

Calculating the Ad Budget

Business owners have long been taught to budget 5 to 6 percent of total sales for advertising and another 5 to 6 percent for rent, or **cost of occupancy**. This formula, however, often results in underperformance due to too little being spent on advertising. The business owner who spends only 1 or 2 percent of total sales on **cost of occupancy** is seriously underspending when only 5 to 6 percent is budgeted for advertising.

The purpose of advertising is to increase the **exposure** of your business beyond what is provided by your physical location. The business owner who saves money by investing in a weak location will have to advertise much more heavily. A high **cost of occupancy** for a landmark location is often the least expensive *advertising* your money can buy.

Although there's no "one size fits all" formula for calculating the correct advertising budget, there is a concise formula for calculating the ad budget for *retail* businesses, and, in my experience, the formula can be easily adjusted to serve other business categories as well.

The following formula assumes a retail business averaging a 100 percent markup (in other words, a 50 percent gross profit margin.)

Step 1: Budget 10 to 12 percent of total *projected* sales for **total cost of exposure**.

Step 2: Adjust this figure by the store's average markup (above cost of goods sold). If the average markup is 100 percent ("keystone"), then the formula will be unadjusted (10-12 percent of projected sales \times 100 percent). If the average markup is only 91 percent, then the adjusted budget for total cost of exposure will be reduced by 9 percent (10-12 percent of projected sales \times 91 percent — see?) Likewise, if the average markup is 150 percent, then the adjusted budget for total cost of exposure would be increased by 50 percent (10-12 percent \times 150 percent).

Step 3: Deduct your **cost of occupancy** from your adjusted **total cost of exposure**. The remaining balance is your ad budget.

NOTE: Please be careful to use **MARKUP** rather than **MARGIN** in this calculation. (**Markup** is gross profit dollars expressed as a percentage of cost-of-goods. **Margin** is the same gross profit expressed as a percentage of gross sales. Hence, a 100 percent markup yields a 50 percent margin. A 200 percent markup yields a 66.67 percent margin.)

Margin is $\frac{\text{Gross Profit Dollars}}{\text{Gross Sales Volume}}$

Markup is $\frac{\text{Gross Profit Dollars}}{\text{Cost of Goods}}$

	Low budget	High budget	High budget	
	Medium markup	Medium markup	Low markup	High markup
Total annual sales	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
	x 10%	x 12%	x 12%	x 12%
Budget for total cost of exposure (occupancy + advertising)	100,000	120,000	120,000	120,000
Average markup	x 92%	x 92%	x 61%	x 117%
Adjusted budget for total cost of exposure	92,000	110,400	73,200	140,400
Cost of occupancy	-36,000	-36,000	-36,000	-36,000
AD BUDGET	\$56,000	\$74,400	\$37,200	\$104,400

See how markup affects the ad budget?