Period Cost and its Impact on Financial Statement

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Abstract

Period costs are extremely important for financial disclosure because they are running directly in the P&L account, having an immediately impact on income statement, and thus on financial performance.

In the management accounting, period costs are deducted from revenues without ever having been included as part of inventory, whereas in the financial accounting they are assigned to the accounting period.

In this paper we posit that employees benefits (IAS19) represent period costs, highlighting the main difference in treatment of fringe benefits on the short term and on the long run, where accrual approach intervenes. (IAS37).

Keywords: *period costs, treatment in month end closing, accrual accounting method, fringe benefits*

JEL classification: J31, J32, J33

1. Introduction

In this study we analyse the impact of period costs on financial statements. As costs are running directly into the profit and loss account (P&L), they have an immediately impact on the finacial result and thus on financial performance.

In relation to German accrual principle the author highlights the main difference in period costs treatment in Romania and Germany: the acruall approach of fringe benefits.

At the end is presented the impact of employee benefits' period costs on the trial balance, P&L, Balance sheet and Cash flow in month end closing and thus on the financial statements of the reporting period.

2. Period Cost Delimitation

In the financial accounting period costs relate to the accounting period (year, month) because of the independence principle according to Collier. (2003, p. 178) That means that only events occurred in given period should be posted in the corresponding accounting period. (Todea, 2001, p.16). Period belonging cost should

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In managerial accounting, the most comprehensive period cost delimitation belongs to Horngren, Datar and Foster (2012, p.38-42): period costs are all costs in the income statement other than cost of goods sold. They are deducted from revenues without ever having been included as part of inventory. They are all nonmanufacturing costs, typically called selling, general, and administrative expenses in the income statement. Thus most of the administrative costs of a business can be considered period expenses.

Ebbeken, Possler and Ristea (2000, p.19) declares that period costs are respective period related expenses that have nothing in common with inventories. Regarding period costs is of paramount importance the value of expense in any given period and not the detailed structure of it. (Hoitsch & Lingnau, 2004, p.14)

According to Horngren, Datar and Foster (2012, p.42) following mistake is frequently made in relation with indirect costs such as rent, telephone and depreciation, when assuming they are always costs of the period in which they are incurred being not associated with inventories. When these costs are incurred in marketing or in corporate headquarters, they are period costs. However, when these costs are incurred in manufacturing, they are manufacturing overhead costs and are inventoriable. Moreover, manufacturing overhead costs impact work in process (WIP) inventory as part of total manufacturing costs incurred and furthermore as cost of goods manufactured.

In large companies costs, Research and Development (R&D) costs are treated as period costs because, although these costs may benefit revenues in a future period if the R&D efforts are successful, it is highly uncertain if and when these benefits will occur. Expensing period costs as they are incurred best matches expenses to revenues. (Horngren, Datar, Foster, 2012, p. 42, p. 38). Some other usual period costs in large companies are interdivisional charges and customer service costs as for example bids costs, that simply flow into the finacial result.

Common period costs for each business, no matter what industry are labor costs, comprised in general and administrative expenses, including direct labor costs. Fringe benefit costs or so-called perks are non-wage labor costs and benefits provided by the employer such as company car, house allowance, paid vacations, free child care, free parking, personal assistants or private secretaries, health care, recreational club memberships, an office with a view, or flexible work hours. These may include employee medical health insurance, child care, physical fitness facilities, and retirement plans and private pensions as well as flexible fringe benefit programs called cafeteria plans. These plans contain a “menu” of fringe benefit options including cash compensation and nontaxable benefits alternatives. All above mentioned are generally being offered to middle and top management, and rarely to workers or so-called blue-collars. Current bonus arrangements or year-end bonuses may arise when performance is above some specified quantitative measure. (Barfield, Raiborn, Kinney, 1994, p.562, 940-944).

Employee benefits are identified within IAS19 within five categories.

Table 1: Extras from IAS19- Employee benefits

Types of Employees Benefits identified by IAS19
1. Short time employee benefits (for example, bonuses, wages, and social security)
2. Postemployment benefits (for example, pensions and other retirement benefits)
3. Other long-term employee benefits (for example, long service leave and, if not due within twelve months, profit sharing, bonuses and deferred compensation)
4. Termination benefits
5. Equity compensation benefits (for example, employee share options per IFRS2)

Source: Greuning, 2007, p.299

Analyzing fringe benefits, extreme opposite ones may shock. For example in Philippines, disease is an authorized cause for termination of labour contract, according to Philippines Labour Code[1], whereas in most developed countries, sick leave is actually paid. Legally, German employers must continue to pay employees at least their average net pay for the first six weeks of sickness, much more than the five days paid by the Romanian ones. German Employers would sometimes make up the difference for a not inconsiderable period thereafter, particularly to long-serving executive employees, who may worth their weight in gold, although usually without a formal obligation to do so. Thereafter, the health insurance institutions will provide sick pay to their members, but this is no fringe benefit and thus not the objective of this paper. Furthermore, our perspective on the fringe benefits is the way they mirror on the financial statements.

3. Impact of Accounting Method on financial statements

The accounting treatments influence the image of the entity's annual financial statements (Dănescu, 2014, JAA, p.16). Thus, there are differences of image by using different accounting models “cash” or "accrual". This image must be analyzed also in terms of the factors that may affect the user in retrieving information required. The risk associated with selection of alternative accounting treatments impacts the manager and the auditor in the evaluation of the managerial process. (Dănescu, 2007, p.103)

In author’s opinion the accrual method has a greater influence on the impact of period costs on the financial statements, because in this case, the balance sheet (BS) is involved also, aside from traditional profit and loss account (P&L).

The accrual accounting principle must be followed by the financial statements in Germany[2]. The accrual method is required because of the matching principle: the accrual basis is the matching of expenses with the revenue that they helped produce. Under the accrual method of accounting, revenue is recognized

[1] Philippines Labour Code Available at: https://www.dole.gov.ph/pages/view/29 [Accessed on 31.3.17]

[2] PWC study, Doing_Business_in_Germany_Guide_2017, p. 68, Available at: http://www.pwc.de/de/internationale-maerkte.html [Accessed on 30.03.2016]

only when it is earned and expense is recognized only when it is incurred. (Lerner, 2004, pp. 22-27)

Under the accrual method of accounting, period costs such as selling, general and administrative expenses are reported on the income statement in the accounting period in which they are used up or expire. They are referred to as period costs because they are not assigned to products, and therefore cannot be included in the cost of items held in inventory. (Horngren, Datar, Foster, 2012, p. 43) Building provisions and accruals facilitate decision-making and ensure that the company's decisions are based on the receipts and especially on expenses expected in the future and moreover are presented within in the financial statements. In the period expenses' context, we are highlighting the provisions only, because these are made only for expected future expenses, whereas accruals are made for both receipts and payments. Basically from period cost perspective we are interested only in provisions, in line with theme of this paper.

Prudent provision must be made for all foreseeable financial risks, every manager will say. Consistency and prudence principles are strongly emphasised, in Germany as it is in Romania also, because building provisions are allowed even for probabilities under 50%, as may be deducted from the table no. 1 bottom. Expenses already incurred must be accrued. Provisions for a loss in the value of assets are deducted from the assets themselves; provisions for claims and other expenses are shown on the liabilities side of the balance sheet.

Table 2: Generally Accepted Accounting Principles for Provisions in Germany and Romania

	German GAAP (HBG)	IFRS	Romanian GAAP
Provisions (IAS 37)			
Building provisions	Even probability is under 50%, the provision building is accepted	Building provision is accepted only for a probability of minimum 51%	Even probability is under 50%, the provision building is accepted; Only for waranty and uncertain clients
Provisions for expenses	Forbiden exept art. 249 al.1 HGB	Fobiden	Forbiden
Provisions for pensions	Building and discharge immediately into expenses of the period; there are two accepted methods: partial values method and Projected Unit Credit Method (PUCM) ; Discounting is allowed for 15 years	Fluctuations of accrued interest goes totally or partially in the result (P&L). Some argue that in the future no more such deductions. Accepted discounting method is only PUCM.	No indication

Sources: http://www.ifrsportal.com/Dokumente/unterschiede_ifrs_ifrssme_hgb.pdf and http://www.iasplus.com/en/binary/dttpubs/ce2000.pdf

Dănescu and Rus (2014, p.23) as well as Dumitrescu (2014, p.99) share the same opinion that "the liberty of choosing the accounting policies by management lead to either a diminution or an augmentation of the result." The author share the same opinion that the accounting policies impact the income statement and moreover the result. Unfortunately the accounting as well as the fiscal result may be affected and in many cases non-conformities and irregularities occur, with catastrophic consequences. (Dănescu, Todea et.al, 2011, p.3) Speaking of disasters, the Volkswagen scandal raises many questionmarks concerning what can be hidden in the very detailed and bulky reports that comply with the highest corporate social responsibility standards. Interestingly, for German quoted companies the declaration of complience according to the Code of Corporate Governance is a must. (PWC, p.63). As Chersan states, a KPMG study in 2015 reveals that information concerning corporate responsibility is increasingly relevant to understand risk and opportunities. Stock exchanges and governments institute requirements for companies concerning the inclusion of corporate responsibility data in annual reports. (Chersan, 2015, p. 433)

4. Impact of Period Cost on Financial Statements

In the following we will focus on the period costs' impact on financial statements. For income statement the flow of period costs including employee benefits on the short run is clear and simple for any given accounting method. In case of employees' benefits on the long run, we may also see the period costs' impact in month end closing (MEC) on balance sheet and furthermore on cash flow statement as well.

Period costs are naturally running directly into P&L account, having an immediately impact on income statement. The income statement sets out the amount of each function and enables management, stockholders, analysts, and others to study the changes in function costs over successive accounting periods. (Lerner,2004, p.58)

Income statement or the(P&L) statement provide an image about "financial performance" of an entity. Performance may be distinctly interpreted by diverse information users according to each interest. Under these circumstances, need for a logical explanation of the financial result emerges and the solution will be the P&L account. Taking into consideration that expenses represent economical advantages cuts (Girbina and Bunea, 2007, p.42-45), the steady impact of period cost becomes an important objective, closely related to performance.

Horngren, Fatar and Foster explain that inventoriable costs and period costs flow through the income statement at a manufacturing company similar to the way costs flow at a merchandising company. At a merchandising company, however, the flow of costs is much simpler because the only inventoriable cost is the cost of merchandise. Period costs in figure no.1 are given in the red selected aria of operating costs, on the left hand for manufacturing sector companies and on the right hand for merchandising ones.

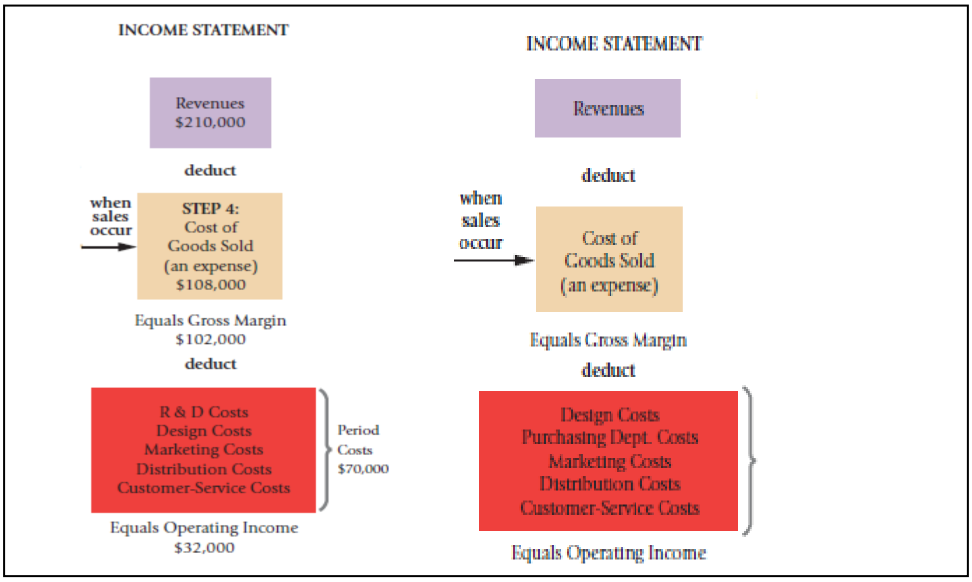

Figure 1: Period costs for a manufacturing sector company (left) versus a merchandising one (right)*Source*: Extract from Horngren, Datar, Foster (2012, p.39 and 43)

Preparation of monthly reporting should ensure financial reporting accuracy. Up to reporting activities, closing ones impose review of the month-end adjustments of accruals and diverse provisions, reconciliation of balance sheet accounts as well as review of the accounting transactions in order to ensure proper classification of transactions according to the profit- respectively cost- centers.

Dănescu states that financial statements must be looped with ratio method. Also the analyse has to be supplemented with detailed assessment and study of the dependencies between balance sheet, income statement and cash flow and their elements or group of elements. (Dănescu&Rus 2014, p. 22)

5. Impact of Fringe Benefits on financial statements

In the following we will take a look to the huge gap in accounting treatment of fringe benefits offered to employees in Romania and Germany, especially nonwage labor costs and benefits, retirement plans and private pensions. Differences lay not only in compensation packages levels but for example in the way pension are handled under different GAAPs. The accounting method has a consistent influence as Germany follows the accrual principle.

Expense Reports on given levels exhibit the fringe benefits line along with direct and indirect labor. Other Direct labor represents borrowed work force or consultant fees from external entities that should be direct allocated. Surprisingly under IFRS there are fringe benefits calculated for blue collars that earn a salary.

As far as expected under Romanian GAAP perspective, fringe benefits will be granted for merits of white-collars. Fringe benefits for direct and respectively indirect labor costs flow directly into the P&L sooner or later in the month end closing process, but for sure, both of them before the end of the period, as bottom example shows. Normally, the direct labor on indirect expenses level must be zero, as Direct Labor firstly settled.

Table 3: Proposal of Expense Reports for labor costs

Expense Report on indirect expenses level	Actual Month
Direct Labor (Blue Collars)	0
Other Direct Labor (Other extern blue collars)	0
Indirect Salaries and Wages	55.000
Fringe Benefits	29.000
Fringe Benefits extern	0
Subtotal Indirect Salaries and Wages	**84.000**
Expense Report on cost element level	**Actual Month**
Direct Labor	269.477
Wage (Blue Collars)	1.687
Salary (White Collars)	322.790
Sal.Split Direct Labor	-269.477
Indirect Salaries & Wages	**55.000**
Fringe Benefits Salaries	-8.256
Fringe Benefits Wages	263.444
Fr. Benefits Pension costs	20.491
Fringe Benefits	**275.679**
Sub-Total Salaries & Wages	330.679

Source: m

The calculation of the fringe benefits for blue collars (workers) and white collars (clerks) is made according to the budget under the terms of estimated rates. These estimations are contract based and given at the factory level. What worth mentioning here is that as in our given example out from practice of manufacturing sector reporting under IFRS, settlement percents for Fringe Benefits of blue collars may be higher than those for white collars. This is awkward according to the Romanian mentality, where actually blue collars remuneration is far away of the white collars compensation package levels.

Table 4: Fringe benefits budgeted rates

Site	Fringe Benefits	
	blue collars	white collars
	%	%
Factory 1	50,77	47,26
Factory 2	77,00	57,00
Factory 3	69,91	42,74
Factory 4	72,15	52,81
Factory 5	100,00	91,00

Source: made-up example

Among fringe benefits of German companies, there are two traditional retirement related ways: the relief fund and the unfunded pension plan, as PWC study explains. The relief fund is the almost equivalent of Romanian pension fund and aims the help of present and retired employees in need. It is financed by regular contributions by the employer that are tax deductible when made. Naturally in the accounting reports we will see these contributions as an expense in the P&L and as a liability in the balance sheet.

Unfunded pension plans in Germany are not equivalent to private pension plans in Romania because the first are reflected in the financial statements as a provision for future and current pensions payable**,** with a large extend of benefits variety. Annual allocations to the provision are tax deductible as current expense provided the amounts are supported by an actuarial computation based on a prescribed official rate. Because there is no funding requirement, granting present employees future pension rights achieves a current tax deduction without a cash outflow for the employer and without a corresponding burden on the beneficiaries, who do not tax the income until receipt. Naturally in the accounting reports we will see these contributions as an expense in the P&L and as a provision in the balance sheet.

Table 5: Provisions related to fringe benefits costs

Provisions on the long run		
	- Retirement benefit obligations	
		Obligations for current pensions and also for qualifying period
	- Provisions non-current	
		Long term provisions, for other long term personal related
Provisions on the short run		
	- Provisions current	
		Bonus arrangements; Social plans and Severance payments;
	- Other provisions	
		For example for fees, for loss suffered or damages, for claims to compensation, bond risks
* Short run obligations that are only probably such as not taken vacation should be declarated in the accruals section		

Source: made-up example

Long-term provisions have an expected duration of over twelve coming months. These are discounted over the expected period of reversal at the average market rate of interest during the past seven years, also with 5,5% discount rate, except provisions for pensions: to which the average market rate of interest during the past ten years will be applied.(6%). Average interest rates for this purpose are published monthly by the „*Bundesbank*”. For pensions an average reversal period of fifteen years maybe assumed. PWC, pp .64-69.

Rather recently, retirement benefits and pension funds have gained in popularity in Germany. Private pension in Germany is similar to Romania but under certain limitation as far as provided prescribed formalities and limitations are meet, because the annual expense is deductible for the company, but the income is not taxable by the employee until receipt. Naturally in the accounting we will see these contributions as an expense in the P&L. Pension funds are supervised by the official supervisory authority but are not subject to the same restrictions on investment as insurance companies. Most pension funds are managed by insurance companies, banks and other operators as a service. Contributions are tax deductible, but the company does not have to show a future pension liability in its accounts if the pension fund is reinsured. (PWC,p.63)

5.1. Impact on Balance Sheet (B&S)

According to Todea and Cenar (2003, p.101-102) the B&S exists for over 600 years in Europe, since 1340 in Geneva, 1341 in Florence and 1368 in Rome than firstly in Geneva's bank in 1408. It is a ”wealth balance” that should objectivly reflect the real financial position of the company and its performance. It is of paramount importance the image that B&S shows, as its main scope is informational. Under this circumstances we have to focus on the image that we already showed is influenced by the accounting method.

Period costs belong classically into the P&L. Nevertheless, under the accrual system, the accounts are adjusted at the end of the accounting period to properly reflect the revenue earned and the cost and expenses applicable to the period.(Lerner, 2004, p.27) Normally in MEC happens the reversal of provisions and accruals of prior period and the reposting of respectively cummulated amounts according to cost allocations in the current actual one. According to Needles, Anderson and Caldwell the reversal operations are not a must, but an option and they address any accumulated receips or expenses. (2011,p.152-153)

Due to double entry principle, labor costs as an example of significant period costs show in the trial balance as well as in P&L up. Respective correspondences are depicted by Needles, Anderson, Caldwell. (2011,p.110) As a consequence of a period end closing, they will appear in the Balance Sheet, being carried from trial balance in any given reporting period.

5.2. Impact on Cash Flow Statement

The impact of period costs on cash flow statement is indirect
as the most frequent influence come from correction of interest for pensions liabilities.

Cash is king because without it, no company can make it. It is not a proper measure of performance because one still goes bankrupt in case cash is not there, no matter what profit. According to Todea (2001, p.113) the cash flow represents the net profit plus amortisations and provisions minus capital expenditure and working capital variation.

In the following we present the way provisions on the long run, as for example those for fringe benefits including for pensions may influence the operative cash flow.

As far as pensions schemes are concerned, these are rarely subject for modifications within one year, as these are projected on the long shot. Nevertheless fluctuations arise although from actuarial calculation, as we may see in line14.

Table 6: Example for Impact of variation of provisions on Free Cash Flow

No.	Description	Acc. Period
1	**EBITDA**	**200.000**
2	Change of Inventories	4.494
3	Change of Trade receivables (current)	3.005
4	Change of Customers with credit balances	0
5	Change of Trade liabilities (current)	-160
6	Change of Suppliers with debit balances	-379
2+..6	**Change of Trade Working Capital**	**6.960**
7	Change of Other Assets	0
8	Change of Other provisions & liab. (current)	-69
9	Change of Trade & other non-financial liabilities (non-current)	-7.337
10	Change of Deferred income (non-current)	0
11	Change of Provisions (non-current)	0
12	Change of Net pension provisions	0
13	Change of Other Provisions (non-current)	0
14	Corrections P&L interest Pension liabilites	-1.419
7+..14	**Change of Other Working Capital**	-8.825
1+..14	**Operative Cashflow**	**196.270**
15	CapEx (cash)	0
16	Disposals	100.100
17	Change of other fixed assets (financial, non-current)	0
18	Normalisations / Adjustments	0
19	**Free forecasted cash flow**	**96.170**
20	**Total financing cash flow**	
21	**Change in net cash**	
22	**Change of Change of Cash in hand and bank**	

Source: made-up example

Table no.6 shows in line 11 that the variation of provisions influences the Operative Cash Flow and in the end, the Free Cash Flow. Cash Flow Statement is object to financial disclosure for Romanian companies and only for quoted German companies. (PWC, p. 63; ANAF).

6. Conclusions

Period costs are extremely important for financial disclosure because they are running directly in the P&L account. In this line of thought period costs should be elaborately analysed and in author oppinion in extenso collected as they deliver many answers regarding the economic information about the entity and furthermore they directly impact the economic performance.

The image on the financial statement is influenced by the accounting policies and moreover by used accounting methods. Furthermore, the implementation of IFRS to a larger extend impacts the finacial statements.

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