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Accounting Research BULLETINS

October, 1946

No. 26

Accounting for the Use of Special War Reserves

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Issued by the

Committee on Accounting Procedure,
American Institute of Accountants,

13 East 41st Street, New York 17, N. Y.

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1. The propriety of the use of reserves to achieve more significant financial statements,* particularly those prepared to report the results of business operations, has long been recognized. The creation of reserves by charges against current revenues for foreseeable expenses, costs or losses applicable to such revenues, results in more adequate financial statements for the current period and, at the same time, serves to eliminate from income statements of subsequent periods the effect of the final determination or incurrance of the costs or losses provided for and thus makes possible a more adequate reflection of the results of operations of both periods. The applicability of this accounting technique in the measurement of the financial results of war and postwar periods was recognized in *Accounting Research Bulletin* No. 13.

2. During the war years many industrial companies created special war reserves. Data given in the annual reports of such companies indicate that many of these special war reserves were of a composite or omnibus nature and that a precise classification of the nature of the costs and losses for which the reserves were provided was difficult. This fact has been reflected in the variety of practice in the treatment of these reserves and in the diverse nature of the charges that have been made thereto.

3. The committee recognizes that it is impossible to generalize with respect to the diverse situations created by the termination of the war. In general, however, two concepts have been advanced as theoretical bases for the determination of the items considered appropriate as charges to special war reserves. The first of these theories or concepts may be characterized as one which would consider the war reserves available for items representing the costs or losses of war production incurred after the termination of that production. Such costs would include the expenses of getting productive and other facilities which had been converted to wartime uses recon-verted for peacetime operations as well as the nonproductive or stand-by expenses of that period of reconversion. In general, this

*"It is not permissible to create reserves for the purpose of equalizing reported income."
Accounting Research Bulletin, No. 13, p. 112.

theory reflects the view that wartime operations and revenues should be charged with expenses, costs or losses determined on a "round-trip" basis, i.e., costs of terminating wartime operations and of resuming peacetime production as well as the expenses, costs or losses of wartime conversion and operation. The other theory or concept may be characterized as that under which the special war reserves would be considered available not only for such costs of war production but for other expenses, costs or losses which usually arise in a disrupted postwar situation or in the economic dislocations which are the aftermath of a war.

4. In application these theories permit differing results. The first presumes that charges against a war reserve ordinarily should be restricted to the expenses, costs or losses incurred during a relatively short period after the termination of war production within which reasonable peacetime operations could be resumed and to the expenses and costs incurred after that time which are clearly attributable to plant reconversion or otherwise clearly identifiable as costs of war production. The second theory provides no similar presumption and hence imposes a less restrictive limitation for charges to the reserve.

5. The committee recognizes that differences in concepts of the nature of special war reserves and variations in the treatment of items to be charged to them were to be expected because of the rapidity of the development of wartime accounting problems and the absence of time for experience upon which to develop their solution. The reflection of these differences in the financial statements prepared for the period in which hostilities ended was not of material importance. Statements for that period could not serve as reports of either wholly wartime or wholly peacetime operations. However, with the economic reconversion of wartime productive activity to peacetime productive activity now substantially accomplished, the committee believes that a useful purpose will be served if it suggests that the range in the variation of treatment given special war reserves may now properly be narrowed.

6. After careful consideration of the various problems involved, and without implying any criticism of the use of these reserves during the period of the development of the preferences expressed herein, the committee has reached the conclusion that in the determination of the expenses, costs or losses which, in the future, should be considered as proper charges to special war reserves, the application of the first theory will provide the greater utility in making financial statements more universally significant. The committee believes that the theory or concept of limiting charges to war reserves to items representing costs of war production on a "round-trip" basis generally permits the reasonable determination of some early date

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at which war reserves can be considered to have fully served their purposes. Evidence would indicate that, in most instances, such a time would be fixed within a relatively short period after the termination of hostilities. The committee considers the alternative theory less desirable.

7. In the opinion of the committee costs and losses which may arise from such causes as: (a) strikes occurring after the resumption of peacetime operations; (b) failure to achieve full peacetime production because of material or other shortages; (c) failure to make profits on peacetime products because of the limitations of price ceilings or because of the lack of full production; and (d) inventory losses on peacetime products from future deflationary price adjustments, should be considered proper charges to peacetime revenues and hence, in general, such items are not considered appropriate charges to reserves created for expenses, costs or losses allocable to the income of the war period.

8. In view of the extensive progress in the transition to peacetime operation achieved by business generally, the concept of the nature of war costs preferred by the committee calls for the prompt determination of charges to special war reserves and the early resolving of the remaining expenses, costs and losses for which the reserve will be carried. Accordingly, the committee recommends that in the period which follows that in which hostilities ended, the balance of the special war reserve be adjusted to the amount which reasonably may be required for the applicable items of expense, cost or loss still to be incurred, such items being clearly designated, and that excess reserves, if any, be eliminated. The committee does not consider it appropriate to charge a special war reserve with an item which would not be an appropriate charge to the income of the period or periods prior to the date upon which reasonable peacetime operations were resumed, to designate or devote an excess balance of such reserve for a purpose other than one for which the reserve was originally provided, or to carry such an excess as a general reserve for undesignated contingencies. The manner of accounting for the disposition of excess reserve balances should be such that it will not distort the income of the period in which the reserve is eliminated.

9. The committee believes it appropriate also to direct attention again to the effect of taxes upon the presentation of periodic data relating to the results of the business operations. As suggested above, an important purpose underlying the use of reserves, in addition to charging current income with expenses, costs and losses applicable thereto, is that of eliminating such items from the income account of future years in order that the financial measurement of the results of operations in those years will not be distorted by the effect of those expenses, costs and losses. Were it not for tax considerations

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this result might be achieved by charging to the reserve the expenses, costs or losses as they are ultimately incurred or determined. However, charging the reserve with the full amount of the determined items may result in materially affecting net income because of the reduction in taxes due to those expenses, costs and losses deductible for tax purposes which are not reported in the income account. The committee considered this problem and stated its conclusions in *Accounting Research Bulletin* No. 23. The procedures suggested in that bulletin are considered to be particularly appropriate in the treatment of charges to special war reserves.

The statement entitled "Accounting for the Use of Special War Reserves" was adopted by the assenting votes of eighteen members of the Committee. Three members, Messrs. Bell, Inglis, and Nissley dissented.

Mr. Bell dissented largely because he thinks "the publication of the bulletin at this time will (notwithstanding the statements to the contrary) be understood to apply retroactively and thus unjustifiably to condemn practices of some companies during the year 1946 which seemed to them proper and which were not condemned at the time." Mr. Bell further objects to the statement that an excess balance in a war reserve should not be designated for another purpose or be carried as a general reserve for undesignated contingencies, since he believes that such matters should be left to the judgment of the management of a company, subject only to the generally recognized restrictions as to the utilization of any such reserve.

Mr. Inglis states that he agreed fully with Bulletin 13 and therefore does not concur with the committee's preference for a more restricted use of the reserves than, in his opinion, was contemplated when that bulletin was issued and when the reserves were created. The two concepts considered in this statement seem to him to have been regarded in Bulletin 13 as a reasonable basis for the creation of the reserves and he does "not feel, therefore, that the committee is justified at this time in adopting a narrower concept." Mr. Inglis believes the reserves should be used for the purposes for which they were created if such purposes embraced "experience during and following the first World War and recent well defined social trends." (Bulletin 13.) He also believes that "to try to limit the period within which the reserves should be used, or the purpose, ignores past experience and is contrary to conservative accounting or good business practice."

Mr. Nissley dissents from the bulletin "because the illustrations in paragraph 7 are clearly related to or grow out of the war and

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would be chargeable to war reserves under the second concept (paragraph 3). With disclosure, charges for such items, made to reserves provided therefor, during the very unsettled economic conditions (caused primarily by the war) existing since the war, do not violate generally accepted accounting principles existing during that period. The committee, in particular, made no previous pronouncement on this subject. By implication, the aforesaid sentence recommends a retroactive accounting principle. This contradicts the statement in the bulletin that the recommendations of the committee are not intended to be retroactive. It is inconsistent with the first sentence in paragraph 6 which makes recommendations only as to items determined in the future for *all* items related to the war under the second theory."

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

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