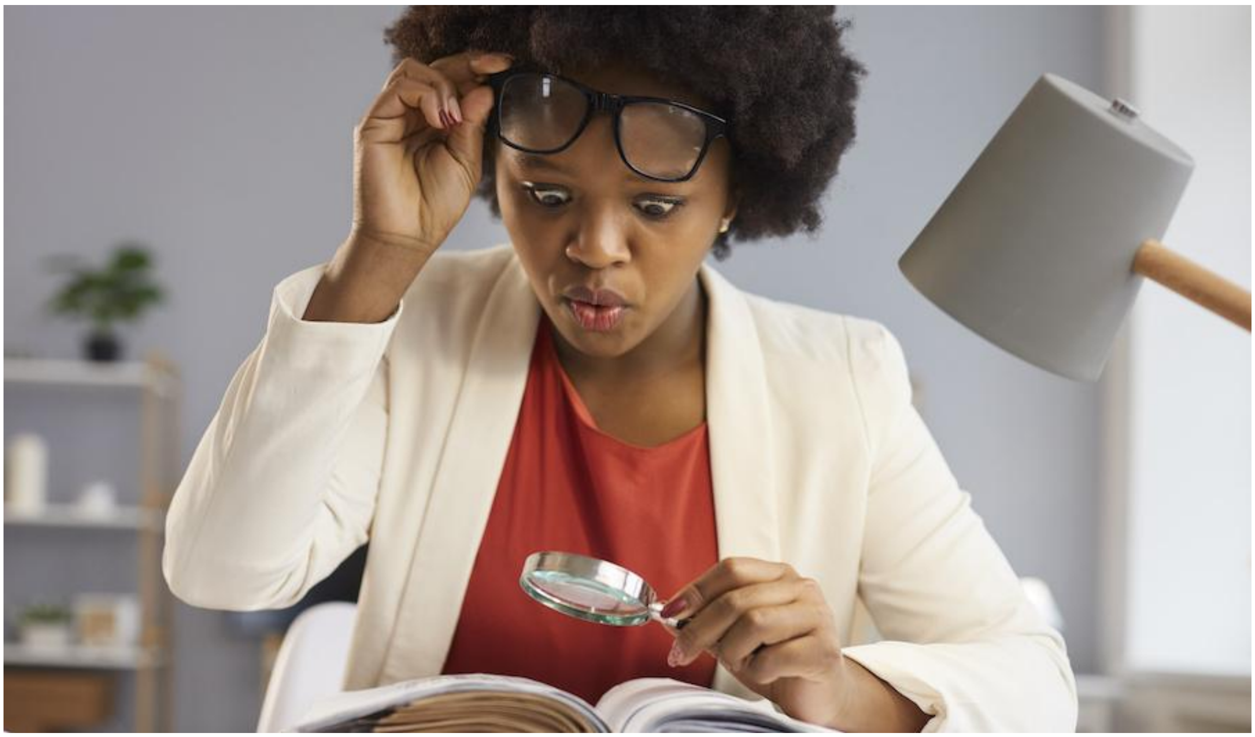
See the Red Flags in Your Profit & Loss Statement Before It's Too Late

6 min read



Key Takeaways

- Declining Profit and Shrinking Profit Margins: Calculate your gross profit margin every month to see how much you're paying for every dollar you earn to watch how your margins change month over month, too.
- Wage Costs Increasing Faster Than Revenue: If your wage costs increase at a faster rate than your revenue increases, this is a problem
- Decreased Sales & Marketing Spending: You've heard it before: "you have to spend money to make money." This old adage rings true.

If you're getting accurate and reliable financial reports, you're off to a great start! **The question is, do you know what to do with the information?**

Having accurate financial reports is one of the first steps to becoming a successful business leader. The next is learning how to interpret them and knowing what warning signs you should be on the lookout for every time you review your monthly financials.

Although all of your financial reports are important to understand, we'll focus on the profit and loss (income) statement and some of the most important warning signs you should be checking for...

Top 3 Red Flags to Watch for in Your Profit & Loss Statement

1. Declining Profit and Shrinking Profit Margins

Each month when you look at your profit & loss statement, one of the first items you should be checking is profit – your bottom line. Of course, you're looking for a positive number to make sure you didn't suffer a loss, but you should also be paying attention to your profit trends.

Additionally, a positive trending bottom line does not necessarily mean your business is becoming more profitable. You also need to calculate your gross profit margin every month to see how much you're paying for every dollar you earn to watch how your margins change month over month, too.

- Gross Profit Margin = (Revenue - Cost of Goods Sold) / Revenue

If you notice a steady decline in profits or shrinking margins, this is a red flag, and it's one that you want to catch as early as possible.

So, if you notice declining profits, what should you do first?

Look for Seasonal Trends

Check your trailing twelve-month charts (TTM) for seasonal trends.

Analyzing and comparing data from the current and previous twelve months will help you obtain a much clearer understanding of your actual financial trends, without having these numbers clouded by [seasonal changes]in business demand and sales.

The downturn may be a pattern that happens every year. If this is the case, it's less cause to worry, but also something you should be aware of so that you can better plan for next year's inevitable slump.

Evaluate and Lower Your Expenses

If your profit margins are shrinking while your revenue has remained flat or is increasing, then the problem is in your costs. Evaluate your expenses to confirm that they are, in fact, increasing and determine the reason why.

- Do certain job types or clients cost more than they should? (Hint: pull a profit & loss by job type or client to look into this question.)
- Is productivity declining?
- Did you increase wages?
- Have material costs increased?

Once you've identified the source of your increased expenses, take stock of the situation and determine whether you can cut costs to improve your margins. Then, move on to the next step to re-evaluate your pricing.

Fix Your Pricing Problems

If you simply can't cut your costs enough to strengthen your profit margins, then you have a pricing problem that needs to be addressed.

There are several ways to optimize prices such as looking at offering different pricing models like subscriptions (These will lower your customer acquisition costs, too!) or adjusting your repayment agreements to collect more upfront to shrink days sales outstanding and take advantage of early payment discounts on your own bills.

The most obvious and likely most effective fix, however, is simply raising your prices to better accommodate your increasing costs. The simplest method for calculating your prices is called bottom-up pricing.

To calculate bottom-up pricing, start by adding your materials and labor costs. Then use cost allocation and job costing to determine how much of your indirect expenses your prices also need to cover. Finally, add a markup – your profits – to build a stronger profit margin right into your pricing.

2. Wage Costs Increasing Faster Than Revenue

At face value, there's nothing wrong with your wage costs increasing; you're going to need to hire more people as your business grows. You're going to offer raises and other monetary incentives to motivate and reward your people.

However, if your wage costs increase at a faster rate than your revenue increases, this is a problem.

It indicates a lack of foresight in your human capital management strategy and also likely poorly timed hiring (i.e. bringing on new people before you truly need them).

While it's a delicate act to balance, you should strive for your team to grow at the same rate as your company's revenue.

Otherwise, you'll run into profit margin challenges that can't be quite as easily addressed with price increases or expense cuts because in this case, cutting unnecessary costs would mean letting people go.

3. Decreased Sales & Marketing Spending

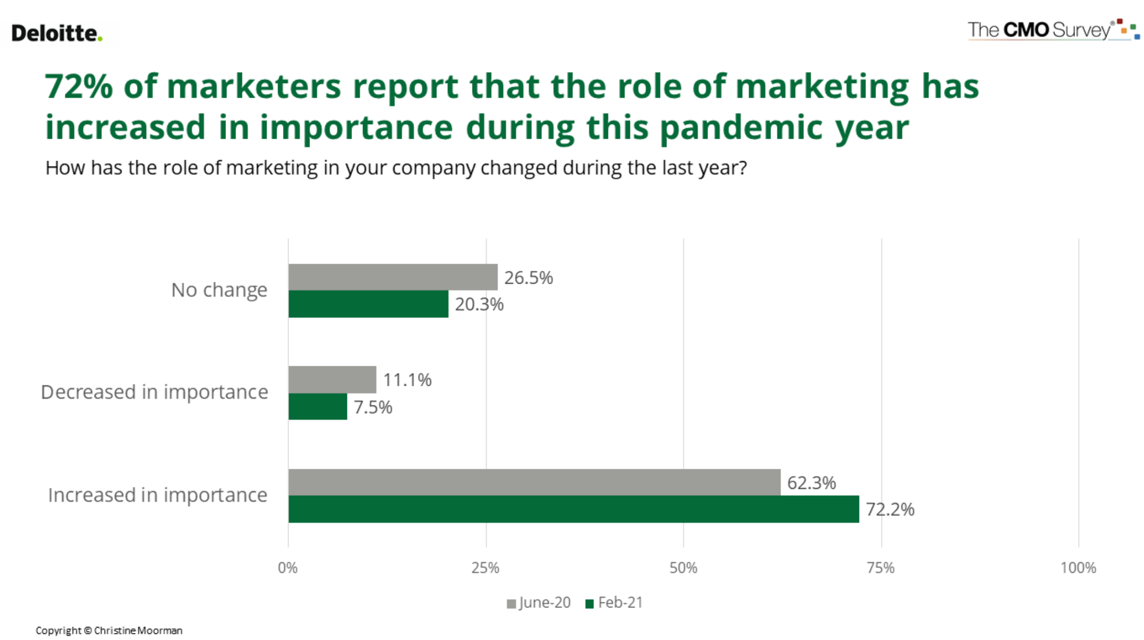
Business, unfortunately, doesn't work like The Field of Dreams. If you build it, they probably won't come unless you invest in marketing and advertising.

A downward trend in sales and marketing spending is actually a bad sign. Effectively managing this spend is key, as in, consistent analysis and adjustments to improve your ROI. Keep an eye on this expense and make sure you're investing a reasonable amount in promoting your business brand and services so that you can continue to grow.

“Because its purpose is to create a customer, the business enterprise has two -- and only these two -- basic functions: marketing and innovation.”- Peter Drucker

You’ve heard it before: “you have to spend money to make money”. This old adage rings true. Ignoring your marketing and sales KPIs is a fast track to a suffering bottom line. Why? Closely monitoring and evaluating this data enables you to drive future (and hopefully better) results.

In particular, given the recent shift in digital workspace, the role of marketing is more important now than ever. Customers are looking for a strong digital experience- and marketing is a key player in delivering this experience.



72.2% of marketers reported that the importance of marketing within their organizations has increased from the pandemic. [1]

Each company's sales and marketing spend should vary based on the industry, size of the business, and growth stage. The average spend on sales and marketing varies quite a bit by industry, ranging from about 24% in consumer and packaged goods to 4% in the energy sector, according to data from The CMO Survey. [2]

Be A Proactive Leader: Using Insights To Drive Your Business Forward

Carefully monitoring your income statement for these important red flags each month will help you become a more proactive and strategic business leader.

Rather than being someone who leads via reaction and hindsight, knowing your numbers enables you to detect challenges before they occur to make the data-driven decisions necessary to protect your company from pitfalls while leading it toward a more successful future.

An automated back office will only get you so far- it's the unique combination of expert teams and smart technology that helps business leaders grow stronger.