How to avoid three common profit mistakes

What exactly is profit in a business? This article shows you how to avoid three common profit mistakes that can seriously affect the success of your business.

1. Sales are NOT profit

The biggest beginner mistake is assuming that sales are profit.

People new to business can easily confuse sales with profit, but there is a very clear distinction between them. As the saying goes, 'sales are vanity, profit is sanity'.

Let's assume sales are going well in your new business. You're in a happy mood because you have all that profit coming in. Except it may not be profit...

Your profit is actually what is left after ALL your costs have been deducted from sales.

If you haven't calculated your selling prices correctly, the danger is that your business might seem to be thriving when it is in fact operating at a loss, or at very little profit.

It does happen.

The main point here is: NEVER set a selling price or tender a price for a job until you know ALL the costs involved.

There are two types of business costs. First are the variable costs. These are direct costs of production that vary with sales levels. They include the cost of raw materials or stock, and the direct labor costs of producing the goods or supplying a service.

Second, all businesses have fixed costs, also called overheads. However much or little you sell each month, you must pay relatively fixed costs such as rent or mortgage, phones and Internet, utilities, vehicles, loans and leases, and other office costs. You need to include these costs, or at least a percentage of them, in your pricing.

When you start a business, it's important to get your pricing and job costing checked by an experienced accountant or financial adviser, because they may well identify costs that you have overlooked.

Only when you know all your costs can you start selling with the confidence that your prices are profitable.

2. Markup is NOT profit margin

Once you have calculated all your costs, you must include the profit margin you need to sustain the business. This leads on to the second profit mistake.

Many business owners assume that if they intend to make, say, a 20% profit, they can simply add 20% on to the cost-price of a product or service. So if the item or service costs them $100, they add on 20%, making the selling price $120. They assume this will give them their desired profit margin of 20%.

Wrong.

Markup is not the same as profit margin. In this case, the owner may assume the business is making a 20% profit, but the profit on the actual sales price is only 16.67%.

You can use this formula to work out profit margin:

Price - Cost

Price x 100

In this example, 120 – 100 is 20, divided by 120 and multiplied by 100 (for a percentage), resulting in an actual profit margin of16.67%.

So while the owner assumes the business is making 20% on all sales, the selling price is actually giving away 3.3% of the expected profit.

The gap between markup and profit margin keeps widening as required margins get higher. If you want to make a 50% profit margin on an item that costs $100, the correct selling price would have to be $200, since 50% of $200 is $100.

If you had instead simply added a 50% markup to the cost price of $100, the selling price would have been set at $150. Apply the formula above, and the profit margin works out to be only 33.3%. The mistake of using markup to achieve your desired 'profit margin' would have meant giving away nearly 17% of profit margin. You can see how dangerous this mistake can be to a business.

The point is to check your profit margins are really what you want them to be. Decide what minimum acceptable profit margin you need to sustain your business, and then get help if necessary from your financial adviser to check that your selling price will actually deliver the required profit margin.

3. Profit is NOT your salary

Many new business owners assume any surplus profit is what they should take out of the business as their salary. But profit has other purposes than providing a salary.

Your salary should instead be included as part of business costs, so profit more accurately becomes any surplus money left over after you have taken your salary and paid all other costs (including tax).

All businesses need profit and its purpose is to sustain and grow your business.

Of course it may take some time for a start-up business to reach the break-even point and start making a profit. During this time you may not be able to draw much money from the business. Being thrifty during this period is a common necessity for start-up owners.

But in the medium to long term, you need to aim for a salary that is at least in line with what you could earn elsewhere as an employee – and preferably better. Otherwise, what is the point of all the risk and hard work in starting a business?

You also need to aim to make enough profit to continue growing your business and renewing the assets that help it produce the wealth. Your advisers can help you work out a sustainable profit level for your business, and this should be reflected in your pricing.