How to Calculate Net Income: Here’s a Comprehensive Guide

Net income seems straightforward: It is the result when expenses (administrative expenses, business expenses, interest expenses, operating costs and other expenses) are subtracted from revenue. This idea is crucial to understand, whether on a grand scale or a small business level.

Understanding net income (often called net earnings) gives you a clear picture of your business’s profitability and also helps you look at your business’s financial health so you can make informed predictions and decisions. Still, this “simple” concept requires a deep understanding to recognize the scope of its power.

What is net income?

As stated above, your company’s net income is the result of subtracting your expenses from your total revenue. In a business setting, this includes all operating expenses. It is a critical metric that investors and lenders consider when considering whether to invest in your business or lend you money. This implies the importance of how net income looks on a financial statement and how it factors into calculating other essential metrics, such as net profit margins and operating cash flow.

What’s the difference between net income and gross income?

An important distinction and commonly confused term with net income is gross income. This is the number that you have

before subtracting expenses. It’s your gross profit. Misunderstanding these numbers can lead to significant issues when budgeting or preparing for a quarter. Because costs are not considered, gross profit is not a useful measure of profitability.

Related: What Is Adjusted Gross Income? Everything You Need To Know.

How do you calculate net income?

Before fully understanding its utility, you need to know the formula to calculate net income. Additionally, don’t be tricked by this seemingly simple equation. Multiple factors interact with this calculation.

- Net income = total revenue – total expenses

How do you use the net income formula?

You need to know your revenue and expenses to find the net income. As a quick refresher, total revenue is the amount generated for the given period of your calculation. This is your operating income, which you can find by adding up the income generated from sales or services.

Conversely, your expenses include the total direct costs incurred, like the cost of goods sold (COGS).

How to determine which expenses to cut?

Each setting will be unique, and cutting expenses depends on the specific financial situation of the business. There are a couple of general rules to follow when cutting costs.

Make sure that you identify all the expenses. This can be as simple as a list of all fixed and variable expenses. Since

cutting a cost usually means losing a service or advantage, having a list to compare profitability can be very effective in determining how valuable that expense is.

Also, consider long-term implications. Cutting expenses may provide short-term relief but can also have long-term consequences. For instance, cutting back on employee training may save money in the short term but can also hurt the business's ability to stay competitive in the long run.

What factors can influence net income?

The higher your expenses, the lower your net profit. So it should be your goal to calculate your costs and be prepared to remove any line items on your balance sheet that aren't worth losing money over.

If you're reporting negative net income (or a net loss), your expenses exceed your total income – you need to cut the costs that aren't worth it. Incompetent workers and older technology are just two examples of this kind of expense. Additionally, be looking to find more cost-effective ways to run your business.

Competition

Your competition will always bring your income down. Invest in better marketing, products or pricing to attract customers and increase revenue. Using competitors as goals to surpass in net income can be a great way to look at your business strategy and adjust to compete.

Depreciation of capital

Always consider your capital investments. With the ever-growing and evolving world of technology, staying current on

the technology that would help streamline your business would be financially irresponsible.

There can always be depreciation in efficiency because of this capital. However, you can mitigate the risks of working capital through the amortization of initial costs.

Productivity of your labor force

As discussed above, the impact of incompetent workers can be minimal when dealing with a small number. Still, inefficient workers can majorly affect your income if left unchecked.

If you let that issue continue and compound, you'll end up with a problem severely eating into your net income. You can't get rid of all of those people all at once. Always look at the quality of workers you hire and monitor the number of employees.

Why is it important to understand net income?

The tools at your disposal, with your net income number, are numerous. Net income is typically reported on a company's income statement and provides valuable insights into the business's financial health. Financial analysts use net income to evaluate a company's profitability and make investment decisions. But there are a few more things to take advantage of with this number.

1. Making informed decisions

Because net income displays the business's overall financial health, business owners can use this metric to calculate profit margins, return on investment (ROI) and debt-to-equity ratio, giving more detailed views of a corporation's financial standing.

These tools can give you means of moving forward and making decisions for the better of your company without as much risk. This confidence can allow your company to be a leader in the future for success in your industry.

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2. Can help you attract investors

Business owners can use net income to attract investors because nearly every investor looks at the net income of any business before investing. If you have a high net income, you have a much higher chance of receiving investments in your business, allowing you to pursue more ambitious goals at a larger scale.

3. Building a budget

You can use net income to budget and allocate resources more effectively in a business setting. This creates financial stability and peace and allows for a stronger foundation for a business.

Related: The 5 Essentials for Aligning Your Budget With Your Business Strategy

Net income FAQs

1. Is net income post-tax?

Net income can be before or after taxation, depending on the situation. It is generally considered the amount of income left over after all applicable taxes (for example, income taxes) have been deducted from taxable income. However, financial statements will differentiate between “pre-tax income” and “after-tax income.”

2. What’s the difference between net income and profits?

These two terms are commonly misunderstood and used interchangeably. Net income refers to the amount of money left over after all expenses and taxes are deducted. Profit refers to different types of income that do not always account for all expenses.

3. What’s the difference between individual net income and business net income?

Individual and business net income are commonly confused as well. Individual net income is the income an individual receives after taxes, usually calculated annually.

Business net income refers to the amount of money a business receives after all taxes. The business net income calculation usually has many more streams of income and debts from expenses. Because of its small scale, the individual only focuses on the individual’s income, usually one single stream.

Another distinction is the source of income. Individual net income is typically based on a single source of income, while net business income can come from various sources, such as sales of products or services and investments.

How can you use net income moving forward?

Educating yourself is the most important thing you can do. Understanding concepts like net income and ROI can help your business thrive. However, filling in the formula isn’t enough. While having a healthy number at the bottom line of the income statement is beneficial, you still must understand what it

implies for your company’s health.

You should know what factors play into calculating this number and how it affects the future of your business. Understanding the fundamental reason is much more important than understanding the formula.

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