REPRINTED FROM THE

TUESDAY, DECEMBER 12, 2006

NEW YORK

Real Estate Journal

COVERING ALL OF LONG ISLAND, NEW YORK CITY AND UPSTATE NEW YORK

Simple mistakes in the business world can lead to dire results

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During Game 6 of the1986 World Series, the Red Sox were one strike away from winning the World Series, but ultimately lost when first baseman Bill Buckner allowed a slow grounder to roll under his glove into right field. The Red Sox eventually lost the World Series which is considered one of the greatest collapses in sports history.

The University of North Carolina played the University of Michigan for the Men's College Basketball National Championship in 1993. Michigan trailed by 2 points with 19 seconds left and Michigan forward, Chris Webber, called a timeout. Unfortunately for Webber, Michigan had no timeouts remaining and a technical foul was assessed. North Carolina subsequently made both free throws and eventually won by 6. The errant time out haunted Webber throughout his career in professional basketball.

For those of you that are not sports fans, I'll never forget the day that Vice President Quayle told a sixth grader that "potato" was spelled with an "e" at the end. He later wrote a book in 1994 and devoted a whole chapter to the events in the classroom at Munoz Rivera School. "It was a defining moment of the worst kind imaginable," Quayle wrote in the autobiography.

In the business world, I have noticed that a simple concept is often misunderstood by the average entrepreneur and the result can be damaging to the respective business. The concepts of mark-up and gross profit margin (GPM) are so basic that they are taught in Accounting 101. However, they are often calculated improperly and often mistaken to mean the same thing. In addition, these simple calculations can help assess the financial picture of most businesses.

Mark-Up (Based on Cost)

Mark-up is the percent or dollar amount by which the purchase price/cost of a product is increased to arrive at the sales price. For example if the purchase price/cost of a product/service is $300 and you mark-up by 25%, the selling price would be $375. The mark-up on cost is $75 or 25%.

Gross Profit Margin (Based on Sales Price)

Gross profit is the dollar amount of profit generated from a product or service. Using the above example, the gross profit is also $75 ($375 selling price less $300 purchase price/cost). However, the GPM is calculated by dividing the gross profit of $75 by the sales price of $375 and amounts to 20% of the selling price.

Difference

The difference is fairly easy to see in the above calculation. A 25% mark-up on costs is the equivalent of a 20% GPM. I am amazed by the number of individuals that believe a 25% mark-up yields a 25% GPM. Let's assume that you actually needed a 25% GPM in your business to break even. The mark-up would be 33.33% as follows: purchase price/cost of the product/service is $300 and you mark-up by 33.33%; the selling price would be $400. The mark-up on cost is $100 or 33.33%. The GPM is $100 divided by $400 = 25%. Let's assume that you actually needed a 50% GPM in your business to break even. The mark-up would be 100% as follows: purchase price/cost of the product/service is $300 and you mark-up by 100%; the selling price would be $600. The mark-up on cost is $300 or 100%. The GPM is $300 divided by $600 = 50%. One can easily see the serious ramifications of assuming that mark-up and GPM are the same.

The following formula calculates the mark-up for a desired GPM

Cost divided by (100% - Target GPM). For example, if the cost of the product is $1 and you require a 25% GPM, the mark-up is calculated as follows: $1 divided by (100% - 25%) = $1 divided by .75 = $1.33 sales price or a 33.33% markup. If you require a 50% GPM, $1 divided by (100% - 50%) = $1 divided by .50 = $2 sales price or 100% markup).

Utilizing Gross Profit Margin

- The GPM for a business can be compared to the average for the respective industry. Deviations from industry average should be thoroughly investigated and included as part of the due diligence if acquiring a business.
- The GPM can be calculated by product or service provided. Items that provide no or low gross profit margin should be reassessed.
- Breakeven analysis by product/service or the business as a whole can be calculated.
- If the calculated GPM (based on mark-up) is not being achieved, the respective sales prices must be reviewed for accuracy.

Unfortunately, simple mistakes in the interpretation of business concepts can have a significant negative impact on business profitability.

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