

HYPERGROW YOUR BUSINESS!®: Its All in the Margins

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Law three of the HYPERGROW program looks at the topic of pricing, one which challenges many small (and large) business owners to "refine to perfect pricing." No discussion of "perfect" pricing is complete, however, without considering the concept of margins.

When looking at margins, we are examining the intersecting point of two vitally important concepts in the development of the business: marketing - the comprehensive relationship between a company and its customers and potential customers, and finance - the way money flows into and out of a business. Both factors rely on each other and cannot succeed without the other. Margin is where these points come together in a business - as they are both influenced by pricing decisions, so the concept cannot be overemphasized.

For a better understanding, let's dive into some accounting semantics and define some of the major terms. Typically margins refer to the accounting concept of GROSS MARGINS, which are found on the income (also called the profit and loss) statement. GROSS MARGINS can be expressed both in terms of a dollar amount and a percentage. Let's look at an example.

Consider that Jane has a gift shop and buys a certain gift item for \$6 each, but turns around and sells that product to customers for \$9 each, making a \$3 profit each unit. In this instance, GROSS MARGIN subtracts the selling price (\$9) from the product cost (cost of goods sold - \$6), to come up with a GROSS MARGIN DOLLARS of \$3 per unit. This is considered not only by individual unit, but also on the combined whole. If she sells \$23,000 in a given month and her cost of goods sold for those items is \$12,000, then the GROSS MARGIN DOLLARS are \$11,000.

And while knowing gross margin dollars is important, it is perhaps even more important to learn the GROSS MARGIN PERCENTAGE, which simply divides gross margin dollars by the sales price. In the instance with the \$9 item, the GROSS MARGIN DOLLARS are \$3 or 33% of revenues. In the case of \$23,000 sales in a month with \$11,000 of cost, the GROSS MARGIN DOLLARS are \$12,000, but the percentage is 52.2%.

Tracking and managing margins can be one of the most important things a business does. In some businesses, for instance a law firm, may not sell physical products and the concept of "cost of goods sold" may not be as tangible. The firm does, however, pay its employees a certain amount per dollar, yet bills their services out at a higher rate. So the concept of margins also applies here as well.

So what does this have to do with pricing? Well a lot. One way you can use margins is to determine a targeted margin rate. A way to start with this process is to look at the average margin percentages companies earn in your industry. It does not mean to be average, but it gives you a baseline understanding of the ballpark you should

be in. It also lets you make a conscious decision about where your margins should perform in relation to the industry average. Being higher (or even lower) is fine, but make that decision with the knowledge of where the industry performs.

How do you find these averages? Talk to vendors, talk to other businesses in your industry who are maybe not competitors, talk with your accountant based around a margin target necessary to support your business and meet your profit objectives, and consult the financial books which list some of these average financial ratios by industry. For instance, RMA, FRA, and the IRS all have books which list standard industry ratios. (Gross margin percentage is a ratio, by the way!)

While comparing yourself to others in the industry is valuable, even more important is tracking your own margin rates over the course of time. Are they getting stronger or weaker? How much? And why? Much of this article is rather basic, but I have worked in many larger, well established companies who could do a significantly better job tracking their margins over time. Personally, I prefer to use charts - they paint an important picture.

Another thing to consider is markup - a related, but different concept. Often people use the terms "margin" and "markup" interchangeably, and while the two terms talk about a similar theory, they are different. Markup actually divides the GROSS MARGIN DOLLARS by the product cost, not by the product selling price as margin does.

Go back to our instance of a product which sells for \$9, but costs the retailer \$6. The gross profit dollar per unit is \$3. The gross margin % is 33%, but the markup % is 50%. Markup compares the profit (\$3) to the cost paid (\$6). While the concept is the same, the result is - and usually will be - different. For instance, a product with a 100% markup, actually has a 50% gross margin percentage.

When discussing this concept, be sure you do not confuse margins and markups. Many business owners have done this with a high cost! The key is to clarify when you are speaking with others people (vendors, employees, etc) knowing that many people mix these two concepts up.

A simple tip is that gross margins can NEVER be above 100% (technically, unless you have a negative product cost). Markups can and often are over 100%. You will commonly hear people say "200% margin," which is just not possible. They mean markup. Sorry if that's a little confusing, but making this basic distinction can be very important.

Managing your margins is a huge part of "refining to perfect pricing" and ultimately in the successful results you seek from your business. Put margins on the front burner of how you run - and HYPERGROW - your business!

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