Woman C.P.A.

Volume 27 | Issue 6 Article 1

10-1965

Accounting Trends and Techniques — Income Statement

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The income statement is of great importance because it is a basis upon which investors, stockholders, creditors, management, and governmental and other regulatory agencies analyze the results of a business' operations and its continued profitability. Because of its importance the determination of the net income figure and the presentation of the amounts making up net income should be in accordance with generally accepted accounting principles. This discussion will describe recent trends and techniques concerning the title, form, and terminology of the income statement and the application of generally accepted accounting principles thereto as set forth in the American Institute of CPAs' 1964 edition of *Accounting Trends and Techniques.* Recent trends and techniques as they affect several matters of particular current interest will also be discussed.

Title

Although the titles of income statements show variety, the use of the term "income" still predominates; nevertheless the term "earnings" is gaining acceptance. With respect to the title "Profit and Loss," which is least desirable, the trend has been noticeably away from its use.

Form

Generally, the form of the income statement falls into two categories: the multiple-step form and the single-step form. The multiple-step form contains the usual groupings of items showing such captions as gross profit and operating income; the single-step form presents all sales and income credits in one section; another section covers deductions for all costs, expenses, and income charges, the difference representing net income.

Advocates of the single-step form believe that the multiple-step form can be misleading because no profit is realized until all costs and expenses are deducted, and because the various subheadings have no recognized meaning.

Although there has been a trend toward the use of the single-step form, many companies use a variation of the two forms by including a separate section at the end of the income statement which sets out tax and special items. The use of a separate section will be discussed later in connection with extraordinary items.

Although over 50 per cent of the companies included in the American Institute of CPAs' survey used separate statements of income and retained earnings, there has been a marked trend since 1946 toward the use of the combined statement; however, the number of companies presenting a combined statement in 1963 did not increase.

Terminology

The Committee on Terminology of the American Institute of CPAs found a lack of uniformity of terms used as captions for items within the income statement and has given definitions of such terms and recommendations for their use in its *Accounting Terminology Bulletin No. 2—Proceeds, Revenues, Income, Profit, and Earnings* and *Bulletin No. 4—Cost, Expense and Loss.*

In the income statement the term "Net Sales" is now predominantly used. Cost of goods sold is shown as a single caption by a majority of companies because of the trend towards the use of the single-step form.

Pension and Retirement Plans

Because of the inherent differences in pension and retirement plans there is a lack of uniformity in the accounting treatment for pension costs. In connection with the accounting treatment of costs arising out of past service, the American Institute of CPAs sets out in Chapter 13 of *Bulletin No. 43* its opinion that:

"(a) Costs of annuities based on past service should be allocated to current and future periods; however, if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year;

(b) Costs of annuities based on past service should not be charged to surplus."

The American Institute of CPAs further discussed accounting for costs of pension plans in *Bulletin No. 47* and made the recommendation

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that "costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations." It was further recommended that disclosure of the adoption or change of a plan be set out in notes to the financial statements if the plan involves costs of a material amount.

In *Accounting Research Study No. 7, Inventory of Generally Accepted Accounting Principles for Business Enterprises*, written by Paul Grady, a listing of the alternative methods of implementing generally accepted accounting principles in connection with pension plans outlines the difference in accounting treatment. Of the companies in the American Institute of CPAs' survey, approximately two-thirds referred to pension or retirement plans in their annual reports. Of these a majority of the plans mentioned were described as being funded or partially funded. Details concerning the plan, method of funding, and the related current or past service costs were set out in notes to financial statements by a majority of the companies. Some companies set out the charge to income in the statement of income, letter to stockholders or in supplementary schedules. It is noteworthy that 24 per cent of the companies referring to pension or retirement plans in their annual reports failed to disclose the related costs.

Accounting Research Study No. 8, "Accounting for the Cost of Pension Plans" by E. L. Hicks (a summary of which is contained in the May 1965 *Journal of Accountancy*) deals with suggested recommendations for the accounting treatment of pension plans.

Depreciation and Depletion

The methods of determining depreciation and depletion of fixed assets vary greatly by industry and by companies within industries. They are set out in *Accounting Research Study No. 7.*

From the data given in the American Institute of CPAs' survey it appears that accelerated depreciation methods are most often used. These methods may be employed either as the basis for computation of taxes or for both book and tax purposes. The survey also indicated that almost one-third of the companies in the study indicated in their 1963 reports the adoption of the new Guideline rules (in part or in full) issued in 1962 by the U.S. Treasury Internal Revenue Service.

As to those companies that disclosed a charge for depletion, very few revealed their method or basis for determining the amount provided.

Income Tax—Adjustments

The American Institute of CPAs in discussing income tax adjustments in Chapter 10 of *Bulletin 43* states that such adjustments "should be included in the income statement unless they are so material as to have a distorting effect on income; in such event they may be charged or credited to surplus with indication as to the period to which they relate."

Of the companies included in the American Institute of CPAs' survey that presented income tax adjustments, most dealt with prior year tax accruals and carry-forward operating losses. A majority of the prior year tax accrual adjustments were presented in the income statement, usually in the last section. Operating loss carry-forward was generally presented in footnotes or in letters to stockholders.

Income Tax Allocation

Allocation of income taxes may be necessary when there is a material difference between financial income (as determined in accordance with generally accepted accounting principles) and taxable income. Much has been written about the effect of certain items on taxable income versus financial income, and the American Institute of CPAs has dealt with income tax allocation in great detail in Chapter 10B of *ARB No. 43*. The American Institute of CPAs has also dealt with the problem of differences between tax and book figures in their bulletins concerning Emergency Facilities and Declining-Balance Depreciation and in the opinions of the Accounting Principles Board covering the New Depreciation Guideline and Rules and the Investment Credit. Material differences between tax and book income also result when statutory depletion as allowed by the Internal Revenue Service is taken for tax purposes and cost depletion is used for book purposes; and when intangible development costs are capitalized for book purposes, yet deducted as incurred for tax purposes.

Approximately 50 per cent of the companies included in the American Institute of CPAs' survey presented income tax allocation items, the increase over the 1962 survey being due primarily to deferment of taxes resulting from the use of "Guideline" depreciation and the Investment Credit. Most extraordinary items giving rise to tax allocation were presented net of the related tax effect. As in the case of tax adjustments, most instances of tax allocation were presented in the income statement in the last section.

Extraordinary Items

The problem of overstating or understating net income due to nonrecurring and extraordinary gains and losses of a material amount has been discussed in Chapter 8 of *Bulletin No. 43*, which gives the opinion that "there should be a general presumption that all items of profit and loss recognized during the period

(continued to page 9)

pany can get a reduction in its annual insurance premium on this type of coverage of approximately 16% of the total insurance premiums paid. An example of the policy endorsement for the $1,000.00 franchise clause could state "When the amount of loss under this policy and all contributing insurance arising out of one occurrence is less than $25,000.00, this Company shall be liable under this policy only for its proportion of 104% of that part of such loss which is more than $1,000.00 and less than $25,000.00. Such proportion shall be determined in the same manner as this Company's proportion of the whole loss would have been determined had this provision not been part of this policy, but disregarding all deductible provisions, if any, of this policy." The savings in insurance expense resulting from the reduced insurance premiums will usually more than pay for any losses which might result under the policy over a given number of years.

The risk involved in getting this type of insurance coverage is rather small for most businesses as they usually can raise the additional capital to pay the damages for a small loss; but in the event of a total destruction or catastrophe, they would be out of business if no insurance were carried.

This type of insurance coverage allows the Company to reduce its insurance cost and at the same time protects it against any major catastrophe.

If a Company has inventory in many different locations which is kept on leased premises (such as a chain of men's clothing stores), consideration should be given by management on the decision of being a full self-insuror of fire and extended coverage and use and occupancy losses.

In these cases, the Company can usually find a temporary location to open its business immediately, and merchandise from other locations can be shipped to the temporary location immediately so that the Company's profit from loss of sales will be kept to a minimum. If you assume that the Company has merchandise in twenty-five different locations and that each location's inventory is about the same, and that the inventory never exceeds $50,000.00 at one location, it can be seen that a complete fire loss at one location will not put the Company out of business as the total merchandise loss after allowing for the tax savings of about 50% will be about $25,000.00.

Whenever a Company becomes a self-insuror, it is always advisable to set up a reserve for self-insurance in the balance sheet, and charge operations with the estimated amount of losses, based on past experience and current projections. Some companies use the estimated insurance premiums which would be paid to set up this reserve, and charge all losses to the reserve when they occur.

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Trends—Income Statement

(continued from page 4)

are to be used in determining the figure reported as net income. The only possible exception to this presumption relates to items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period." Generally, these items represent material charges or credits (other than ordinary, recurring adjustments) related to prior years' operations or represent material charges or credits that do not result from the usual operations of the business. These items may also represent material losses or catastrophies not usually insured against and write-offs of material amounts of intangibles or unamortized bond discount or premium.

As pointed out in Chapter 8 of *Bulletin 43*, two methods may be used for the presentation of extraordinary items: they may be presented (1) as direct charges or credits to retained earnings or (2) as separate items on the income statement after the amount designated as net income. Although the first method is preferred, the second method is acceptable provided care is given to identify the final figure, for example, "net income and special item."

Of the companies included in the American Institute of CPAs' survey, one-third disclosed extraordinary items, the majority representing gain or loss on disposal or sale of fixed assets. Other extraordinary items resulted from various gains or losses and from changes in the valuation bases of inventories, investments, and fixed assets. Most extraordinary items were presented in the income statement, only one-fourth being set out after the net income for the year.

Chapter 8 of *Bulletin 43* indicates the necessity for clearly designating the figure of net income when extraordinary items are presented in a separate last section of the income statement. Companies indicated exclusion of the extraordinary item from net income by such designation as:

Net Income for the Year
Special Item
Net Income and Special Item.

(concluded on page 14)

have been tedious, time-consuming, and costly can now be obtained quickly and easily with modern computers. Also with computers, model programs can be set up for budget projections, letting the computers do our "guessing" in a systematic fashion.

Inventory situations are another class of decision problems which can be solved more easily with our new tools. Finally the article discusses linear or other mathematical programming and points out that, while the ideas are not new, the methods of using them are new.

The author concludes that with the kinds of tools, data processing equipment, and analytical ability at the disposal of the management accountant, he may be expected to do more than merely provide data on request. His task is to help management recognize problems and to provide information for solving them before management requests it. Accounting must highlight conditions, analyze causes, and suggest and test solutions.

The article is a brief but excellent statement of some of the opportunities facing management accountants today. If accountants are going to be a part of the management team, they must learn to use new tools to help solve some of the problems facing modern management.

M. E. B.

"A Casualty Insurance Survey for the Smaller Client," by Frank Perry Walker, CPA, *The Journal of Accountancy*, July 1965, Volume 120, Number 1

At the outset there is presented a checklist of the various types of insurable risks and of properties which may be damaged. Too often the accountant merely verifies the propriety of the more obvious forms of insurance, but with this checklist as a guide it is possible to call the client's attention to many other types of losses which should be protected. There are pertinent observations concerning the "fire legal liability" of a tenant and the necessity of proper wording in leases to eliminate the possibility of a suit from the landlord's insurance company. Special situations and the policies needed to cover them are also touched upon. Similarly, losses due to interruption of operations and liability to third parties are discussed and practical solutions are suggested.

This article emphasizes a phase of the accountant's responsibility that is often neglected, particularly in the case of the small business. Actually inadequate insurance coverage can have deleterious effects on the small business and should, therefore, receive the utmost consideration.

D. L. B.

Trends—Income Statement

(concluded from page 9)

Others indicated inclusion of the extraordinary item in net income by such presentations as:

1. Net Income Before Special Item
   Special Item
   Net Income for Year
2. Net Operating Income
   Special Item
   Net Income

Of the companies disclosing extraordinary items, most reported only an earnings-per-share figure based on total net income and extraordinary items; most gave no figures showing separate earnings-per-share figures for net income and net income including extraordinary items.

Conclusion

The indications set forth in the American Institute of CPAs' 1964 edition of *Accounting Trends and Techniques* illustrate that among the companies surveyed many alternative methods exist for recording and reporting the results of operations of a business in accordance with generally accepted accounting procedures. Because of the increased importance of the income statement, net income should be determined in such manner as neither to understate nor overstate materially the results of operations of a business. The income statements should present the results of operations in such manner as to be not misleading, and yet to be in clear, concise terminology understandable by the lay reader of published annual reports. Although great progress has already been made, it is the responsibility of the accounting profession to take a definite stand on controversial issues and to make specific recommendations concerning their accounting treatment.

Trends—Balance Sheet

(concluded from page 5)

tion. In 1950, only one class of stock was shown by 280 of the survey companies; and by 1963 this number had increased to a total of 332 companies. The term "capital" as applied to common stock is giving away to the term "common," and the term "par value" is being used more frequently than "no par value."