

Parts of an Income Statement, Part 3

While some lines of an income statement depend on estimates or forecasts, the interest expense line is a basic equation. When accounting for income tax expense, however, a business can use different accounting methods for some of its expenses than it uses for calculating its taxable income. The hypothetical amount of taxable income, if the accounting methods used were used in the tax return is calculated. Then the income tax based on this hypothetical taxable income is figured. This is the income tax expense reported in the income statement. This amount is reconciled with the actual amount of income tax owed based on the accounting methods used for income tax purposes. A reconciliation of the two different income tax amounts is then provided in a footnote on the income statement.

Net income is like earnings before interest and tax (EBIT) and can vary considerably depending on which accounting methods are used to report sales revenue and expenses. This is where profit smoothing can come into play to manipulate earnings. Profit smoothing crosses the line from choosing acceptable accounting methods from the list of GAAP and implementing these methods in a reasonable manner, into the gray area of earnings management that involves accounting manipulation.

It's incumbent on managers and business owners to be involved in the decisions about which accounting methods are used to measure profit and how those methods are actually implemented. A manager can be required to answer questions about the company's financial reports on many occasions. It's therefore critical that any officer or manager in a company be thoroughly familiar with how the company's financial statements are prepared. Accounting methods and how they're implemented vary from business to business. A company's methods can fall anywhere on a continuum that's either left or right of center of GAAP.