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Classification of Income and Profit and Loss Accounts

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Notwithstanding the work that has been done in recent years to improve the terminology and classification of accounts, for the purpose of securing greater simplicity and uniformity in respect thereto, with a corresponding increase in efficiency, it is generally acknowledged that before the desired end can be attained much additional standardization will be required.

As one of the most important phases of the subject relates to the main divisions or groupings of the income and profit and loss accounts, attention will first be called to two of the leading types of classification of these accounts, and the question of the advisability of the adoption of a third classification will then be considered.

These three classifications, in condensed form, confined to accounts for a manufacturing corporation, are as follows:

A. 1. Operating account.
   (a) Gross.
   (b) Net.
2. Income account.
3. Profit and loss account.
4. Surplus account.

B. 1. Manufacturing account.
2. Income account.
3. Net income account.
4. Profit and loss account.

C. 1. Operating account.
   (a) Gross.
   (b) Net.
2. Income account.
3. Profit and loss account.

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In type A, with the exception of the first main division and its two sub-divisions, which have been termed operating, in the one case, and gross operating and net operating respectively, in the other, we have the form that is, perhaps, in most general use. In the case of the sub-divisions, at least, it is not asserted that they have been known by these terms. In fact, this is one of the matters to which attention is called, viz., the need of a general agreement as to the terms to employ in describing these divisions of the operating account, which correspond in the older account forms of statement to the manufacturing account, trading account and first section of the profit and loss account.

In this classification the operating account shows, first, the gross profit on sales after deducting the cost of the goods sold from the net sales, and, second, the net profit (or income) from operations after deducting the selling and administrative expenses.

The income account includes, in addition, all secondary or other income, so-called—that is, income arising from the use of capital as such, in the form of loans, investments, etc., or from outside operations not directly related to the principal purpose of the business. It is charged with expenses in connection with the use of capital, such as interest, cash discounts, etc., and with losses relating to outside operations. Rents, taxes and insurance are also included by those accountants who feel that the economic theories on the subject should govern in the matter. The balance of the account represents the net income for the period and is transferred to the profit and loss account.

The profit and loss account includes the current fiscal period's proportion of miscellaneous profits and losses together with such items of income and expenses as do not recur periodically. The balance of the account represents the surplus for the period. From this balance are deducted any dividends or other appropriations of income for the period as distinguished from the cumulative profits of the undertaking, the remainder being transferred to the surplus account.

The surplus account represents the cumulative unappropriated profits and includes occasionally extraordinary profit and loss items not applicable to the current period. It is charged with all dividends or other appropriations of net profits which do not apply specifically to the income for the period.

In type B we have a classification that has been recommended by A. Lowes Dickinson in his book *Accounting Practice and Procedure.*

As compared with type A, as I understand it, the manufacturing account corresponds to the gross operating account; the income account to the net operating account; the net income account to the income account; and the profit and loss account to the surplus account.

In type B, however—largely on the ground that if otherwise treated the income account would not disclose over a period of years the true result of that period—all delayed operating or income items, including all profit and loss items so-called, except those of an extraordinary character, irrespective as to whether or not, they may apply to previous periods, are taken up in the income or net income accounts. There is no one account, therefore, that corresponds to the profit and loss account in type A.

There are included in the profit and loss account in type B only extraordinary items of receipt or expense, not applicable to any particular year, such as profits realized on sales of property or losses on sales or dismantling of property or due to its reconstruction. Where property in good condition is abandoned, it is recommended that only the difference between its depreciated and scrap values be charged to profit and loss, the income account being made to stand the remainder of the loss.

There are also included in the profit and loss account items of such character as the total amount of discount on an issue of bonds, provided it is written off at one time.

In this classification it will be noted there is no surplus account, the profit and loss account taking its place.

The essential difference, however, between the two methods of classification may be said to consist of the treatment of delayed operating and income items and of the so-called profit and loss items. In classification B, as previously pointed out, such items are included in income—in other words, in the accounts showing the results for the period, extraordinary items only excepted. If the propriety of this procedure be admitted, then it follows that in addition to the net income account as used in this classification, there is required but one account, the function of which is to show the cumulative profits of the business.

It is worth noting that this is substantially the view taken by the interstate commerce commission in its *Classification of Income and Profit and Loss Accounts for Steam Roads,* issue of 1914.

In type C we have a classification consisting of three main divisions or accounts.

It is apparent that it is modeled very closely after the classification recommended by Mr. Dickinson, and in fact, except in the matter of terminology, the two classifications are practically identical.

While the claim is made that this classification has but three main divisions, and thus is simpler and more easily understood, especially by the lay mind, than one having four divisions, it is true that this statement should be qualified and attention drawn to the fact that, although the operating account is considered as the first division, it actually consists of two sub-divisions (a) gross operating, (b) net operating, which, except perhaps for similarity of name, possess all the characteristics of main divisions.

However this may be, it does not seem illogical to consider gross operating and net operating as sub-divisions of the operating account or division. Of course, before this position can be reached, the propriety of substituting the terms gross operating for manufacturing and net operating for income must first be decided.

While this question can be gone into only very briefly it may be said that there is no doubt as to the existence of more or less misunderstanding as to the use and meaning of the term "manufacturing account." On the other hand, it is thought that the term "gross operating" would not be open to the same objections, as it would seem to indicate sufficiently well the nature of the account which shows the gross profit on sales.

It is also thought that the term "net operating" describes with reasonable clearness the character of the account showing the net profit on sales, or as it is more commonly stated, the net profit from operations or income from operations.

The use of the term "income" as the title of this account is objected to on the ground that it is associated in the minds of many with the account which includes the secondary income of the business—in other words, with the account having that title in the A classification.

We thus have two accounts whose titles indicate that their function is to reflect different phases of the results of the main operations of the business, the final expression of which constitutes the primary income.

The term "income" is used to designate the next account or division because it is considered the one most generally employed to indicate the account which includes both the primary and secondary income for the period. It corresponds, therefore, in treatment to the net income account in the B classification.

The third or final account or division, the profit and loss account, corresponds in all respects to the account with similar name in the B classification.

A form of a partly condensed statement of income and profit and loss in report form is presented in conclusion, but no forms of detailed supporting schedules are given.

It may be pointed out that it does not follow that no more than four group accounts should be kept in the ledger, or that in the account form of statement, for example, a separate section may not be devoted, if desired, to showing the net sales or income (revenue ?) from sales. However, by making a direct deduction on the credit side of the statement from gross sales of the items of returns, allowances, etc., and preferably, by avoiding the use of the term "income" in this connection, there would be a resultant gain in simplicity and clearness. The selling profit after deducting the selling expenses is sometimes shown, but this item rarely, if ever, appears in condensed statements.

An examination of the following form will show that no provision has been made for appropriations of net income—as distinguished from the cumulative profits—for dividends or other purposes, including arbitrary provisions for depreciation. In such cases after making the deductions in question from item No. 13, net income, the remainder could be termed "balance net income," as stated in the classification previously referred to of the interstate commerce commission, or some such term as "net income surplus for the period" could be used.

The better to illustrate the text, the main divisions and principal sub-divisions have been indicated on the form and the items numbered.

STATEMENT OF INCOME AND PROFIT AND LOSS

I. Operating Account	Gross Operating Account	1. Gross sales 2. Returns, allowances, etc. (deduct) 3. Net sales 4. Cost of goods sold (deduct) 5. Gross profit on sales manufactured goods 6. Gross profit on sales trading goods 7. Total gross profit on sales
	Net Operating Account	8. Deduct—selling expenses administrative expenses 9. Net profit (or income) from operations
II. Income Account		10. Other income 11. Gross income 12. Deductions from income 13. Net income
III. Profit and Loss Account		14. Extraordinary profits (Give details here) 15. Profit and loss surplus at beginning of period 16. Gross profit and loss surplus available 17. Extraordinary charges (deduct) (Give details here) 18. Net profit and loss surplus available 19. Deduct—dividends other appropriations 20. Net profit and loss surplus at end of period—as per balance-sheet