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# Bottom Line

## P&L statements are a window into your company's success

By Dennis L. Monroe

It is said that the eyes are the window to the soul. I would say the same about a company's profit and loss statement (or P&L). Profit and loss statements are the window to a company's success. Here are the seven categories of franchise P&Ls.

**1 Sales.** The most important exercise when analyzing your sales is to make sure you understand each component of sales, by type and by product. Sales needs to include an in-depth review of customer counts, customer check averages, sales by day part, sales by day of the week and any other way you can slice and dice sales. I particularly like "sales by customer," sometimes called check average. It helps analyze customer trends, a key element in today's volatile market.

**2 Cost of goods sold.** There are two components in this category: Product costs and labor costs.

Product costs, like sales, needs to be analyzed in groups to determine a true product mix, and have an understanding of profitability by products sold.

If you are dealing with things like food costs, I like to see a detailed understanding of food costs by food group, particularly items such as protein and non-protein. In other types of businesses, such as auto service and repair businesses, the various types of product sales like tires, auto parts, services, and labor should also be detailed. It is important to understand the number of units sold for each classification.

Labor costs are broken into:

- Production labor, which is normally hourly, non-exempt labor used to produce the product sold;
- Management or exempt labor used to manage the business; and

Having a well-designed P&L is like having all your exits and entrances covered.

- Everything involved in labor including health insurance, workers' compensation, payroll taxes and severance payments.

**3 Gross margin.** Sales less cost of goods sold equals gross margin. This is the first real key matrix. Each sector in franchising has a different matrix as it relates to costs of goods sold, gross margins and income from operations.

For instance, if you are in the restaurant or auto aftermarket industry and are working with a high cost-to-goods-sold ratio and significant labor and high product cost, we normally see gross margins in the 30-to-40 percent range. It is very important to analyze gross margins based on other businesses in your industry. In addition, many franchise businesses determine the bonus for the management team based on gross margins.

**4 Operating expenses.** Sometimes labeled as controllable and uncontrollable expenses, this category includes:

- Marketing expenses, such as free products, reservation systems, employee and community relations, social media and ad-fund fees.
- Administrative. These are expenses involved at a store level, such as credit card fees, legal and accounting fees and office expenses.
- Repair and maintenance. This includes all necessary repairs and expenses that are not capitalized, including removal and cleaning.

**5 Operating income.** Subtract operating expenses from gross margin and you've got operating income, the holy grail of franchise-unit economics. Unit-level economics for store-operating profit should be in the neighborhood of 15 percent. Much lower than 15 and it may be difficult to pay corporate overhead and debt service.

**6 Other income and expenses.** From operating income we then subtract the non-store or over-store expenses, which we call other income and expenses. Interest expense (netted with interest income), depreciation and amortization are included.

**7 Net income.** Net income is the deduction of all of the above to come up with the bottom line; that is, the economic effect of the business to the owners. I have omitted any taxes in arriving at net income because most entities involved in the franchise industry are flow-through entities, such as Sub Chapter S corporations or LLCs and pay minimal tax.

### P&L problems

- Inadequate accounting for labor. Vacation and sick pay should be included.
- Rent expenses not complying with GAAP. Rent expense is average rent payments over the life of the lease, rather than cash payments.
- Under accrual for percentage rent.
- Repair and maintenance costs are either too aggressive by expensing everything, or under aggressive with too much capitalization.
- Improper accrual for rebates, loyalty clubs, and gift cards.
- Incorrect treatment of equipment leases.
- Excess management fees (sometimes also called corporate G&A). In most cases, we like to see the G&A at 5 percent of sales or less.

I would be remiss in not discussing the famous earnings before interest, taxes, depreciation and amortization, or EBITDA. In most cases this is equal to operating income less corporate overhead, adding back any depreciation amortization and interest and taxes. This really is the ultimate free cash flow.

There are no items on the P&L that should not be analyzed. Benchmarking with other franchisees or other like industry companies is key. FT

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