

Margin versus Markup

From "Know Your Numbers,
Unlocking Financial Success for Small Business",
Developed by the Northland SBDC of MN

In the context of selling products for a business, margin and markup are two important concepts that help determine pricing and profitability. Margin refers to the difference between the cost of a product and its selling price, expressed as a percentage. It represents the portion of revenue that exceeds the cost of goods sold (COGS) and other expenses. Margin is calculated using the formula:

$$\text{Margin} = (\text{Selling Price} - \text{Cost}) / \text{Selling Price} * 100\%$$

Markup, on the other hand, is the percentage by which the cost price of a product is increased to determine its selling price. It reflects the proportion of profit added to the cost of the product. Markup is calculated using the formula:

$$\text{Markup} = (\text{Selling Price} - \text{Cost}) / \text{Cost} * 100\%$$

Let's say you have determined you need to make **26%** on the products you sell to obtain a high enough gross profit to pay the expenses and yourself.

You purchase a widget for \$4.00. You decide to multiply the \$4.00 by **1.26** to incorporate 26% profit, and you get a sale price of \$5.04. Will this give you the desired **26%** you want?

If you sell 1 widget for \$5.04 and the cost is \$4.00 you will have made \$1.04 in profit.

This is called markup.

Now let's change how we decide on a selling price. Using the same \$4.00 cost we will figure selling price based on margin instead of markup. Take the **26%** you want to make and subtract it from 100%. You get 74% or 0.74 converted to decimal.

Now take the \$4.00 cost and divide by 0.74 and you get a selling price of \$5.41.

You have now made \$1.41 in profit as opposed to \$1.04., an increase of \$0.37 cents per widget.

If we go back and look at the margin for the \$5.04 price. \$1.04 profit divided by \$5.04 will give us \$.206 or 20.6 % margin versus the 26% margin.

[Video: What's the Difference Between Gross Margin vs Gross Markup?](#)

Target Ratios

Ratios and Benchmarking

A ratio is a calculation and method of looking at your numbers. We develop ratios to compare your company with industry benchmarks for companies like yours. We use the NAICS codes or North American Industry Classification System to compare similar companies.

[Video: Financial Ratio Analysis](#)

Common Ratios for business financial analysis are as follows.

| Ratio | Formula | Significance |
|-----------------------------------|---|---|
| Balance Sheet Ratios | | |
| Current | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ | Measures Solvency: e.g. a ratio of 1.76 means that for every \$1 of current liabilities, the Co. has \$1.76 in Current Assets with which to pay. |
| Quick | $\frac{(\text{Cash} + \text{Accts. Rec.})}{\text{Current Liabilities}}$ | Measures Liquidity: e.g. a ratio of 1.14 means that for every \$1 of current liabilities, the Co. has \$1.14 in Cash and Accounts Receivable with which to pay. |
| Net Margin | $\frac{\text{Net Profit Before Tax}}{\text{Sales}}$ | Measures Net Profitability: e.g. a ratio of 2.9% means that for every \$1 of sales, the Co. produces 2.9 cents of gross profit. |
| Specific Efficiency Ratios | | |
| Inventory Turnover | $\frac{\text{Cost of Goods Sold}}{\text{Inventory}}$ | Measures the Rate at Which Inventory is Being Used on an Annual Basis: e.g. a ratio of 9.81 means that the average dollar volume of inventory is used up almost ten times during the fiscal year. |
| Inventory Turn-Days | $\frac{360}{\text{Inventory Turnover}}$ | Measures the Average Number of Days that Inventory Remains in Stock: e.g. a ratio of 37 means that the Co. keeps an average of 37 days worth of inventory on hand throughout the year. |
| Accts. Rec Turnover | $\frac{\text{Sales}}{\text{Accts. Rec.}}$ | Measures the Rate at Which Accts. Rec. are Being collected: e.g. a ratio of 8.00 means that the average dollar volume of Accts. Rec. are collected 8 times during the year. |
| Avg. Collection Period | $\frac{360}{\text{Accts. Rec. Turnover}}$ | Measures the Average Number of Days that the Co. Must Wait for Its Accts. Rec. to be Paid: e.g. a ratio of 45 means that it takes 45 days on average to collect its receivables. |
| Accts. Pay. Turnover | $\frac{\text{Cost of Goods Sold}}{\text{Accts. Pay.}}$ | Measures the Rate at Which Accts. Pay. Are Being Paid: e.g. a ratio of 12.04 means that the average dollar volume of Accts. Pay. are paid about 12 times during the year. |
| Avg. Payment Period | $\frac{360}{\text{Accts. Pay. Turnover}}$ | Measures the Average Number of Days that a Co. Takes to Pay its Accts. Pay.: e.g. a ratio of 30 means that it takes the Co. 30 days on average to pay its bills. |

Finding Cash in Your Business

Inventory although a very important component of product-based companies is also a very important component in the company's cash situation. You need to look at every piece of inventory as actual dollars sitting on the shelf.

If you have an item that cost you \$20.00 and it has been sitting on your shelf for 2 years, that is \$20.00 that could have been in your checking account and available to pay debt, payroll, and other business expenses - or even cash distribution to you.

Not enough inventory and you run out of stock and customers are not happy. Too much inventory and you are lacking cash because it is sitting on the shelf.

Your inventory level can be measured in many ways. One way is to look at the ratio of how many times your inventory turns during a year or quarter or month. The more turns the faster your inventory is being depleted and replenished.

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| Inventory Turnover | $\frac{\text{Cost of Goods Sold}}{\text{Inventory}}$ | Measures the Rate at Which Inventory is Being Used on an Annual Basis: e.g. a ratio of 9.81 means that the average dollar volume of inventory is used up almost ten times during the fiscal year. |
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| Inventory Turn-Days | $\frac{360}{\text{Inventory Turnover}}$ | Measures the Rate at Which Inventory is Being Used on an Annual Basis: e.g. a ratio of 9.81 means that the average dollar volume of inventory is used up almost ten times during the fiscal year. |
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A second way to find cash in your business is to look at accounts receivable and how long it is taking your customers to pay you. Again, if you are not being paid on time you will need to borrow or look for cash to put into the business.

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| Avg. Collection Period | $\frac{360}{\text{Accts. Rec. Turnover}}$ | Measures the Average Number of Days that the Co. Must Wait for Its Accts. Rec. to be Paid: e.g. a ratio of 45 means that it takes 45 days on average to collect its recievables. |
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