# Part I
# Margins and Profits

Peter Drucker has written that the purpose of a business is to create a customer. As marketers, we agree. But we also recognize that a business can't survive unless it makes a margin as well as a customer. At one level, margins are simply the difference between a product's price and its cost. This calculation becomes more complicated, however, when multiple variations of a product are sold at multiple prices, through multiple channels, incurring different costs along the way. For example, a recent *Business Week* article noted that less "than two-thirds of GM's sales are retail. The rest go to rental-car agencies or to company employees and their families—sales that provide lower gross margins."[1] Although it is still the case that a business can't survive unless it earns a positive margin, it can be a challenge to determine precisely what margin the firm actually does earn.

In the first section of this part, we explain the basic computation of unit and percentage margins, and we introduce the practice of calculating margins as a percentage of selling price.

Next, we show how to "chain" this calculation through two or more levels in a distribution channel and how to calculate end-user purchase price on the basis of a marketer's selling price. We'll explain how to combine sales through different channels to calculate average margins and how to compare the economics of different distribution channels.

In the third section, we discuss the use of "statistical" and standard units in tracking price changes over time.

We'll then turn our attention to measuring product costs, with particular emphasis on the distinction between fixed and variable costs. The margin between a product's unit price and its variable cost per unit represents a key calculation. It tells us how much the sale of each unit of that product will contribute to covering a firm's fixed costs. "Contribution margin" on sales is one of the most useful marketing concepts. It requires, however, that we separate fixed from variable costs, and that is often a challenge. Frequently, marketers must take "as a given" which of their firm's operating and production costs are fixed and which are variable. They are likely, however, to be responsible for making these fixed versus variable distinctions for marketing costs. That is the subject of the fifth section of Part I.

In the sixth section, we discuss the use of fixed- and variable-cost estimates in calculating the break-even levels of sales and contribution. Finally, we extend our calculation of break-even points, showing how to identify sales and profit targets that are mutually consistent.

| | Metric | Construction | Considerations | Purpose |
|---|---|---|---|---|
| 1. | Unit Margin | Unit price less the unit cost. | What are the standard units in the industry? May not reflect contribution margin if some fixed costs are allocated. | Determine value of incremental sales. Guide pricing and promotion. |
| 1. | Margin (%) | Unit margin as a percentage of unit price. | May not reflect contribution margin if some fixed costs are allocated. | Compare margins across different products/sizes/forms of product. Determine value of incremental sales. Guide pricing and promotion decisions. |

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| 2. | Channel Margins | Channel profits as percentage of channel selling price. | Distinguish margin on sales (usual) from markup on cost (also encountered). | Evaluate channel value added in context of selling price. Calculate effect of price changes at one level of channel on prices and margins at other levels in the same channel (supply chain). |
| 3. | Average Price per Unit | Can be calculated as total revenue divided by total unit sales. | Some units may have greater relevance from producers' perspective than consumers' (e.g., ounces of shampoo versus bottles). Changes may not be result of pricing decisions. | Understand how average prices are affected by shifts in pricing and product mix. |
| 3. | Price per Statistical Unit | SKU prices weighted by relevant percentage of each SKU in a statistical unit. | Percentage SKU mix should correspond over medium-term to actual mix of sales. | Isolate effect of price changes from mix changes by standardizing the SKU mix of a standard unit. |
| 4. | Variable and Fixed Costs | Divide costs into two categories: those that vary with volume (variable) and those that do not (fixed). | Variable costs may include production, marketing, and selling expenses. Some variable costs depend on units sold; others depend on revenue. | Understand how costs are affected by changes in sales volume. |
| 5. | Marketing Spending | Analyze costs that comprise marketing spending. | Can be divided into fixed and variable marketing costs. | Understand how marketing spending changes with sales. |

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| | Metric | Construction | Considerations | Purpose |
|---|---|---|---|---|
| 6. | Contribution per Unit | Unit price less unit variable cost. | Ensure that marketing variable costs have not already been deducted from price. | Understand profit impact of changes in volume. Calculate break-even level of sales. |
| 6. | Contribution Margin (%) | Contribution per unit divided by unit price. | Ensure that variable costs are consistently based on units or revenue, as appropriate. | Same as above, but applies to dollar sales. |
| 6. | Break-Even Sales Level | For unit break-even, divide fixed costs by contribution per unit. For revenue break-even, divide fixed costs by contribution margin (%). | Variable and fixed cost estimates may be valid only over certain ranges of sales and production. | Rough indicator of project attractiveness and ability to earn profit. |
| 7. | Target Volume | Adjust break-even calculation to include profit target. | Variable marketing costs must be reflected in contribution margins. Sales increases often require increased investment or working capital. | Ensure that unit sales objectives will enable firm to achieve financial hurdle rates for profit, ROS, or ROI. |
| 7. | Target Revenues | Convert target volume to target revenues by using average prices per unit. Alternatively, combine cost and target data with knowledge of contribution margins. | Same as above. | Same as above, applied to revenue objectives. |