

THE DR. IS IN

By **LESLIE SHINER**



MARGINS & MARKUPS

Are you calculating correctly, and do you really know the difference?

Most electrical systems contractors (ESC) can tell me right off the bat what their markups are for equipment. They live and die by markups. At the same time, everyone complains that margins are falling—it's harder to sell products and services to obtain a high enough margin to cover overhead and profit. All these statements are true—but does your Profit and Loss (P&L) statement tell you what margins you need? What markups you should charge?

Don't confuse margin with markup

Many ESCs understand the difference between margin and markup. But many other small business owners continue to confuse the two numbers. I've spoken with many ESCs who look at their P&L and incorrectly interpret margin numbers to use as a markup.

The key is to remember that margin is always represented as a percentage of revenue; markup is always represented as a percentage of costs. If you charge the customer \$120 for something that costs you \$78, then you make a \$42 gross profit. That means that \$42 is left over to pay your overhead and leave some profit. The margin is determined by taking the gross profit (\$42) and dividing by the sales (\$120) to achieve 35 percent. Gross profit refers to dollars; gross margin refers to percentages. Therefore, in the above transaction, you earned a 35 percent gross margin.

$$\$120 - \$78 = \$42 \quad \$42 \div \$120 = 35\%$$

The markup is determined by taking the gross profit (\$42) and, instead of dividing by it by the sales, divide it by the costs (\$78). Therefore, the markup is 54 percent.

$$\$42 \div \$78 = 54\%$$

"Sure", you say, "I knew that!" The mistake comes when you use a margin number as a markup. If you print out a P&L, it typically provides only margin numbers. It represents all costs as a percentage of sales. So if you sold 100 of those items and created a P&L, it will look like this:

Profit & Loss Statement		
Sales	120,000	100.0%
COGS	78,000	
Gross Profit	42,000	35.0%
Overhead	30,000	25.0%
Net Profit	12,000	10.0%

In fact, if you ask your accountant what your overhead and profit is, he or she might just tell you that it is 25 percent and 10 percent respectively. But that's 35 percent of your sales (not of your costs). Remember, your sales figure should always be significantly larger than your cost figure. What happens if you use that number the next time you create a proposal? If you have a job that includes the same \$78 of equipment, you might be tempted to mark it up by 35 percent (25 percent for overhead and 10 percent for profit). The result is that you will only charge \$105 for that same product. And your financial statement would then look like this:

Profit & Loss Statement		
Sales	105,300	100.0%
COGS	78,000	
Gross Profit	27,300	25.9%
Overhead	30,000	28.5%
Net Profit	(2,700)	-2.6%

And, now you've lost money!

Therefore, if you want to use the margin numbers from your financial statements to price out proposals, you need to divide by

2	1,293	41	25.73%
8	2,487	115	23.96%
8	2,384	112	17.96%
1	1,429	63	41.00%
6	1,203	44	16.77%
	3,094	123	2.81%
	2,094	75	5.24%
	3,027	131	1.71%
	7,115	1,391	10.75%
		110	1.84%
		263	1.77%
		460	2.14%
		243	4.33%
		1,076	2.62%
			2.71%
			4.67%
			3.62%
			1.96%
			4.82%
		32	3.39%
		107	13.78%
		131	1.31%
		134	12.85%
	68	372	8.18%

the reciprocal of that margin. If you want to price that \$78 piece of equipment, take the cost and divide by 65 percent (100% - 35%). \$78 divided by 65 percent produces the \$120 sales price.

- Cost = \$78
- The margin = 35%
- The reciprocal of the margin (100% - 35%) = 65%
- To price the job, divide the cost by the reciprocal $\$78 \div 65\% = \120

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As many ESCs reduce prices to stay busy, they are often underpricing jobs so drastically that they are not able to cover their overhead. This is a dangerous position.

As I travel around the country speaking to ESCs, I'll ask how many in the audience determine the sales price by multiplying expected costs by a number and how many divide by a number. And the answer is typically about half and half. You can do it either way, but what you can't do is determine the costs of the job and multiply by the margin goal. If you do, you will consistently underprice your jobs. You may stay busy, but sooner or later, you will not make enough money to cover your overhead, let alone earn a profit.

What's the right number?

Now the \$64,000 question: "What is a good markup?" or "What margin should I use?" I can't answer that question, since there are many factors that you need to consider. Your margin must provide enough money to:

- Cover your overhead
- Provide a profit
- Cover potential slippage

Slippage occurs when you spend more money on the job than you expected. If, after the job is complete, the gross margin is less than expected, you have slippage. Therefore, if you consistently price jobs with a 40 percent margin, but come in at 30 percent, you are not managing the jobs and your gross margin will suffer from slippage.

As many ESCs reduce prices to stay busy, they are often underpricing jobs so drastically that they are not able to cover their overhead. This is a dangerous position. It is better to do less work with a consistent profit than more work at a loss. You can't

compensate for low profit by raising your volume. Review your financial statements to determine what margin you are making on your jobs. Separate and analyze the margin on equipment as compared to the margin on labor. If the margin you achieve on labor is significantly different than the margin on equipment, be careful when you produce a proposal that has a considerably different equipment-to-labor mix.

Look at the type of work you are doing—commercial work typically yields a lower margin than residential work. If you are considering moving from one market to the other, be sure that you have a system in place to track actual costs against expected costs. And make sure you do not confuse your markup with your margin the next time you produce a proposal. **CR**