

BOOKKEEPING BEGINNER 14 min

How to read a profit and loss statement

A practical guide to understanding turnover, gross profit, operating profit, margins and the difference between profit and cash.

The profit and loss statement, often shortened to P&L, tells you whether your business made money over a period of time. It is usually the first report founders look at when they want to understand trading performance.

You may also see it called the profit and loss account, income statement, or statement of comprehensive income. The labels vary, but the core question is the same: did the business earn more than it spent?

10 STEPS

01 Understand what the P&L tells you

A P&L summarises income and expenses over a defined period: a month, quarter, year, or any other reporting window.

It answers a different question from the balance sheet and cash flow statement. The balance sheet shows what the business owns and owes at one point in time. The cash flow statement shows where cash moved. The P&L shows trading performance on an accruals basis.

Accruals matter because income is recorded when earned, and expenses when incurred, not necessarily when cash moves through the bank.

Profit and cash are related, but they are not the same thing.

02 Read the standard UK layout

Most UK P&Ls follow the Companies Act style layout: turnover, cost of sales, gross profit, distribution costs, administrative expenses, operating profit, finance income or costs, profit before tax, tax, and profit after tax.

Brackets normally mean amounts deducted. The subtotals that matter most are gross profit, operating profit, profit before tax and profit after tax.

Some reports use a nature of expense layout instead, grouping costs by what they are, such as employee costs, raw materials or depreciation. The purpose is the same: to explain how income turns into profit.

Focus first on the structure of the report, not the exact labels your software uses.

03 Start with turnover and cost of sales

Turnover is income from ordinary trading activities, shown net of VAT if you are VAT-registered. For most small UK companies, turnover and revenue are effectively the same number.

Cost of sales means the direct costs of producing the goods or delivering the services that generated that turnover. Product businesses might include materials and manufacturing labour. Service businesses might include delivery staff, freelancers, subcontractors and client-specific tools.

The test is whether the cost varies with the work you do. Rent does not usually vary with each sale, so it is normally an overhead, not cost of sales.

Misclassifying overheads as cost of sales can distort your gross margin.

04 Use gross profit to judge the business model

Gross profit is turnover minus cost of sales. It shows what is left after paying the direct cost of what you sold, before the wider running costs of the business.

Gross margin is gross profit divided by turnover. It is one of the most useful percentages on the whole report because it shows whether the underlying offer has enough margin.

The right gross margin depends on the industry. SaaS companies often run much higher margins than e-commerce, retail or food businesses. A number is only meaningful in context.

If turnover is growing but gross margin is falling, pricing or delivery costs need attention.

05 Separate operating costs from financing costs

Distribution costs and administrative expenses are the indirect costs of running the business. They include marketing, sales, rent, office costs, professional fees, insurance, admin salaries, software and similar overheads.

Operating profit is gross profit minus those operating costs, plus any other operating income. It shows the profit generated by the trading operation before borrowing costs and tax.

Finance income and finance costs sit below operating profit because they reflect financing decisions, such as interest earned on deposits or interest paid on loans, rather than the trading performance itself.

Two companies can trade equally well but show different profit before tax because one carries more debt.

06 Understand profit before tax and profit after tax

Profit before tax is operating profit plus finance income minus finance costs. It is the profit generated before corporation tax.

The tax line is the accounting tax expense for the period, not necessarily the cash payment made to HMRC during that same period. Payment timing is shown through the cash flow statement and tax creditor balances.

Profit after tax, also called net profit or profit for the year, flows into retained earnings on the balance sheet. It may be available for dividends, subject to distributable reserves and the company law rules.

Profit after tax is not automatically the cash you can take out of the business.

07 Read the P&L vertically and horizontally

Vertical analysis means expressing each line as a percentage of turnover. This shows the shape of the business: cost of sales, gross profit, overheads and operating profit as percentages of sales.

Horizontal analysis means comparing each line across periods, such as the last three months, quarters or years. This reveals the direction of travel.

If turnover is up 20% but gross profit is only up 5%, direct costs may be rising too quickly. If administrative expenses are up 30% while operating profit is flat, overheads may be expanding faster than the business can support.

A single P&L gives a snapshot. Comparatives tell the story.

08 Track the three core margin ratios

Gross margin is gross profit divided by turnover. It shows how much margin your offer generates before overheads.

Operating margin is operating profit divided by turnover. It shows how efficiently the whole operation runs after overheads.

Net margin is profit after tax divided by turnover. It shows how much of each pound of sales ultimately drops to the bottom line for shareholders.

Margins are most useful tracked over time and compared with similar businesses. A healthy margin in one sector can be weak in another.

Do not judge a margin in isolation. Compare it to your own history and your industry.

09 Avoid the common founder traps

The most common confusion is expecting profit to match the bank balance. It will not. Profit excludes loan principal repayments, dividends, some capital purchases and timing differences around debtors, creditors and tax payments.

Another common confusion is EBITDA. EBITDA means earnings before interest, tax, depreciation and amortisation. It can be useful for comparison, but it ignores real economic costs such as replacing assets that wear out.

Software labels also vary. Overheads, operating expenses and administrative expenses often describe broadly the same part of the report. What matters is what is being subtracted from what.

If the P&L says you made money but cash is tight, look at debtors, stock, tax, loan repayments and dividends.

10 Choose the right review rhythm

A P&L is only useful if the bookkeeping behind it is current. Unreconciled bank feeds, uncategorised expenses and missing supplier invoices make the report unreliable.

For early-stage founders, a quarterly review is often a practical rhythm. At year end, ask your accountant to walk through the P&L properly. Before big decisions, such as hiring, borrowing or launching a product, bring the books up to date and review the numbers.

As the business grows, monthly management accounts become more valuable because stale numbers become more expensive.

The question is not how often you can run the report. It is how often the report is reliable enough to use.

KEY TAKEAWAYS

A useful P&L answers three questions quickly: is turnover moving in the right direction, is gross margin holding up, and are overheads growing sensibly relative to the size of the business?

If the report does not answer those questions clearly, the issue is usually the bookkeeping structure behind it: chart of accounts, categorisation, timing and reconciliations.

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For guidance only. This guide does not constitute legal or financial advice. Always verify with HMRC or a qualified adviser.