cash in and out of the business on a periodic basis. This is essential and will show how much working capital is needed to enable the business to continue operating.

The cash flow is generally forecast on a month-by-month basis, although other periods may be appropriate for some businesses. Income and expenditure are recorded as they are due to be received or paid rather than when incurred. A liability is created (incurred) when goods are delivered or services provided even though the payment may be due (say) thirty days later.

THE CASH FLOW FORECASTS RECORDS THIS LIABILITY WHEN IT IS PAID, NOT WHEN IT IS INCURRED

All revenue and expenditure is recorded as they fall due and a net surplus or deficit established for the period. Any shortfall will show up as a surplus of expenditure over income (negative).

Budgets

Put simply a budget (Profit & Loss or P&L) is a forecast of the trading results for the year (or other period if preferred).

This is not the same as the cash flow forecast as a budget matches income and expenditure into the periods in which they are incurred not paid.

Goods sold in June but paid for in July will be included in the **budget for June** and the **cash flow forecast for July**.

The budget is a predicted profit and loss account, which will show if the planned operation will be profitable or not.

In the same manner as the cash flow, it is broken down into income and expenditure but it only includes those items relevant to determining the profit for the period. Capital items and GST are not included but depreciation is included.

Budget Control Strategies

Once the budget has been prepared, it is important to monitor actual results against the forecast.

Exercise good management control over the business operation with a view to ensuring the budget is met or compensations are made. Some examples of corrective action are: -

- If sales are down, reduce expenses where possible.
- Consider means of increasing turnover.
- Investigate ways to increase profit margins.
- Are there other sources of income?

(NOTE be cautious about reducing advertising expenditure. It may be better to rearrange advertising with a view to boosting sales.)