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Understanding Profit Metrics: Gross, Operating and Net Profits

When investors want to see how a company is performing, chances are they'll browse the company's website or annual report for its income statement. One sees the business's total revenue at the top, followed by several rows of expenses. The very bottom row shows what's left over: the net profit or loss. If this number is bigger than last year's, one might presume the firm is doing better. But is it?

As it turns out, an organization's performance is a little more complex than its "bottom line". That's why most analysts look at more than one form of profit when evaluating a stock. In addition to the net profit, they may also factor in gross profit (a.k.a. gross income) and operating profit (a.k.a. operating income). Each of these line items on the income statement tells important information about how the company is doing. And if the investor knows what to look for, the different measures of profit can help indicate whether recent trends – good or bad – are likely to continue.

The Three Major Profits

To understand each type of profit, it's useful to get a grasp on the income statement itself. This is a financial document that shows the company's revenue and expenses for a specific time period, usually a quarter or a full year. If it's a publicly traded company, an individual can virtually always find it on the company's investor relations webpage. The following is a full-year income statement for Active Tots, a maker of outdoor children's toys.

(in millions)	2012	2011
Net Sales	2,000	1,800
Cost of Goods Sold	-900	-700
Gross Profit	1,100	1,100
Operating Expenses (SG&A)	-400	-250
Operating Profit	700	850
Other Income (Expense)	-100	50
Extraordinary Gain (Loss)	400	-100
Interest Expense	-200	-150
Net Profit Before Taxes (Pretax Income)	800	650
Taxes	-250	-200
Net Income	550	450

The top line of the table shows the company's revenue or net sales – in other words, all the revenue it has generated over a given stretch of time from its day-to-day operations. From this initial sales figure, the business subtracts all the expenses associated with actually producing its toys, from raw materials to the wages of people working in its factory. These production-related expenditures are referred to as the "cost of goods sold". The remaining amount, usually on line 3, is the gross profit. The next row down shows the business's operating expenses, or SG&A, which stands for selling, general and administrative expenses. Essentially, these are its "overhead" expenses. Companies can't just make products and collect the proceeds. They need to hire salespeople to bring the goods to market and executives who help chart the organization's direction. Usually they'll also pay for advertising as well as the cost of any administrative buildings. All of these items are included in the operating expense figure. Once this is subtracted from gross profit, we arrive at the operating profit.

Toward the bottom of the income statement are expenses not related to the firm's core business. For example, there's a line for extraordinary gains or losses, which include unusual events such as the sale of a building or business unit. Here, we also see any gains or losses from investments or interest expenses. Finally, the document includes a line representing the corporation's tax expense. Once these additional expenses are deducted from operating profit, the investor arrives at the net income or net profit – or net loss, if that's the case. This is the amount of money the company has either added to or subtracted from its coffers over a given time period.

Understanding the Differences

So why use these different metrics? Let's examine the Active Tots income statement to find out. Many beginning investors will naturally look right for the net profit line. In this case, the company earned $550 million in its latest fiscal year, up from $450 million the year before.

On the surface, this looks like a positive development. However, a closer look reveals some interesting information. As it turns out, the firm's gross profit – again, the revenue that remains after subtracting production expenses – is the same from one year to the next. In fact, the cost of goods sold grew at a faster pace than net sales. There could be any number of reasons for this. Perhaps the cost of plastic, a primary material in many of its products, rose significantly. Or, perhaps its unionized plant workers negotiated for higher wages.

What is perhaps more interesting is that the business's operating profit actually went down in the latest year. This may be a sign that the company's staff is becoming bloated, or that Active Tots has failed to rein in employee perks or other overhead expenses

How, then, is the company earning $100 million more in net profit? One of the biggest factors appears toward the bottom of the income statement. Last year, Active Tots recorded an extraordinary $400 million gain. In this case, the one-time windfall was the result of selling its educational products division.

While the sale of this business unit increased net profit, it's not income the company can count on year after year. For this reason, many analysts emphasize operating profit, which captures the performance of a firm's core business activity, over net profit.

It's important to note, however, that not all spending increases are negative. For example, if Active Tots saw its operating expenses shoot up as a result of a new advertising campaign, the firm might more than make up for it the following year with increased revenue. In addition to looking at the income statement, it's important to read up on the company to find out why figures are changing.

Evaluating Performance

Profit metrics can help assess a company's health in two ways. The first is to use them for an internal review – in other words, comparing new numbers to the firm's historical data. A knowledgeable investor will look for trends that help predict future performance. For instance, if the costs associated with production have risen faster than the company's sales over multiple years, it may be difficult for the company to maintain healthy profit margins going forward. By contrast, if its administrative expenses start to take up a smaller part of revenue, the company is probably doing some belt-tightening that will enhance profitability.

Investors should also compare these three metrics – gross profit, operating profit and net profit – to those of its competitors. Many investors look at earnings per share figures, which are based on net profit, when deciding which stocks offer the best value. However, because one-time gains or expenses can distort financial performance, many securities analysts will instead key in on operating profit to determine what shares are worth.

The Bottom Line

While it's tempting to look at the bottom line of an income statement to size up a company, investors should be mindful of this figure's shortcomings. Because gross profit and operating profit focus on the company's core activities, these numbers are often the best barometer for determining an organization's future course.