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Emergency facilities; Accounting Research Bulletin, no. 27

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Emergency Facilities

1. During the war period, many companies acquired productive facilities under certificates of necessity issued pursuant to section 124 of the Internal Revenue Code. These certificates, covering "emergency facilities" considered essential to the war effort, permitted the owner of the facilities to amortize their cost for income-tax purposes over a period of 60 months, or, under certain conditions, over a shorter period. An Executive Order proclaiming the end of the emergency period, for purposes of the section of the Internal Revenue Code relating to the amortization of facilities acquired under certificates of necessity, was issued on September 29, 1945. By the provisions of the Code, the previously unamortized cost of emergency facilities at September 29, 1945, thus became deductible for tax purposes over the periods of their use ending at that time.

2. The financial statements of industrial companies issued during the war period show that many companies acquiring emergency facilities depreciated or amortized their costs at rates permitted for tax purposes. Statements issued since September 29, 1945, show that additional accelerated depreciation or amortization of those facilities, as permitted for tax purposes, has been recorded by many such companies. The committee has studied this accounting treatment of the cost of emergency facilities and has considered the problems arising therefrom. As a result of this study the committee has concluded that the conventions and practices of accounting for productive assets under ordinary business and economic conditions are not wholly applicable to these problems, and that special adjustments of past accounting for emergency facilities may in some cases make possible the preparation of more useful and significant financial statements.

3. The cost of a productive facility represents the cost of the series of services to be derived from its use, and accepted accounting practice dictates that such cost should be matched against the revenues obtained from the services. This matching of expenses and revenues is effected by the procedures of depreciation accounting, "a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in

a systematic and rational manner. It is a process of allocation, not of valuation."[1] Moreover, under most circumstances, costs once identified and absorbed through amortization or depreciation charges are not considered to be subject to further accounting, and corrections of estimates affecting the allocations are commonly reflected in revised charges during the remaining life of the property.[2]

4. This method of treating corrections is supported by the fact that in ordinary experience an overestimate or underestimate of the useful life of a facility is recognized before a major proportion of its service life has elapsed. Accordingly, changing rates of amortization or depreciation to be used during the remaining estimated life ordinarily does not result in differences sufficiently material to require any adjustment of the amounts previously charged. Even when a mistake in estimating the life of a facility is not discovered or, having been discovered, a change in the rate is not made, and fully amortized or depreciated property is continued in use without accompanying charges to income, the effects upon representations in the income statement are often not of sufficient significance to justify a restatement of the accounts. Moreover, underestimates of the useful lives of some assets are frequently found to be offset, in whole or in part, by overestimates of the lives of others, so that in the annual operating results no material or significant change would be effected by a restatement.

5. From an accounting standpoint there was nothing inherent in the nature of emergency facilities which required the depreciation or amortization of their cost over a shorter period than would have been proper had no certificate of necessity been issued. However, in a great many cases there were major uncertainties related to the length of their wartime use and to their usefulness and worth in peacetime which are not ordinarily encountered in the acquisition and use of operating facilities under normal circumstances. These uncertainties generally provided sufficient reason for the recording of the amortization or depreciation of the cost of emergency facilities in conformity with their amortization deductions granted for tax purposes. In some cases, however, this treatment has resulted either in displaying facilities having a substantial usefulness and worth for peacetime production at only nominal amounts in the financial statements or in eliminating them entirely therefrom. In these situations, the committee believes that careful consideration of the conditions

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[1] *Accounting Research Bulletin* No. 22.

[2] "It is one of the most generally accepted practices in depreciation accounting that estimates should be made since exact amounts are not ascertainable and that corrections of estimates should normally be reflected in revised charges for later years." Committee on Accounting Procedure—letter to Nelson Lee Smith, Chairman, Committee on Depreciation, National Association of Railroad and Utilities Commissioners, January 28, 1941.

may show that an adjustment of the recorded amortization or depreciation of such facilities is appropriate.

6. In special situations in which material amounts of depreciable assets are determined to have a substantially longer or shorter life than was originally anticipated, a more adequate assignment of cost to the future revenues to be derived from such assets during their useful lives may result from an adjustment or restatement of the accumulated depreciation previously recorded. Such a reallocation of the cost of assets between past and future operations and revenues may be desirable when there have been circumstances which prevented the determination of an ordinary and reasonable approximation of the useful lives of assets and when the amounts of such assets and the annual depreciation charges thereon are large in relation to the total property in use and to the annual net income. In general, useful financial statements are not achieved by an understatement or an overstatement of asset carrying value which is to be accompanied by an overstatement or understatement of future income because of materially excessive or deficient prior allocations of costs.

7. It is the opinion of the committee that where the facts clearly indicate that the accelerated amortization or depreciation of emergency facilities at rates permitted for tax purposes has resulted in a carrying value materially less than that reasonably chargeable to revenues to be derived from the continued use of the facilities and where such difference would have a significant effect upon the financial statements, the adjustment of accumulated amortization or depreciation of such facilities is appropriate. The committee recognizes that in the determination of the usefulness and worth of such facilities it will be necessary to consider their adaptability to peacetime use, the effect of their use upon effective utilization of other facilities, the possibilities of an inflated initial cost, and the fact that no tax deductions for amortization or depreciation will be allowable in future years. Consideration of these factors, the committee believes, will usually result in the determination of a carrying value for emergency facilities less than the cost of the facility reduced by the depreciation that would have been appropriate had no certificate of necessity been involved.

8. In reaching the conclusion that it is proper, in certain circumstances, to adjust accumulated amortization or depreciation of emergency facilities, the committee has been strongly influenced by the importance of corporate financial statements to the ever-growing number of owners of corporate securities. To these and other persons, financial statements are the chief source of data relating to the position and trends of the business economy. Such data in postwar periods will be of particular significance. When the utilization of emergency facilities is an important factor in the peacetime operations of a busi-

ness and when the omission or reduction, as a result of the accounting treatment adopted because of wartime conditions, of charges for the amortization or depreciation of the cost of those facilities results in significant differences in the data reporting the results of peacetime operations, the committee believes it appropriate that the accounting treatment be reconsidered in the light of present conditions.

9. The committee wishes to emphasize the fact that it does not favor an adjustment of the accumulated amortization or depreciation in cases in which such an adjustment would not have a substantial effect upon the representations that will be made in future financial statements. However, it does believe that in cases in which the effect on future financial statements resulting from such an adjustment would be clearly significant, an adjustment of the accumulated amortization or depreciation of the cost of the facilities will provide more useful financial statements.

The statement entitled "Emergency Facilities" was adopted by the assenting votes of fifteen members of the committee, of whom one, Mr. Stans, assented with qualification. Six members, Messrs. Chamberlain, Conick, Inglis, Nissley, Talbot, and Wagner dissented.

Mr. Stans assents to the conclusions of this bulletin, as applied solely to war facilities, but dissents from that portion of the rationale contained in the sixth paragraph, which he considers unnecessary to the result. Since this paragraph would permit recomputations of accrued depreciation on other properties in special situations, Mr. Stans feels that the application of individual judgment as to what is a "special situation" could lead to abuses in practice. He is especially opposed to permitting redepreciation for financial accounting purposes (as distinguished from theoretical cost accounting purposes) whenever assets are found at a given time to be overdepreciated. He believes the third paragraph and footnote (2) deal adequately with such cases.

Mr. Inglis opposes the issuance of this bulletin because in his opinion it is inadequate in that it deals only with a part of the problem of fully depreciated facilities.

Mr. Chamberlain dissents because "to restate the value of emergency facilities which have been amortized in a systematic and rational manner will result in accounting for the same cost twice." This he regards as "contrary to good accounting practice. Further, the application of the factors suggested in paragraph 7 of the bulletin will result in bringing into financial statements values which cannot be tested by any objective standards."

Mr. Conick dissents because he does "not believe it appropriate to adjust future income by re-allocation of amortization or depreciation which has been fully recovered from revenues, and thus has already been identified and charged through income. The bulletin does not recognize the alternative of full disclosure as being adequate."

Mr. Nissley dissents "because of the emphasis on changing, as a result of hindsight, accounting procedures adopted during the war which conform with the ideas of Congress on the subject when it authorized the recovery, by means of reduced income taxes and renegotiation refunds, of the entire cost of emergency facilities from wartime revenues. Such costs cannot properly be charged twice, i.e., against both the wartime and postwar periods. Disclosure of the cost of such facilities, and of the fact that they are available for postwar use without further charge, may well produce more realistic financial statements than the method suggested, particularly in view of the great difficulty of determining their postwar value now on any reasonably objective basis. In any event, the adjustment suggested in section 7 should not be made unless a corresponding adjustment is made in the net carrying value of all other fixed assets."

Mr. Talbot dissents because he believes that financial statements are necessarily historical records and that for the most part emergency facilities were acquired on the assumption that the amortization of their costs would be proper charges against the earnings of the war period. He believes that the users of future financial statements would be best served by a full disclosure of the facts regarding any significant amount of fully amortized emergency facilities or any other fully depreciated fixed assets still in use. He believes that a restatement of the amortization is equivalent to converting the financial statements to a pro forma basis in this respect.

Mr. Wagner dissents from the issuance of the bulletin since it is likely to open the broad subject of fully depreciated assets and because he thinks the depreciation adjustment procedure may place accountants in the rôle of appraisers. In his opinion adequate information with respect to fully depreciated assets may be given by notes to the financial statements.

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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