

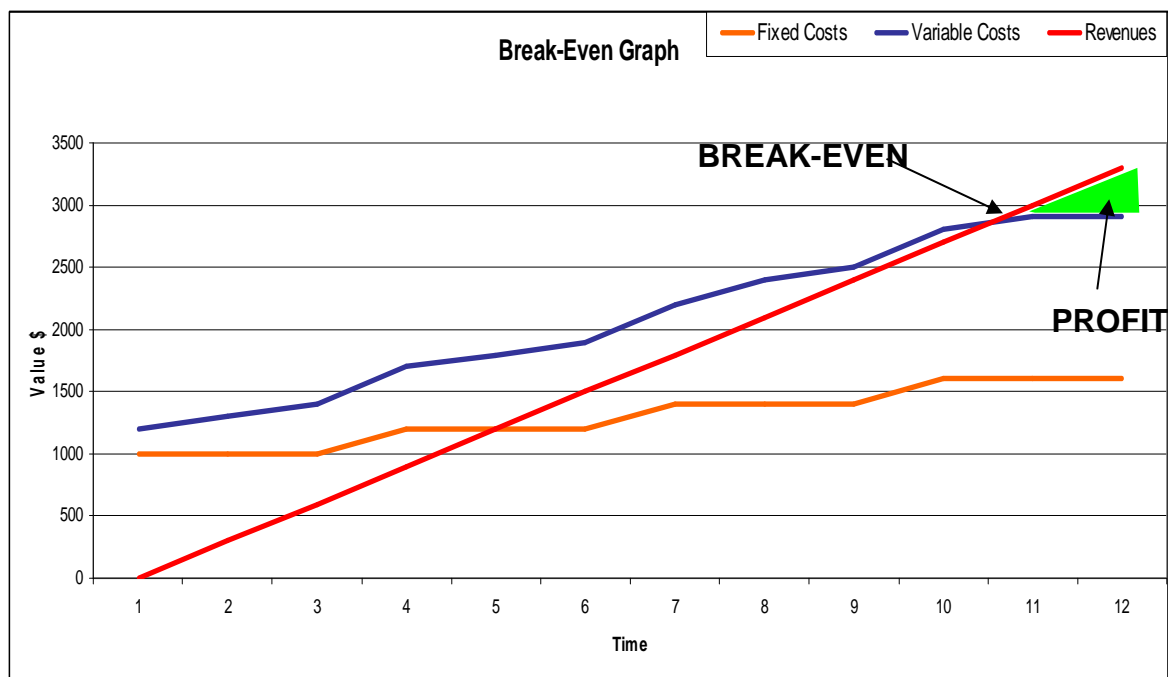
Understanding Profit & Loss (P&L) and Break-Even (B/E)

Knowing your break-even is critical to managing your business. Many owners leave this out however, as it “looks complicated”. Well like anything, it’s in the knowledge, and fortunately knowledge can be gained. Let’s begin by understanding how it all comes together.

It is recommended that you persevere with this document and work at understanding every component. This is a SIMPLE explanation only. Get this right and you will know it forever. Work through the example and then use your own numbers.

Depending on your business, it might be worth knowing the B/E on every single product, otherwise an overall view can be useful at a high level. It may also be necessary to determine a B/E on various business structures. For example, a business that has both retail and wholesale divisions may have very different B/E points.

The following chart depicts a typical sales/expenses scenario; the blue line is the total of Variable costs and Fixed Costs (orange Line) The red line is the sales, income or revenue. The green area shows the profits. This is the total of all income less expenses. At a Mastery level these numbers are the least you need to understand.



Note that profit is only achieved after break-even, so it’s a great number to know. Before then it’s a loss.

OK, now that you have a basic understanding of the outcome, let’s go through the detail.

First of all you will need a copy of your Profit & Loss (P&L) for a given period. A quarter (90days) would be a good time, however for the purposes of generating information that is very accurate, a 12 month P&L is best. This is because the Fixed Costs (FC) component often has annual numbers, like Insurances. Using periods less than 12 months can distort your overall results.

A P&L typically consists of 2 main areas: Income and Expenses.

The Income is the total of all sales or revenue generated. This is often expressed in different terms because sales are often not the only way of generating income. For example, interest earned can be a revenue, but not a sale. Freight charged also is not a sale, but a revenue.

The income area also includes the cost attached to directly “buying” that income. This is referred to as COGS, or Cost Of Goods Sold. For example if you buy £300 of goods, and then sell them for £1000, you will have income of £1000, with COGS of £300. Calculating this will result in a Gross Profit or a final earned income of £700.

This is also calculated as 70% Gross Profit margin. So let’s look at that in a typical P&L set up:

Profit & Loss for Company X					
Jul 2003 – Jun 2004					
	Q1	Q2	Q3	Q4	Total
Income					
Revenue	£ 250	£ 250	£ 250	£ 250	£1,000
COGS	£ 75	£ 75	£ 75	£ 75	£ 300
Gross Income	£ 175	£ 175	£ 175	£ 175	£ 700
Gross Profit %	70%	70%	70%	70%	70%

(Note: These numbers are NOT related to the graph shown above.)

The next area is expenses. Most P&Ls are broken into functional categories, such as wages, light and power, motor vehicle and so on. This assists in managing those areas within a business. What they do not show is whether they are fixed or variable costs. What’s the difference?

Put simply a Fixed Cost (FC) is an expense that, regardless of whether you have a sale or not, you will still have an expense. Rent is a good example of this, as would be the Managers salary and Insurances. No matter how many sales come to the business (or not) these are expenses that will have to be paid. Think of this as having a shop setup for business without any customers.

A Variable Cost (VC) are those expenses that change as the business changes. As an example Light and power could be a VC, because (especially in a production business) the more that is produced, the more machinery will run and for longer hours, therefore using more lights and power. Some wages such as Casual labour are also a VC, because they increase or decrease depending on the amount of business conducted. Think of these as the money sent when customers actually walk in the door.

There is no hard and fast rule for this break-down. Each business can determine their own. The key is to keep it as simple as possible. Don’t get too clever.

So let’s look at how to calculate the rest of the P&L. A typical Expense area will look like this:

Profit & Loss for Company X					
Jul 2003 – Jun 2004					
	Q1	Q2	Q3	Q4	Total
Expenses					
FT Salary	£ 80	£ 80	£ 80	£ 80	£ 320
Casual Wages	£ 25	£ 15	£ 30	£ 30	£ 100
Rent	£ 40	£ 40	£ 40	£ 40	£ 120
Insurance	£	£	£ 50	£	£ 50
Light & power	£ 30	£ 30	£ 30	£ 30	£ 120
Total Expenses	£ 175	£ 165	£ 230	£ 180	£ 710

The final P&L can then be calculated:

Profit & Loss for Company X						
Jul 2003 – Jun 2004						
	Q1	Q2	Q3	Q4	Total	
Income						
Revenue	£ 250	£ 250 A	£ 250	£ 250	£1,000	
COGS	£ 75	£ 75 B	£ 75	£ 75	£ 300	
Gross Income	£ 175	£ 175	£ 175	£ 175	£ 700	
Gross Profit %	70%	70%	70%	70%	70%	
Expenses						
FT Salary	£ 80	£ 80	£ 80	£ 80	£ 320 FC	E
Casual Wages	£ 10	£ 15 B	£ 20	£ 30	£ 75 VC	
Rent	£ 40	£ 40	£ 40	£ 40	£ 160 FC	E
Insurance	£	£	£ 50	£	£ 50 FC	E
Light & power	£ 20	£ 15 B	£ 20	£ 15	£ 70 VC	
Total Expenses	£ 150	£ 150	£ 210	£ 165	£ 675	
Net Profit	£ 25	£ 25	£ (35)	£ 10	£ 25	
Net Profit %	14.2%	14.2%	(20.0%)	5.7%	3.6%	

You will note that by subtracting the total expenses from the Gross profit, you are left with (in this case) a profit of £25 for the total period. This is 3.6% of the Gross Income. Sometimes this is also expressed as a percentage of the original income, and often more relevant. In that case it would be 2.5%. As a consequence therefore COGS are 30%, expenses 67.5% and profit 2.5%.

Notice however that not all quarters made a profit. Q3 had a loss. That's the reason that looking at a longer period can be more useful in estimating the real business position.

So what about the Break-Even?

This next information refers to the breakeven calculator in the *90 Day Business Plan*. There is one at the end as an example. Each identifying letter (A,B,C etc.) from the plan is explained in detail and added to the example. Take the time to work it through and understand each step. Do it once properly and you'll understand it forever.

For the purpose of a P&L, VC and FC aren't relevant. But for a B/E analysis they are. The higher your FC, the more you will be driven to get to a base level of business before making a profit. Structured businesses such as factories and retail have many FC, whereas a consulting business may have very few.

The first step is to sort out the Fixed and Variable Costs. In the above scenario Casual wages and Light & Power will be VC, and the rest will be FC. Note that in Q3 there is an insurance that if only calculated on a quarterly basis may be missed and show an inaccurate B/E.

Now let's look at each area in detail. Work through each calculation step by step referring o the plan at the end.

For this example we will use Q2 as the time period.

1st Calculate your gross margin: the percentage of each pound you sell that stays with you to pay for overhead.

- A. Total sales/revenue. In this case is: **£250.**
- B. This is the addition of all the VC and COGS **£15 + £15 + £75 = £105**
- C. Subtract B from A: **£250 - £105 = £ 145**
- D. Divide C into A for the Gross Margin: **£145 / £250 x100 = 58%**

Note that this Gross margin is different to the P&L gross profit. That is due to the inclusion of the VC into the B/E figure.

2nd Calculate your break-even sales: the total sales you need to break-even on your fixed costs.

The second part of the B/E calculator is the FC component. These are the steps:

- E. Calculate the FC numbers on an annual basis by adding them together: **£320 + £160 + £50 = £530**

At this point it doesn't matter if you continue to work annually or break it back down into quarterly. If breaking back down just divide by 12 for months, 52 for weeks or 4 for quarters. We'll stay with annual for the moment.

- F. Enter D from Section 1: **58%**, and then calculate E / D: **£530 / 58 x100 = £914**

This is the B/E amount of sales, or the sales required to cover all expenses. Now calculate that into quarterly/weekly etc if required.

For this exercise the quarterly calculation has been completed. You will note that B/E sales are £228.50 which is just short of the £250 achieved in the P&L. As you saw on the P&L some quarter's sales were enough and others were not. We know now that getting £228.50 will ensure on average you achieve B/E.

3rd Calculate your break-even transactions: the total # transactions you need to reach break-even sales.

Now let's move to the last part of the calculator, which is a bonus on a typical B/E calculation. This section shows the transactions required to B/E. This is where your 5 ways T&M will be essential.

- G. Enter your average £ Sale. This is gained from your test & measure information. In this case we will say it is **£2.00**
- H. Now calculate F divided by G to arrive at the number of transactions required to B/E: **£914 / £2.00 = 457**
- I. The conversion rate is also found in the test & measure data (hint: you need to test & measure to get this accurate). We will assume it to be **25%**
- J. Now calculate H divided by I: **457 / 25 x 100 = 1,828**

This is the number of leads required on your conversion ability numbers to achieve a breakeven point. This is valuable information and it's now worth breaking down to a daily number.

Assuming you trade 6 days per week, that would be $52 \times 6 = 312$ days. Divide 1828 by 312 and you will see that you need 6 transactions a day

just to break even. Doesn't sound like much. Well imagine the numbers had 2 zeros at the end...now that would be challenging.

K. The final steps are to calculate the net profits. Subtract **C – E** **£145 - £132.50**

Note that it is necessary to again calculate quarterly to have the correct numbers. This is because you started with quarterly number .

L. Then divide **K** into **A**: **£132.50 / £250 x100 = 5%**

Well that's a B/E calculation. Your challenge is to now use your own data and calculate a breakeven. If any of this information is not available easily then it's a sure sign you are still very into the MASTERY level. If you can't get the data, it's best to talk with your accountant or book keeper.

This is meant to be a simple calculation method for Break Even. Yes **SIMPLE!** It is important that you work through this until you get it right. There is no point just thinking it's too hard. This is one of the key areas of your business...without it you never really stand a chance of understanding how your business functions.

As a final note.

It is not aimed as being the perfect tool. It's a guide that can help you to realise the basic levels of running your business. From here you can know how much you must make **BEFORE** the month starts. Now that's a powerful position for any business. It's also the first step to creating good budgets. Good Luck. If you are stuck, talk this over with your coach.

Break-Even Calculator

Complete this with your profit built in for this coming Quarter (90Days).

1st Calculate your gross margin: the percentage of each pound you sell that stays with you to pay for overhead.

	Time Period	Quarter ___ - 200__
A	Total Sales/Revenues	250
	-	
B	Cost of Sales/Goods Sold/Variable Costs	105
	=	
C	Gross Income - (A - B)	145
D	Gross Margin - (C / A)	58%

2nd Calculate your break-even sales: the total sales you need to break-even on your fixed costs.

		Yearly	Quarterly	Monthly	Weekly	Daily
E	Fixed Costs	530	132.50	44.17	10.19	
	/					
	Gross Margin - Part 1 - D	58%	58%			
	=					
F	Break-Even Sales - (E / D)	914	228.50	76.17	17.58	

3rd Calculate your break-even transactions: the total # transactions you need to reach break-even sales.

G	Average £ Sale - G	2.00	(Value of average order/sale)			
H	B/Even Transactions - (F/G)	457				
I	Conversion Rate	25%	(% of leads converting to sale)			
J	# Leads Require - (H / I)	1828	457	152	35	6
K	Net Profit £ - (C - E)		12.50			
L	Net Profit % - (K / A)		5%			