Accounting Best Practices: Nurturing Your Income Statement

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Summary: our previous article was on the balance sheet, and after our review below of the income statement, a subsequent installment will cover internal controls and cash management. Our vision for this series is to present a basic financial review and best practices for co-ops.

Accounting best practices are derived from GAAP (Generally Accepted Accounting Principles), and many involve tax laws and requirements. Our review here is primarily concerned with presenting consistent, accurate information for interpretation and not with the interpretation of those amounts. A qualified accountant is an important resource in ensuring that the numbers you have on your financial statements are accurate and follow tax and legal requirements. If you are not certain what a specific financial statement entry item is, how to calculate it, or where to include it, please don’t guess.

For many people, the income statement (also called profit and loss statement) is the only financial statement that they ever see or review. While it is an important indicator of financial performance and health, it does not tell the entire story by itself. Together and over time, the income statement, balance sheet, and cash-flow statement (all properly constructed), along with their comparative ratios, can provide you with the information you need to tell the story of your cooperative business and to make decisions that will guide it now and in the future.

In this article, we discuss income statement presentation for both internal and external users, including some tax considerations. Over the years, food co-ops have worked together to develop a common understanding of what is included in expense items and other financial statement categories in order to allow for better comparisons between co-ops. What follows here are overall considerations, items for inclusion in your income statement, definitions, and tax considerations.

### Definition and considerations

The income statement summarizes the income and expenses for a specified period of time. The order and composition of items included on the income statement is not strictly standardized. However, the first line is always sales, followed by cost of goods sold, and then gross margin. What follows after that are expenses (with a subtotal of income from operations), other income and expenses, income taxes, and finally net income (otherwise referred to as “the bottom line”).

Use unique chart of accounts numbers. A very important best practice in a good accounting system is the assignment of unique chart of account numbers to each account. Accounts are generally created to allow for the most detailed level that will be needed for management reporting and decision-making. For external reporting, these accounts should be summarized. The account numbers must be assigned to meet all of the reporting needs for various users.
Note: Some basic software allows accounts to be assigned by name only—a practice that should be avoided. Using a numbered chart of accounts allows for more efficient and effective accounting practices to be put in place. Using a minimum of five digits for each account number will enable you to add summary detail accounts as needed over time.

Who is the audience? In preparing an income statement, understanding who will be using it and for what purpose will assist you in determining the level of detail to include. Operational statements for staff will most likely include much more line-item detail than what you would summarize for your board of directors or an external audience such as a bank or for your annual report. If an item is useful for managing better financial performance and controlling costs, it should be considered for inclusion in internal reports.

**Monthly, quarterly, annual**

How often should we produce an income statement?

**Monthly:** For co-op managers, income statements are normally produced monthly to ensure expense review and control. These statements include detailed line items and are often produced by department as well. Since most co-ops only conduct complete store inventories on a quarterly basis, it will be necessary to make an inventory adjustment for the monthly statements. (Please ask if you do not know how to make this adjustment.)

**Quarterly:** Income statements are generally produced for the staff and board with the agreed-upon level of detail each of them needs in order to do their respective jobs.

**Annually:** Income statements for outside users are normally generated on an annual basis and may be reviewed or audited by an outside accounting firm. The net income before taxes from your annual income statement is also the starting point for determining your federal and state tax obligations.

Are additional columns required? A good income statement lets you see at a glance how you performed compared to a benchmark. The most common comparison column compares the current period to last year for the same period with an additional column showing the variance between the two. You might also compare the current period to budget or to a year-to-date income statement.

**Best practice:** Include variance columns as well as a column of percentages next to each expense category or line item included in the income statement that shows the percentage that item is of gross sales. Food co-op operational budgets/income statements are built, managed, and monitored using these percentages.

**Presentation of the financial statements**

**Gross Sales:** Sales are presented first. This consists of sales of your primary products, generally groceries. The sales number required by GAAP is the sales after regularly imposed markups or discounts are applied. So if you charge nonowners 5 percent more, the GAAP sales total is shelf price plus that markup. And if you give owners a 5 percent discount on every purchase, the GAAP sales total is shelf price less that discount. The most meaningful presentation often is to start with sales before discounts or markups and then subtract or add those to get to a net sales number that represents the GAAP sales.

One way to think of this is that your shelf price is not your true sales number if you charge everyone a price different from that shelf price. Your sales number is what you are regularly charging everyone. Sales should, however, not reflect the net after staff or working volunteer discounts. Those discounts are part of your personnel costs and should be classified with those expenses.

**Cost of Goods Sold:** Cost of goods sold (COGS) is next, just below sales. COGS includes the prices paid for goods, including any and all vendor costs or allowances such as: freight costs, volume discounts, packaging, and any other costs or allowances that vendors attach to products you are selling. An accurate cost of goods sold report requires that an accurate inventory be taken at the beginning and ending of the income statement period.

**Gross Margin:** The gross margin is the subtotal of sales less COGS. It is also called the gross profit. Food co-ops record sales by department (such as produce and deli), and each department has its own target gross margin. In order to compute department margins accurately, you must ensure that your chart of accounts aligns department line items in each of three areas: sales, purchases, and inventory.

So, if you want to calculate margins in 15 different departments, each with several subdepartments, you must have 15 account numbers with their subdepartments in each of those areas.

In addition, bookkeeping practices and operational systems must support the accurate recording of entries in each of those areas to their appropriate department. Register sales have to be assigned to the correct department, invoices must be coded to the correct department, and inventory counts must be attributed to the correct department. Maintenance of margin systems and importantly, price-update systems, are imperative for achieving expected margins.

**Expenses**

Below the gross margin subtotal are the expenses. These will include all of the expenses for running your store. The presentation may

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**Accrual or Cash Accounting (accrual, please)**

A fundamental choice that your cooperative business must make is whether you will be presenting the income statement on a cash basis or accrual basis. For presentation to a board of directors, a summary for members, or for outside users such as banks, it is assumed you are using GAAP numbers. Comparability between entities and to industry standards requires using the same basis, and that is generally GAAP. Since GAAP financial statements are always accrual, it is a best practice to use accrual accounting.

**Accrual accounting** recognizes transactions when income is earned or when an expense is incurred regardless of when cash is actually received or a bill is paid. For example, if your fiscal quarter ends on a Thursday, you would accrue the invoices for any products received through that day (expense them in that quarter), though they haven’t been paid yet. Wages and benefits for staff who worked through that day should also be expensed in that quarter, even if your payroll period doesn’t end until the following Sunday.

Under **cash accounting**, the revenues from a transaction are not recognized until cash has been received, and expenses are posted only when they are paid. Cash income statements show just the effect of income received and expenses paid within the stated period, often modified to include some accrual adjustments such as depreciation and inventory.
be highly summarized, sometimes just one line, or it may be disaggregated into as many categories as you like. We will discuss a summary presentation of some common lines. The details of accounts that constitute each summary line may be shown in an internal report but would generally not be shown to outside readers.

**Personnel:** The first expense category is typically personnel, in part because it is the largest expense after cost of goods sold. Personnel expenses include all costs of staff: wages, bonuses, paid time off, employment/payroll taxes, benefits, workers’ compensation insurance, worker sales discounts, recruiting, and training. A best practice: Staff benefits should be expensed as they accrue. Many co-ops have a paid time off policy (PTO) where a staff person accrues PTO according to a formula that is based on hours paid. If a full-time employee accurses one week of PTO per quarter (13 weeks), this expense should appear on your quarterly income statement as an accrued benefit. When that person takes a vacation, it will be deducted from that accrued benefits line item.

**Occupancy** is all of the costs of leasing or owning your space. It includes rent, insurance, real estate taxes, repairs, maintenance, and utilities, but typically not interest, which is presented separately. Two best practices:

- **Real estate taxes should be expensed monthly** (one-twelfth of the estimated total), even though they are paid once or twice annually. **Building depreciation can be included here,** but it is a better practice to list it as a part of Depreciation (below).

**Operating expenses:** These include bank fees, technology, vehicles, supplies, and small equipment (equipment that you can expense rather than depreciate).

Depreciation may be presented as part of operating expenses or separately. For our purposes, it incorporates all depreciation, including building depreciation (if you own your building.) It is a noncash expense and is normally calculated by your accountant to ensure that you are depreciating items properly.

**Best practice:** For your income statements, you should apportion this expense monthly instead of once a year.

**Administrative expenses** include office supplies, accounting, professional services, dues, and subscriptions.

**Board or governance expenses** are often presented separately and reflect that the board has its own budget. These are typically direct board costs (such as meeting expenses and board professional services), as well as linkage costs such as owner meetings or mailings.

**Promotions or marketing expenses** include advertising, marketing consultants, contributions, newsletters, and merchandising.

**Income from operations:** Expenses are normally subtotaled and then subtracted from the gross margin to show the income from operations. **Staff often use this number and/or EBITDA (Earnings Before Interest, Taxes, Depreciation, Amortization) as a metric that reflects the profitability of store operations.**

**“Other” lines**

Other income and expenses will normally be any income earned or expenses incurred that are outside of your day-to-day operations.

Patronage dividends received from other
cooperatives are typically classified under “Other income and expenses” since they are at most annual in frequency.*

Interest expense is typically shown with other expense since it is considered a cost of financing and not a direct expense related to your operations. Costs of expansions or relocations are also typically shown in other expenses to highlight the costs and to indicate that they are not a regular part of operations.

Other income generally includes interest income, gain or loss on sale of fixed assets, rent income, newsletter advertising, and fees for fieldtrips or workshops. Other income would also include any administrative charges related to member equity installments, as well as membership dues, if applicable.

Other income and expenses are normally subtotaled and subtracted from operating income to generate the net income before income taxes.

**Fiscal Year End**

Your co-op has a date when the fiscal year ends for book and for tax-reporting purposes. This may be either on a 52/53-week year or just at a month’s end. The most common year ends for food co-ops are either June or December. Year ends are typically chosen for business reasons with the most common having the year close just after the strongest quarter. The 52/53-week year allows you to close your periods on the same day of the week instead of according to the calendar. In general, this can aid in the comparability of year-to-year and other comparisons.

Note: Changing the year end requires obtaining permission from the Internal Revenue Service, which is not difficult but follows a strict set of rules. Do this with your accountant.

**Income taxes and net income**

Income taxes will include federal, state, and local income and franchise taxes. It will also include any adjustments for deferred taxes.

**Net Income:** the total of taxes is then subtracted from your net income before income taxes to show your net income.

Please note: your co-op can have a positive net income and still not have enough cash to survive. Watch for our next article on cash management and internal controls!

* There is a valid argument that patronage dividends from other co-ops should be netted against the expenses originally incurred. The netting might typically be to COGS or to membership dues. This is in accordance with the idea that patronage dividends are a refund of an “overcharge” by the cooperative. A policy on classifying patronage from each cooperative vendor could be made based on an analysis of each relationship. These decisions are often made with your accountant.

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