PREPARING PROFIT & LOSS STATEMENTS
(ALSO KNOWN AS THE INCOME STATEMENT)

Perhaps the information an owner/manager wants MOST about the performance of the business is its profitability. For a particular period of time, did the company make a profit or experience a loss? The Profit and Loss Statement (sometimes called an Income Statement) describes the net result, over a period of time, of revenue less expenses. The familiar term, "the bottom line" refers to the last line on the Profit and Loss Statement—the one indicating the company's net profit (or loss). Stated simply, the Profit and Lose Statement is represented by the equation:

Revenue - Expenses = Income

The Figure, below is an example of the format and types of categories commonly found on a Profit and Loss Statement. The first thing to notice on the statement is the dates on the top. A Profit and Loss Statement always covers a particular period of time--a month, a quarter, a year, etc. This means that revenue and expense items appearing on the statement were actually incurred during the time indicated. The element of time should be kept in mind when examining the various accounts listed on the statement.

Profit & Loss Statement – October 1 – December 31, 19--

	Dollars	Percent
Net Sales	$68,116	100.0
Cost of Goods Sold	47,696	70.0
GROSS PROFIT & SALES	**$20,420**	**30.0**
Expenses		
Wages	$6,948	10.0
Delivery Expense	954	1.4
Bad Debts Allowance	409	0.6
Communications	204	0.3
Depreciation Allowance	409	0.6
Insurance	613	0.9
Taxes & License	1,021	1.5
Advertising	1,566	2.3
Interest	409	0.6
Other Charges	749	1.1
TOTAL EXPENSES	**$13,282**	**19.5**
Net Profit	$7,138	10.5
Other Income	886	1.3
TOTAL NET INCOME	**$ 8,024**	**11.8**

Net Sales
"Net Sales" refers to the total sales for a period, less necessary adjustments. To arrive at a Net Sales figure, use the following process:

Gross Sales	$XX,XXX
Less Sales Returns & Allowances	-X,XXX
Net Sales	$XX,XXX

Many small businesses treat sales returns and allowances as direct reductions of the sales figure. However, it is advisable to establish a separate account to record Sales Returns and Allowances. This will aid the owner/manager in determining if too much merchandise is being returned.

Another, less frequent reduction to the total sales figure involves the sale of merchandise to be delivered at a later time. The concern on a Profit and Loss Statement is to match revenues and expenses. To record a sale that will be completed later may be misleading. In such a case, it may be advisable to check with an accountant for suggestions on the best way to record the sale.

Cost of Goods Sold
The primary expense incurred in selling merchandise is the cost of the goods sold. The process for arriving at their cost is controlled by the merchandise inventory valuation methods discussed in the previous chapter and is calculated:

Beginning Inventory	$XX,XXX
Add Merchandise Purchased	+XX,XXX
Merchandise Available for Sale	$XX,XXX
Less Ending Inventory	-XX,XXX
Cost of Goods Sold	$XX,XXX

Start with the beginning inventory, the inventory on hand on the first day of the period covered by the Profit and Loss Statement. Add the total of merchandise purchased during the period, less any items returned to the supplier. The resulting figure represents the merchandise that was available for sale. From this figure, subtract the ending inventory as of the last day of the period covered. The difference is the cost of goods sold. This cost can then be entered on the Profit and Loss Statement, above.

Notice the column on the far right of the statement titled "Percent." The various costs of doing business are expressed as a percentage of Sales in this column. The cost of goods sold in this example is 70 percent of sales. This means that 70 percent of sales dollars are eaten up by the cost of the merchandise.

Gross Profit on Sales
The gross profit on sales (or gross margin) in the preceding example is 30 percent. The gross profit on sales is found by subtracting the cost of goods sold from net sales. The percentage is computed by dividing the amount of gross profit on sales by the net sales figures.

Expenses
All business expenses are then recorded on the Profit and Loss Statement, totaled, and the total subtracted from the gross profit on sales. Expenses are often split into two categories to aid in identifying problem areas. One type may be categorized as operating expenses. These expenses generally vary with the level of sales. Sales commission expense, for example, varies relative to the volume of sales. The second expense category is often referred to as fixed (or overhead) expenses. Rental expense, for instance, stays the same from month to month, regardless of the level of sales.

The sample Profit and Loss Statement in Figure 4-1, contains common expense accounts. Wages expense includes all employee reimbursement and comes from the gross salaries account recorded in the Cash Disbursements Journal. Delivery expenses represents costs associated with delivering merchandise to customers. Freight costs associated with receiving merchandise are treated as part of the cost of the merchandise and not included in this category.

Bad debt allowance is an estimate of the amount of Accounts Receivable that will not be paid. While the exact amount that will turn out to be uncollectible cannot be determined in advance, reasonable estimates can be made based on past experience.

Communication expense refers to the various activities involved in conducting business communications--telephone, mail, and related expenses.

Depreciation
The expense item called Depreciation Allowance refers to an account established to recognize the cost of property in generating income. A delivery truck, for example, may be purchased at a cost of $15,000. Because the truck will be used over a number of years, its cost should be spread over its useful life. This matches expenses with revenues. Because depreciation systems may change through Congressional legislation, always refer to the latest Publication 534 from the Internal Revenue Service.

What Can Be Depreciated
Depreciable property is property for which a depreciation deduction is allowed. Many different kinds of property can be depreciated, such as machinery, buildings, and equipment.

Property is depreciable if it meets these requirements:

1) It must be used in business or held for the production of income;
2) It must have a determinable life of longer than one year; and
3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

In general, if property does not meet all three of these conditions it is not depreciable.

ACRS Method
ACRS (accelerated cost recovery system) is mandatory for most tangible depreciable assets placed in service after 1980. Other methods require you to make determinations on matters such as useful life and salvage value. Under ACRS, salvage value and useful life are not relevant.

ACRS allows you to recover the unadjusted basis of recovery property over a recovery period. Your property's recovery period is determined by its class life. Generally, the class life of property places it in a 3-year, 5-year, 10-year, 15-year, or 18-year class. A recovery percentage for each year of the recovery period is prescribed for figuring your ACRS deduction. The deduction is figured by multiplying your unadjusted basis in the property by the applicable recovery percentage. (For detailed information on ACRS see Internal Revenue Service Publication 534.)

Recovery Property
Recovery property is tangible, depreciable property that was placed in service after 1980 and that is not excluded property. It usually includes new or used property acquired after 1980 for use in trade or business or to be held for the

production of income. Property acquired and used for any purpose before 1981 is not recovery property.

Unadjusted Basis
The ACRS deduction is figured by multiplying the unadjusted basis in recovery property by its applicable percentage for the year. Salvage value is disregarded under ACRS. The unadjusted basis may not be reduced by any salvage value when figuring deductions under ACRS.

Recovery Periods [NOTE: THERE HAVE BEEN IRS REVISIONS TO THIS SECTION]

Each item of recovery property is assigned to a class of property. These classes of recovery property establish the recovery periods over which the unadjusted basis of items in a class are recovered. The six classes with examples of inclusive property are:

1) 3-year property (automobile and light-duty trucks)
2) 5-year property (office furniture and fixtures)
3) 10-year property (manufactured homes)
4) 15-year real property (real property placed in service before March 16, 1984)
5) Low-income housing
6) 18-year real property (real property placed in service after March 15, 1984)

Classes of Recovery Property
The class to which an item of recovery property is assigned is determined in part by whether it is section 1245 or section 1250 class property.

Section 1245 class property is any depreciable property that is:

1) Tangible personal property;

2) A special purpose structure or storage facility that is also depreciable tangible property. A building or its structural components may not be included. The facility must be an integral part of a certain business activity, such as a research facility used in connection with this activity, or a bulk storage facility for replaceable commodities sed in connection with this activity. Such an activity includes manufacturing, production, extraction, or the furnishing of transportation, communications, electrical, energy, gas, water, or sewage disposal services;

3) A single purpose agricultural (livestock) or horticultural structure;

4) Or a storage facility (other than a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum.

Section 1250 class property is all depreciable real property not classified as section 1245 property or an elevator or an escalator.

Excluded Property

VACRS may not be used for certain property placed in service before 1981 but transferred after 1980. Property that does not come under ACRS must be depreciated under other methods of depreciation, such as straight line or declining balance. In addition, owners may elect to exclude certain property from the application of ACRS.

Election to Exclude Certain Property

If you depreciate property under a method of depreciation not based on a term of years, such as the unit-of-production method, you may elect to exclude that property from ACRS. A depreciation deduction under the unit-of-production method is figured by dividing the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. The resulting amount is applied to the units produced in a year to arrive at the depreciation for that year.

Dispositions

Gain or loss from an asset is usually recognized on its disposition or retirement. Nonrecognition rules may, however, allow the postponement of some gain. (See Internal Revenue Service Publication 544, "Sales and Other Dispositions of Assets".)

Other Depreciation Methods

Before ACRS was enacted, other methods were used to figure depreciation. If property was placed in service before 1981, or if the property does not quality for ACRS, these methods must be used. However, these methods may not be used for property that qualifies for ACRS. Because some states do not accept the ACRS method for state taxes, check with your state tax office to determine how to reconcile state requirements with the ACRS method now required by the Federal Government.

There are many different methods of figuring depreciation. Any method that is reasonable may be used if it is applied consistently. These methods, such as the straight-line method, the sum-of-the-years-digits methods, and the declining-

balance method are not discussed here. They are described in numerous references, including SBA's Business Development Booklet SBMS No. 32, Financial Recordkeeping for Small Stores.

Remaining Expenses
Insurance expense includes the cost of various insurance policies. If an insurance policy premium is paid for a period exceeding the period covered by the Profit and Loss Statement, include only the portion paid for the statement period. The remaining portion of the paid premium becomes a temporary asset called Prepaid Insurance (or Prepaid Expenses) and would be recorded on the Balance Sheet.

Taxes and Licenses expense includes governmental fees, license fees, sales taxes, etc. It does not include tax on business income. Income tax is computed on the Net Income.

Advertising expense includes all costs associated with advertising the business. Again, prepaid advertising is not included as an expense, but treated as an asset and recorded on the Balance Sheet. Interest expense is the interest paid on any loans during the period covered by the statement. Other charges is a category used to record miscellaneous expenses that are incurred. Total expenses is derived by adding all the expenses listed on the statement.

Net profit can then be determined by subtracting total expenses from Gross Profit on Sales. Net profit can be thought of as operating income or profit earned on operations. Total Net Income is the sum of Net Profit and Other Income.