

EXPERTS' FORUM | Bank/Financial

5 Ways to Determine your Profitability

How do you really judge the profitability of your business? There are some leading indicators that will tell you and your investors, whether it be a banker or venture capitalist, how your performance is tracking. These indicators involve doing a little math and using your financial statements as a resource.

#1. What's your Gross Profit Margin ratio? Sound daunting? Not really. It's simply your Gross Profit (in other words, Sales minus Cost of Goods Sold) divided by your Sales. The result is your Profit Margin. Calculate this for a span of years. If it's going down, you may need to increase product pricing or improve your inventory management. As a manufacturer, it could indicate that production costs are rising faster than product prices.

Check your ratio against your peer group. If it's higher than your competitors, you are much more efficient in production and distribution than they are. Standard and Poor's is one source for checking rating information.

#2. Are your Operating Profit Percentages trending up or down? How much money are you actually making on your standard business operations? Your Operating Profit Percentage shows the percentage of each sales dollar remaining after all normal costs of operations. Because the figure excludes miscellaneous income and tax expenses, the operating profit percentage produces an accurate picture of the profitability of your primary business. To determine this indicator, use the figures from your Income Statement. Take your Operating Income and divide by Sales. You now have your Operating Profit Percentage. Reductions in this figure over time might indicate a need to re-evaluate your pricing or your suppliers, or look for ways to cut down on your operating expenses. Hopefully, your numbers are trending up.

#3. Are you meeting your Net Profit Margins? While a dipping Net Profit Margin won't tell you

what is actually going wrong in your business, it is a cautionary indicator. If you want to pinpoint a cause, look at Gross Margin or Operating Margin to lead you in the direction of the problem. What Net Profit Margin will tell you is how much of each sales dollar is available to you. Take your Net Income and divide it by Sales. The resulting number or percentage is your Net Profit Margin. Is it what you had predicted for your business? If not, the number could be unrealistic or an indicator of a looming problem. Check that your costs aren't getting too high.

#4. How well is your business using its assets to generate income? Your Return on Assets will let you know. Don't confuse this with return on capital or return on equity. Generally this measurement reflects management's ability to generate profits during a given period, usually a year.

To determine your Return on Assets, divide Net Income by Total Assets. Then look at the number as a percentage. Compare this percentage to industry standards and see where you stand. The higher the return, the better. Remember that assets frequently need to be revalued so your return could change. There are other ways you can determine this same ratio as well.

#5. Compare your Return on Equity with other possible investments to check your progress. In fact, you might compare your business's Return on Equity with what you might earn in the stock market or even a bank account over the same period. You should be earning at least the same amount that you would in more conservative investments or a bank CD. How do you calculate Return on Equity? Divide Net Income by the Owner's Equity.

All of these ratios have been simplified to give you a basic understanding for determining profitability of your business. To get a clearer understanding, talk to your accountant or business banker.



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