THEME: THE BOTTOM LINE

By John W. Day, MBA

ACCOUNTING TERM: Net Profit or Loss

Net Profit or Net Income is the amount by which total revenue exceeds total expense. Net Loss is the amount that remains when total expense exceeds total revenue. The more popular expression of these two situations is called "The Bottom Line".

FEATURE ARTICLE: Understanding The "Bottom Line".

What's there to understand? The bottom line is the last line on the Statement of Income and Expense and it is either a profit or a loss. That's all you need to know, isn't it? Yes, it is important to know whether you are making a profit or losing money, but understanding how financial statements work requires a working knowledge of each general ledger account and how that particular account fits into the overall accounting framework. For example, are you aware that the entire Statement of Income & Expense (more popularly known as a Profit and Loss (P&L) Statement) is an extension of one line item located in the Equity section of your Balance Sheet? Take a moment and review the Accounting Model by clicking on this link:

http://www.reallifeaccounting.com/accounting_model.asp

Notice there are five elements that make up the parts of the financial statements:

Balance Sheet
(1) Assets (2) Liabilities (3) Equity

Profit & Loss Statement
(4) Revenue (5) Expense

You will find that the exact same amount on the P&L statement's bottom line is also listed in the Equity section as Net Profit or Loss. For example:

Profit & Loss Statement:

Revenue	$500
Expense	- 400
Net Profit	**$100**

Balance Sheet:

Owner's Equity:

Capital Contributions	$100
Owner's Equity	800
Owner's Draw	300
Net Profit	**100**

Why is this? Net Profit means an increase (credit) in Equity and Net Loss means a decrease (debit) in Equity. Look at the Accounting Model to verify this. This is double-entry accounting. If there is a credit amount on the right side of the ledger then there must be an equal amount as a debit on the left side of the ledger. Remember, Equity is what is yours. Therefore, if there is an increase (credit) in Equity then it makes sense to think that there is an increase (debit) in Assets, probably in the form of cash, receivables, inventory, or property. Or, if there is a decrease (debit) in Liabilities it indicates an increase (credit) in Equity, since there is less owed to creditors.

Similarly, it stands to reason that if there is a loss, indicating a decrease (debit) in Equity that there will also be a decrease (credit) in Assets or an increase (credit) in Liabilities. In other words, you now own less, because Assets were used up, or money was borrowed to pay for the expenses that helped create the loss.

Think of a Balance Sheet as a still photo of your business and your Profit & Loss statement as a movie of your business. The snapshot is taken as of a certain date, usually at the end of an accounting period whether it be a month, quarter, or year. The movie shows the activity of revenue and expense of your business *during* an accounting period. The snapshot will include the *culmination* of revenue and expense activity that occurred during an accounting period at the time of the snapshot <u>because</u> it is included in the Equity section of your Balance Sheet.

A common question that is often asked is, "If I'm showing a Profit, then where is all my money?" The answer to that question can be found on the Balance Sheet, because every penny is accounted for when using double-entry accounting. However, it takes an understanding of how the general ledger accounts work, in relation to each other, for the Balance Sheet to become meaningful.

<u>QUESTION: Why Is The Owner's Draw Not Taxable?</u>

When I mention the Owner's Draw I am obviously referring to a Sole Proprietorship. This is a frequently asked question. The owner or sole proprietor takes draws for personal purposes throughout the year and begins to think, "Hmmm, I'm going to have to pay taxes on all this money I'm taking out." Sort of, but not exactly. Look at the journal entry when a draw is taken:

DESCRIPTION	DEBIT	CREDIT
Owner's Draw	25,000.00	
Cash		25,000.00
To record Owner's Draw		

Here's the kicker. Cash is being decreased, but where did the cash come from? Here are a couple of possibilities other than from Net Profit:

- Maybe the owner borrowed some money and put it in the business, but then decided to use some of the money for personal purposes. You don't have to pay tax on borrowed money.

- Perhaps, a while ago, he contributed some of his own money that he had previously paid taxes on and now is paying himself back. You certainly wouldn't have to pay taxes on the same money twice.

The rule is that taxes are based on Net Profit because Net Profit relates to income *earned*. However, use caution here because if you are a "cash basis taxpayer" and your books are recorded on an accrual basis then you must adjust your Net Profit accordingly. This essentially means you must subtract Accounts Receivable and add back Accounts Payable to the Bottom Line when reporting financial information on your personal tax return.

Even if your books are recorded on a cash basis, your Net Profit may not relate directly to cash. For instance, usually a business has some depreciation that is a non-cash deduction. There are a number of reasons why the Owner's Draw may be something different than Net Profit even though there is a loose relationship between the amount of money available to the owner and Net Profit.

TIP: How To Avoid Double-Taxation In A Corporation

Double taxation occurs when a corporation has taxable income, pays corporate tax, and then pays a dividend to its stockholders who then pay personal income tax on the dividends received. Assuming you have a small corporation and you are never paid an adequate salary, it is a fairly simple matter to adjust your salary in order to keep Net Profit at a minimum. Remember in the examples above, that if there is an increase in Net Profit (credit) there should be a corresponding increase (debit) in your Assets (hopefully enough cash to pay your salary bonus). Of course, you could have used all the extra money to decrease (debit) Liabilities and have no money to use for salary. This is why it is a good idea to do tax planning during the year.

You should also know that there is an IRS rule requiring corporations that accumulate over $250,000 in Retained Earnings to pay out dividends to their stockholders unless they have a very good reason to use the money elsewhere. Retained Earnings is the account into which all the Net Profit from prior years accumulates. This is not a problem for most small business corporations. Bonus salaries and pension contributions can usually whittle the Net Profit down to nothing. Hence, no dividend payments are required and, consequently, there is no double-taxation.

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