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Checklist for Profit Watching

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Making a profit is the most important — some might say the only objective of a business. Profit measures success. It can be defined simply: Revenues - Expenses = Profit. So, to increase profits, you must raise revenues, lower expenses, or both. To make improvements, you must know what's really going on financially at all times. You have to watch every financial event without any kind of optimistic filter.

This document is a series of questions with comments to help you analyze your profits, their sufficiency and trend, the contribution of each of your product lines or services to them, and to help you determine if you have the kind of record system you need. The questions and comments are not meant to be definitive presentations on the subjects. They are meant to point to areas where further study might be profitable.

Are You Making a Profit?

Analysis of Revenues and Expenses
Since profit is revenues less expenses, to determine what your profit is, you must first identify all revenues and expenses for the period under study.

Have you chosen an appropriate period for profit determination?

For accounting purposes, firms generally use a twelve month period such as January 1 to December 31, or July 1 to June 30.

The accounting year you select doesn't have to be a calendar year (January to December); a seasonal business, for example, might close its year after the end of the season. The selection depends upon the nature of your business, your personal preference, and/or possible tax considerations.

Have you determined your total revenues for the accounting period? In order to answer this question, consider the following questions:

- What is the amount of gross revenue from sales of your goods or services? (Gross Sales)
- What is the amount of goods returned by your customers and credited? (Returns and Rejects)
- What is the amount of discounts given to your customer and employees? (Discounts)

- What is the amount of net sales from goods and services? (Net Sales = Gross Sales - (Returns and Rejects + Discounts).
- What is the amount of income from other sources such as interest on bank deposits, dividends from securities, rent on property leased to others? (Non-operating Income)
- What is the amount of total revenue? (Total Revenue = Net Sales + Non-operating Income).

Do you know what your total expenses are? Expenses are the cost of the goods sold and the services used in the process of selling goods or services. Some common expenses for all businesses are:

- cost of goods sold (Cost of Goods Sold = Beginning Inventory + Purchases - Ending Inventory);
- wages and salaries (Don't forget to include your own - at the actual rate you'd have to pay someone else to do your job);
- rent;
- utilities (electricity, gas, telephone, water, etc.);
- delivery expenses;
- insurance;
- advertising and promotional costs;
- maintenance and upkeep;
- depreciation (Here you need to make sure your depreciation policies are realistic and that all depreciable items are included);
- taxes and licenses;
- interest;
- bad debts;
- professional assistance (accountant, attorney, etc.).

There are, of course, many other types of expenses, but the point is that every expense must be recorded and deducted from your revenues before you know what your profit is. Understanding your expenses is the first step toward controlling them and increasing your profit.

Financial Ratios

A financial ratio is an expression of the relationship between two items selected from the income statement or the balance sheet. Ratio analysis helps you evaluate the weak and strong points in your financial and managerial performance.

Do you know your current ratio?

The current ratio (current assets divided by current debts) is a measure of the cash or near cash position (liquidity) of the firm. It tells you if you have enough cash to pay your firm's current creditors. The higher the ratio, the more liquid the firm's position is and, hence, the higher the creditability of the firm. Cash, receivables, marketable securities, and inventory are current assets. Naturally, you need to be realistic in valuing receivables and inventory for a true picture

of your liquidity, since some debts may be uncollectible and some stock obsolete. Current liabilities are those which must be paid in one year.

Do you know your quick ratio?

Quick assets are current assets minus inventory. The quick ratio is found by dividing quick assets by current liabilities. The purpose, again, is to test the firm's ability to meet its current obligations. This test doesn't include inventory to make it a stiffer test of the company's liquidity. It tells you if the business could meet its current obligations with quickly convertible assets should sales revenues suddenly cease.

Do you know your total debt to net worth ratio?

This ratio (the result of total debt divided by net worth then multiplied by 100) is a measure of how the company can meet its total obligations from equity. The lower the ratio, the higher the proportion of equity relative to debt and the better the firm's credit rating will be.

Do you know your average collection period?

You find this ratio by dividing accounts receivable by daily sales. (Daily sales = annual credit sales divided by 360). This ratio tells you the length of time it takes the firm to get its cash after making a sale on credit. The shorter this period the quicker the cash inflow is. A longer than normal period may mean overdue and uncollectible bills. If you extend credit for a specific period (say, 30 days), this ratio should be very close to the same number of days. If it's much longer than the established period, you may need to alter your credit policies. It's wise to develop an aging schedule to gauge the trend of collections and identify slow payers. Slow collections (without adequate financing charges) hurt your profit, since you could be doing something much more useful with your money, such as taking advantage of discounts on your own payables.

Do you know your ratio of net sales to total assets?

This ratio (net sales divided by total assets) measures the efficiency with which you are using your assets. A higher than normal ratio indicates that the firm is able to generate sales from its assets faster (and better) than the average concern.

Do you know your operating profit to net sales ratio?

This ratio (the result of dividing operating profit by net sales and multiplying by 100) is most often used to determine the profit position relative to sales. A higher than normal ratio indicates that your sales are good, that your expenses are low, or both. Interest income and interest expense should not be included in calculating this ratio.

Do you know your net profit to total assets ratio?

This ratio (found by multiplying by 100 the result of dividing net profit by total assets) is often called return on investment or ROI. It focuses on the profitability of the overall operation of the firm. Thus, it allows management to measure the effects of its policies on the firm's profitability. The ROI is the single most important measure of a firm's financial position. You might say it's the bottom line for the bottom line.

Do you know your net profit to net worth ratio?

This ratio is found by dividing net profit by net worth and multiplying the result by 100. It provides information on the productivity of the resources the owners have committed to the firm's operations.

All ratios measuring profitability can be computed either before or after taxes, depending on the purpose of the computations. Ratios have limitations. Since the information used to derive ratios is itself based on accounting rules and personal judgements, as well as facts, the ratios cannot be considered absolute indicators of a firm's financial position. Ratios are only means of assessing the performance of the firm and must be considered in perspective with many other measures. They should be used as a point of departure for further analysis and not as an end in themselves.

Sufficiency of Profit

The following questions are designed to help you measure the adequacy of the profit your firm is making. Making a profit is only the first step; making enough profit to survive and grow is really what business is all about.

- Have you compared your profit with your profit goals?
- Is it possible your goals are too high or too low?
- Have you compared your present profits (absolute and ratios) with the profits made in the last one to three years?
- Have you compared your profits (absolute and ratios) with profits made by similar firms in your line?

A number of organizations publish financial ratios for various businesses, among them Robert Morris Associates, Dun and Bradstreet and Statistics Canada. Your own trade association may also publish such studies. Remember, these published ratios are only averages. You probably want to be better than average.

Trend of Profit

Have you analyzed the direction your profits have been taking?

The preceding analyses, with all their merits, report on a firm only at a single time in the past. It is not possible to use these isolated moments to indicate the trend of your firm's performance. To do a trend analysis performance indicator (absolute amounts or ratios) should be computed for several time periods (yearly for several years, for example) and the results laid out in

columns side by side for easy comparison, you can then evaluate your performance, see the direction it's taking, and make initial forecasts of where it will go.

Does your firm sell more than one major product line or provide several distinct services? If it does, a separate profit and ratio analysis of each should be made:

- to show the relative contribution by each product line or service;
- to show the relative burden of expenses by each product or service;
- to show which items are most profitable, which are less so, and which are losing money; and
- to show which are slow and fast moving.

Mix of Profit
The profit and ratio analysis of each major item help you find out the strong and weak areas of your operations. They can help you make profit-increasing decisions to drop a product line or services or to place particular emphasis behind one or another.

Records
Good records are essential. Without them a firm doesn't know where it's been, where it is, or where it's heading. Keeping records that are accurate, up-to-date, and easy to use is one of the most important functions of the owner-manager, his or her staff, and his or her outside counsellors (lawyer, account, banker).

Basic Records
Do you have a general journal and/or special journals, such as one for cash receipts and disbursements?

A general journal is the basic record of the firm. Every monetary event in the life of the firm is entered in the general journal or in one of the special journals.

Do you prepare a sales report or analysis?

Do you have sales goals by product, department, and accounting period (month, quarter, year)?

Are your goals reasonable?

Are you meeting your goals?

If you aren't meeting your goals, try to list the likely reasons on a sheet of paper. Such a study might include areas such as general business climate, competition, pricing, advertising, sales promotion, credit policies, and the like. Once you've identified the apparent causes you can take steps to increase sales (and profits).

Buying and Inventory System
Do you have a buying and inventory system?

The buying and inventory systems are two critical areas of a firm's operation that can affect profitability.

Do you keep records on the quality, service, price and promptness of delivery of your sources of supply?

Have you analyzed the advantages and disadvantages of buying from several suppliers and buying from a minimum number of suppliers?

Have you analyzed the advantages and disadvantages of buying through co-operatives or other such systems?

Do you know:

- How long it usually takes to receive each order?
- How much inventory cushion (usually called safety stock) to have so you can maintain normal sales while you wait for the order to arrive?
- Have you ever suffered because you were out of stock?
- Do you know the optimum order quantity for each item you need?
- Do you know (or can you) take advantage of quantity discounts for large size single purchases?
- Do you know your costs of ordering inventory and carrying inventory?

The more frequently you buy (smaller quantities per order), the higher your average ordering costs (clerical costs, postage, telephone costs, etc.) will be, and the lower the average carrying costs (storage, loss through theft, depreciation, etc.) will be. On the other hand, the larger the quantity per order, the lower the average ordering cost and the higher the carrying costs. A balance should be struck so that the minimum cost overall for ordering and carrying inventory can be achieved.

Do You Keep Records of Inventory for Each Item?
These records should be kept current by making entries whenever items are added to or removed from inventory. Simple records on 3x5 or 5x7 cards can be used with each item being listed on a separate card. Proper records will show for each item: quantity in stock, quantity on order, date of order, slow or fast seller, and valuations (which are important for taxes and your own analyses).

Other Financial Records
Do you have an accounts payable ledger?

This ledger will show what, whom, and why you owe. Such records should help you make your payments on schedule. Any expense not paid on time could adversely affect your credit, but even more importantly such records should help you to take advantage of discounts which can help boost your profits.

Do you have an accounts receivable ledger?

This ledger will show who owes money to your firm. It shows how much is owed, how long it has been outstanding, and why the money is owed. Overdue accounts could indicate that your credit granting policy needs to be reviewed and that you may not be getting the cash into the firm quickly enough to pay your own bills at the optimum time.

Do you have a cash receipts journal?

This journal records the cash received by source, day, and amount.

Do you have a cash payments journal?

This journal will be similar to the cash receipts journal but will show cash paid out instead of cash received. The two cash journals can be combined, if convenient.

Do you prepare an income (profit and loss) statement and a balance sheet?

These are statements about the condition of your firm at a specific time and show the income, expenses, assets, and liabilities of the firm. They are absolutely essential.

Do you prepare a budget?

You could think of a budget as a "record in advance," projecting "future" inflows and outflows for your business. A budget is usually prepared for a single year, generally to correspond with the accounting year. It is then, however, broken down into quarterly and monthly projections.

There are different kinds of budgets: cash, production, sales, etc. A cash budget, for example, will show the estimate of sales and expenses for a particular period of time. The cash budget forces the firm to think ahead by estimating its income and expenses. Once reasonable projections are made for every important product line or department, the owner-manager has set targets for employees to meet for sales and expenses. You must plan to assure a profit. And you must prepare a budget to plan.