

Mark up or gross margin? Which is better

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What's the difference between markup and gross margin? Which is better to use? I was told our gross margin percentage is much smaller than our mark up percentage. That disturbed me as I thought they were pretty much the same! Now I wonder if we're in control of our costs and profit as much as I thought.

Markup and gross margin are both essential tools for predicting and controlling the business' future. Comparing markup percentage with gross margin percentage is like comparing the energy it takes to climb up hill with running down hill. It takes more energy to climb up hill, just like it takes a bigger percentage to get from cost to produce (or cost of goods sold) to revenue - which is your mark up, as compared with the energy it takes to run down hill, which would be the gross margin percentage, or percentage of revenue that turns into gross margin.

Revenue from every sale gets divided into two buckets. Bucket #1 is the **cost to produce bucket**, aka the cost of goods sold, and bucket #2 is the **leftovers bucket**, aka gross margin.

Gross margin and cost of goods sold add up to 100% of sales revenue. Every sales dollars goes into one bucket or the other. Whatever doesn't go to produce the goods sold, ends up in the leftover, or gross margin, bucket.

The leftovers bucket, aka gross margin, pays for things like fixed overhead costs, overhead salaries and benefits, marketing and sales efforts, debt repayment and reserve building, as well as profits for the owner. Salaries, overhead, and debt repayment are generally the first dollars to come out of the leftover bucket. Owner profit usually comes from the bottom of the leftover bucket after everything else is taken out.

Calculate gross margin by deducting from sales all costs required to produce those goods that were just sold. Calculate gross margin percentage by dividing gross margin dollars by revenue from sales. Here's an example, let's say that 2009 results year to date look like the following:

- Sales revenue: \$200
- Cost to produce the goods or services that must be delivered: \$125

Now calculate:

- Gross margin \$: $(\$200 - \$125) = \$75$
- Gross margin %: $\$75 / \$200 = 37.5\%$

Check facts from a previous year.

- Sales revenue: \$300
- Cost to produce the goods or services that must be delivered: \$185

Now calculate:

- Gross margin \$: $(\$300 - \$185) = \$115$
- Gross margin %: $(\$115 / \$300) = 38.3\%$, pretty close to 2009's 37.5%

If the gross margin percent is way off, you probably have some fixed carrying costs in the cost to produce goods or services.

Get those fixed costs that are related to sales, but don't vary as sales go up and down, out of cost of goods sold and into their own category in overhead expenses.

Gross margin percentage helps to define the amount of dollars left over after sales are delivered. You can use the gross margin to play out scenarios ahead of time. Guess at what revenue you think will come in, whether up or down, and calculate the amount of gross margin that will come in as a result. Then compare gross margin with overhead carrying costs, to see if there will be enough left over to pay you, the owner, as well as to make payments on loan principal and invest in future growth efforts and infrastructure.

Now that you have a good handle on what will happen to the business under varying income conditions, you can start to plan. There's a competitive advantage to knowing ahead of time if you're going to like the outcome. Knowing what will likely happen in the future gives you incentive to keep going in a positive way, or make changes before things play out in a way you don't want.

Once you've calculated revenue and gross margin, you can run the figures back upwards, to check your markup. Figure out the dollars of gross margin you'll make in a specific scenario. Divide your revenue target by gross margin dollars target to figure out your markup. Decide if this markup is sufficient to keep the business on track with it's markup. If so, keep going, if not, go back to the drawing boards to figure out if the problem is that you're not charging enough, or your customers have hit their limit of what they'll pay and you'll have to figure out how to produce more inexpensively, or both.

Looking for a good book? Try "Gross Margin, 26 Factors Affecting Your Bottom Line" by Bill Lee.

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