

Getting to know Markup



ALL THINGS FINANCIAL

Paul Fyfe, an Independent Financial Advisor, Property and Business Broker explores and gives commentary on the above subject.

UNDERSTANDING MARK UP AND GROSS PROFIT.

So often in the process of buying and selling a business, either the buyer or the seller gets confused with the aspects of mark-up and gross profit, sometimes with disastrous effects. The importance of understanding the difference can be seen in this simple example:

After buying a stock item for R100 a shopkeeper adds R15 to the sale price to cover his expenses and a further R15 mark up to provide the necessary profit. A cash buyer is then offered a 20% discount which reduces the price of R130 to R104. This leaves the shopkeeper with a R4 gross profit from which he still has to deduct his expenses of R15. The end result is a loss of R11 on the sale. The problem arose because he mistakenly thought that as he had added 30% onto the cost of the product, he would still make 10% if he gave away 20%. He didn't understand mark-up and gross profit. Mark up is what is added to the cost price of the item to cover expenses and provide a gross profit. Gross profit is what is left after deducting the costs of the item from the selling price. Run-

ning expenses need to be deducted to reach the net profit. This is a very common mistake and will lead the business to financial ruin. Obviously the seller will sell more than one item to contribute to covering the expenses, but the point is to be careful. In your investigations you will also want a breakdown of the gross profit percentage for each item. This will help to determine which items are contributing the most to the gross profit. It should be possible to determine whether these percentages are average for the industry. For instance, why should a particular hardware store be showing a 40% gross profit when the average for that business is 35%? The answer could be that the store is in a monopolistic position and can therefore sell at a higher price or maybe the owner gets bulk discount from the wholesaler. Conversely, if he only achieved a 30% gross profit, was the cause poor buying or perhaps pilfering? This could be an opportunity for a buyer to find the problem and turn it round into a larger profit. In 99% of small to medium sales, the buyer would not take over the seller's debtors and creditors. He would buy the business as a going concern and the seller would collect all



the money due to him and pay all his accounts up to date. In regard to the debtors the buyer needs:

- ◆ An age analysis to determine how much time clients have been given to settle accounts. The longer the period, the greater the working capital needed.
- ◆ A breakdown of bad debts. It's one thing making a sale, it's another getting paid.

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