BIZ INFO LIBRARY

The P&L: Your Scorecard of Profitability

August 01, 2001
Alexander Auerbach
Content provided by The Edward Lowe Foundation

Sometimes it seems that the hardest part of building a company is fighting through unfamiliar accounting terminology. Executives who have no problem calculating the earned-run average of their favorite baseball pitcher can become glassy-eyed at discussions of "net profit margin ratio" and "break-even analysis."

Yet behind those confusing phrases are some powerful ideas. By gaining a better grasp of these terms and learning some simple tools, you can monitor your company's profitability — and improve it.

P&L jargon busting

Your company's **profit and loss statement (P&L),** or income statement (the two names are synonymous), shows your company's profit performance. It details precisely how money flowed into your company in the form of sales and other income and how it flowed out again to buy inventory and pay salaries, rent and other expenses.

The **balance sheet** reports what your company is worth and what it owes at a given instant; it's like a financial snapshot. In contrast, the P&L is more like a motion picture: It reports on cash flow over a period of time. That may be a year, quarter, month, week — or any length of time that helps you obtain the information you need.

Use your P&L statement to get a precise look at the financial "weather" your company is experiencing. What's more, you can use it to forecast stormy periods, which enables you to "batten down the hatches" in advance.

Today, companies of every size have easy access to powerful accounting software programs that make it easy to generate profit and loss statements, balance sheets and other financial reports with a few keystrokes. But first you need to understand different categories of income and expenses:

- **Revenues, or sales,** are what you receive for your products or services. This is the top line of your income statement. You subtract from it all of your expenses, and what's left is profit — the "bottom line."
- **Cost of goods sold,** also known as **cost of sales,** is the first item

subtracted from revenues. In accounting parlance, it means only the expenses that are directly related to making the products you sold during the period of time the income statement covers. These typically include purchases of raw materials or inventory, as well as the labor, freight and packaging that were directly linked to that production. *Note:* Service businesses may show little or no cost of sales on the P&L statement.

- **Gross margin** is obtained by subtracting the cost of goods sold from *net sales* (gross sales less any returns and discounts) for the period. ("Margin" is another way of saying "difference.") *Note:* Gross margin leaves out a lot of important expenses.
- **Selling expenses** include the direct and indirect costs you incur to make sales, including salaries of salespeople, commissions, sales-office costs, advertising, and costs associated with warehousing and shipping merchandise to customers. Think of this category as all the expenses related to taking and fulfilling orders.
- **General and administrative expenses** (G&A) are all of those costs that are not directly associated with the manufacture or sale of goods. G&A expenses include the salaries of people who are not in production or sales, as well as supplies, rent, depreciation, utilities, telephone, travel, license fees and other "overhead" expenses.
- **Profit from operations** is obtained by subtracting selling and G&A expenses from the gross margin.
- **Net profit before taxes** accounts for other expenses and income that don't fit into the categories above. No "other" items? Then profit from operations and net profit before taxes are the same.
- **Net profit after income tax** — the bottom line — is what's left when you calculate the amount of income taxes your company will owe and subtract that figure from net profit before taxes.

5 tools for analyzing profits

Below are five tools that you can use to measure your company's profitability.

1. Gross profit margin ratio

Divide your company's gross profit margin (what's left after you subtract cost of goods sold from net sales) by net sales. *Example:* Last year, a company's net sales totaled $10 million, while costs for inventory and production totaled $7 million. Gross profit ($10 million in sales minus $7 million in cost of goods sold) was $3 million. Divide the $3 million in gross margin by the $10 million in net sales, and you get 0.30, which means the gross profit margin ratio last year was 30%.

If you use an accounting program like QuickBooks, Peachtree or Great Plains, the software will do the calculating for you. In QuickBooks, for example, just call up a standard P&L report, click on "modify report," and select "add column for % of income." Every item on the QuickBooks

P&L will be shown in dollars and as a percent of sales.

Applying the ratio: Look back and compare your company's gross profit margin ratio to previous operating periods. Is the ratio lower today than it was earlier? If so, that suggests your production costs have risen as a percentage of sales, which means you're operating less efficiently today than you once were. If your gross profit margin ratio is higher, then you're operating more efficiently today.

Because accounting software makes it easy to generate these reports, you may want to look back quarter by quarter for several years. Even if the year-to-year percentage hasn't changed very much, you may discover significant fluctuations within the year, as weather or seasonal changes in customer demand causes your inventory levels to move up and down.

If that's the case, perhaps you can modify pricing to encourage customers to balance their purchasing. Or you may consider using outsourcing or temporary help to meet peak-period demand. You also want to ensure you have enough working capital to finance short-term inventory and production needs as your company grows.

2. Operating profit margin ratio

Operating profit margin ratio is calculated the same way as gross profit margin ratio, except that you include selling and G&A expenses. Operating profit margin is especially important because it's the primary source of your company's cash flow. If it rises from one period to the next, that's a good indication that your company is healthy. But a trend in the opposite direction is a reason to worry — and start searching for the cause fast.

As you review the historical data for your company, look for any divergences in trends for gross profit margin ratio and operating profit margin ratio. *Red flag:* If the gross profit ratio shows an up trend while the operating profit ratio does not, your selling or general and administrative expenses are rising more rapidly than sales or production expenses.

If you've deliberately increased your selling expenditures to increase market share or launch a new product, a short-term decline in operating profit margin is to be expected. But if the divergence in these ratios was not planned, it may mean you simply have allowed selling and overhead costs to creep up as a percentage of sales. That's not uncommon in fast-growing companies, where control systems are not well developed. Once you spot the problem, reining in those costs is often easy, and the result can be a sharp upturn in profits.

3. Net profit margin ratio

If you subtract all expenses including income tax from total revenues, you get net profit after tax. Calculating that as a percentage of revenues

or sales yields the net profit margin ratio.

Here again, look for fluctuations over time, by year and by quarter, to see if your company's tax situation has changed. Also, because net profit includes "other" income and expenses (items that don't fit in routine categories), variations may reflect nonrecurring items.

4. Common-size ratios

By looking at the elements of your P&L as percentages of sales, rather than as dollars, you can quickly compare your income statement with that of another company, or of your company in prior periods, line by line. *Example: Example:* In 2000 IBM's gross profit margin was 36.7% of sales, while its selling, general and administrative expense ratio was 17.7% of sales. Your P&L may have a lot fewer zeroes than IBM's, but by using ratios or percentages rather than dollars, you can immediately compare your company's operations to those of IBM or any other company. (See the sidebar "Snooping on your competition.")

5. Break-even analysis

If your company is *not* making a profit, you obviously want to know what it will take to get back in the black. If you are profitable, it's wise to keep a close eye on how much of a safety margin you have. A break-even analysis helps you accomplish this.

Break-even is the point at which your company's revenues precisely equal your expenses. You are not losing money, but you are not making any either.

To calculate the break-even point for your company, you need three pieces of information:

- Fixed expenses that your company incurs while it operates. These expenses don't fluctuate with sales volume and include items such as rent, salaries, office expenses, depreciation and overhead.
- Variable expenses that rise and fall as volume changes, such as inventory, raw material and production labor.
- Total sales. You are at the break-even point when your sales (in dollars) are equal to the total of fixed and variable expenses. *Formula:* S = F + V (S is sales, F is fixed costs and V is variable costs). If S is greater than F + V, you are beyond the break-even point and are making a profit. If S is less than the sum of F + V, you are operating in the red.

If you are below the break-even point, a glance at this formula will indicate what you need to do to correct the situation. Fixed expenses can't be changed, at least in the short term, which means your only options are to increase sales or cut variable expenses, or both.

Some simple calculations can also show you how to attain a desired level

of profit. Suppose you want to determine what level of sales will generate a pretax profit of $50,000. Remember that variable expenses are a percentage of sales. If your variable expenses are 75% of sales, replace V in the break-even analysis formula with 0.75(S). At break-even S = F + 0.75(S). If you remember your grade-school math, that's the same as S - 0.75(S) = F, or 0.25(S) = F.

But your goal isn't just to break even. If you want to surpass that by $50,000, the formula becomes 0.25(S) = F + $50,000. Assume that your fixed costs are $75,000. Now the formula becomes 0.25(S) = $75,000 + $50,000, or 0.25(S) = $125,000. That means S = $500,000. As a result, you need to achieve sales of $500,000 to show an operating profit of $50,000.

Financial tools like these give you a broad overview of your company's operations. Get familiar with them, and use them regularly. They will help you spot problems early and move more quickly toward your profitability goals.

Writer: Alexander Auerbach

About This Item
Category: Financial Management
Subcategory: Financial Statements
Keywords: Financial Analysis, Income Statements, Profit & Loss Statement (P&L Statement), Self Assessment

Content provided by:

The Edward Lowe Foundation was created by Ed and Darlene Lowe in 1985 to "champion the entrepreneurial spirit." Headquartered near Cassopolis, Michigan, the foundation works with entrepreneur support organizations nationwide to encourage peer learning among second-stage business owners. Before his death in 1995, Ed Lowe, the creator of Kitty Litter, had become an advocate for entrepreneurship as the key to the success of the free-enterprise system.

Contact: 800-232-LOWE(5693) or edwardlowe.org