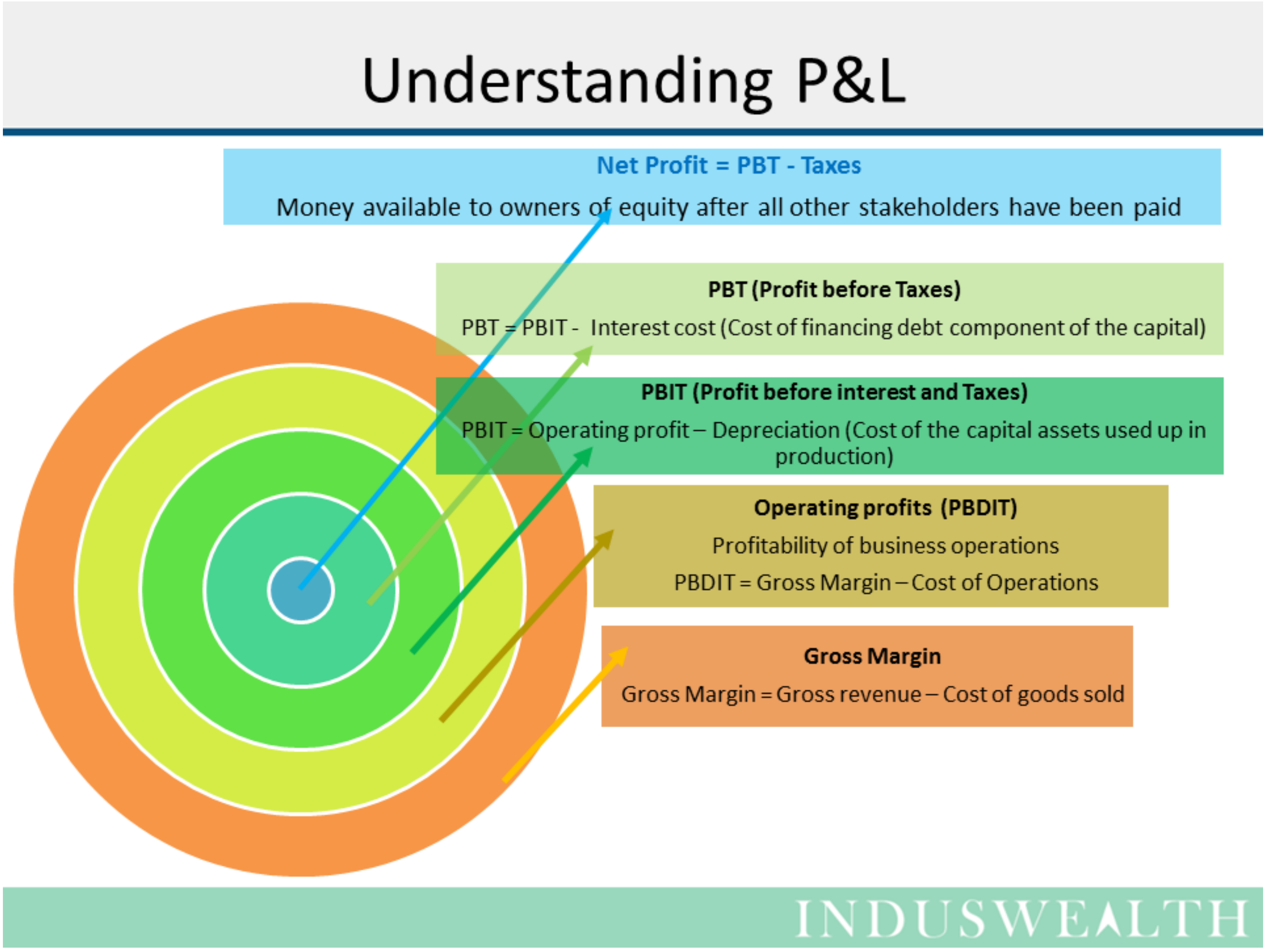
Continuing from last week – The picture below represents how after various claims on gross margins it becomes Net profit – that is claimed by the owners of the firm.



One should not only look at each of these parameters independently but also understand the trends in these over a period of time. This will help in better forecasting of the future profitability.

Gross revenue	• An improvement in gross revenues means that the firm is able to increase its sales
Gross Margin = Gross revenue – cost of goods sold	• If the is an improvement in gross revenues that means the firms is able to procure its raw material at a lower price or it is able to charge it customers more for the output.
PBDIT = Operating profits = Gross margin – operating expenses	• A trend of increase in operating margins indicates that the firm is able to add value to the raw material more effectively by controlling the input costs like sales costs, salaries, manufacturing expenses, etc.
PBIT = PBDIT – Depreciation	• This indicates the methodology of depreciation that is being followed by the firm. Used effectively, it could help optimize the capital expenses of the firm.
PBT = PBIT – Interest	• Improving trends in PBT could indicate more effective capital structure for the firm.
Net profit margin = PBT – Taxes	• An increase in the net profit margins indicates that the firm is being more effective in running the firm and generating profits for the equity shareholders.

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 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 Operational expenses are 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.