Evaluating a company's P&L (Profit & Loss) statement

A company makes money by selling the goods and services it produces – this is called its **GROSS REVENUE**. A company can be looked at as a household where there are 6 claimants for the money. They come in a particular order to claim their share of the money. Let's look at each one of them

First person is Mr COGS – He says – "I brought in the raw material that was used to create the goods and services. Without me we could not have been in the business. I need to be paid first". So Mr COGS – a.ka. – '**C**ost **O**f **G**oods **S**old' – is paid first. Money left after paying Mr COGS is called **GROSS MARGIN**

Next comes Mr OP-Ex. He says – I need to be paid next as I was responsible for converting the raw material to finished goods by supplying the people who did the work to create the goods, people who sold the goods, I have also paid the electricity, water, and other utilities that were used to create the final product. So Mr "OP-EX – a.k.a "Operational expenses" – gets paid second. Money remaining after paying Mr OP-Ex is called **OPERATING PROFIT OR PBDIT** (Profit Before Depreciation, Interest and Taxes)

Next comes Mr Dep. He says – I need to be paid next as I represent the equipment that was used to produce the goods and services. We use up part of the equipment every year to create the goods and services, after a few years we will have to buy new equipment. I will hold this money so that we can buy new equipment once the current ones stop working. Mr Dep – "depreciation" get paid third. Money left after paying Mr Dep is called **PBIT** (Profit Before Interest and Taxes)

Next comes Mr Int. He says – I lent you the money that you needed to produce your goods and services. You need to pay me the rent (interest) for using my money. Mr Int – a.k.a Interst gets paid next. Money left after paying Mr Int is called **PBT** (profit before taxes).

Next comes Mr Tax – he says – I am the government which helps create the infrastructure – like roads, railways etc used by your business. I also provide security though police, and help provide a stable business environment for you to do your business. Mr Tax – gets paid next. Money left after paying Mr Tax is called **Net profit** or **PAT** (Profit After Tax)

Last but not the least, comes Mr Owner – He says I am the one who has brought in the money to start the business, put in the equipment, hired the management and staff who is running the business. I have the claim on all the money that is left after paying others. Mr Owner claims the **Net Profit**.

The company P&L (profit and loss statement) is the document that shows the portion of money claimed by the 6 claimants. Understanding how the company is generating revenue and spending it is the key to be able to assess it future potential to generate profits.

The proportion of the revenue each claimant gets provides insights into the nature of the business as well as the management effectiveness in running the business. Let's look at a few examples.

- If Mr COGS gets a large percent of the revenue– this means the company is adding very little value to the goods. This could be Jewellery maker where the cost of gold or diamonds is a significant part of the final product. It is also possible that the firm is in the business of trading goods where the trader adds minimal value to the goods.
- If Mr OP-Ex gets a large portion of the revenue, that means the company is in services business. For instance IT, BPO and consulting companies will have a higher OP-ex, as employee salaries are the bulk of their expenses. High operating expenses as a percent of Gross revenues could also be due to inefficiencies or it could be a high volume – low margin business.
- High depreciation as a percent of gross revenue could indicate that the nature of the business is capital intensive – for instance steel and power plants etc. It is also possible that management is using accelerated depreciation to shelter the profits from taxes (this could also means that once the asset is fully depreciated the taxes could increase significantly).
- Very high interest could mean that the firm is borrowing heavily to run its business - this is possible in Capital intensive industries like infrastructure, banking etc. High debt sometimes means that the company is exposed to interest rate risk and has limited cushion to face uncertain environments.
- Portion of revenues paid in taxes could also provide insights into management effectiveness in operating the business using tax efficient legal structures. For instance management can select SEZ's (Special Economic Zones) or low tax geographies to do the business and shelter profits from taxes.

Owner's objective is to maximize the Net Profit. We have seen in articles so far that the value of the business is based on its ability to generate profits. The greater the ability of a business to generate profits, the higher is the value of the business.

In summary P&L can give significant insights into the how the company is operating, its effectiveness generating profits for the Owners. One needs to understand the P&L well to be able to value the company.