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## Terminology Department

American Institute of Accountants. Committee on Accounting Terminology Committee

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## Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON TERMINOLOGY OF THE AMERICAN  
INSTITUTE OF ACCOUNTANTS

The special committee on terminology submits the following tentative definitions for consideration and criticism. Comments from readers will be welcome. Letters may be addressed to the committee in care of THE JOURNAL OF ACCOUNTANCY.

### *PROFIT—PROFITS:*

The word "profit" is frequently used alone to indicate the excess of proceeds over cost in an incidental transaction or of revenue over expense in the case of a minor subsidiary department, introduced as a net figure into the profit-and-loss account; for example, profit on sale of real estate (or investments); profit from commissary department. When so used it may be regarded as having its ordinary, non-technical meaning.

The word "profits" in accounting is used in a technical sense and may be regarded as a generic term, employed almost invariably in conjunction with some qualifying word or phrase. The most usual forms in which it is used are:

Gross profits  
Net profits  
Gross profits on sales  
Net profits on sales  
Trading profits  
Net operating profits  
Undivided profits  
Undistributed profits

Care should be exercised to describe the kind of profit to which it is desired to refer.

When used alone, the word "profits" generally has its ordinary, non-technical meaning (e. g., the profits of the business), when the definition given in July, 1922, applies: "That which remains—which is left over after defraying expenses and providing for loss of capital."

### *GROSS PROFITS:*

In manufacturing and trading businesses, the difference between (a) the net proceeds of goods sold (before deduction of cash discounts and bad debts) and (b) the net production cost or the net purchase cost thereof (also before deduction of cash discounts).

Inasmuch as in the ordinary form of manufacturing or trading account the cost of sales is arrived at by adding inventory at beginning to, and deducting inventory at end of period from, total cost of production or total purchases for the period, the cost-of-sales figure includes inventory losses (loss by theft, disappearance, breakage, deterioration, reduction in market value, etc.), and the gross profits are accordingly determined after provision for these items.

Where cost of sales is specifically determined on the basis of goods actually sold, and inventory losses are separately measured or are arrived at by compar-

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ing physical and book inventories, the gross profits before provision for inventory losses are sometimes referred to as prime gross profits.

In a business dealing in real estate, gross profits are the excess of the net proceeds of sales over the net cost of property sold, including in the latter figure the proportions of cost of improvements and development applicable to such sales.

In stating gross profits of manufacturing businesses in summarized form for publication, it is frequently desired to show depreciation of plant as a separate item of deduction from profits. In such cases the item of gross profits shown should be stated as "Gross profits before provision for depreciation."

### *NET PROFITS:*

The term "net profits," without qualifying expression, should be used only to describe the profits remaining after including all earnings and other income or profit and deducting all expenses and charges of every character, including interest, depreciation and taxes. Net profits should represent the amount available for dividends and surplus. The term is not synonymous with net earnings.

### *GROSS PROFITS ON SALES:*

The excess of the net proceeds of goods sold over the net production cost or the net purchase cost thereof. See "gross profits." Where the term "gross profits on sales" is used, it should be applied in the same manner as the term "prime gross profits," i. e., before provision for inventory losses.

### *NET PROFITS ON SALES:*

The balance remaining after deduction from gross profits on sales of inventory losses, selling expenses, commissions, advertising, bad debts and all other expenses chargeable against sales, actual or prospective.

### *TRADING PROFITS:*

The balance remaining after adding to net profits on sales the amounts of any incidental profit from trading operations (e. g., commissary, stores, etc.) and deducting all general expenses other than financial charges, corporation expenses, and corporate and income taxes.

### *NET OPERATING PROFITS:*

Substantially the same as trading profits. The term "net operating profits" is, however, applicable to industries in which the gross profits are from other than sales in the ordinary sense, such as laundries, warehouses, garages and similar quasi-service businesses.

### *UNDIVIDED PROFITS:*

Where this expression is used in corporation accounts, its meaning is the accumulated net profits of the business after deduction of all dividends and amounts carried to reserve. In such cases the balance of net profits for any individual accounting period is generally described as "Balance carried to undivided profits," or "Balance carried to surplus and undivided profits."

It is then usual in the balance-sheet to include undivided profits with surplus, under the heading of "Surplus and undivided profits." In cases in which the item of undivided profits is shown in a separate item from surplus it indicates an attempt to distinguish profits arising from regular business operation from extraneous corporate profits legally divisible as surplus, and to allocate divi-

dends paid against the former rather than the latter. In view of the legal questions involved the practice is not generally recommended.

In partnership accounting the expression "undivided profits" is used to designate divisible profits for a period not yet paid or credited to the individual partners.

*UNDISTRIBUTED PROFITS:*

A term sometimes used erroneously as synonymous with undivided profits.

In the accounting sense the expression has no meaning other than that in the dictionary. For example, the profit shown by a statement of account of a joint venture, before division among the parties interested, might properly be described as "undistributed profits."

*EXPENDITURES:*

Charges against income, whether actually paid or merely incurred; to be distinguished from disbursements, which represent actual cash outlays of every description.

Certain accounts, chiefly those of a fiduciary character, are described as "income and expenditure accounts," or "accounts of revenue and expenditures." The expression "budget expenditures" is also used in governmental accounting, meaning the forecast of charges to be met out of budgeted revenues.

The expression "capital expenditures" means charges paid or incurred for additions to property and plant.

*SECURITIES:*

When used in a balance-sheet the term "securities" denotes stocks, bonds, certificates of indebtedness and other corporate or government obligations.

When used under the heading of current assets, the item of securities includes only temporary investments of the funds of the business of a marketable character.

Securities of subsidiary corporations should be shown separately. When held for temporary investment and readily marketable, the item may be included in current assets. Stocks of such companies held for control should either be stated under a distinct balance-sheet caption or should appear under the heading of fixed assets.

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The recent work of the special committee on terminology has brought forward a number of cases where some difference of opinion exists among qualified accountants, and it may be worth while to give a few such instances.

*ACCOUNTS RECEIVABLE:*

The definition published in August is criticized as being too narrow, for it is said that the term, when unqualified, includes amounts due by all debtors on open account, not only those arising "in the regular course of business."

The committee is inclined to agree with the critic, but when the definition was drawn the controlling idea was the use of the term in a balance-sheet, and the federal bulletin on the preparation of balance-sheet statements appears to limit "Notes and accounts receivable" to those due by customers and, presumably, in the regular course of business.

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### *COMMISSION-SELLING:*

In this case, one member of the committee objects strenuously to any implication that such commissions are ever contingent liabilities. He says, "I can not agree. The commission is a liability in any case *if the sale is taken up*. It can not be a contingent liability. If a sale be taken up the full amount of the sale would appear in the accounts receivable; if the commission appeared as a contingent liability the balance-sheet would show too much net assets. The account receivable at the best can produce only the amount of the sale *less the commission*, and the liability for commission is a *positive* deduction from the account receivable, not a contingent one."

To this another member replies that in some businesses, notably in those concerned with real estate, it is a general practice to treat as a "sale" a contract providing that title to the property involved will be given when certain conditions are fulfilled.

In such cases it is also a general practice to make the payment of the commission to the salesman contingent upon the purchaser making payments and in such cases both the sale and the commission might be called contingent.

### *NOTES RECEIVABLE—OFFICERS, STOCKHOLDERS AND EMPLOYEES*

In the definition which appeared in the August number, there is this sentence: "The propriety of including them in 'quick assets' depends upon the circumstances of each case." As to this, a correspondent writes, "Never! They are a most untrustworthy asset."

In the great majority of cases, this criticism is applicable, but we have known exceptional cases, especially in close corporations, where the amounts due by the officers in a flourishing concern were the best assets the company had and were those on which the bankers placed most reliance.

### *PROVISION FOR BAD DEBTS:*

The committee gladly accepts the following suggested amendments:

Provision for bad debts usually is calculated in one of two ways:

- (1) By setting aside each period a percentage of total sales, charging against the sum so set up any ascertained bad debts and carrying forward any unused residue to the next period.
- (2) By estimating, on the basis of a scrutiny of each account, the amount of probable loss in collection, adjusting the provision so that it shall equal the total of such estimated losses.

The first plan is likely to produce a reserve either too large or too small; it has the advantage of giving a reasonably correct monthly profit statement. The second plan is more accurate but can be used only when it is practicable to examine each of the accounts in detail.

### *COST OF SALES—COST OF GOODS SOLD:*

Another letter has been received and is of sufficient interest to publish in full, especially since the committee is sent too few such constructive criticisms. In this case it cheerfully accepts the definition suggested for "cost of goods sold" and tenders its thanks to the professional correspondent.

"This letter refers to the definition of 'cost of sales' appearing on page 138 of the August issue of *THE JOURNAL OF ACCOUNTANCY*. It seems to me that this proposed definition is unfortunate in several respects.

"In the first place it might be stated that the term 'cost of goods sold' is preferable to 'cost of sales.' The latter term is confused by laymen with the 'expense of making sales.' This is likely to be increasingly true as cost accounting for marketing activities becomes, as it will, a steadily more important feature of our accounting work.

"In the second place, if the 'cost of goods sold' is arrived at by the periodic-inventory method there is automatically included in the figure all adjustments of the actual cost of the goods which have been sold due to (a) reductions in inventory prices due to market fluctuations, (b) merchandise losses due to shrinkage, spoilage, theft, obsolescence, and other factors, (c) under or over absorbed manufacturing overhead. What is called 'cost of goods sold' then becomes cost of goods sold, spoiled, destroyed, or disappeared, plus or minus increase or decrease in inventory values.

"In the third place the statement that cost of sales 'is determined by deducting . . . etc.' is erroneous as to a large majority of concerns which determine their cost of sales by recognized cost accounting principles and show 'inventory variations' as a distinct item of expense or deduction from profits.

"As a basis for working out an alternative definition I suggest the following: Cost of sales (better termed cost of goods sold) is the cost of those goods which have been sold and delivered during the period; this consists in the case of trading concerns of the purchase cost of the merchandise sold, including inbound delivery expenses, and in the case of manufacturing concerns of the total production cost of the goods sold, including raw materials, labor, and manufacturing expenses."

*PREPAID EXPENSES* }  
*DEFERRED CHARGES* } :

Another correspondent suggests that in the definitions of these two expressions, it is erroneous to call expenses or charges "prepaid" if such charges have merely been made through crediting voucher account or accounts payable.

The committee used the expression "for which settlement has been made." It might better conform to accepted practice to say "which have been entered in the accounts."

While in some cases the expression "prepaid expenses" may not be literally accurate, it is a recognized and useful term which can not now be abolished or restricted in meaning as the correspondent suggests.

The correspondent asks the committee to answer certain questions as to the use of these terms, but the committee is of the opinion that such discussions are beyond its field of work.

The correspondent is referred to Charles B. Couchman's work *The Balance-sheet* which deals with this matter clearly and at length, particularly on page 31, where, inter alia, it is said:

"Deferred charges do not represent any legal right to collect from any one the amount shown in the form of cash, commodities or service; whereas prepaid expenses do involve such right."

Examples are given showing that if rent be paid in advance, the tenant has the right to the use of the building and the rent is a prepaid expense, whereas if an amount is paid for moving from one place to a new situation, a deferred charge might be set up.