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By John W. Roberts

Among the vicissitudes of modern business is the necessity of restating the operations of the year for purposes of the income-tax return. The items of income and deductions required on the return follow the terms of the law, which were not adapted to fit the accounting of any particular concern or industry, but of necessity had to be so general as to apply to all industry. The result is that nearly every corporation, after closing its books in accordance with an accounting system developed for commercial purposes to suit its particular needs, finds itself obliged completely to overhaul its profit and loss account and all that entered into it.

Many highly developed cost systems include a programme of numerous closing entries whereby expenses of a specific nature are distributed to other expense accounts, which in turn are distributed to still other accounts, until the nature of the expenditures in such terms as are recognized as allowable deductions in the income-tax law are lost to sight and the profit and loss account may show little more on one side than profits by departments and on the other side dividends and income taxes paid. The systems range all the way from this to that in which every detailed class of expenditure is carried in an account by itself and closed direct to the profit and loss account.

Seldom does the profit and loss account itself present the items required by the income-tax form. Repairs are quite likely to be found imbedded in manufacturing overhead. Taxes may be distributed in such a way that part has been included in manufacturing overhead and part in general expense. Interest received and interest paid are frequently merged in one account. In 1917, due to the limitation on interest paid and the consequent effect on invested capital, the segregation of interest paid in many cases had a radical effect on the amount of the tax. Depreciation is often, and properly, included in manufacturing overhead: and yet it must be segregated and shown separately on the return.

To restate the profit and loss in terms of the items required in the return is often a laborious undertaking, and, unless all the papers in the matter are clear, it may be difficult to prove the accuracy of the resulting statement when a revenue agent comes to audit it. The object of this article is to suggest means of reducing the labor and clarifying the record. The following procedure is suggested:

Prepare an analysis of each account that enters directly or indirectly into profit and loss or surplus and contains or may contain more than one kind of income or expense as classified on the form for income-tax return. In these analyses all transfers between nominal accounts should be clearly stated, so that they can be indexed from one analysis to another by letters. The debits and credits should exactly offset each other. There then remain only simple, direct debits and credits covering specific kinds of expense and income. These remaining debits and credits in the entire set of analyses give a complete detailed statement, though lacking arrangement, of the increase in surplus for the year.

The next step is to index them numerically to the lines of schedule A of the return in which they should be included. There will be some items that find no place in schedule A. These unindexed items such as income-tax paid, dividends paid, exempt income, etc., will constitute the reconcilement between the taxable net income and the increase in surplus as shown by the balance-sheets.

A simple example of this method illustrating its application may make it clearer than many pages of description. Below are given a set of such analyses.

Surplus account, analysis A.	*Debits*	*Credits*	*Index*
Balance at beginning of the year.......		$125,000	—
Dividends paid	$ 25,000		—
Profit and loss for the year............		60,000	B
Balance at end of the year............	160,000		—
	$185,000	$185,000	

Profit and loss, analysis B.	*Debits*	*Credits*	*Index*
Profit on sale of investments..........		$ 1,000	C
Sales, less returns and allowances......		473,000	1
Merchandise	$360,000		D
General expense	34,700		H
Reserve for income tax...............	18,000		K
Interest	500		L
Bad debts written off................	800		17
Surplus	60,000		A
	$474,000	$474,000	

Profit on sale of investments, analysis C.

		Debits	Credits	Index
Original cost of stocks 1907.....	$6,000			
Market value March 1, 1913.....	9,000			
Profit in pre-tax period.....			$ 3,000	—
Market value March 1, 1913.....	$9,000			
Proceeds of sale...............	7,000			
Loss in taxable period............		$ 2,000		22
Profit and loss......................		1,000		B
		$ 3,000	$ 3,000	

Merchandise, analysis D.	Debits	Credits	Index
Inventory, finished goods, beginning of year	$ 24,000		2
Purchases of finished goods...........	10,000		2
Work in process	353,000		E
Inventory, finished goods, end of year..		27,000	2
Profit and loss......................		360,000	B
	$387,000	$387,000	

Work in process, analysis E.	Debits	Credits	Index
Inventory, work in process, beginning of year	$ 54,000		2
Productive labor	103,000		2
Raw material	186,000		F
Manufacturing expense	87,000		G
Inventory, work in process, end of year.		77,000	2
Merchandise		353,000	D
	$430,000	$430,000	

Raw material, analysis F.	*Debits*	*Credits*	*Index*
Inventory raw material, beginning of year	$ 26,000		2
Purchases, less returns	180,000		2
Inventory raw material, end of year		20,000	2
Work in process		186,000	E
	$206,000	$206,000	

Manufacturing expense, analysis G.			
Indirect labor	$ 50,000		2
Ordinary repairs	3,000		14
Expense supplies	8,000		2
Depreciation of factory plant	11,000		18
Cartage inward	2,000		2
Excess tax on product	3,000		16
Taxes on factory real estate	1,000		16
Salary of vice-president	7,000		13
Sundries	2,000		2
Work in process		$ 87,000	E
	$ 87,000	$ 87,000	

General expense, analysis H.			
Salaries of president and treasurer	$ 15,000		13
Salaries of clerks	11,000		12
Capital stock tax	500		16
Stationery, printing and postage	1,200		12
Salesmens' commissions	4,000		12
Depreciation of office equipment	300		18
Outward trucking	1,200		12
Telephone and telegraph	500		12
Sundries	1,000		12
Profit and loss		$ 34,700	B
	$ 34,700	$ 34,700	

Reserve for income tax, analysis K.			
Balance in reserve, beginning of year		$ 42,000	—
Paid during the year	$ 43,800		—
Profit and loss estimated provision		18,000	B
Balance in reserve end of year	16,200		—
	$ 60,000	$ 60,000	

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Interest, analysis L.	*Debits*	*Credits*	*Index*
Interest paid on notes	$ 2,000		15
Interest received on exempt securities		$ 2,500	—
Interest on bank balances		1,000	5
Discounts allowed on sales	6,000		12
Discounts taken on purchases		4,000	10
Profit and loss		500	B
	$ 8,000	$ 8,000	

By adding together all the items of each given index number, we obtain the following statement of taxable income.

Gross income

1.	Gross sales less returns and allowance	$473,000	
2.	Less cost of goods sold	335,000	
			$138,000
5.	Interest received		1,000
10.	Gross income from other sources		4,000
11.	Total of items 1 to 10		$143,000

Deductions

12.	Ordinary and necessary expense	$ 24,900	
13,	Compensation of officers	22,000	
14.	Repairs	3,000	
15.	Interest paid	2,000	
16.	Taxes	4,500	
17.	Bad debts	800	
18.	Exhaustion, wear and tear	11,300	
20.	Total of items 12 to 19		$ 68,500
21.			$ 74,500
22.	Loss on sale of investments		2,000
27.	Net taxable income		$ 72,500

The reconcilement with the balance-sheets is compiled from the unindexed items as follows.

Balance in surplus per initial balance-sheet..........		$125,000
Net taxable income		72,500
Dividends paid	$ 25,000	
Profit prior to March 1, 1913, on bonds sold..........		3,000
Income tax paid	43,800	
Decrease in reserve for income tax..................		25,800
Interest received on exempt securities...............		2,500
Balance in surplus per final balance-sheet............	160,000	
	$228,800	$228,800

The schedules to accompany the return are easily prepared by stating in suitable arrangement the details that bear the same index numbers. For example, cost of goods sold is compiled as follows:

Cost of goods sold, schedule A-2

Merchandise purchased		$ 10,000
Productive labor		103,000
Raw material purchased		180,000
Manufacturing expense:		
Indirect labor	$50,000	
Expense supplies	8,000	
Cartage inward	2,000	
Sundries	2,000	
		62,000
Total		$355,000
Add initial inventory:		
Finished goods	$24,000	
Work in process	54,000	
Raw material	26,000	
		104,000
Total		$459,000
Deduct final inventory:		
Finished goods	$27,000	
Work in process	77,000	
Raw material	20,000	
		124,000
Cost of goods sold...............................		$335,000

It will be noted that most of the analyses illustrated above are merely condensed statements of accounts found in the books. That of the profit on sale of investments, however, differs from the rest in presenting facts that do not appear in the books but are necessary in order to show what treatment should be accorded to the item of $1,000.00 appearing in the profit and loss account.

The same idea of setting up in analysis form all information needed for the tax return may be applied to all matters that require special treatment for income-tax purposes. Interest on Liberty bonds, for example, appears in the books as received or accrued, irrespective of its taxability. If it appears in the above-described analyses without such distinction, a further investigation is necessary. A schedule is prepared for submission with the return showing the exemptions and the amounts of interest exempt from and the amount subject to excess-profits tax. When this has been done the results are stated in analysis form and included in the set of analyses. The total interest received can then be eliminated by indexing it by letter to the other analyses and the taxable portion can be indexed to the return form.

The foregoing method, in addition to providing a clear record of what went into each item of the return, has the advantage of great elasticity. The accountant when starting to compile a return can never tell how many adjustments and rearrangements will have to be made in order to present the information demanded. Unless his working papers are carefully planned and the scheme provided is susceptible of indefinite expansion, confusion is likely to result, and a clear record may become almost unobtainable.

It also has the advantage that it can be readily applied by junior accountants, who can dig out most of the detail of the analyses, while the accountant in charge supervises their work, ties the analyses together, indexes to the return those items that can be so indexed and calls for further analyses of those that appear still to be of a composite nature.

This method is complementary to that described in an article on the *Technique of Consolidated Returns* published in the January isue of THE JOURNAL OF ACCOUNTANCY. It provides the means for stating in terms of the return form the "increase in surplus per books." The previous article explained how, if the books are erroneous, the necessary corrections may be made to both the "increase in surplus per books" and the balance-sheets.

The burdens of the income tax are heavy, and not the least of those burdens is the expense and annoyance of preparing and proving the returns. Every step toward the perfecting of the accounting technique involved should help to lighten this part of the burden.