Maintaining Business Profitability

by Richard Shank

Why does the gross profit percentage shown on my business Profit and Loss report change from year-to-year, if the profit markup I use remains constant?

First of all, let's clarify our terms. Gross profit is the difference between what you pay for goods, and the price at which you sell them. It's gross profit because it is the initial profit before you have any expenses. It is also known as 'margin.' You are right to be concerned, because if you consistently use the same markup percentage, you should always have the same gross profit percentage, year after year. Your gross profit percentage is usually the single most important factor involved in making a profit. There are at least six problem possibilities you should examine when searching for the solution.

Possibility 1: Confusing the mathematical calculation of markup and margin
Markup is the process of multiplying your cost by a given percentage. For example, if you purchased a widget for $52.50, and then multiplied that $52.50 times 30%, you will have a markup of $15.75 (52.50 x .3 = 15.75). Your selling price would be $68.25 (52.50 + 15.75 = 68.25). But your margin of profit is only 23%, not 30%! What?? Yes, that's right, only 23%. We can prove this by dividing the profit dollars, $15.75, by the selling price, $68.25 (15.75 ÷ 68.25 = 23%). When we speak of profit percentages, it is critical that we always think in terms of the margin percentage, not the markup percentage. Markup is only the mathematical calculation method used to arrive at the desired selling price.

What calculation method should be used to correctly price my products? For most folks, it's easier to understand this when they use division rather than multiplication. Remember the selling price is always 100%, regardless of the dollar amount. You first decide what gross profit margin you need for your business to make enough profit to cover all expenses and leave you with a fair profit. You then use that percentage to learn the divisor you need to use to calculate the retail price. You do this by subtracting the desired gross profit (margin) from 100. The answer is your divisor. Let's assume for this illustration that you need a margin of 30%. You subtract 30 from 100 to get a divisor of 70 (100 – 30 = 70). Next, you divide your cost by .70 to achieve a margin of 30%. In the case of our $52.50 widget, this method produces a selling price of $75.00 (52.50 ÷ .70 = 75.00). Let's prove the accuracy of our calculation. In our example, we achieved a margin or gross profit of $22.50. We know this is a fact by subtracting our $52.50 cost from our selling price of $75.00. We can check our calculation by dividing our margin (22.50) by the selling price (75.00). This calculation proves we have correctly calculated a 30% margin or gross profit (22.50 ÷ 75.00 = 30%).

But even if the owner always uses correct math to price his products, he may be relying on one or more employees to do some of the pricing, and they may not understand how to mathematically achieve a 30% margin. Check your employee's mathematical work on a regular basis if you want to avoid financial shipwreck. The nice thing about this pricing method is that you never need a markup chart. You only need to remember that the divisor is achieved by subtracting the margin percentage needed from 100. For example, to achieve 40% gross profit, the divisor is 60; for 25% gross profit, the divisor is 75, etcetera.

Possibility 2: Using outdated cost numbers

Keeping your retail prices current can be a chore, especially when you may sell thousands of items. Many businesses without a good system think it too time consuming to change retail prices promptly when their cost changes. Hence, they may only change a few of the more costly items as prices increase, but do nothing about those of lesser cost. It's not unusual to find a business with retail prices based on 10 year old cost price sheets! Let's look at the seriousness of failing to increase retail prices promptly. For this example, we'll start with the situation used in Possibility 1. The owner doesn't change the $75 retail price, although his cost has risen from $52.50 to $58.50 in one or more steps. His margin is now $16.50 (75.00 - 58.50 = 16.50). We next divide the current margin (16.50) by the selling price (75), and learn the current margin percentage is now only 22% instead of 30%! You may want to ask an Anabaptist Financial advisor for ideas on simple ways to keep this disaster from happening in your business.

Possibility 3: Discounting

We all have customers who demand discounts—because of a large purchase they are negotiating, or what they claim is a lower price down the street, or for dozens of other reasons. As owners we want to make the sale. We need the business, and don't want to lose the order to someone else. So, we are tempted to give a discount. But be careful. Perhaps you are wavering about giving a 15% discount off of your regular $1,000 price. You may feel a discounted price is better than no sale. After all, you'll still be receiving $850. Really? Let's suppose your regular price was figured to give you a 25% margin. That means you have $250 calculated into the regular price as your margin. By discounting it 15%, you are giving away more than 1/2 of your gross profit. Do you have enough of margin left to cover your fixed operating expenses? That is doubtful. It's quite probable that you will actually lose money on the transaction, even if you used the correct mathematical calculation to achieve your intended 25% margin before the discount. But what if you are still using the wrong markup method? That is, multiplying your cost times .25 to figure a 25% margin (see Possibility 1 above). Using the wrong method to figure 25% only provides you with a 20% margin, and now you are proposing to give 3/4 of that meager 20% away by discounting 15%? Preposterous!

But you may ask, "What can I do to prevent the loss of a sale I need so badly, unless I discount?" Learn proper selling techniques, and you can turn many of your 'discount or else' prospects into customers who will pay you a fair price. Persons who are merely order-takers are the ones vulnerable to discount demands.

Possibility 4: Selling to wholesale customers

We all recognize the fact that wholesale customers legitimately buy at wholesale prices. So it's easy to understand why our total business margin shrinks when we offer both wholesale and retail sales. At first glance, it appears that we have the same problem as in Possibility 3—Discounting. But it is different. Wholesaling may be a good thing. Please don't misunderstand. It may be good, or it may not be good. It depends on several factors. The first thing to consider is what expenses you may save with wholesale customers. For example, pretend you give a 20% wholesale discount, and further that you can service those customers with a 50% savings in your normal expenses. The result may be an adequate net profit even at the wholesale price.

You begin by separating your business into two distinct divisions: Retail and Wholesale. Sales, Expenses, and Cost of Goods are kept separate. It's almost like having two separate businesses. Yes, you can share some expense items. For example, perhaps both divisions do business from the same building. You choose a fair distribution of the rental cost. Perhaps the retail division is charged 60% of the rent, and the wholesale division is charged 40% (or any other equitable division). But the critical thing is that each division has its separate margin and separate financial statements. In this way your margin percentages aren't being skewed by the ratio of retail and wholesale sales to the total. Each division stands alone, and each can be judged on its own profitability.

Possibility 5: Obsolescent merchandise

This item probably isn't a big factor in a business such as auto parts. A muffler made to fit a 2003 Chevy probably has just as much value in the year 2009 as it did in 2008. But a 2008 model Chevy auto which was never sold is worth much less in 2009 than it was in 2008, just because it is now last year's model. Businesses which are vulnerable to obsolescent or shop-worn merchandise must constantly be alert. They need to have a higher than normal profit margin, to offset the inevitable closeout prices required to clear out the leftovers at the end of the season. They need to buy very carefully to minimize leftovers. In fact, it is usually better to 'sell-out' of seasonal merchandise before the end of the season, then to have a lot of seasonal stock leftover which you need to sacrifice at leftover prices at season end. Care must be taken to minimize inventory damage by better display methods, and in rotating stock. Again, ask for assistance from persons who have had experience dealing with this problem.

Possibility 6: Inventory shrinkage

Shrinkage is a benign word to describe a bad situation. Let's call it what it is: it's the stealing of your inventory by your customers and employees. In many businesses with large shrinkage losses, employees may steal for many years before the owner becomes aware of the problem. But a business that monitors its margin percentage constantly will be aware that something is awry if the margin percentage begins dropping for no apparent reason. This fact emphasizes the importance of tight margin control. Margin percentage then becomes an 'early warning signal' if shrinkage begins. We don't have space in this article to describe things you need to do to minimize shrinkage. But be alert. It is usually the long-term employee whom you totally trust who develops sticky fingers.

Richard Shank serves as a Business advisor for Anabaptist Financial. He has over 30 years of business experience, and has participated in owning and managing four businesses. Richard also serves on various non-profit ventures including President of Christian Light Publications, Inc.