1-1-1959

Accounting research bulletin, no. 1-42

American Institute of Certified Public Accountants. Committee on Accounting Procedure

Follow this and additional works at: https://egrove.olemiss.edu/dl_aia

Part of the Accounting Commons

Recommended Citation


https://egrove.olemiss.edu/dl_aia/361

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in American Institute of Accountants by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
GENERAL INTRODUCTION

In presenting its first statements of the results of studies of accounting questions, it seems desirable that the committee indicate the standpoint from which it has approached the subject. Its present and future pronouncements should be read in the light of these remarks.

Accounting and the Social System

The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties.

The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur. In the last forty years the outstanding change in the working of the corporate system has been an increasing use of it for the purpose of converting into liquid and readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This development brought in its train certain uses of the processes of law and accounting, which have led to the creation of new controls, revisions of the law, and a reconsideration of accounting procedure.

Accounting Information for Transitory Owners of Securities

As a result of this development in the field of accounting, problems have come to be considered more from the standpoint of the current buyer or seller in the market of an interest in the enterprise than from the standpoint of a continuing owner. The significance of this change
is perhaps not yet fully appreciated, and whether or not the rapid exchange of owners is beneficial to society is a large and important question which society itself should carefully consider; but as long as the practice exists accounting must have due regard for it.

One manifestation of it has been a demand for a larger degree of uniformity in accounting, although it may be pointed out that the change of emphasis itself is bound to lead to the adoption of new accounting procedures, so that for a time diversity of practice is likely to be increased as new practices are adopted before old ones have become completely discarded. It is of interest to point out that "uniformity" has usually connoted a similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences between the cases. Another sense of the word would require that different authorities, working independently on the same case, should reach the same conclusions. This at any rate is an ideal which all will agree to strive for, and perhaps is more readily attainable.

Other phases have been increased recognition of the significance of the income statement, with a resulting increase in the importance attached to conservatism in the statement of income, and a tendency to restrict narrowly charges to earned surplus. The result of this emphasis upon the income statement is a tendency to regard the balance-sheet as the connecting link between successive income statements and as the vehicle for the distribution of charges and credits between them. Important as this concept is, however, it should not obscure the fact that the balance-sheet has significant uses of its own.

Accounting for "Investment Trusts"

The accounting problems of investment trusts, which for this purpose include all corporations, the business of which consists of owning or trading in the securities of other corporations for purposes other than control, are so special that the committee will, at the appropriate time, issue a statement devoted to them. In the meantime the general pronouncements of the committee should not be regarded as necessarily applicable to investment trusts.

Committee Votes as to Adoption of Pronouncements

The committee regards the representative character and general acceptability of its pronouncements as of the highest importance, and to that end has adopted certain rules for its own procedure.

By unanimous vote it was resolved that:

a. Any opinion before issue shall be submitted in final form to all members of the committee either at a meeting or by mail.
b. No such opinion shall be issued unless it has first received the approval of two-thirds of the entire committee.

c. Any member of the committee dissenting from an opinion issued under the preceding rule will be entitled to have the fact of his dissent recorded in the document in which the opinion is presented.

Pronouncements Not Retroactive

It was unanimously resolved that:

No pronouncement issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus a pronouncement will ordinarily have no application to any transaction arising prior to its publication, nor to transactions uncompleted at the time of publication. But, while the committee considers it inexpedient to make its general statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if the accountants think it desirable in the circumstances.

Pronouncements Not Applicable to Immaterial Items

The committee contemplates that its pronouncements will have application only to items large enough to be material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest.

Exceptions to General Pronouncements

The committee recognizes that its general rules may be subject to exception and that in extraordinary cases truthful presentation and justice to all parties at interest may require exceptional treatment. But the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary.

The Company and Its Auditors

At the base of all committee pronouncements is the further understanding that the accounts of a company are primarily the responsibility of its officers. The responsibility of the auditor is to express his opinion as to the correctness of the accounts and to make qualification to the extent that he considers it necessary to explain, to amplify, to disagree, or to disapprove. While these pronouncements will be read by public accountants whose problem is to decide what they may properly report, the prior application of the rules to those who must
prepare the accounts is also included in the committee's considerations.

Other Pronouncements Consulted

The committee has, in the course of its study, given careful consideration to prior pronouncements on the several topics, and will continue to do so in all subjects taken up. In particular, weight has been attached to the accounting opinions of the chief accountant of the Securities and Exchange Commission.

Rules Formerly Adopted

In order that the record may be complete, the committee reissues herewith the following rules:

1. The six rules adopted by the membership of the Institute in 1934, the first five of which had been recommended in 1933 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges; these are the only rules so far accepted by the Institute as a whole.
2. The report of the committee on accounting procedure to the executive committee in 1938, dealing with profits or losses on treasury stock.

Statements Now Issued

The committee now submits two new statements, entitled respectively:

1. "Unamortized Discount and Redemption Premium on Bonds Refunded."
2. "Quasi-Reorganization, or Corporate Readjustment."

In the first of these statements the committee saw its opportunity to add to its opinion or findings a memorandum of the considerations which have influenced it in reaching its conclusions, making this statement of greater length than will as a rule be necessary in the future. This practice will be followed whenever the controversial character of the subject seems to require it.

Topics for Future Consideration—Suggestions Invited

The committee renews its invitation to all members of the Institute to submit questions upon which they would like to have pronouncements made. In formulating its program the committee has in mind not only the relative importance, but also the timeliness of the several topics. It therefore welcomes any suggestion from members arising out of their current problems.
General Introduction

It may be of assistance to members for the committee to state that the following matters are already receiving attention:

1. A more exact determination of the basis of inventory valuation.
2. Definition of "cost" of fixed assets under varying conditions as to payment or consideration for them.
3. Should accounting recognize a classification of losses other than revenue losses (the so-called capital losses)? If so, what are the distinguishing characteristics of the classification, having regard to the nature of surplus, and of its subdivisions?
4. The possibility of combining the income statement with the statement of surplus, or alternatives to emphasize their related character.
5. An apparent trend toward viewing the annual corporation report to stockholders as being in the nature of a prospectus to investors.
6. The accounting treatment: (1) of options issued to officers and employees of a corporation for services rendered or to be rendered, and (2) of capital stock issued or issuable under these options.
7. Depreciation on appreciation.
8. Comparative statements.
9. Accounting for the purchase and retirement of bonds other than through refunding operations.
10. The proper recording of capital-stock dividends in the books of the issuing company, and of the recipient.
11. The treatment of voluntary payments made by corporations under pension plans.
12. Accounting for cash in foreign banks.

Expressions of opinion which members may offer on any of these topics will be welcome.

RULES FORMERLY ADOPTED

Below are printed the rules already adopted (I) by the membership of the American Institute of Accountants, or (II) by its committee on accounting procedure:

I

* "On motion duly seconded the report of the special committee on development of accounting principles, which had been distributed to members of council prior to the meeting, was accepted, and it was ordered that the report be published in the Bulletin of the Institute.

The motion embodied approval of the following rules or principles which the committee had recommended that the Institute formally adopt:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.”
"Profits or Losses on Treasury Stock *

The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

TO THE EXECUTIVE COMMITTEE,
AMERICAN INSTITUTE OF ACCOUNTANTS:

This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on coöperation with stock exchanges.

As a result of discussions which then took place, the special committee on coöperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

'Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?'

The opinion of the special committee on coöperation with stock exchanges reads in part as follows:

'Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.'

This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to

taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

The special committee on coöperation with stock exchanges continued and concluded its report with the following statement:

'Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).'

This committee agrees with the special committee on coöperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance. This committee recommends that the views expressed be circulated for the information of members of the Institute.'
The treatment of unamortized discount and redemption premium at the retirement of bonds by the creation of new debt well illustrates some of the recent developments and tendencies of accounting, and has been the subject of extended study and pronouncement by regulatory bodies. It has therefore been selected by the committee as the appropriate subject for its initial major study, and the results are presented in greater detail than will be necessary for some other topics.

Discussion of the question in the past has revolved mainly about three methods of disposing of the unamortized balance:

1. A direct charge to earned surplus;
2. Amortization over the remainder of the original life of the issue retired; or
3. Amortization over the life of the new issue.

Each of these methods has found considerable support in regulatory decisions and technical discussions. The conclusions reached by the committee in regard to them are given here.

**OPINION**

1. The first alternative, writing off the amount to earned surplus when the refunding takes place, conforms more closely than any other to hitherto accepted accounting doctrines and has the support of a decision of the Supreme Court and the approval of many regulatory bodies.

In the opinion of the committee it is clearly a permissible method, and there is no occasion for qualification of the report in cases in which it is employed. At the same time, this method is open to the objection that while conservative with respect to the balance-sheet, it tends to produce an understatement of income charges for the cost of borrowing. The committee attached weight to this objection, especially in view of the growing recognition of the importance of the income ac-
count as compared with the balance-sheet. As a general principle, the committee favors the absorption of charges in the income account and a corresponding limitation of charges to earned surplus.

If the debt is finally discharged—otherwise than by refunding—prior to the original maturity date of the issue, any balance of discount and redemption premium then remaining on the books should be written off at the date of such retirement.

2. The second alternative, distributing the charge over the original life of the bonds refunded, has in the opinion of the committee considerable support in accounting theory and has the great merit that it results in the reflection of the expense as a direct charge under the appropriate head in a series of income accounts.

The committee is clear that this method should be regarded as permissible, and expresses the further opinion that it perhaps conforms more closely than either of the other methods to the current trend of development of accounting opinion.

The committee is not prepared at this time to express a preference for this method so definite as to call for a qualification of the certificate if any other method is employed, but proposes to reconsider this aspect of the question as a part of a study to be undertaken of the general question of charges to earned surplus.

3. The third alternative, amortization over the life of the new issue, does not seem to be adequately supported by accounting theory, but to run counter to generally accepted accounting rules. It does not seem to possess any marked practical advantages in comparison with the second alternative of amortization over the life of the old issue, which finds far better support in accounting theory—on the contrary, it seems to the committee to exaggerate the annual saving from refinancing, and therefore may tend to encourage transactions which are not, when properly viewed, advantageous. Although this method has in the past been freely permitted by regulatory bodies, the committee believes that it should not be regarded by the profession as an acceptable method for the future. It must, of course, be permissible for corporations to adopt it in cases where it has been prescribed or authorized by regulatory bodies to which they are subject. The committee believes that in any other cases in which this method is employed an accountant should make an exception in respect of such treatment from any certification that the accounts conform to accepted accounting principles.

4. The committee is further of the opinion that, if the unamortized discount and redemption premium are carried forward after refund-
Unamortized Discount and Redemption Premium on Bonds Refunded

ing, it should be regarded as permissible to accelerate the amortization of the amount as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year.

Whatever method is employed, it should be clearly disclosed, and if the unamortized discount and redemption premium on refunding are carried forward, the amount of the annual charge should, if significant in amount, be shown separately from other charges for amortization of bond discount and expense.

The considerations which have led the committee to the conclusions herein expressed are set forth in detail in the memorandum which follows:

MEMORANDUM REGARDING UNAMORTIZED DISCOUNT AND REDEMPTION PREMIUM UPON THE REFUNDING OF BONDS

(1) General considerations

In this memorandum the committee will endeavor to present the arguments for and against the several alternative methods of treatment of unamortized discount and redemption premium on refunding of bonds, and to reach a conclusion on the question of which method or methods should be regarded as acceptable and whether any one method should be regarded as definitely preferable to others. It will attempt to discuss the subject in such a way as to bring out clearly those considerations which have a more general application than to this particular question.

(2) The case considered

It will probably be convenient to consider in the first instance the general question in relation to a hypothetical case, leaving any problems involved in less typical cases for later consideration.

The hypothetical case which will be assumed is as follows: A corporation in 1929 issued $10,000,000 face value of bonds maturing in 25 years, bearing coupons at the rate of 5%; the net proceeds of the issue were $9,654,000, making what is usually called the "effective rate" of interest 5 1/4%. In accordance with the customary practice, it recorded the face value of the bonds as a liability on its books, and entered the difference between the face value and the net proceeds as unamortized bond discount and expense, the amount being $346,000. In the succeeding 10 years, it charged to its income account the interest accruing annually at the coupon rate and a provision for amortization of bond discount and expense at the annual rate of
1/25th of $346,000, or $13,840, so that at the end of exactly 10 years from the original issue it had written off $138,400 and was carrying a balance of $207,600.

At the end of 10 years it retired the bond issue, in accordance with the provisions of the contract, at 105% of par, raising the amount required for the purpose by an issue of new bonds maturing in 25 years and bearing a coupon at the rate of 3 ½% per annum, which it sold at such a price as to make the net proceeds exactly equal to the par value of the bonds. (For the sake of simplicity, the repayment of the old bonds and the issue of the new will be regarded as taking place simultaneously.)

The question then to be decided is, what disposition should be made of the unamortized discount and expense item of $207,600 and the redemption premium over par of $500,000 paid on the issue retired. After examination of a considerable number of reports, the committee believes the case is typical in so far as the redemption premium is larger than the unamortized discount and as there is a clear benefit from refunding greater than the amount of that discount.

(3) Treatment of discount on bonds in general

It seems desirable to discuss briefly the present method of treating discount on bonds in general, particularly because a change of opinion in regard to such treatment has taken place in recent years which may be significant in its bearing on the question now under consideration.

Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount, it is customary to charge the coupon interest directly to income account and to distribute the discount over the term of the bond issue, under the general accounting rule that expenditures made for a future benefit should be charged against the period during which the benefit may be expected to be received.

Until the early days of the century, it was common to regard such discount as being a capital charge; and when the unsoundness of this treatment was recognized, alternative methods of treatment became accepted, under one of which the discount was distributed over the term of the issue, and under the other, the discount was charged immediately against surplus, the latter being regarded generally as the preferable course. Even today, the Interstate Commerce Commission grants an option to railroads under its jurisdiction to charge bond discount to profit and loss (surplus) when the bonds are issued, or to an-
Unamortized Discount and Redemption Premium on Bonds Refunded

ticipate by an appropriation from profit and loss the amortization of such charges through income in later years (Accounting Classification rev. to January 1, 1936, pages 191 and 197).

This committee is of the opinion that the treatment of such discounts as a part of the cost of borrowed money in the annual income account of the company to be distributed systematically over the term of the issue is the sound accounting procedure, and it believes that this view is shared by the overwhelming majority of present-day accounting authorities. The anticipation of this income charge by a debit to income of a previous year or to surplus has in principle little more justification than would a corresponding treatment of coupons due in future years.

This history of the change of opinion on the proper treatment of bond discount in general is significant not only in itself, but because of its bearing on the attitude of regulatory bodies. It is not surprising that regulatory bodies, which have sanctioned the charging of discount on bonds still outstanding against profit and loss (surplus) should authorize a similar treatment of unamortized discount on bonds refunded.

The change also illustrates a general alteration of viewpoint of far-reaching importance. The argument in favor of immediately writing off discount was that it extinguished an asset that was only nominal in character and resulted in a conservative balance-sheet. In recent years, the weight attached to this argument has steadily diminished and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance-sheet is of dubious value if attained only at the expense of a lack of conservatism in the income account, which is far more significant.

(4) Should bond discount and redemption premium be dealt with separately or as one?

As a preliminary matter it may be desirable to consider the suggestion sometimes made that the unamortized discount and the premium on redemption perhaps require different treatment. This suggestion seems to the committee to be largely a reflection of the common practice of attaching undue importance to the nominal par value of bonds and the nominal interest rate thereon.

The real premium paid on redemption is the difference between the redemption price and the present value at the redemption date of the liability to maturity under the old issue, computed at the effective rate of interest at which the loan was originally contracted. This is
true, notwithstanding the fact that in determining whether or not refunding is advantageous, only the redemption price enters into the computation.

Thus, in the hypothetical case assumed, in order to determine what interest rate would make refunding advantageous we have to ascertain the effective yield of a 5% bond with 15 years to run, bought at the redemption price of 105. Since we find this to be 4.54%, the refunding will be advantageous if and to the extent that it can be effected at a rate lower than 4.54%. However, the amount of premium to be considered at the time of refunding is the difference between the present value of the amount due at maturity on the original issue rate of 5½%, namely 97.43% of par, and the redemption price of 105; this difference is 7.57% of the par value, or $757,000. (See Appendix B.) The charge for amortization of the discount and premium, added to an effective rate of 4.54% on the new issue, will bring the total charge up to the equivalent of a 5½% basis, the effective rate on the old issue. (See Appendix C.) The conclusion is that the unamortized discount and redemption premium should be dealt with as one.

(5) The alternative methods of treatment of unamortized discount and redemption premium that have received substantial approval

These are three in number:

a. A direct charge to earned surplus;
b. Amortization over the remainder of the original life of the issue retired; and
c. Amortization over the life of the new issue.

The existence of three approved methods is attributable partly to difference of opinion as to the accounting rule properly applicable, partly to differences in the interpretation of the facts themselves, and partly to consideration of the practical results of alternative forms of treatment.

(6) The accounting doctrines involved

The accounting rules, the applicability and interpretation of which are subjects of argument, are:

a. The rule that a loss or expense should be written off not later than the time when the series of transactions giving rise to it is completed;
b. The rule that when a cost is incurred the benefit of which may reasonably be expected to be realized over a period in the future,
it should be charged against income over such period rather than against income of the period in which the amount is paid or ascertained.

Conflict between these two rules is not infrequent in accounting. As the emphasis has shifted from the balance-sheet to the income account, the tendency has been to bring more and more transactions within the second rule.

The completed transaction rule has undoubtedly serious defects. In the first place, it enables the accounting corporation to avoid taking an indicated loss by refraining from completing the transaction which would make it necessary to accord accounting recognition to that loss. A common instance is the failure to dispose of fixed assets that have become in fact obsolete and, apart from salvage value, worthless.

In the second place, it is apt to result in charges which are relatively large in amount and which are not fairly attributable to the period in which the transaction is completed. If the charge is made against the current income account, the results for that year are distorted, while if the charge is made against surplus, the fact that it is a proper charge against income for some period or periods is apt to be overlooked. There is today a definite and growing disposition to avoid such results wherever possible by distributing charges over a period of years and of reflecting them under the appropriate head in the income account.

(7) Questions of fact and interpretation of fact

As has been pointed out already in paragraph (4), unamortized bond discount and redemption premium together represent (though with only approximate accuracy) the amount required to be paid for the privilege of terminating a borrowing contract. The advocates of the immediate charge of the amount to surplus regard the amount as being a payment for the privilege of terminating a contract which has become unprofitable. Upon this view, no part thereof can properly be charged to a period subsequent to the retirement of the issue.

The advocates of carrying forward the amount and distributing it over a period subsequent to the refunding, interpret the transaction differently. They regard the amount as being, rather, the price of an option to refund the issue if and when refunding seems profitable. The proper view of the course of events, they contend, is somewhat as follows:

An original issue of bonds is normally made with a view to the expenditure of the proceeds for a specific purpose or purposes. Whether
the expenditure is justified often depends largely on the cost of the money. By the creation of a bond issue, the maximum cost of the money becomes fixed for a substantial period of years (corresponding, perhaps, with the term necessary for the amortization of the expenditures to be made from the proceeds). It is, however, usual and prudent to include in the contract an option to enable the borrowing corporation to anticipate the maturity if it finds it possible to refund the obligation at a lower cost, either as the result of a favorable change in interest rates or as the result of its own improved credit.

Of course, some payment has to be made for this privilege; broadly speaking, this price is represented by the unamortized discount and premium here under consideration. Continuing the line of reasoning, it is argued that the cost of money over the entire period of the original issue is affected by the terms of the original contract, and that if the cost of anticipating maturity is incurred, it is only because it is advantageous to do so; if the saving over the unexpired term of the old bonds will exceed the amount of unamortized discount and premium to be disposed of, the amount may properly be spread over that unexpired term. It seems to this committee that this argument has substantial merit and that the mode of thought which it reflects is one that is gaining increasing acceptance.

It is possible that the advantages of refunding may lie not in a lower cost of money but in improvement of other conditions attaching to the issues. It nevertheless remains true that the refunding will rest upon comparisons made for the remaining period of the old bonds and that such cases therefore do not change the above conclusions.

(8) Practical considerations

If the unamortized discount and redemption premium are written off when refunding is effected, an abnormal charge against income or earned surplus is created. This, as already pointed out, results in a distortion of the income account, whether the amount is charged off wholly against income in the year in which refunding takes place or whether it is charged to surplus, in which case it at no time passes through the income account of any year.

Moreover, the resulting charge to income or earned surplus may in some cases exhaust the available surplus and produce results that are inequitable. Holders of preferred stock may have a just cause for complaint if a refunding takes place which will have a beneficial effect on the earnings available for the common stock and yet the accounting treatment is such as to exhaust the surplus and make it illegal, temporarily, to pay dividends on the preferred stock.
Unamortized Discount and Redemption Premium on Bonds Refunded

(9) Decisions of courts and commissions

The leading case in which the question was considered was that of Great Western Power Company of California v. Commissioner of Internal Revenue (297 U. S. 543), decided by the United States Supreme Court on March 16, 1936. (See Appendix A.) There, the court had before it two questions. One related to an exchange of bonds pursuant to the provisions of the contract under which previously outstanding bonds had been issued—the other related to retirements of other bonds in the same category in cash from funds which it appears were raised by a refunding issue.

On the first point, it held that the unamortized discount should be spread over the life of the new bonds issued in exchange for the other; on the second point, it decided that the unamortized discount was a loss in the year in which the retirement of the old bonds took place, saying, “It has accordingly been held that where an issue of bonds is retired for cash, whether the cash be obtained by the sale of a new issue or not, the items in question are deductible in the year of retirement.”

This, it is true, was a tax case and the decision on the second point turned largely on the fact that regulations, providing that the unamortized discount on bonds became a deductible loss when the retirement took place, had been issued by the Treasury and that Congress had re-enacted substantially the same provisions of the law with the knowledge of the existence of these regulations. These regulations were not, however, based on any express provision of the law, but on the interpretation by the Commissioner of an act which provided that losses should be deducted when actually incurred and that the return should be made in such a way as fairly to reflect income. Therefore, although this is a tax case, the decision would seem to have more application to accounting in general than tax cases ordinarily have.

The attitude of regulatory bodies may be illustrated by reference to the treatment prescribed in the uniform system of accounts issued by the Federal Power Commission and the National Association of Railroad and Utility Commissions. The regulations call for the immediate charge of unamortized discount and redemption premium to surplus or, as it is sometimes termed, profit and loss. They, however, provide that where debt retirement is effected through refinancing and the utility desires to amortize the discount and premium over a period subsequent to the date of the refinancing, it may do so provided that the permission of the commission is obtained, and in practice such permission seems to be freely granted.

In judging the weight to be attached to these provisions, it should be borne in mind, first, that the commissions occupy a special relation
to utilities and consumers such as does not exist in general industry; and, secondly, that these commissions have in the past permitted the anticipation by charges to profit and loss of discount on bonds outstanding, which discount would otherwise become a charge against the income of subsequent years, a practice which as already indicated (paragraph 3) the committee regards as now being contrary to sound accounting rules. The consideration of balance-sheet conservatism has clearly weighed heavily with commissions.

(10) The alternative of spreading the unamortized discount and redemption premium over the life of the new issue

This alternative seems to the committee to be the one most open to objection. It cannot be justified under the rule that cost may be spread over the period during which the benefit therefrom may be presumed to be accrued. In our illustrative case, it is clear that a benefit will accrue over the first fifteen years of the new issue, during which time it will be replacing the previous outstanding issue. During this period the annual cost of money under the old contract, had that remained in force, would have been: interest—$500,000; discount amortization—$13,840; together—$513,840. After the refinancing, the cost would be: interest—$350,000; charge for unamortized discount on old bonds—$13,840; charge for redemption premium on refunding—$33,333; total—$397,173.

When, however, the final ten years of the new issue are considered, it is apparent that there is less evidence to justify the assumption that a benefit from the financing will result in that period. The benefit, if any, must be the difference between the $3\frac{1}{2}\%$ payable for those ten years on the refinancing issue now made and the rate of interest that would have to be paid on a new borrowing effected at the original maturity date of the old issue. It is impossible to foresee the interest rates for any such period, and there is therefore no ground for assuming that a benefit will result therein. The truth of this statement is strikingly illustrated by current refinancing of refunding bonds issued within the last few years.

In the second place, there is no logical relationship between the amount of the unamortized discount on the old issue and the term of the new issue.

Thirdly, it is unconservative from both the balance-sheet and the income standpoint to carry forward part of the unamortized discount and redemption premium over the longer period.

Finally, as a practical matter the treatment of the unamortized bond discount or redemption premium on the old issue as a charge
over the life of the new issue results in an understatement of the annual cost of money after refunding and during the remainder of the term of the old issue. Consequently, the adoption of this procedure tends to encourage the consummation of transactions which are not, in fact, advantageous to the corporation.

An argument by which this method is sometimes supported is that the expense of retiring the old issue is a part of the cost of the new transaction. This argument seems to the committee to be fraught with danger.

In view of all these considerations and of the desirability of narrowing the range of choices in the treatment of the expense here under consideration, the committee feels that this alternative should not be regarded as an acceptable accounting procedure.

The committee is aware that the method has been very generally authorized by regulatory commissions in the case of public utilities. It feels, however, first, that a special relation exists between utilities and consumers which makes precedents in this field of doubtful validity in other fields where no such relationship exists; second, that the authorization of the use of this method by commissions has usually been based either on an assumed expediency or on an inadequate analysis of the problem.

The committee, of course, recognizes that this treatment must be regarded as acceptable in those cases in which it has been expressly ordered or approved by a regulatory body to whose jurisdiction the accounting corporation is subject. It is furthermore contemplated that, if the debt is to be paid off through a new issue with a term less than that of the old issue, the amortization should be completed over the shorter period.

(11) The alternative of writing off unamortized discount and redemption premium on refunding over the remaining life of the issue refunded

This method seems to be free from the objections discussed in the preceding paragraph. The serious arguments against it are, (1) that it results in a balance-sheet that is not as conservative as is desirable; (2) that the cost of retirement is more correctly regarded as the cost of terminating an agreement which has become disadvantageous than as a part of the cost of making a more advantageous arrangement for the unexpired term of the old agreement.

(12) The alternative of charging off the unamortized discount and redemption premium immediately against income and earned surplus

The arguments for and against this method have been indicated in the foregoing discussion (paragraph 8). It results in a conservative
balance-sheet and historically finds more support in legal decisions, commission regulations, and accounting theory than any other method. The objections to it are that it results in a distorted or un-conservative income account; that under it, when interest rates fall and refunding becomes advantageous, a charge to surplus is created if the opportunity is availed of, a charge which would not arise otherwise. In some cases this charge may extinguish or so reduce surplus as to make the payment of dividends illegal, with a resulting hardship on holders of senior securities. Thus, the adoption of this alternative may tend to discourage transactions which are desirable from every standpoint or to encourage undesirable transactions. In other cases, in order to avoid such a result, the charge may be made to surplus account, thereby creating a deficit, and that deficit may be extinguished by a capital readjustment. In this way the practical result may be much the same as if the charge had been made in the first instance against capital surplus, a procedure which is generally regarded as unacceptable.

(13) Conclusion

The conclusion reached by the committee is that either immediate writing off or amortization over the term of the old issue must today be regarded as acceptable accounting practice. The existence of the two alternatives is not to be construed as a reflection on accounting or accountants. It arises from a difference of opinion as to the relative weight to be attached to different objectives and reflects a conflict between two modes of thought. In the opinion of the committee, there is a definite trend of opinion towards procedures which emphasize the income account rather than the balance-sheet and which bring costs into the income account of some year or years under the appropriate head rather than directly into surplus.

The treatment of unamortized discount and bond redemption on refunding as a charge over the unexpired term of the old bonds seems to be that which conforms most closely to this tendency, and if this tendency continues it may well become the preferred or required method of treatment. At the present time, however, the method of writing off the unamortized discount and bond premium to surplus upon retirement (whether bonds are retired through refunding or otherwise) has too much support in accounting theory and practice and in the decisions of courts and commissions for the committee to recommend that it should be regarded as unacceptable or inferior.

The committee therefore recommends that either of these two methods should be regarded as permissible and that no qualification
Unamortized Discount and Redemption Premium on Bonds Refunded

of a certificate to accounts should be deemed to be called for when either is employed. In the committee’s opinion, however, exception should be taken to spreading the item over the life of the new bonds, except that spreading the amount over the life of the new issue must be accepted as permissible in any case in which that treatment has been authorized or prescribed by a regulatory body to whose jurisdiction the accounting corporation is subject, or has been adopted by the company prior to the publication of this pronouncement. Charging the amount to capital surplus is also, in the committee’s view, unacceptable.

(14) Acceleration of amortization

The question has been raised whether it is permissible to spread unamortized discount and redemption premium over a period subsequent to refunding which is shorter than the unexpired term of the old issue. Earlier in this statement the committee has expressed the opinion that anticipation of the systematic charge for amortization of discount on bonds still outstanding is, in principle, scarcely more justifiable than the anticipation of future interest charges.

The same considerations do not seem to apply to the question of acceleration of the amortization of discount and premium on bonds which have been refunded. Such acceleration may be regarded as a middle course between two alternatives (immediate writing off and spreading over the life of the old issue), each of which is acceptable, and, therefore, as being itself permissible. Indeed, it might not unfairly be claimed that this method achieves in the highest practicable degree the desirable result of producing a conservative balance-sheet without resorting to surplus charges or distorting the income account for a single year. The committee feels, therefore, that such acceleration should be permitted, provided the charges are made against income and are not so large as seriously to distort the results presented for any particular period.

(15) Minor points

a. In this discussion it is assumed that the annual charge for interest and amortization (including amortization of both discount and premium on the old issue and discount on the new issue) during the period from refunding to maturity of the old issue will be less than the charge that would have existed had the refunding not taken place. This, of course, will normally be the case, since only in such circumstances will refunding be likely to take place.

b. If unamortized discount and redemption premium on bonds
Accounting Research Bulletins

refunded is being carried forward and the debt is subsequently retired otherwise than by refunding, the amount of unamortized discount and redemption premium not theretofore written off should immediately be charged to income or, if the amount is so large that it would seriously distort the income for that year, to earned surplus.

APPENDIX A

Bibliography


Court Decisions:

Great Western Power Company of California, Petitioner, v. Commissioner of Internal Revenue; 297 U. S. 543.

Helvering, Commissioner of Internal Revenue, v. California Oregon Power Company; 75 F. (2d) 644.

Helvering, Commissioner of Internal Revenue, v. Central State Electric Corporation; 76 F (2d) 1011.

Helvering, Commissioner of Internal Revenue, v. Union Public Service Company; 75 F (2d) 723.

Helvering, Commissioner of Internal Revenue, v. Union Pacific Railroad Company; 293 U. S. 282.
Unamortized Discount and Redemption Premium on Bonds Refunded

Public Utility Commission Decisions:

Re Monrovia Telephone and Telegraph Co. (1927), 30 California R.C.R. 735.

APPENDIX B

On page 14 the amount of premium to be considered at the time of refunding was computed to be $757,000. In the details of the illustrative case given on page 12, the unamortized discount and expense on the books of the company at the time of refunding was $207,600 and the premium to be paid upon retirement of the old issue was $500,000, a total of $707,600. The difference is due to the fact that discount and expense were amortized by the effective-rate method in making the computations on page 14 and by the straight-line method in the description of the illustrative case as given on pages 11 and 12.

The committee does not desire to widen the scope of this statement by discussing current practice in the amortization of bond discount in detail. It recognizes, however, that the method commonly followed of writing off bond discount by equal instalments over the term of the issue is open to criticism as an oversimplification both of the underlying theory and of the application thereof. The effective-interest method of writing off discount sometimes employed is open to the first of these criticisms, if not to the second.* The justification of the straight-line method lies in its practicability and in its conservatism; a more refined analysis would usually result in lower charges to income in the early years of the life of a bond issue and correspondingly larger charges in the later years. The almost universal use of this method may be regarded as a striking indication of the importance attached to simplicity and conservatism in present-day accounting.

Nor does the committee deem it opportune to discuss the theoretical soundness and practicability of adopting an alternative treatment of bonds which would recognize in some respects the nominal character of the terms "principal" and "interest." If accounts were used only by accountants, there would be much to be said in favor of treating liabilities as negative assets and applying to them a principle analogous to that of historical cost and amortization commonly applied to assets. Under this procedure, on the issue of a bond only the net proceeds thereof would be recorded as a liability, and by a process which would be the converse of amortization this liability would gradually be written up through charges against income to the amount ultimately payable.

It is historically interesting to note that an accounting method which took cognizance only of the proceeds of obligations when sold was adopted in English railroad accounting in the middle of the last century, and that notwithstanding the influence of English investors in American railroads the practice never extended to this country.

Those who are interested in pursuing the matter further will perhaps find consideration of the marginal case the most useful approach. Thus, assume in an illustrative case that at the end of ten years a refunding is effected by issuing at par bonds in the amount of $10,500,000, having a coupon rate of 4.54% and serial to the extent of $500,000, in such a way that the payments of interest and principal together will be exactly the same on the new issue as on the old. The company is no better or worse off than before (except perhaps that the character of the new issue is more favorable, e.g., debentures instead of mortgage bonds).

This illustration perhaps presents the case for carrying forward the un-amortized discount and redemption premium over the life of the old issue at its strongest. It also points the defect of the proposal to spread that discount and premium over the life of the new bonds. For assume next a modified case in which the payments up to the maturity date of the old issue are the same, but that the principal sum of $10,000,000 is extended for a further fifteen years on a 4.54% basis on which the whole new borrowing is effected. Then if the discount and premium on the old issue are spread over the whole twenty-five years, the result will be that the total charge against income in the first ten years will be less than if no refunding had taken place, and the charge for the final fifteen years will be in excess of 4.54%.

The statement entitled "Unamortized Discount and Redemption Premium on Bonds Refunded" was adopted by sixteen affirmative votes received by August 17, 1939. On that date votes had not been received from four members of the committee. Professors W. A. Paton and Roy B. Kester dissented.

COMMITTEE ON ACCOUNTING PROCEDURE

CLEM W. COLLINS, Chairman
GEORGE O. MAY, Vice-Chairman
FREDERICK B. ANDREWS
GEORGE D. BAILEY
CARMAN G. BLOUGH
SAMUEL J. BROAD
ARTHUR H. CARTER
CHARLES B. COUCHMAN
A. S. FEDDE
HENRY B. FERNALD
STANLEY G. H. FITCH
HENRY A. HORNE
FREDERICK H. HURDMAN
LINCOLN G. KELLY
ROY B. KESTER
LEWIS LILLY
A. C. LITTLETON
WARREN W. NISSLEY
WILLIAM A. PATON
CHARLES F. RITTENHOUSE
WALTER A. STAUB
VICTOR H. STEMPEL
JOHN L. CAREY, Secretary
The following rule was adopted by the Institute in 1934:

"Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fail to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to, and the action as formally approved by, the shareholders as in reorganization."

In view of the fact that the Institute was the first to put forward in any formal manner the proposition contained in the second sentence of the rule, it has, perhaps, a special responsibility in the premises. Certain problems have arisen since 1934 regarding the application of this proposition which warrant amplification of this part of the rule.

Readjustments of the kind mentioned in the second part of the rule fall in the category of what are sometimes called quasi-reorganizations. This statement does not aim to deal with the general question of quasi-reorganizations but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases will be referred to as "readjustments," and the problems fall under two questions, (a) what may be permitted in a readjustment, and (b) what may be permitted thereafter.

Procedure in Readjustment

If a corporation elects to bring about a legitimate restatement of its assets, stock, and surplus through readjustment and thus avail itself of the permission to relieve its future income account or earned-surplus account of charges which should otherwise be made thereagainst, it should make a clear report to the stockholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair and conservative balance-sheet as at the date of the
readjustment, in which assets and liabilities should be so stated that no artificial credits will arise from realizations of the assets or discharge of the liabilities. Furthermore, the readjustment of values should be reasonably complete, in order that there be no continuation of the circumstances which justify charges to capital surplus.

The effective date of the readjustment from which the income of the company is thereafter determined and which is included in its dated earned-surplus account should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

When the amounts to be written off have thus been determined, they should be charged first against earned surplus to the full extent thereof; the balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus will be carried through a readjustment in which some losses have been charged to capital surplus.

If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company’s interest therein should be regarded as capitalized by the readjustment, just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

Understatement as at the effective date of the readjustment of assets which are likely to be realized thereafter, though it may result in conservatism in the balance-sheet at that date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at a fair and not unduly conservative value, determined with due regard for the accounting rules to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the item should be described as an estimate and any material difference in value subsequently shown (by realization or otherwise) to have existed at that date should not be carried to earned surplus.

Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, reserves may properly be made to cover the maximum probable losses or charges. If the reserves are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset gains or losses originating after the readjustment, but should be carried to capital surplus.
Quasi-Reorganization or Corporate Readjustment

Procedure after Readjustment

When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

After such a readjustment, as already stated, previously earned surplus cannot properly be carried forward under that title. A new earned-surplus account should be established, described as from the effective date of the readjustment.

Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; in other words, it becomes subject to rule 2 quoted above. Charges against it should be only those which might properly be made against the initial surplus of a new corporation.

It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past, or to eliminate amounts which, by universal agreement, do not give rise to charges in respect of exhaustion or amortization. In this statement the committee deals only with that type of readjustments in which either the current income or earned surplus account or the income account of future years is relieved of charges which should otherwise be made thereagainst.

The statement entitled "Quasi-Reorganization or Corporate Readjustment" was adopted by nineteen affirmative votes received by August 17, 1939. On that date votes had not been received from three members of the committee.

COMMITTEE ON ACCOUNTING PROCEDURE

CLEM W. COLLINS, Chairman
GEORGE O. MAY, Vice-Chairman
FREDERICK B. ANDREWS
GEORGE D. BAILEY
CARMAN G. BLOUGH
SAMUEL J. BROAD
ARTHUR H. CARTER
CHARLES B. COUCHMAN
A. S. FEDDE
HENRY B. FERNALD
STANLEY G. H. FITCH
HENRY A. HORNE
FREDERICK H. HURDMAN
LINCOLN G. KELLY
ROY B. KESTER
LEWIS LILLY
A. C. LITTLETON
WARREN W. NISSLEY
WILLIAM A. PATON
CHARLES F. RITENHOUSE
WALTER A. STAUB
VICTOR H. STEMPEL
JOHN L. CAREY, Secretary
INTRODUCTORY NOTE

Pursuant to a resolution of the executive committee adopted at a meeting held October 19, 1939, the committee on accounting procedure and the research staff have considered the question of treatment of foreign business operations of United States corporations in view of the present disturbed conditions.

Since it was necessary that the statement on the question should be issued promptly the committee has restricted its consideration to the questions most immediately at issue. It still has under consideration a number of related questions, such as treatment of valuation reserves in general.

The committee and the research department have carefully examined the available literature, including memoranda issued by a special committee of the Institute in 1931 and 1933 (which seem to call for no substantial modification), and have discussed the subject with accountants and others actively engaged in practice in which such questions frequently arise. A statement by the committee is accordingly submitted.

For convenient reference the statements of 1931 and 1933 are reprinted at the end of the present statement.

FOREIGN OPERATIONS AND FOREIGN EXCHANGE

Treatment of Earnings and Assets

1. The disturbed conditions abroad, and the uncertain future, make it necessary to reconsider the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business, and included in the financial statements of United States companies.

It is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed.

2. While there are comparatively few countries with unrestricted
currency and exchanges, yet it is also true that many companies are doing business with foreign countries having varying degrees of restriction; in some cases they are carrying on all operations hitherto regarded as normal, including the transmission of funds. Furthermore, some important countries are on a permit basis, the operation of which in a given case cannot be predicted.

3. As to earnings, a safe rule for United States companies to follow would be that in their own accounts earnings from foreign operations for the current year should be shown only to the extent that actual remittances for them had been received in the United States. Provision should be made also for known losses of subsidiaries. In other words, the position shown should not be made better by the omission of foreign results.

Any earnings to be reported beyond the amounts already received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant and they should be reserved against to the extent that their realization in dollars may be doubtful.

4. As to assets held abroad, the accounting must take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Furthermore, the possibility of these risks and restrictions being extended must be faced.

5. In these conditions it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent of foreign items there included.

**Consolidation of Foreign Subsidiaries**

6. The following procedures are among the possible ways of providing adequate disclosure of information relating to foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish: (1) statements in which only domestic subsidiaries would be consolidated; and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The aggregate amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any amount of surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the
Foreign Operations and Foreign Exchange

consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it permissible to include inter-company profits which would be eliminated if such subsidiaries were consolidated.

(b) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition the summary described in (a) (2) above.

(c) To furnish: (1) complete consolidated statements, and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition parent company statements showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries.

Any of the foregoing statements, or other alternative statements, which include earnings of foreign subsidiaries, should be prepared with due regard for paragraphs 3 and 7.

Losses and Gains on Foreign Exchange

7. Realized losses or gains on foreign exchange should be charged against or credited to operations.

Provision for declines in conversion value of foreign net current and working assets should be made and shown separately.

In considering whether such a provision should or should not be deducted in arriving at the amount of net income for the year from which the net income per share is ordinarily computed, it must not be overlooked that if the amount of the provision is relatively large, the balance shown before making the deduction, the deduction itself, and the balance after making the deduction are all significant. It is desirable that investors should consider the component elements of net income and surplus changes and should be given reasonable information to enable them to do so, and that they should not be encouraged to attach undue importance to a single figure.

Where a corporation publishes a continuous statement of income and surplus, the situation can be met by showing the income before and after the deduction of the provision and refraining from describing either figure as “Net Income for the Year” without amplification of the expression.

Where the corporation’s practice is to carry the balance of income to a separate surplus statement, either (1) the provision should appear as a charge in the income statement, the balance before and after the charge perhaps being shown, or (2) if the amount and the circumstances are such that this would seriously impair the value of the in-
come statement as an indication of earning capacity, and the charge for that reason is made to surplus, a clear disclosure of the treatment should appear in a note in the income statement.

The preceding statement entitled “Foreign Operations and Foreign Exchange” was unanimously adopted by the twenty-two members of the committee.

FORMER STATEMENTS REPRINTED

Below are reprinted* the statements of a special committee of the Institute, issued in 1931 and 1933.

MEMORANDUM ON ACCOUNTING FOR FOREIGN EXCHANGE GAINS

After consideration of accounting problems related to the decline of the dollar on foreign markets during recent months, the Institute’s special committee on accounting procedure has prepared a supplement to its memorandum of December, 1931, dealing with foreign-exchange fluctuations in accounts.

The problem presented at that time was to account properly for foreign-exchange losses due to the decline of foreign monies in relation to the dollar. The present difficulty centers about the treatment of profit-on-exchange items which may be of a purely transitory nature because of the unstable condition of the international money market.

The report here submitted has not been considered by the council nor by the executive committee and therefore has not the official endorsement of the Institute. Its recommendations, representing the personal opinion of the members of the special committee, are offered in the hope that they may be helpful in the preparation of year-end statements for corporations with subsidiaries abroad.

The text of the report is as follows:

In view of the exceptional conditions affecting foreign exchange transactions at the present time, the special committee on accounting procedure considers it opportune to submit the following notes supplementing the memorandum on foreign exchange prepared in December, 1931:

The general principles of accounting applicable to the foreign exchange situations, as set forth in the original memorandum, have naturally not been changed. It is correct practice to show the value of net current assets at the rate of exchange prevailing at the date of the balance-sheet, but certain points must be kept in mind.

The application of these principles will at the present time generally result in an increase in the net worth of a corporation as stated in dollars, but it will

be impossible, in the case of many corporations carrying on business abroad, to convert all the assets expressed in currency into physical dollars, due, in part, at least, to the impracticability of turning net current assets situated abroad into cash.

Attention is called to the fact that, particularly where manufacturing or trading branches (as distinguished from branches engaged entirely in selling) are maintained in foreign countries, there must always remain in such countries net current assets which cannot be converted into dollars at reasonably short notice.

Bearing this in mind, it is desirable to recommend strongly to clients that during such a period as the present, when rates seem liable to a considerable future fluctuation, either upward or downward, any apparent increase in the net worth arising from the classes of assets referred to in the preceding paragraph should be carried to a suspense account until exchange has become more stabilized or it is reasonably safe to assume that future fluctuations of exchange will tend permanently to increase the net book worth in dollars of the concern under review.

Furthermore, when dealing with such assets, other basic principles should not be violated. Of course, inventories should be valued at cost or market, whichever was lower, and the cost of such inventories, as affected by exchange variations should be borne carefully in mind; when the goods in question are manufactured abroad and it becomes necessary to express the cost in dollars, unless the period of manufacturing and the basis of costing are carefully considered from every angle, including the correct relative rate of exchange, errors of principle may easily occur.

In times like the present, "blocked" cash, not available for the company's normal operations in the country where it is blocked, should also be considered carefully. It would appear desirable to take such monies out of current assets and not to take into profit-on-exchange the apparent gain that might arise from converting the nominal quotation into dollars, even though the client has taken into earnings exchange "gain" on other assets.

It should also be noted that where there are losses through the conversion of net liabilities existing in a foreign country, such losses should be provided for out of operations.

Since at the time of the fall of many foreign currencies in 1931 it was fair and proper in the case of American companies adversely affected, to state as a special item of loss the loss occasioned by countries abandoning the gold standard, conversely, at this time it is important to insist that any items which may properly be carried into the income account should be shown separately in that statement, so far as such gain is in excess of normal exchange earnings. This paragraph is not intended in any way to weaken the recommendation of the committee made earlier in this memorandum to the effect that clients should be advised to retain in "suspense account" profits that are merely book increases.

It is realized that where there is a steady tendency of decline, as has been the case during the past year in the dollar exchange rates, it is not practicable to state exactly the gain occasioned by these fluctuations, as was possible with regard to exchange losses in many cases in 1931. Each case will necessarily be considered individually, and the best available methods to determine a
reasonable estimate for the special gain accruing to the company should be utilized.

Special committee on accounting procedure:
J. H. Stagg, Chairman, WM. H. Bell, H. B. Fernald,

December 27, 1933.

This memorandum should be considered in conjunction with the 1931 report, which is reprinted here for the convenience of members:

“... The meetings of the special committee on accounting procedure held during the month of November have been devoted to the consideration of the question of foreign exchange. The committee realizes that there is considerable discussion in financial circles as to the correct method of stating in forthcoming accounts of American corporations the consolidated results of their business conducted in foreign currency, having regard to the numerous and severe fluctuations in foreign exchange that have occurred during the year. It believes that members of the American Institute of Accountants might find it helpful to have the underlying principles affecting such accounts restated briefly as an aid in answering inquiries which undoubtedly will be made to them on this question.

**Balance-sheet**

“Fixed assets should be converted into dollars at the rates prevailing when such assets were acquired or constructed. Where large units are purchased for American dollars the American dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency then the cost of the fixed assets should be the equivalent of the amount of foreign currency* in American dollars, at the rates of exchange prevailing at the time payment is made. In consolidated accounts, the depreciation charged on fixed assets should be kept strictly on the American dollar cost, even though for purposes of local taxation it may be impossible to show the full currency equivalent on the foreign statements.

“An example of this would be where a plant had been erected in France at the cost of Frs. 1,000,000 when such Frs. 1,000,000 was equivalent to $200,000.00. Assuming an average rate of 6 per cent, depreciation of $12,000 should be provided for in the consolidated accounts (both balance-sheet and income account), even though there could be taken up on the French records only Frs. 60,000, or the equivalent, at the present rate of exchange, or $2,400.

“Cash, accounts receivable and other miscellaneous current assets should be converted at the rate of exchange prevailing on the date of the balance-sheet, unless protected by forward exchange contracts.

“Inventory should follow the standard rule of market or cost, whichever is lower in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not treated as an ordinary current asset and converted at the rate of exchange prevailing on the date of the balance-sheet, the burden of proof should be on the client.

“There are, however, undoubtedly many cases where the cost or a portion

* Throughout this memorandum currency is used in the sense of local currency as opposed to dollar assets or commitments.
Foreign Operations and Foreign Exchange

of the cost of an article was incurred when the foreign currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in currency at which it appeared in the records of the local branch or subsidiary company. In some cases the market price in currency would undoubtedly have been increased since the fall in exchange, and it would be inequitable to treat 'the lower of market or cost' as a mere conversion at the closing rate of the currency cost price, where the article could now be replaced only at a much higher amount in currency. Where the market price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost price of the article in dollars at the rate prevailing as of the date of purchase, such original dollar equivalent may be considered as the cost price for purposes of inventory.

"Current liabilities payable in foreign currency should be converted into dollars at the rate of exchange in force on the date of the balance-sheet.

"Long-term liabilities should not be converted at the closing rate, but at the rate of exchange prevailing when the liability was actually contracted. This is a general rule, but exceptions might exist in particular cases: for example, where there are assets receivable over a term of years, which are converted at the current rate, particularly where such assets could be applied to the retirement of such liabilities.

"As a case in point, assume a corporation had a series of bonds to be retired in ten equal annual payments in currency and corresponding receipts from assets sold on the deferred-payment system, falling due at or about the same time as the payments due to the bondholders, then such offsetting items might reasonably be carried at the same rate of exchange.

Profit-and-Loss Statement

"A loss arising through a fall in foreign exchange is a risk incidental to foreign business, and should be a charge to operating accounts and not a charge to surplus; however, in such a year as the present, the item will be a substantial one in many cases and may be stated separately in the published accounts of a business, if so desired. All businesses engaged in foreign trade have what may be considered normal exchange differences which would properly be included under the ordinary captions. It is probably impossible to formulate an absolute general rule to cover the determination of the amount of special loss on foreign exchange during such financial periods as are now closing.

"Where a loss could be considered as occurring to a large extent within two or three days through the country in which business is being conducted suspending or abandoning the gold standard, a fair measure of the loss might be taken by calculating the fall in the dollar equivalent on the net current assets carried in such depreciated currency, as outlined above. In other cases, the special loss may fairly be determined by a similar calculation at the end of the fiscal period, but in this case an adjustment may be desirable if remittances from currency to dollars have been markedly below or in excess of the normal operations subsequent to such fall in exchange.

"Where a definite loss could not be established, a figure based on the average expense which has been incurred through exchange during recent periods might be considered as a fair charge to usual or normal operations, and the remainder of the loss on exchange for the entire financial period treated as the special loss.
"In cases of foreign branches or subsidiaries, corporations conducting their business in foreign currencies, (buying, selling and manufacturing) operating statements should be converted preferably on the average rate of exchange applicable to each month, where there have been wide fluctuations in exchange or if this will involve too much labor on a carefully weighted average.

"It will be appreciated that the foregoing is nothing more than a brief resumé of the generally accepted principles pertaining to the treatment of foreign exchange as applied to the statements of accounts of American corporations. In practice it will be found that absolute definite information will, in some cases, be missing, in which case considerable care should be used to determine a reasonable average to be applied.

"On the treatment of foreign exchange in accounts many admirable volumes have been published, but an excellent brief resumé was noted by the committee in the paper read by Mr. Cecil S. Ashdown at the annual meeting of the Institute held in Chicago, September, 1922, and published the following month on page 262, volume XXXIV of The Journal of Accountancy."

Special committee on accounting procedure:

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

John K. Mathieson, Chairman
George O. May, Vice-Chairman
George D. Bailey
Carmen G. Blough
Archibald Bowman
Arthur H. Carter
Clem W. Collins
Charles B. Couchman

A. S. Fedde
Henry B. Fernald
Stanley G. H. Fitch
Henry A. Horne
Frederick H. Hurdman
Lincoln G. Kelly
Roy B. Kester
Lewis Lilly

A. C. Littleton
Warren W. Nissley
William A. Paton
Charles F. Rittenhouse
Walter A. Staub
Victor H. Stempf

John L. Carey, Secretary
SCOPE OF THIS STATEMENT

1. The committee has given extended consideration to the question of the proper accounting for depreciation on appreciation. The research staff has studied the available literature, and has caused several special memoranda to be prepared. The committee has discussed the subject at three of its meetings, and by correspondence. As a result the committee now makes a definite recommendation with respect to the charge to be made against income in such cases, but has as yet developed no definite recommendations on other aspects of the problem. It has therefore been considered useful for the committee to issue this statement of its conclusion as to the proper charge against income, and to add thereto a discussion of other relevant questions. The latter discussion will, it is hoped, be helpful in furthering the formulation of conclusions on these other questions.

2. Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations. The problem which the committee here considers is the treatment of charges against income where appreciation has in fact been entered on the books.

3. The word “depreciation” is here used in its ordinary accounting sense and not as the converse of “appreciation”.

This discussion does not deal with cases in which the value of property may exceed the amount at which it is carried on the books because of increment due to lapse of time—such as the growth of timber, or to such causes as solidification or adaptation—as of the roadbed of a railroad or a dam, or by reason of excessive allowance for depreciation in the past. On these cases no opinion is here expressed or implied. This bulletin is concerned primarily with appreciation due to (1) increases in the relevant price levels, or (2) demonstration that the property has greater usefulness than is reflected in the
amount at which it is carried in the books, as discussed later in paragraphs 11 and 12.

CONCLUSION AS TO CHARGE AGAINST INCOME

4. The committee is of the opinion that when such appreciation has been entered in the books, income should be charged with depreciation computed on the new and higher values. This proposition is the most important part of the present statement and for it there seems to be general support. A corporation should not at the same time claim larger property values in its statement of assets, and provide for the amortization of only smaller property sums in its statement of income.

5. It is recognized that in the past the contrary view has been held in the profession and in other authoritative quarters, and in some cases it may be unreasonable to require a corporation to change a treatment adopted in good faith in the past. The committee believes, however, that a change to conform to the views now expressed is very desirable, and that members of the Institute should exercise their influence to the utmost to bring about such changes.

Discussion of Conclusion

6. From the strictly accounting point of view the depreciation charge against income is the element of primary importance. It should fairly reflect the consumption or expiration of property usefulness that has taken place.

The conclusion does not rest upon any basis of narrow logic or precise classification; it is derived from considerations of equity and public policy of the broadest character. These include an application of something analogous to the legal doctrine of estoppel, which asserts that one who has made certain representations is thereby precluded from afterwards averring anything inconsistent with them. In the present case this would mean that a company which has made representations as to an increased value of plant cannot afterwards account for depreciation and income as if it had never made such representations. When a company has made representations in its balance sheet as to an increased value of its property and others have bought its securities upon those representations, it is not unreasonable to interpret the formal adoption of the larger amount for plant as implying an intention on the part of the company to maintain that larger amount of invested capital intact by proper charges against income. To implement such intention it is necessary that the company charge income with depreciation on the larger values represented.

7. If securities have been issued on the basis of a prospectus in
Depreciation on Appreciation

which the higher values were claimed, there may be a legal, and there would certainly seem to be a moral, obligation to provide for depreciation of the property on the basis of these higher figures in arriving at the amount of profits available for distribution. Even if no prospectus has been issued, but the corporation has sought a market for its securities by listing them on an exchange, so that the new values have been shown in published annual reports, similar considerations may today be regarded as applicable. It may reasonably be argued that new purchasers of securities of the corporation are led to acquire them upon the understanding that the higher values already exist and have been given formal recognition, and therefore form a part of the values which they acquire by their purchase of the stock, and that consequently they may be misled if dividends are subsequently paid to them on the basis of earnings computed with depreciation charged on original cost.

DISCUSSION OF OTHER ASPECTS OF THE PROBLEM

The following paragraphs deal largely with questions upon which, as stated above, the committee has as yet reached no conclusions. Most of these paragraphs do not represent opinions of the committee as a whole, but set forth the conflicting considerations which require careful study before more extended conclusions can be reached.

Accounting for Fixed Assets

8. The view expressed in paragraph 2 relates to accounts which form the basis for reports to stockholders and similar statements. Manifestly, there is no objection to showing estimated present values, nor to the computation of depreciation on that basis, for internal administrative purposes. A distinction can be made between the internal accounting for an enterprise and the accounting for the corporation which carries on the enterprise. From the standpoint of the enterprise, cost to the corporation is not of controlling significance, but, to the corporation itself, cost is the proper foundation of its accounting.

9. It must be recognized that in many cases appreciation has already been recorded on the books; it seems desirable, if practicable, to develop a standard procedure in such cases. In addition, instances occasionally arise in which appreciation is relatively so large and so well assured that it may be permissible from an accounting standpoint, and desirable upon more general grounds, to record it in the books. It should be added that in many cases the object sought could be better obtained by explanatory notes."

10. The cases of mines and industrial enterprises are not entirely
Accounting Research Bulletins

analogous, but consideration of the problem of mine depletion furnishes an illustration which may be helpful in dealing with the more complex problem of an industry. It is of course recognized that mines are often not legally required to make, and do not make, depletion charges.

The capital value of a mine is, in theory, the sum on which the mine may be expected to yield a fair return after provision has been made for amortization of that capital value. The accounting basis will normally be cost, but where the present value of future income is very greatly in excess of the unamortized part of the cost of the mine to the corporation which owns it, a balance sheet of the corporation in which the properties are stated at cost may be less useful to the average investor than a balance sheet in which the properties are stated at a figure more nearly commensurate with existing values, and on which depletion is computed accordingly. In this, as in industrial cases, there is considerable question as to whether the situation cannot best be shown in the form of supplementary information not included in the accounts.

It has been suggested that one method of including the appraisal in the balance sheet with the least disturbance is to show the entire balance sheet on a cost basis, with totals, and then to add on the assets side the unamortized amount of the property appraisal increment, and on the liabilities side the corresponding appraisal credit.

11. Comparable cases arise in industrial practice only when an extreme inflation occurs, or when assets have been acquired at an abnormally low cost. It is not necessary here to discuss the former case; that might call for reconsideration of many practices followed in more normal times. It may be useful, however, to examine the case of a property acquired at an abnormally low cost, the appropriate treatment of which turns to a considerable extent on the importance attached to different functions of accounts.

12. If in such case operations are charged with depreciation based on the low cost, the result will be to include in earnings from operations a profit which is in reality due to the exceptional character of the original purchase. It may be conceded that this profit is realized and available for dividends, but some hold the view that a clearer picture of the efficiency of the management will be presented if operations are charged with a provision for depreciation on a fair going concern value.

Treatment of Earned Surplus after Revaluation Entry

13. Some of those who feel it to be permissible or even necessary to charge operations with depreciation based on the higher appraisal
Depreciation on Appreciation

value, would nevertheless like to have the final earned surplus reflect depreciation on original cost. These results might be attained by (1) charging operations with depreciation based on the revised book figure; (2) carrying to earned surplus as a separate credit the excess of the depreciation charged to operations over depreciation based on cost, with a corresponding charge to the revaluation credit account.

14. Assuming this view to be accepted, the questions would remain whether the credit last mentioned should reach earned surplus through income account or directly, and whether it should be deemed to be a part of the free earned surplus or should be regarded as appropriated earned surplus. If the arguments advanced in paragraph 6 are sound, so that a company which has written up its property values is deemed to be bound to charge income with the depreciation on the larger values represented, it is not proper to undo the effect of such a charge by making a transfer from the revaluation credit to income account. The conclusion reached in paragraph 4 requires that no such credit be made. Upon the same reasoning, even if the credit is conceded to form a part of earned surplus, it would seem that it should not form the basis of ordinary dividends, but should be regarded as appropriated surplus, or made the basis of dividends specifically described as to the source from which they are paid.

Treatment of Revaluation Credit Account

15. It was noted in paragraph 13 that some accountants favor regular periodic transfers from the appraisal credit to earned surplus, of amounts equal to depreciation on the appreciation recorded. Others argue that the appraisal credit should remain until disposed of by special action. Examples of such action would be: (1) transfer to capital stock by means of a stock dividend; (2) transfer to earned surplus, when appraised units are retired, of the amount of appraisal credit which has been realized with respect to such retired units; (3) lump-sum transfers to earned surplus, in amounts not exceeding the appraisal credit actually realized. Amounts transferred under (2) and (3) might perhaps be separately stated as a subdivision of earned surplus, appropriately described to indicate their source and nature.

16. When plant is stated at an increased value on the assets side of the balance sheet, should that increased amount of assets be regarded as implying an equivalent increase in “capital” as used in a restricted sense on the liabilities side of the balance sheet? Obviously it does not necessarily signify an increase in the legal stated capital; but some contend that it implies an increase in the unstated capital, in capital surplus in other words. To this it is sometimes added that capital
surplus is just as much "capital" as capital stock—a proposition which is economically sound, but is subject to legal limitations which, since a corporation is the creation of law, the accountant cannot ignore.

17. Those who take this view say that the write-up has the effect of a quasi-reorganization—that it is an upward restatement of capital on the liabilities side, as well as of plant on the assets side. Accepting that view would mean that the credit item would be regarded as part of the capital structure, and not as available for transfer to earned surplus. Some go further and assert that an upward restatement of assets should not be entered in the books unless the management regards the situation in this light and is prepared to accept the consequences as stated. These consequences include, according to this view, not only the charging of income with depreciation on the larger amount—a point on which, as stated, there is general agreement—but also the "freezing" of the resultant credit item until it is disposed of, if at all, into capital stock by means of a stock dividend.

18. Those who do not share the foregoing views find their point of departure in the nature of the representations made when the appraisal value is entered. They hold that the representation is merely of the present value of the plant, and not of the nature of the resulting credit item, at any rate not to the extent of classifying it definitely as capital. They regard the credit as a sort of suspense item, the true nature of which is to be determined by the future course of events, and to be assigned to earned surplus, or by stock dividend converted to capital stock, as circumstances may require. Others deny that the credit is a capital increase, and assert that it is merely an unusual profit, to be distinguished from ordinary operating profits.

Other Considerations

19. Certain other difficulties may be touched upon. It is not possible to make a general statement as to the legal standing of appraisal figures. This varies in different jurisdictions, and for different purposes. For example, appraisal figures usually have no recognition for income-tax purposes. However, there are exceptions, such as the March 1, 1913 values adopted as a starting point. Some state statutes recognize unrealized appreciation as a basis for asset values and for certain types of dividends. Regulatory commissions tend to favor cost as the basis of property accounting, but for other purposes consideration has frequently been given to appraisals, the degree depending on the circumstances of the particular case. The attitude of the S. E. C. on the question is not yet fully developed, its decisions in
Depreciation on Appreciation

this area having involved chiefly the question whether a given appraisal was fair and reasonable.

20. The committee is not yet prepared to adopt any one of the foregoing viewpoints to the exclusion of the others. It may be that varying circumstances will in any case require that alternative treatments be available. The committee hopes to return to this subject at a later date when further discussion and experience have clarified the issues.

21. Appendices A and B give some factual information with respect to the problems discussed in this paper.

Appendix A contains data concerning the balance-sheet treatment of property items, based on a study of 500 balance sheets for 1938.

Appendix B quotes from a published source some figures showing (a) the amounts of write-ups and write-downs for a ten-year period, and (b) the number of corporations making such write-ups or write-downs, both based on a study of 272 corporations.
Accounting Research Bulletins

APPENDIX A

PRACTICE WITH RESPECT TO CARRYING VALUES OF FIXED ASSETS
AND STATEMENT OF CAPITAL SURPLUS OR EQUIVALENT ITEMS

A study of 500 published balance sheets for 1938 shows:

On Assets Side

Of the 500 balance sheets, 480 contained one or more property items
to the number of. ............................................. 562

Of these 562 property items:
  Number described as at cost, at cost less reserves, or acquisition
  values .......................................................... 251
  Number described as appraised or revised values—in various forms 135
  Other captions (most frequent being “book values”—33) .......... 75
  No basis of valuation indicated .................................. 101

  Total property items ........................................... 562

On Liabilities Side

Of the 500 balance sheets, 321 contained items of capital surplus
or equivalent items to the number of. .......................... 332

Of these 332 items of capital surplus:
  Number described as “capital surplus” .......................... 239
  Number described as “paid-in surplus” or equivalent terms ....... 57
  Number described as arising from revaluation or appraisal ....... 10
  Number described as acquisition surplus, conversion surplus, etc. 26

  Total capital surplus or equivalent items ....................... 332


44
Depreciation on Appreciation

APPENDIX B

The following tables have been taken from *Capital Consumption and Adjustment*, by Solomon Fabricant, a publication of the National Bureau of Economic Research. They furnish some conception of the extent of write-ups and write-downs.

Write-ups and Write-downs of Property, Plant and Equipment, 1925–1934

<table>
<thead>
<tr>
<th>Year</th>
<th>Write-ups</th>
<th>Write-downs</th>
<th>Net Write-ups</th>
</tr>
</thead>
<tbody>
<tr>
<td>1925</td>
<td>28,309</td>
<td>12,813</td>
<td>15,496</td>
</tr>
<tr>
<td>1926</td>
<td>65,944</td>
<td>24,356</td>
<td>41,588</td>
</tr>
<tr>
<td>1927</td>
<td>23,248</td>
<td>16,432</td>
<td>6,816</td>
</tr>
<tr>
<td>1928</td>
<td>26,255</td>
<td>68,429</td>
<td>-42,174</td>
</tr>
<tr>
<td>1929</td>
<td>14,359</td>
<td>128,578</td>
<td>-114,219</td>
</tr>
<tr>
<td>1930</td>
<td>24,392</td>
<td>16,723</td>
<td>7,669</td>
</tr>
<tr>
<td>1931</td>
<td>5,924</td>
<td>194,686</td>
<td>-188,762</td>
</tr>
<tr>
<td>1932</td>
<td>23</td>
<td>251,468</td>
<td>-251,445</td>
</tr>
<tr>
<td>1933</td>
<td>123</td>
<td>117,315</td>
<td>-117,192</td>
</tr>
<tr>
<td>1934</td>
<td>77</td>
<td>117,426</td>
<td>-117,349</td>
</tr>
</tbody>
</table>

Corporations reporting Revaluations of Property, Plant and Equipment, Number, 1925–1934

<table>
<thead>
<tr>
<th>Year</th>
<th>Write-ups</th>
<th>Write-downs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1925</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>1926</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>1927</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>1928</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>1929</td>
<td>12</td>
<td>15</td>
</tr>
<tr>
<td>1930</td>
<td>8</td>
<td>23</td>
</tr>
<tr>
<td>1931</td>
<td>4</td>
<td>48</td>
</tr>
<tr>
<td>1932</td>
<td>1</td>
<td>55</td>
</tr>
<tr>
<td>1933</td>
<td>2</td>
<td>44</td>
</tr>
<tr>
<td>1934</td>
<td>1</td>
<td>27</td>
</tr>
</tbody>
</table>

---

1 Table 43 (page 213).
2 Including 113 millions for United States Steel Corporation.
3 Table 45 (page 215).
4 Out of 272 corporations examined.
The statement entitled “Depreciation on Appreciation” was adopted by the assenting votes of eighteen members of the committee. Four members, Messrs. Blough, Couchman, Fernald and Paton dissented.

The grounds for dissent were varied. Without giving a full discussion of these, the main points may be stated. Mr. Blough dissented with respect to paragraph 5; in his opinion the rule in paragraph 4 should be applied at once in all cases. Mr. Couchman dissented on the ground that he would prefer to return more strictly to the cost basis, rather than allow further departures therefrom. In cases where appreciation has been entered in the books, he would prefer that the appraisal credit be deducted from the appraised value in the balance sheet, thus restoring it to a cost basis. Mr. Fernald dissented as to the legal implications of paragraphs 6 and 7, considering that financial statements do not constitute any representation or commitment that invested capital will be maintained intact or dividend payments will be limited except only as applicable law may from time to time prescribe. Mr. Paton does not approve of any departure from the cost basis for depreciation charged in determining the final net income figure reported, except in cases where the appraisal is a feature of a formal or quasi-reorganization.

Mr. Fedde assented to the paper with the proviso that depreciation based on appreciated property values be charged in two amounts, (1) depreciation on cost, and (2) depreciation on appreciation.
Depreciation on Appreciation

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

JOHN K. MATHIESON, Chairman
GEORGE O. MAY, Vice-Chairman
GEORGE D. BAILEY
CARMAN G. BLOUGH
ARCHIBALD BOWMAN
ARTHUR H. CARTER
CLEM W. COLLINS
CHARLES B. COUCHMAN

WILLIAM D. CRANSTOUN
A. S. FEDDE
HENRY B. FERNALD
STANLEY G. H. FITCH
HENRY A. HORNE
LINCOLN G. KELLY
ROY B. KESTER
LEWIS LILLY

A. C. LITTLETON
WARREN W. NISSLEY
WILLIAM A. PATON
CHARLES F. RITENHOUSE
WALTER A. STAUB
VICTOR H. STEMPF

JOHN L. CAREY, Secretary
THE increasing use of comparative statements in the annual reports of companies is a step in the right direction. The practice enhances the significance of the reports, and brings out more clearly the nature and trends of current changes affecting the enterprise. The use of statements in comparative form serves to increase the reader’s grasp of the fact that the statements for a series of periods are far more significant than those for a single period—that the statements for one year are but one instalment of what is essentially a continuous history.

It is therefore recommended that the use of comparative statements be extended. In any one year it is ordinarily desirable that the balance sheet, the income statement and the surplus statement (the two latter being separate or combined) be given for the preceding as well as for the current year. Footnotes, explanations and accountants’ qualifications already made on the statements for the preceding year should be given, or at least referred to, in the comparative statements. If, because of reclassifications or for other reasons, changes have occurred in the basis for presenting corresponding items for the two periods, information should be furnished which will explain the change. This is in conformity with the well recognized rule that any change in practice which would affect comparability should be disclosed.

The question of responsibility to be assumed by the accountant in his report requires consideration. In general it is desirable that he should accept the responsibility of satisfying himself that the figures for the preceding year fairly present the position and results, and are properly comparable with those of the current year, or that any exceptions to their comparability are clearly brought out. In the common case in which the accountant will have examined the accounts of both years no difficulty in assuming this responsibility should arise. Circumstances vary so greatly that it is not practicable to deal here
specifically with all cases. The accountant should, however, make very clear what statements are included in the scope of his report and any reservations which he may have in regard to accounts not so included.

The statement entitled “Comparative Statements” was unanimously adopted by the twenty-two members of the committee.

Mr. Henry B. Fernald assents to this statement but with some reservation regarding comparative income accounts. He feels that sometimes they may be misunderstood unless accompanied by adequate explanations, and that too much importance must not be attached to a showing of income differences from one year to the next.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

JOHN K. MATHIESON, Chairman
GEORGE O. MAY, Vice-Chairman
GEORGE D. BAILEY
CARMAN G. BLOUGH
ARCHIBALD BOWMAN
ARTHUR H. CARTER
CLEM W. COLLINS
CHARLES B. COUCHMAN
WILLIAM D. CRANSTOUN
A. S. FEDDE
HENRY B. FERNALD
STANLEY G. H. FITCH
HENRY A. HORNE
LINCOLN G. KELLY
ROY B. KESTER
LEWIS LILLY
A. C. LITTLETON
WARREN W. NISSELY
WILLIAM A. PATON
CHARLES F. RITTENHOUSE
WALTER A. STAUB
VICTOR H. STEMPF
JOHN L. CAREY, Secretary
FOREWORD

Below are presented two reports of the committee on terminology, which, as stated in the first report, has been constituted from the committee on accounting procedure. It is thought convenient to issue these reports in a form to be included in the Research Bulletins binder. It should be noted, however, that while the committee on accounting procedure approved the reports for presentation to the Council and has now authorized publication of these reports, they do not represent formal pronouncements of that committee, as preceding bulletins do.

REPORT OF THE COMMITTEE ON TERMINOLOGY

Midyear, 1940

To the Council of the American Institute of Accountants:

Gentlemen:

The committee on terminology has this year been constituted from the membership of the committee on accounting procedure. This emphasis on the relation between the tasks of the two committees suggests a re-examination of the work and program of the committee on terminology.

The committee was constituted in 1920 and entered on the task of compiling a vocabulary of words and expressions used in accounting and gradually preparing definitions thereof. In 1931 the committee brought together definitions which had been formulated, in a volume which was published by the Institute under the title Accounting Terminology, but without official approval and with emphasis on its tentative character. In 1932 a differently constituted committee prepared another and apparently quite independent tentative compilation which was never published.

A comparison of the two reports shows how vain was the hope expressed by the committee of 1931 that its definitions would be accepted
Accounting Research Bulletins

as representing "the sense of the great majority of the leading accountants." It also indicates very clearly how loose and variable was the accounting use of terms.

In the years that have since elapsed events have forced accountants to give more careful consideration to the use of words, as the responsibilities that may flow from inaccurate usage have become more serious and manifest.

An examination of the reports above referred to suggests that the words and phrases defined fall into four classes.

First, there are words or phrases that are fundamental and are used in accounting in senses more or less at variance with the senses which attach to them in the public mind. (Value, assets, liabilities, surplus, etc.) Second, there are a small number of purely technical terms developed by accountants and unfamiliar to the public, such as balance sheet, double entry. Third, there are words originating in other fields, particularly law and business, with which the accountant is frequently concerned. Fourth, there are terms used in auditing as distinct from accounting.

This committee believes that the words or phrases in the first class, and a few in the second class, should be those to which the efforts of the committee should be primarily directed.

As a field of activity or thought extends, and a need for new modes of expression arises, the need may be met by the development of new words, or by extending the meaning of words already in use. Either course has its dangers; in the one case that of not being understood, in the other that of being misunderstood. Where, as in the case of accounting, the need arises from the growth of an old activity, the second alternative is likely to be adopted more freely than the first and the resulting danger of being misunderstood is very real.

The first task of the committee might therefore well be to prepare a discussion of the specialized usage in accounting of common terms, that would be more extensive than mere definitions and might perhaps include suggestions for modifications of present practice, with the object of minimizing misunderstandings. Such a discussion might not only be circulated in the profession, but brought to the attention of publishers of general dictionaries with a view to recognition of the special usages in the new editions of such works.

To illustrate its point, the committee draws attention to the present uses in accounting of the words "value," "assets" and "liabilities." A correct understanding of these uses is fundamental to the definition of many other accounting terms.

The report of 1931 lists thirty-one phrases using the general term
"value." But although the general dictionaries recognize no use of the word "value" in a pecuniary sense except as connoting worth, and although many of the thirty-one definitions implicitly assume the use of that word in a different sense, the report gives no explicit recognition to such use nor any definition of "value" as used in accounting. It cannot be denied that today "value" is used in accounting to describe not necessarily worth but some attribute of a thing (most commonly, but not always, property), capable of being expressed in terms of money, the particular attribute being normally indicated by a qualifying adjective (e.g., book value, replacement value, etc.).

Furthermore in accounting, "values" as thus broadly defined, although not homogeneous, may be aggregated or deducted from one another. Thus, it is a universally accepted practice to add the cost value of one asset to the market value of another, and to deduct from the sum the nominal value of a liability to arrive at a net figure. (The use of the term "net worth" to describe this figure still persists, although it is becoming less common.) This procedure, although open to obvious criticism of its mathematical propriety, possesses so many practical advantages and is so well established both here and abroad, in accounts subject to regulations as well as in accounts not so subject, that it is not likely to be abandoned.

To continue the illustration, in a realistic view one must recognize that the words "assets" and "liabilities" are in accounting usage often no more than substitutes for Dr. and Cr. as the headings for the two sides of a balance sheet, and further that not all the items carried under those heads are assets or liabilities in the ordinary sense of those words, and not all the items that are assets or liabilities in the ordinary sense are commonly included under these heads. Thus in one case goodwill, which may be the most valuable of assets, may not appear, but in another discount on common stock may appear under the head of assets.

It cannot be suggested that the special uses in question are chargeable as misuses to the accounting profession, because they are at least as common in governmentally regulated accounting as in accounting not so regulated.

In passing it may be noted that while the use of "assets" and "liabilities" as balance sheet headings is more common in America than in England, the first volume of the Oxford Historical Dictionary, published in England in 1888, recognizes it. In the course of the definition of assets it states: "The Dr. and Cr. sides of a Balance Account contain 'assets' and 'liabilities' respectively." American general dictionaries apparently do not recognize this usage.
As noted in the report of 1931, “assets” (a singular noun) originally meant a sufficiency of property to meet an obligation; then by extension it was used in the plural to mean the property itself, still with the question of sufficiency in mind. Since it was applied in relation to debts and legacies, the measure of an asset was of course its estimated realizable value. Thence it came into use in double entry balance sheets in which the “values” of assets are not necessarily measured by worth, as they were in the old single entry statements of net worth.

The report of 1931 does not explicitly recognize the use of the word “asset” as merely a heading for one side of a balance sheet, but it does so implicitly in that it mentions (though it disapproves of the practice) that even a deficit is “not infrequently” included in the total assets.

The report of 1932 gives as one definition of liabilities: “All debts owing plus net worth. In this sense it is used as a balance sheet heading.” The report of 1931 does not recognize this usage. Moreover, the earlier report indicates that liabilities include forms of obligations other than debts, and thus is perhaps more accurate than the later report.

The word “surplus” falls in a somewhat different category, the general definition being so broad that any accounting use must come within it. The *Historical Dictionary* defines it as “that which remains over and above that which has been taken or used.” The objective of the Institute in this case should clearly be to make the significance of the word as used in accounting more precise and uniform.

The failure of accountants to emphasize the conventional uses of such terms has given rise to much unwarranted criticism of accounts and of the profession. Students from other fields discovering these uses, and finding no extensive recognition of them in the literature of the profession, are apt to regard as revelations and as grounds for severe criticisms what are really truisms accepted by regulatory bodies, accountants and business men generally.

A question may no doubt be raised whether all such uses are necessary or expedient or whether some should be abolished. This would seem to be a question for the committee on accounting procedure to consider.

The committee on terminology asks the approval of the Council for the preparation of a monograph on specialized accounting uses of common words or phrases, to be prepared in cooperation with the committee on accounting procedure and with the assistance of the research staff. It contemplates that such a monograph should be brought to the notice of compilers of dictionaries, with a view to
Report of the Committee on Terminology

recognition being accorded to the special uses in new editions of such works.

Respectfully submitted,

GEORGE O. MAY, Chairman
GEORGE D. BAILEY
VICTOR H. STEMPEL

May 14, 1940

REPORT OF THE COMMITTEE ON TERMINOLOGY
October, 1940

To the Council of the American Institute of Accountants:

GENTLEMEN:

In its mid-year report, this committee referred especially to the difficulties which arise from the use of special terms in accounting in a technical sense as contrasted with the sense attaching to the same words in the public mind. It was proposed that this committee proceed to a discussion of some of the more common words in the hope of clearing up some of the ambiguities that exist.

The committee has been requested by the Executive Committee to suggest a definition of public accounting, and the work of the committee on accounting procedure has created a demand for a definition of accounting principles. In this report, therefore, the committee offers a discussion and suggested definitions of accounting, accountancy, public accounting, and accounting principles.

Accounting—Accountancy

No words are employed more commonly than these, either in the practice or in the teaching of the subject, and while it may at first seem superfluous to discuss them, your committee believes that many differences that arise in accounting writings have their roots in different conceptions of these basic terms. A careful consideration of these words will therefore add to understanding, not only among accountants themselves, but also among those outside the profession who have to do with accounting.

The committee suggested that one result of such discussions might be to bring the special uses of accounting terms, as against their general uses, to the attention of publishers of general dictionaries. That publishers have not hitherto given adequate attention to these special uses is very evident from their treatment of the words now under consideration. The Standard 1 contains no definition of “accounting,”

Accounting Research Bulletins

though it uses the word in defining the verb "account" as "To furnish or receive an accounting." For "accounting"—the noun—the more formal "accountancy" is made to serve, and is defined as "The work or art of an accountant." Turning therefore to "accountant," in the hope of finding a definition which did not use the word to be defined, we learn that he is "one who keeps, examines, or is skilled in accounts; one whose business is to keep or examine books of a mercantile or banking house or in a public office."

As if to compensate for the omission of any definition of "accounting," this dictionary adds a definition of "accountics," which is said to be "the science or art of keeping accounts; bookkeeping." We note that "account" is still the root word, and so turn to it to find that it is "a record or statement of debits and credits, of receipts and expenditures or of other business transactions, etc.; any methodical enumeration or reckoning; computation."

This definition, or series of definitions well illustrates the confusion between the general and the special meanings of these words. The first half is obviously intended to define "account" in its special and narrow sense as accountants know it, but the result is a very inadequate statement, of which the writer must have been conscious when he trailed off into "other business transactions, etc." The other two definitions, "any methodical enumeration or reckoning; computation." are the general meanings of the word and need not concern us.

It is not necessary to discuss the definitions in all the dictionaries at the same length, but only to note one or two variations of practice. Webster's definition of "account" is "a reckoning, computation, calculation, enumeration. The preparation of a record of transactions or the like." This shows only broad traces of the meaning of an account in the accountant's sense, but the reverse is the case with the elaborate definition of "accounting," namely: "The art or system of making up or stating accounts; the body of scientific principles underlying the keeping and explanation of business accounts. The application of such principles in practice. Accounting explains the results furnished by the bookkeeper and draws the necessary inferences as to the condition and conduct of the business, a function emphasized in the phrase public accountant." It furnishes a fairly complete description of "accounting" in the accountant's sense, but gives no inkling of any general sense in which the word may be used.

Turning from the general dictionaries to accounting literature, a number of definitions are noted, which form a somewhat variegated pattern,
Report of the Committee on Terminology

In Accounting Terminology, the published work of an earlier terminology committee, "Accountancy" is said to be "The profession dealing with" the several phases of accounting work. Then follows: "The objective is the statement of financial affairs in such a manner as to give due effect to every material factor, making available all the light that past accounts can give to assist in planning for the future." "It consists of two processes: synthesis, such as is used in building up or designing accounts; and auditing, the object of which is to analyze and verify the results submitted."

This is somewhat confusing. The first clause seems to refer to the men who carry on accounting work, but the second and third paragraphs plainly comprise the subject matter of accounting. There is nothing to be gained by identifying—or confusing—accountants with accounting, though they are so obviously related.

The English work, Dawson's Accountants Compendium (1930), gives a fairly comprehensive definition of "Account," but none for accounting, accountant, accountancy, chartered accountant or certified public accountant—illustrating once more how little English accountants are given to generalizing about their own work, and how pragmatic is their attack.

A study of accounting texts yields the following:

From Essentials of Accounting, by W. A. Paton, page 3: "In terms of relation to the operation of the business enterprise accounting may be defined as the body of principles and the technical mechanism by means of which the economic data of the particular concern are classified, recorded and periodically presented and interpreted, for the purpose of effective control and administration."

From Principles of Accounting, by John Raymond Wildman, preface: "Accounting may be defined as that science which treats of the systematic compilation and presentation in a comprehensive manner, for administrative purposes, of the facts concerning the financial operations of a business organization.

"Accountancy is most aptly defined in the 'Certified Public Accountant Syllabus' issued by the New York Education Department as, 'A profession, the members of which, by virtue of their general education and professional training, offer to the community their services in all matters having to do with the recording, verification and presentation of facts involving the acquisition, production, conservation and transfer of values.'"

Proposed Definition of "Accounting"

It would seem that the essential features of all these definitions
might be stated shortly as follows:

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and the results thereof."

The committee accordingly submits this definition for the consideration of accountants and others who may be interested. If a comprehensive term is required to designate those who practise this art, the appropriate expression would seem to be the "accounting profession," and not to make a single word connote both the accountant and his work.

Comment on Proposed Definition

The definitions of Professor Paton and Mr. Wildman imply the more obvious comment upon the foregoing definition. Mr. Wildman's definition calls accounting a "science," whereas your committee prefers to regard it as an "art." By calling accounting a science attention is directed to the ordered classifications used as the accountant's framework, and to the known body of facts which in a given case are fitted into this framework. The committee would not ignore these aspects of accounting, but would emphasize rather the creative skill and ability which the accountant brings to the application of his knowledge to a given problem. Webster and the Standard agree that in part art is science, and that art adds the skill and experience of the artist to science. In this sense the committee would call accounting an art.

In Professor Paton's definition special mention is made of "the body of principles" which should govern the accountant's work. The committee implies the same thing, without express mention. Every art must work according to a body of applicable rules, but it also reserves the right to depart from the rules whenever it can thereby achieve a better result. It is desirable that the accountant conceive of his work as a complex problem to be solved, of his statements as creative works of art, and that he reserve to himself the freedom to do his work with the canons of the art constantly in mind and as his skill, knowledge and experience best enable him.

Public Accounting

It would be a mistake to identify the term "public accounting" too narrowly with "auditing." Auditing itself may be public or private, the latter being commonly known as internal audit. "Public accounting" includes everything comprised in "accounting" when it stands alone, and the word "public" indicates only some attribute of the
agent who performs the accounting, which may be any form of accounting work. That attribute is indicated in Webster's definition of a public accountant as "An accountant whose services are available to the public," and still further in his definition of "certified public accountant," the latter being "An accountant who has met the requirements of the State Law, and has been given a State certificate, and is permitted to use the designation C.P.A. . . ." So far so good, but when it is added " . . . in England called Chartered Accountant" the definition ceases to define.

It seems sufficient to define "public accounting" as "The practice of this art (accounting) by men whose services are available to the public for compensation. It may consist in the performance of original work, in the examination and revision of the original work of others (auditing), or in rendering of collateral services for which a knowledge of the art and experience in its practice create a special fitness."

In addition to defining public accounting, it may be well to distinguish between that part of the work of the profession which is affected with a public interest and therefore naturally subject to the police powers of the State, and that which is not so affected. For this purpose, the language of the proposed provision of the New York bill put forward in January, 1940, by the New York State Society of Certified Public Accountants would seem to be appropriate. That bill contained the following definition, "As used in this article: (1) the 'practice of public accountancy' is defined as follows: A person engages in the practice of public accountancy who, holding himself out to the public as an accountant, in consideration of compensation received or to be received by him, offers to perform or does perform, for other persons, services which involve the auditing or verification of financial transactions, books, accounts or records, or the preparation of, or the reporting over his signature of financial, accounting, and related statements, intended for publication or for the purpose of obtaining credit, or to influence any stockholder or creditor of any corporation, or to influence any person or persons other than those who procured the preparation, certification or verification, subject, however, to the provisions of section fourteen hundred and eighty-five-a hereof;".

Accounting Principles

It is next proposed to consider the nature of the body of rules, the guides to conduct, which have already been referred to as governing, or at any rate assisting, the accountant's work. Whether these rules should be called "principles" is the question.
Webster, The Standard, and The New English Dictionary agree in giving at least three orders of definitions of "principle." The first is "source, origin, or cause," which is of little help to accountants except as it emphasizes the primary character of some principles. The second class of definitions, as given in the New English Dictionary, is "A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths." The third is: "A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice . . . ."

This third definition comes nearest to describing what most accountants, especially practising accountants, mean by the word "principle." Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. But in discussion the word is often invested with an aura of sanctity, arising out of its more fundamental meanings, thus leading many to attribute to the rules of conduct called principles a greater force and a more universal and permanent validity than most of them were ever intended to have. It is not convenient, either in conversation or in writing, to add "(meaning number three)" each time the word "principle" is used, though that essentially is the fact.

The Investment Company Act of 1940 uses (in Sec. 19) the expression "good accounting practice." Objection to this expression has been taken by laymen in the past on the ground that it applies the test of what is rather than of what ought to be, and implies that there is not one best practice, but possibly many that are good. In both respects, however, it is realistic, and since the Congress has used it, the Institute might well do so. The obvious objection is that the phrase "generally accepted accounting principles" is used in the standard form of auditor's report or certificate and confusion would result from attempts to effect a change. At the moment this objection may well be controlling, but if the phrase "accounting principles" is to be retained, every effort should be made to establish clearly the extent and the limits of the significance of the phrase.

In so far, therefore, as "principle" continues to be a necessary word to accounting discussion, care should constantly be taken to make it clear that, as applied to accounting rules of practice, it does not connotate a law of that high order from which there is no appeal. An accounting principle is not a principle in the sense that it admits of no variation, nor in the sense that it cannot conflict with other principles. The analogy to principles of law suggests itself; they frequently
Report of the Committee on Terminology

conflict with each other, and in many cases the question is which of several partially relevant principles has determining applicability. This situation is so familiar in law that it is surprising to find it giving rise to any question in accounting.

Respectfully submitted

GEORGE O. MAY, Chairman
GEORGE D. BAILEY
VICTOR H. STEMPF

October 14, 1940

61
IN RESEARCH BULLETIN No. 1 the committee called attention to the “increased recognition of the significance of the income statement” and the resulting “tendency to regard the balance-sheet as the connecting link between successive income statements and as the vehicle for the distribution of charges and credits between them.” This led to a suggestion that the committee should give consideration to the general form of the income statement, with particular reference to the question of the influence of form upon effective presentation in the light of the enlarged conception of the functions of the statement.

The term “income statement” will be used throughout this memorandum though the committee recognizes that in some cases the term “profit and loss” is used instead of “income,” and “account” instead of “statement.” These differences in usage are under consideration by the committee on terminology.

The committee has noted, from examination of the published statements of a selection of 500 corporations, a considerable tendency toward the practice of closely combining the annual income statement with the statement of earned surplus. For the year 1939 the income statement was presented as a single integrated statement, running from sales to earned-surplus balance, in 19 per cent of the cases examined. In another 32 per cent the income statement and surplus statement were shown as two related exhibits on a single page of the published report. In 32 per cent of the examples the income statement and surplus statement were shown as separate exhibits but with their close relationship emphasized by presentation on facing pages of the report. In only 17 per cent of the cases were the earned-surplus analyses shown otherwise than as incorporated with or adjacent to the current operating data. Appendix A shows a tabulation of these data for 1939 and 1938.

There are decided advantages in such combined statements, but also some disadvantages. The committee therefore feels that a useful purpose will be served if it expresses approval of the practice where it is found feasible, without recommending its general adoption; at the
same time it points out certain considerations which must be borne in mind if undesirable consequences are to be avoided.

**Advantages of the Combined Statement**

The combined statement of income and earned surplus is designed to meet a dilemma which constantly confronts the accountant. Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital-stock transactions, be charged against income. If this principle could in practice be carried out perfectly, there would be no charges against earned surplus, except for distributions and appropriations of final net income. This is a theoretical ideal upon which all may agree, but because of conditions impossible to foresee, it often fails of attainment. From time to time charges are made against surplus which clearly affect the cumulative total of income for a series of years, even if their exclusion from the income statement of the current year is justifiable. There is danger that unless the two statements are closely connected such charges will be overlooked, or at any rate not given full weight, in any attempt on the part of the reader to compute a company’s long-run income or its income-earning capacity. The combined statement of income and earned surplus minimizes the net disadvantage; while charges against earned surplus are effected within a segregated portion of the statement, yet charging them against earned surplus in this way does not completely lose them from view in any consideration of long-run income-earning capacity. In this sense the practice serves to emphasize the tentative character of the income statement.

In giving expression to these views, the committee would like to guard against misunderstanding. The committee recognizes the great importance of distinguishing between charges against income and charges against earned surplus. It does not here undertake to define proper charges against earned surplus. For purposes of this statement it simply takes cognizance of the fact that such charges are from time to time found to be a necessary though perhaps a debatable feature of accounts. It approves the current tendency to discourage such charges wherever possible.

There is a marked tendency to exaggerate the significance of the net income for a single year, and particularly the degree to which the net income can be exclusively identified with that one year. In so far as the combined form calls attention to the character of the income statement as a tentative instalment in the long-time financial results, it serves a useful purpose.
Combined Statement of Income and Earned Surplus

To summarize, the combined income and earned-surplus statement serves the purpose of showing in one statement both earnings applicable to the period proper, and also modifications of earned surplus on a long-run basis. It distinguishes charges and credits of the current period from charges and credits relating to other periods by placing them in different sections of the statement; but all are comprised within a single statement.

Disadvantages and Limitations

In the combined statement, the net income for the year will occur somewhere in the middle of the statement and not at the end. Such wording and arrangement should be adopted as will make this item unmistakably clear. The reader should be left in no doubt as to the point at which the net income has been determined. This figure will continue to be a most important item in the accounts; all concerned will look to the accountant to furnish the figure as exactly as he can.

While it is true that the net income amount, when expressed as "earnings per share," is often given an undue prominence and its significance is exaggerated, there nevertheless remains the responsibility for determination of net income by sound methods, and the duty to show it clearly. The adoption of the combined statement provides no excuse for less care than at present in distinguishing charges to income from charges to surplus. Any such use of this form of statement would immediately discredit it.

APPENDIX A

Classification of Form of Presentation of Income Statement and Earned Surplus Statement in 500 Published Reports

<table>
<thead>
<tr>
<th></th>
<th>1939</th>
<th>Percentage of Total</th>
<th>1938</th>
<th>Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combined statement of income and earned surplus</td>
<td>93</td>
<td>19</td>
<td>90</td>
<td>18</td>
</tr>
<tr>
<td>Separate statements of income and earned surplus on same page</td>
<td>160</td>
<td>32</td>
<td>158</td>
<td>32</td>
</tr>
<tr>
<td>Separate statements of income and earned surplus on facing pages</td>
<td>163</td>
<td>32</td>
<td>167</td>
<td>33</td>
</tr>
<tr>
<td>Other forms of presentation</td>
<td>84</td>
<td>17</td>
<td>85</td>
<td>17</td>
</tr>
<tr>
<td>Totals</td>
<td>500</td>
<td>100</td>
<td>500</td>
<td>100</td>
</tr>
</tbody>
</table>
The statement entitled "Combined Statement of Income and Earned Surplus" was adopted by the assenting votes of eighteen members of the committee. Two members, Messrs. Cranston and Seidman, dissented. One member did not vote.

The dissenting members hold that the above statement attaches undue importance to the question of combined or separate statements. They consider that the primary question is the determination of sound principles for the separation of income and surplus charges and credits, and fear that a statement recommending one form may be interpreted as implying that that form had solved this problem, which, as all members of the committee agree, it cannot do.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

C. OLIVER WELLINGTON, Chairman
GEORGE O. MAY, Vice-Chairman
GEORGE D. BAILEY
CARMAN G. BLOUGH
ARCHIBALD BOWMAN
LESLIE J. BUCHAN
GEORGE COCHRANE
CHARLES B. COUCHMAN
WILLIAM D. CRANSTOUN
JAMES L. DOHR
HENRY B. FERNALD
ARTHUR B. FOYE
ANSON HERRICK
HENRY A. HORNE
A. C. LITTLETON
WARREN W. NISSLEY
WILLIAM A. PATON
J. S. SEIDMAN
WALTER A. STAUD
J. HAROLD STEWART
A. W. TORBET
JOHN L. CAREY, Secretary
FOREWORD

The members of the committee on accounting procedure have read and approved this report of the committee on terminology for presentation to the Council and for publication, but the statements herein contained are not to be regarded as formal pronouncements of the committee on accounting procedure.

At its May meeting the Council of the Institute received the report, and authorized its publication as a research bulletin.

REPORT OF THE COMMITTEE ON TERMINOLOGY

MIDYEAR, 1941

To THE COUNCIL OF THE
American Institute of Accountants:

GENTLEMEN:

Definition of "Accounting"

Of the topics discussed in earlier reports of the committee, its definition of the term "accounting" has provoked the most notice. Several suggestions have been received, chiefly to the effect that the definition should be made more explicit by mention of other details of accounting. The committee for the most part agrees with the substance of the suggestions made, but questions the desirability of writing its definitions in terms which, while they may sharpen the presentation, yet may also limit the scope of the term unduly. One suggestion, however, has seemed deserving of consideration, and that is to mention in the definition the interpretative aspect of the accountant's work. The committee's definition might therefore be amended to read:

Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

1 Accounting Research Bulletin No. 7, p. 58.
Other Terms Defined Here

The committee continues its discussion of common accounting terms, with special reference to those terms over which confusion arises because they are so frequently used in a technical as well as a popular sense. There are several groups of related terms which are of great importance to accountants, and the committee here addresses itself to a discussion of them, leading to suggested definitions. These groups of terms are:

(a) Balance sheet—assets—liabilities
(b) Income—income account (or income statement)—profit—profit-and-loss account (or profit-and-loss statement)—undivided profits—earned surplus
(c) Value and its derivatives
(d) Audit and its derivatives
(e) Auditor’s report (or certificate)

All of these terms will be recognized as basic to accounting and important to all who prepare or use accounting statements. A more general understanding of the specialized accounting uses of the terms is desirable. As indicated in previous reports (Bulletin No. 7, page 54), it is with these specialized uses only that this committee’s reports deal.

(a) Balance Sheet—Assets—Liabilities

The terms “balance sheet,” “assets,” and “liabilities” are so closely related that the definitions of the three can best be considered together. Indeed, often a balance sheet is first defined as a statement of assets and liabilities (or of assets, liabilities and capital) and the definition of assets and liabilities then undertaken. This procedure, however, overlooks the fact in regard to a balance sheet emphasized in the report of the committee on terminology in 1931, that it is a summary of balances prepared from books of account kept by double-entry methods, while a statement of assets and liabilities may be prepared for an organization for which no such books are kept. The committee deems it advisable to emphasize this distinction in any definition. Moreover, “balance sheet” is a distinctly technical accounting term while “assets” and “liabilities” are less so. The committee feels that “balance sheet” should be defined in terms of its accounting origin and that the relation thereto of assets and liabilities should be considered subsequently.

Considered in this way a balance sheet may be defined as:

A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books
Report of the Committee on Terminology

of account kept by double-entry methods, according to the rules or principles\(^1\) of accounting. The items reflected on the two sides of the balance sheet are commonly called assets and liabilities, respectively.

The definition in the *Century Dictionary* is taken from Bouvier's *Law Dictionary* and is worthy of analysis. It reads as follows:

A statement made by merchants and others to show the true state of a particular business. A balance sheet should exhibit all the balances of debits and credits, also the value of the merchandise, and the result of the whole.

The use of the word "true" in the first sentence is regrettable since it adds nothing to the definition but suggests a possibility of certainty that does not exist. The second sentence recognizes the nature of the balance sheet as a statement of balances. The merchandise clause indicates that the definition originated in a day when the inventory was a figure introduced into the books as a part of the final closing. The word "value" is used in the same loose sense in which it is commonly used in discussing accounts, and particularly inventories. When thus analyzed this definition is found to be in no way inconsistent with the definition set forth above. The term "balance sheet," it may be added, has too often been construed in a mood of wishful thinking to describe what the writer would like a balance sheet to be, without regard to the practicability of his desire.

Accounting analysis frequently requires that two accounts be carried, with balances on opposite sides, in respect to the same thing (e.g., a building account and a building-depreciation account). In the balance sheet the net amount of such balances is usually though not invariably shown. A special case of this kind is presented by a corporation which has a deficit. Preferably such a deficit should be deducted from the credit side of the balance sheet but it is still common to show it on the debit side. This being so, a deficit necessarily appears as an exception in the definition of asset which follows.

Those things which are reflected in the debit balances that are or would be properly carried forward are termed "assets," and those reflected in credit balances, "liabilities." Hence the expression "state-

\(^1\) Cf. Accounting Research Bulletin No. 7, p. 60: "Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting." Thus the word "principle" is used in the sense of: "A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice . . ." (*New English Dictionary*).
Accounting Research Bulletins

ement of assets and liabilities” is frequently used as synonymous with “balance sheet,” though as already pointed out not every statement of assets and liabilities is a balance sheet.

Hence, also, “asset,” as used in balance-sheet headings, may be regarded as the name given to anything which is reflected as a debit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods. Since such debit balances may represent either property rights acquired, or costs or expenses incurred, the word “asset” is not synonymous with or limited to property but includes also that part of any cost or expense incurred which is properly carried forward upon a closing of books at a given date. The basis of such carrying forward is that the balances represent either (a) property rights or values acquired or (b) expenditures that are either recoverable in or proper charges against the future. A definition of “asset,” as used in balance sheets, which is consistent with the proposed definition of “balance sheet” would be:

A thing represented by a debit balance (other than a deficit) that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting.

In order to make the definition informative, the following addition might be made:

The presumptive grounds for carrying the balance forward are that it represents either a property right or value acquired, or an expenditure made which has created a property right, or which is properly applicable to the future. Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in balance-sheet classification.

The last named is not an asset in the popular sense, but if it may be carried forward as a proper charge against future income, then in an accounting sense, and particularly in a balance-sheet classification, it is an asset.

Similarly, in relation to a balance sheet, “liability” is:

A thing represented by a credit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be
Report of the Committee on Terminology

accounted for which do not involve the debtor and creditor relation. For example, capital stock, deferred credits to income, and surplus are balance-sheet liabilities in that they represent balances to be accounted for by the company; though these are not liabilities in the ordinary sense of debts owed to legal creditors.

In recent times there has been a disposition in uniform accounting systems of regulatory commissions to adopt some such terms as “Assets and other debits” and “Liabilities and other credits” as the titles of the two sides of the balance sheet. When analyzed these terms are scarcely more illuminating than the headings “Debits” and “Credits” unless a clear distinction is drawn between the items that are assets and those that are other debits, with a similar distinction on the liabilities side. This is not done or at least not accurately done in such classifications.

(b) Income—Income Account (or Income Statement)—Profit—Profit-and-loss Account (or Profit-and-Loss Statement)—Undistributed Profits—Earned Surplus

It is sometimes urged in criticism of the law that it has failed to classify adequately the entities with which it deals, and even has extended some classifications to cover entities not actually falling within them. The same charge can fairly be made against the accounting use of the terms “earnings,” “income,” “profits,” and their derivatives. “Profit” and “profit-and-loss account” (or “statement”) are older, more inclusive, and more informative expressions to be applied to industrial and mercantile enterprises and their results than “income” and “income account” (or “statement”).

The New English Dictionary cites a reference to the “famous accompl of profit and loss” of 1588, and defines the account as “an account in book-keeping to which all gains are credited and losses are debited, so as to strike a balance between them, and ascertain the net gain or loss at any time.” It does not mention the income account and defines “income” as the periodical produce of one’s work, business, lands or investments, with the earliest citation from a work published in 1601.

There was clearly an opportunity for distinctive uses of the terms “earnings,” “income,” “profits,” and of the corresponding accounts or “statements.” The terminology committee of 1931 set forth certain usages which it believed were then “well established” as follows:

Earnings applies to the operations of a concern rendering service, as distinguished from one selling commodities.

Profits applies to manufacturing and mercantile concerns.
Income, while sometimes used by corporations, frequently as applied to net earnings, applies more particularly to the compensation or profits received by a person.

No doubt the income tax is largely responsible for the extension of the use of the term "income" into the industrial field and of the use of the expression "income account" (or "statement"), one result of which has been to reduce the term "profit-and-loss account" to a state of ill defined subserviency to the term "income account."

The Supreme Court has defined "income" in a case in which the meaning of the word as used in a constitutional amendment was the question at issue. The Court said that it must be construed in its generally understood sense rather than as a technical term. The Court’s definition conformed closely to the accounting concept, and is, therefore, appropriate for adoption by accountants for general use as well as for tax purposes. The Court accepted the language of an earlier decision, with an added proviso, so that its definition read:

Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets . . . (Eisner v. Macomber; 252 U. S. 189).

Income is also used in a narrower sense to mean the share of a gain that accrues to a particular person or group of persons, natural or legal. The income of an enterprise may be divisible among many interests in a certain order of priority. The portion which remains after deducting prior charges is the net income from the standpoint of the interest or interests then remaining. As used in corporation accounting, therefore, net income means the portion of gross income remaining after deducting all claims (such as bond interest) ranking ahead of that of the corporation as a legal person.

The distinction between negative elements in determining income and claims against income is, like all accounting distinctions, difficult to draw precisely. For instance, in the case of an industrial company there are items such as "cost of goods sold" which are clearly negative elements in determining income. There are others, such as "interest paid" by an industrial company, which are clearly claims against the income derived from operation of a business. General and administrative expenses may be regarded as occupying an intermediate position. Therefore, while "gross" strictly speaking means no more than whole, the term "gross income" may conveniently and is generally used to indicate the balance remaining after deducting from sales or revenue those costs so closely associated with the production thereof as to be
generally recognized as negative elements in the computation of income. "Net income" is used to indicate the balance remaining after deducting from gross income all negative elements not theretofore deducted and also claims against income ranking ahead of that of the person, natural or legal, with respect to whom the term is used. From this standpoint a statement of income might properly take the following form:

<table>
<thead>
<tr>
<th>Description</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>Less cost of sales</td>
<td></td>
</tr>
<tr>
<td>Gross income</td>
<td></td>
</tr>
<tr>
<td>Deduct expenses</td>
<td></td>
</tr>
<tr>
<td>Net income from sales</td>
<td></td>
</tr>
<tr>
<td>Deduct bond interest</td>
<td></td>
</tr>
<tr>
<td>Net income of corporation</td>
<td></td>
</tr>
<tr>
<td>Preferred dividends</td>
<td></td>
</tr>
<tr>
<td>Net income for common stock</td>
<td></td>
</tr>
</tbody>
</table>

This form is purposely simplified to emphasize the point here at issue. Such questions as showing taxes separately and the questions raised in Bulletin No. 8 are not here considered.

The "income account" (or "statement") is:

An account or statement which shows the principal elements, positive and negative, in the derivation of income or loss, the claims against income, and the resulting net income or loss of the accounting unit.

In the interests of an accurate and expressive terminology the committee would like to feel itself in a position to recommend the restoration of the words "profit," "profit-and-loss account" (or "statement"), and "undistributed profits," in place of "income," "income account" (or "statement"), and "earned surplus." But it recognizes that the latter terms have become the more general usage, at least among the larger companies, and that the powerful influence of the income-tax authorities, of the regulatory commissions, and other bodies tends to confirm this usage.

The difficulty with "income" as against "profit and loss" is that there is no handy term to express the negative forms of income, in the same way that "loss" does in "profit and loss." The natural antonyms of "income" are either "capital" or "expense"; the former term of
course is outside the present discussion, and the latter has acquired a narrower significance than "loss" possesses in the expression "profit and loss." It is important that the accounting profession, in all its educational work, keep the composite nature of "income" (i.e., gain), as the resultant of positive and negative elements, in the forefront of any discussion of the subject.

The difficulty of expressing an unqualified preference for one set of terms rather than the other is illustrated by the following tabulation of practices in 500 reports for 1939:

**Income-statement headings:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Titles including &quot;Income&quot;</td>
<td>309</td>
</tr>
<tr>
<td>&quot;Profit and Loss&quot;</td>
<td>186</td>
</tr>
<tr>
<td>Other titles</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>513</strong></td>
</tr>
</tbody>
</table>

*Thirteen captions included both "income" and "profit and loss."

**Caption for final balance in income statement:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (or phrases including &quot;income&quot;)</td>
<td>240</td>
</tr>
<tr>
<td>Net profit (&quot;profit&quot;)</td>
<td>188</td>
</tr>
<tr>
<td>Net loss and variations</td>
<td>27</td>
</tr>
<tr>
<td>Other</td>
<td>47</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>502</strong></td>
</tr>
</tbody>
</table>

*One caption included both "income" and "profit"; and one included "profit" and "loss."

The considerable use of both "income" and "profit and loss," and variations thereof, makes it inexpedient at this time to make a definite recommendation that would exclude either use. The committee therefore offers this discussion of the elements involved as a step toward a better understanding, which alone can furnish the basis for greater uniformity of practice. It will be understood that where the term "profit-and-loss statement" is used as synonymous with "income statement" the comments on the income statement herein contained become generally applicable to it.

Formerly the cumulative balance of profit and loss after deduction of dividends was called "undivided profits." Today the corresponding balance is more commonly called "earned surplus." The change has brought no increase of accuracy or lucidity but rather the reverse. The word "earned" does not seem to have been derived from the concept of income as earnings rather than profits, but to have been introduced to distinguish undistributed profits from capital surplus. It is difficult
to see why the word "surplus" was used at all, except possibly as a survival of a single-entry concept. If "income" was to be substituted for "profit" it should have sufficed to substitute "undistributed income" for "undistributed profits." The introduction of the challenging and often unwarranted word "earned" seems to be wholly regrettable.

However, the term "earned surplus" gained currency and was used not only in accounting but in legal discussions and statutes. As early as 1927 the Institute apparently accepted it and appointed a special committee whose task was merely to define the expression, not to consider alternatives. That committee, after an extensive inquiry and an issue of questionnaires to the entire membership recommended the following definition:

Earned surplus is the balance of net profits, income and gains of a corporation from the date of incorporation (or from the date of recapitalization when a deficit was absorbed by a reduction of the par or stated value of the capital stock) after deducting losses and after deducting distributions to stockholders and transfers to capital-stock accounts when made out of such surplus.

This committee sees no reason to change the substance of the definition so framed except to modify slightly the parenthetical clause so that the definition would read:

Earned surplus is the balance of net profits, income, and gains of a corporation from the date of incorporation (or from the date when a deficit was absorbed by a charge against the capital surplus created by a reduction of the par or stated value of the capital stock or otherwise) after deducting losses and after deducting distributions to stockholders and transfers to capital-stock accounts when made out of such surplus.

(c) Value and Its Derivatives

Mr. Justice Brandeis has said and Professor Bonbright, in *Valuation of Property*, has proved that "value" is a word of many meanings. In the first place, just as beauty lies in the eye of the beholder, so worth lies in the mind of the appraiser. There is often no unique standard of worth which is both realistic and objective. The fact that there are different criteria of worth is strikingly illustrated in the Supreme Court decisions which have applied different methods of determining value in connection with the regulation, taxation, and reorganization of railroads, respectively. But apart from the difficulty of measuring "value" when the word is used to connote "worth," it is evident that in the literature of business, economics, and accounting, "value" is
used in varying significances, not all of which have any definite connotation of worth. The word should, therefore, seldom if ever be used by accountants without a qualifying adjective. The word is, in fact, commonly employed in accounting to describe the figure at which an asset or liability is carried, even though the amount may be determined by a process which is not one of valuation in any ordinary sense.

Since accounting is predominantly based upon cost, the proper uses of the word "value" in accounting are largely restricted to the statement of items at cost, or at modifications of cost. In accounting the term "market value" is used in senses differing somewhat from those attaching to the expression in law. As applied to securities it means a sum computed on the assumption that value is measurable by market quotations; as applied to inventories it is a constructive market value compiled from a variety of considerations, including market quotations, cost of replacement, and probable sales price. In the case of so-called fixed assets the value shown in accounts is the balance of their cost after deducting recorded depreciation. Thus the following definition would seem to be appropriate:

"Value" as used in accounts signifies the amount at which an item is stated, in accordance with the accounting rules or principles relating to that item. Generally book or balance-sheet values (using the word "value" in this sense) represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

In thus emphasizing the fact that accounting values are predominantly costs, the committee would like to make clear its view that costs are in general much more real and much more significant to those who use accounts, than values in the general meaning of that word. The recognition by the Supreme Court in recent decisions of the crucial importance of expectations for the always uncertain future as a factor in the determination of value confirms the wisdom of the complete rejection in accounting of the "worth" basis for the statement of assets not intended to be sold within any foreseeable future, such as fixed assets.

(d) Audit and Its Derivatives

It is generally known that the origin of the word "audit" relates it to "hearing," and traces of this early usage, signifying the hearing by proper authorities of accounts rendered by word of mouth, still
linger in such phrases as "hearing witnesses"\(^1\) and "examine witnesses,"\(^2\) included in definitions of "audit." From this to the modern applications of the word is, however, a considerable distance. Perhaps the modern practice nearest to the original sense is reflected in the term "audited vouchers," meaning documents examined in the process of establishing the authenticity of payments made or to be made.

From this point the use of the term "audit" has been extended to include the examination of any records to ascertain whether they correctly record the facts purported to be recorded. The next step extended the usage to statements prepared as summaries of records, so that an "audit" was concerned not only with the truth of the records, but also with the question whether or not the statements were faithfully prepared from those records.

But the most notable development in the use of the term is that which has to do with the preparation of statements "in conformity with generally accepted accounting principles," signifying that the auditor is no longer exclusively concerned with the technical accuracy of the records, but is also interested in the principles or rules which have governed the accounting allocations entering into the results shown in the statements. Among the earliest official recognitions of this form of audit was that included in the *Federal Reserve Bulletin* for April, 1917:\(^3\) "any plan for immediate adoption intended to produce practical results must recognize that under present practice probably more than 90 per cent of the statements certified by public accountants are what are called balance-sheet audits." The form of certificate suggested in this bulletin states that the statements "have been made in accordance with the plan suggested and advised by the Federal Reserve Board." The plan referred to had been formulated by a committee of this Institute. Not only is this therefore the first official use of the term "balance-sheet audit," it is also the first official recognition of the desirability of a generally accepted and publicly stated set of general rules to serve as criteria for judging the accounting and auditing practices underlying the statements. The role assumed by the Federal Reserve Board has now devolved upon the Securities and Exchange Commission, in consultation with which the committee on auditing procedure of the American Institute of Accountants has evolved the present standardized form of certificate or auditor's report.

\(^1\) *New Standard Dictionary.*
\(^2\) *The Century Dictionary.*
\(^3\) "Approved Methods for the Preparation of Balance Sheet Statements: A Tentative Proposal Submitted by the Federal Reserve Board."
The auditing requirements implied in the issuing of this form of report have become so generally recognized that the term "audit," used without qualification in relation to the accounts of a corporation, is generally interpreted to indicate that these requirements have been met. Any examination, therefore, which is less in scope than these requirements should not be called an audit without qualifications, but should be described in adequate definitive terms.

It thus becomes clear that the end result of the audit is in many cases the expression of an opinion by the auditor to the effect that the statements are what they purport to be. But such general terms as that could not satisfy the requirements of the situation, since they would leave it open to the reader to supply his own standards or definitions of what the statements are intended to mean. Hence the reference, in the earlier publication, to "the plan suggested and advised by the Federal Reserve Board," and in Bulletin No. 5 of the committee on auditing procedure, to "conformity with generally accepted accounting principles." Only in the light of these principles is it proper to interpret and judge the statements.

The word "opinion" is also important. In the circumstances described it is not possible for the auditor to state as a literal fact that the statements are true, or that they have been prepared "in conformity with generally accepted accounting principles." All that the circumstances warrant is an expression of opinion; and although it is true that the auditor is presumed to have qualified himself to express an opinion, both by his general training and by his examination of the particular case, yet his report is a statement of opinion, not of fact.

Another essential characteristic of an audit of records is that it shall be performed "by one who has no part in their preparation." The same idea is expressed in the S.E.C. requirement that "The financial statements required shall be accompanied by a certificate of an independent public or independent certified public accountant or accountants." Clearly the opinion contained in the auditor's report can have little value unless it is entirely free from any interest which may have affected the original accounting.

These considerations, and an examination of the report of the committee on terminology of 1938 which studied the question carefully, suggest definitions of "audit" as follows:

In general, an examination of an accounting document and of supporting evidence for the purpose of reaching an informed

---

2 Instructions for Form A-2.
opinion concerning its propriety. Specifically:

(1) An examination of a claim for payment or credit and of supporting evidence for the purpose of determining whether the expenditure is properly authorized, has been or should be duly made, and how it should be treated in the accounts of the payor—hence “audited voucher.”

(2) An examination of similar character and purpose of an account purporting to deal with actual transactions only, such as receipts and payments.

(3) By extension, an examination of accounts which purport to reflect not only actual transactions but valuations, estimates, and opinions, for the purpose of determining whether the accounts are properly stated and fairly reflect the matters with which they purport to deal.

(4) An examination intended to serve as a basis for an expression of opinion regarding the fairness, consistency, and conformity with accepted accounting principles, of statements prepared by a corporation or other entity for publication—in this sense more generally called “examination” (See S.E.C. Regulation S-X and Statement on Auditing Procedure No. 5, page 41).

(e) Auditor's Report (or Certificate)

In the foregoing discussion the auditor's statement about the accounts has been called both a "certificate" and a "report." The former has at times been the more common term, but the two terms were long ago regarded as interchangeable.

In Great Britain the Companies Act (1845) required the auditors to "make a special report"; but the Waterworks Act (1847), the Railway Companies Act (1867) and the Metropolis Water Act (1871) all use the terms "certified," "certificate," or "certify." The early volumes of The Accountant (London), dated in the 1880's, have a number of articles entitled "Accountant's Certificates," in the body of which the document is frequently referred to as "the report." The Companies Act of 1929 (a consolidating statute) uses the term "report."

In the United States the Federal Reserve Bulletin (1917) spoke of the "Form of Certificate." The report of the special committee on accounting procedure, dated October 14, 1932, said: "The expression 'auditor's certificate' is still frequently used, describing the short report and opinion of the accountant..." It was therefore natural that the Securities Act of 1933 should repeatedly speak of statements "certified" by accountants, and that this usage should be followed in
the regulations of the Securities and Exchange Commission. Before this date, however, question had been raised as to the propriety and usefulness of the words "to certify" and "certificate"; it was pointed out that they were misleading to the extent that they conveyed to ordinary readers an impression of greater certainty or accuracy than accounts could possess, or that they represented that the auditor was expressing more than his opinion about the accounts. In a letter dated December 21, 1933, the special committee on coöperation with stock exchanges wrote: "To this end, we think it desirable that the document signed by the accountants should be in the form of a report, as in England, rather than a certificate, and that the words 'in our (my) opinion' should always be embodied therein." But one of the notes to the form recommended with that letter spoke of the "certificate," and other committees have frequently found themselves obliged to use "report" and "certificate" interchangeably, as in the recent correspondence between the committee on auditing procedure and the Securities and Exchange Commission.  

In these circumstances the continued use of both terms can scarcely be avoided, and the important thing is to emphasize the fact that the choice of one term or the other implies no difference of scope or purport, and to make that purport clear. This might be done by the following definition:

Report (or certificate) of an independent accountant (or auditor) is a document in which he indicates briefly the nature and scope of the examination (audit) which he has made and expresses the opinion which he has formed in respect of the financial statements.

The word "report" as synonymous with "certificate" (sometimes also called "short form of report") is used primarily in connection with audits of the kind covered by the fourth definition above given. In relation to other kinds of audits the report may take varying forms according to the nature and scope of the work undertaken.

Summary

In the section which follows, the several definitions of specialized accounting uses of terms suggested in this or previous reports are brought together, and there are given also the dictionary definitions which come closest to them of any that the research department has discovered. The latter are included for comparison only, and are not necessarily approved. In some cases they are obviously defective. It should be clearly understood that the committee's definitions are

---

1 Statements on Auditing Procedure—No. 5.
Report of the Committee on Terminology

to be read in connection with the discussion which preceded them and are not comprehensive, nor exclusive of other uses.

Committee Definitions

Accounting:
The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

Audit:
In general, an examination of an accounting document and of supporting evidence for the purpose of reaching an informed opinion concerning its propriety. Specifically:

(1) An examination of a claim for payment or credit and of supporting evidence for the purpose of determining whether the expenditure is properly authorized, has been or should be duly made, and how it should be treated in the accounts of the payor—hence “audited voucher.”

(2) An examination of similar character and purpose of an account purporting to deal with actual transactions only, such as receipts and payments.

(3) By extension, an examination of accounts which purport to reflect not only actual transactions but valuations, estimates and opinions, for the purpose of determining whether the accounts are properly stated and fairly reflect the matters with which they purport to deal.

Dictionary Definitions

Accounting:
The art or system of making up or stating accounts; the body of scientific principles underlying the keeping and explanation of business accounts. (Webster 1)

Audit:
A formal or official examination and verification of accounts, vouchers, and other records. (Webster 1)

---

1 Webster's New International Dictionary (1940).
COMMITTEE DEFINITIONS (continued)

(4) An examination intended to serve as a basis for an expression of opinion regarding the fairness, consistency and conformity with accepted accounting principles, of statements prepared by a corporation or other entity for publication—in this sense more generally called “examination” (See S.E.C. Regulation S-X and Statement on Auditing Procedure No. 5, page 41).

Auditor’s Report (or Certificate):
A document in which an independent accountant (or auditor) indicates briefly the nature and scope of the examination (audit) which he has made and expresses the opinion which he has formed in respect of the financial statements.

Balance Sheet:
A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept by double-entry methods, according to the rules or principles of accounting. The items reflected on the two sides of the balance sheet are commonly called assets and liabilities, respectively.

Asset (as a balance-sheet heading):
A thing represented by a debit balance (other than a deficit) that is or would be properly carried forward upon a closing

DICTIONARY DEFINITIONS (continued)

The certificate issued by an auditor as to the accuracy of accounts. (Webster 1)

A statement made by merchants and others to show the true state of a particular business. A balance sheet should exhibit all the balances of debits and credits, also the value of merchandise, and the result of the whole. (Bouvier 2)

The Dr. and Cr. sides of a Balance Account contain “Assets” and “Liabilities” respectively. (In this sense always used as plural,

1 Webster’s New International Dictionary (1940):
2 Bouvier’s Law Dictionary (1934).
Report of the Committee on Terminology

Committee Definitions (continued)

of books of account kept by double-entry methods, according to the rules or principles of accounting. The presumptive grounds for carrying the balance forward are that it represents either a property right or value acquired, or an expenditure made which has created a property right, or which is properly applicable to the future. Thus, plant, accounts receivable, inventory and a deferred charge are all assets in balance-sheet classification.

Liability (as a balance-sheet heading):

A thing represented by a credit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock, deferred credits to income and surplus are balance-sheet liabilities in that they represent balances to

Dictionary Definitions (continued)

with singular asset applied to a single item appearing on the debit side.) (The New English Dictionary 1)

The series of items on the balance sheet of a business enterprise, showing the book value of its resources at any given date. (Webster 2)

That which one is under obligation to pay, or for which one is liable. Specif. in the pl. one's pecuniary obligations, or debts, collectively:—opposed to assets. (Webster 2)

2 Webster's New International Dictionary (1940).
Accounting Research Bulletins

Committee Definitions (continued)

be accounted for by the company; though these are not liabilities in the ordinary sense of debts owed to legal creditors.

Earned Surplus:
The balance of net profits, income and gains of a corporation from the date of incorporation (or from the date when a deficit was absorbed by a charge against the capital surplus created by a reduction of the par or stated value of the capital stock or otherwise) after deducting losses and after deducting distributions to stockholders and transfers to capital-stock accounts when made out of such surplus.

Income:
The gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets . . . (Eisner v. Macomber; 252 U. S. 189)

Income Account (or Income Statement):
An account or statement which shows the principal elements, positive and negative, in the derivation of income or loss, the claims against income, and the resulting net income or loss of the accounting unit.

Principle (of accounting):
1. Initially, a postulate derived from experience and reason.
2. More especially, such postu-

Dictionary Definitions (continued)

The balance of profits and income of a concern remaining after deducting losses, dividends, and transfers to capital stock accounts. (Webster—accounting definition. 1)

That gain or recurrent benefit (usually measured in money) which proceeds from labor, business, or property; commercial revenue or receipts of any kind. (Webster 1)

In corporation finance, the account that states the amount, sources and expenditure of income.

(Webster 1—accounting definition.)

A general law or rule adopted or professed as a guide to action; a settled ground or basis of con-

1 Webster's New International Dictionary (1940).
Committee Definitions (continued)
lates as have proved useful and have become generally accepted.

Public Accounting:
The practice of this art (accounting) by men whose services are available to the public for compensation. It may consist in the performance of original work, in the examination and revision of the original work of others (auditing) or in rendering of collateral services for which a knowledge of the art and experience in its practice create a special fitness.

Value:
As used in accounts signifies the amount at which an item is stated, in accordance with the accounting rules or principles relating to that item. Generally book or balance-sheet values (using the word "value" in this sense) represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

Dictionary Definitions (continued)
An accountant whose services are available to the public. (Webster—definition for "public accountant.")

No definition has been found in the general dictionaries which corresponds to the accounting definition—but note use of "book value" in Webster's definition of assets.

Respectfully submitted,

George O. May, Chairman
George D. Bailey
William D. Cranstoun

May 13, 1941.

---

2 Webster’s New International Dictionary (1940).
PURPOSES OF THIS STATEMENT

In recent years there has been a significant increase in the amount of taxes. This has been due in part to the acceptance of a wider view of the legitimate scope of governmental services, in part also to the extended use of taxation for the purpose of effecting social adjustments. There has been an effort to relate tax burdens to a concept not very clearly expressed but often referred to as "ability to pay"; in general it has been assumed that income was more indicative of ability to pay than property. Despite these tendencies ad valorem taxes on property—real or personal—continue to represent a very significant part of this country's tax structure.

Questions of the proper allocation of such taxes as between years have in the past received relatively little consideration. Consistency and assurance that a full year's taxes were brought into the income account of each year were all that was deemed essential. With steadily rising taxes, more careful consideration of the tax liability at any balance-sheet date and of the charge for any income period may be called for.

The argument that tax liabilities should receive recognition in accounting at earlier dates than have governed in some cases in the past is strengthened in the minds of some by the fact that taxes themselves, especially federal taxes, have lagged behind governmental expenditures. As a result, it may be said that business enterprises are subject to a large but indeterminate future liability which has not been reflected in their accounting statements. In so far as governmental expenditures are being undertaken which must ultimately be met by increased taxation, it seems reasonable that accountants should bear this point in mind, and exert their influence in favor of early and adequate accrual of tax charges, and should encourage the disclosure of taxes as a separate item in the income statement.

This statement is designed to draw attention to the situation thus outlined and to present some of the considerations which have in the
past or should in the future determine accounting treatment of property taxes.

The question of taxes based primarily on income is also under consideration by the committee and is expected to be the subject of a later bulletin.

THE LEGAL LIABILITY FOR PROPERTY TAXES

Unlike excise, income, and social-security taxes, which are directly related to particular business events, real and personal property taxes are based upon the assessed valuation of property (tangible and intangible) as of a given date, as determined by the laws of each state or other taxing authority. For this reason the legal liability for such taxes is generally considered as accruing at a given moment, rather than over a period of time. Whether such legal accrual should determine the accounting treatment is a question to be discussed later. The date of a particular occurrence is regarded as that of creation of the liability of the taxpayer for the tax. Statements in the tax laws, opinions of accountants and attorneys, income-tax regulations and court decisions have mentioned various dates on which the different property taxes are said to accrue legally. Where the question has been litigated, it has generally been held that the taxes become a liability at the point of time when they become a lien. The following dates are pertinent:

(1) Assessment date.
(2) Beginning of taxing authority’s fiscal year.
(3) Ending of taxing authority’s fiscal year.
(4) Date on which tax becomes a lien on the property.
(5) Date tax is levied.
(6) Date or dates tax is payable.
(7) Date tax becomes delinquent.
(8) Tax period appearing on tax bill.

Most of the foregoing dates are mentioned in the tax laws and in a given case several of them may coincide. While the taxes of each jurisdiction must be considered on their own merits, a preponderance of legal opinion, especially in connection with the deduction of property taxes in federal income-tax returns, holds that real and personal property taxes accrue legally on the lien date; the Internal Revenue Department, however, holds that such taxes accrue on the assessment date. Still, the United States Supreme Court has ruled ¹ that, as a condition to accrual for income-tax purposes, all of the events must have occurred which fix the amount of the tax and determine the liability of the taxpayer. It is argued, in this respect, that ownership on

Real and Personal Property Taxes

the lien date is usually the last of the required events to occur.

A practical aspect of the legal liability for real-property taxes is presented when title to property is transferred. It is then necessary to determine whether the tax is levied against the property or against the owner, a matter which varies in different states and taxing jurisdictions. The Treasury Department and Board of Tax Appeals have held that only the owner of property on the day property taxes accrue in the legal sense already noted may deduct the accrual of such taxes for income-tax purposes. On the other hand, a federal circuit court recently upheld the deduction of real-property taxes, for income-tax purposes, on the basis of a proration between the periods prior to and subsequent to the date of purchase of property by the taxpayer, stating that the tax was levied on the property and not against the owner.\(^1\) Adjustments on account of property taxes paid or accrued are frequently incorporated in agreements covering the sale of real estate, which thereby determine the question for the individual cases as between the buyer and the seller, though not necessarily controlling for income-tax purposes.

ACCOUNTING FOR PROPERTY TAXES

Accrual Accounting

Turning from legal considerations of real and personal property tax accruals, the accounting question arises as to when the liability for such taxes should be set up on the books of a taxpayer keeping his accounts on the accrual basis. The counterpart of this question involves the amounts of taxes to be charged against the income of respective periods. Here again, the decision is influenced to a certain extent by the particular circumstances of each tax. Such terms as assessment date and levy date vary in meaning in the different jurisdictions; and while there is sufficient agreement about lien date to furnish a basis for a general legal rule as already mentioned, it does not follow that the legal rule should necessarily determine the accounting treatment.

The determination of the precise liability for the taxes under discussion often proceeds by degrees, the several steps being taken at appreciable intervals of time. While it is known that the owner of real property is liable, in respect of each tax period, for a tax on property he owns on the assessment day, the amount of the tax may not be fixed until much later. Some accountants are opposed to entering liabilities of indeterminate amount in the books, especially for items like taxes which would ultimately be recorded when paid. While this is one of the circumstances which lead to the occasional mention of taxes in

footnotes as contingent liabilities, as indicated in the summary of practice in the appendix to this bulletin, the inability to determine the exact amount of taxes is in itself no justification for failure to recognize an existing tax liability.

As evidence of the present variations in practice, real and personal property taxes have been charged against income during each of the following periods:

1. Year in which paid (cash basis).
2. Year ending on assessment (or lien) date.
3. Year beginning with assessment (or lien) date.
4. Calendar or fiscal year of taxpayer prior to assessment (or lien) date.
5. Calendar or fiscal year of taxpayer including assessment (or lien) date.
6. Fiscal year of governing body levying the tax.
7. Year appearing on tax bill.
8. Calendar or fiscal year of taxpayer prior to payment date.

Some of the foregoing periods may coincide, as when the fiscal years of the government and the taxpayer are the same. Moreover, the charge to income may be made in full at one time, or ratably on a monthly basis, or on the basis of prior estimates to be adjusted during or subsequent to the period in question.

The different periods mentioned represent varying degrees of conservatism in accrual accounting. Some justification may be found for each period, but all of the circumstances relating to a particular tax must be considered before a satisfactory conclusion can be reached.

In an earlier day, when taxes could quite properly be regarded as the price paid by the taxpayer for the limited essential governmental services rendered, such taxes could fairly be charged against the income of the period in which the services were rendered by the government. This theory perhaps still holds good for real-estate and personal-property taxes; but deficit financing, and the utilization of tax receipts to redistribute wealth and to effect other social purposes make it less true of income, inheritance, gift, and social-security taxes.

In view of all these considerations, consistency of application from year to year is probably more important than the selection of any one of the periods suggested.

As a general proposition, it would appear that the most acceptable basis of providing for property taxes is for the company to accrue such taxes on its books monthly during the fiscal period of the taxing authority for which they are levied. The books will then show, at any closing date, the appropriate accrual or prepayment. In the City of
Real and Personal Property Taxes

New York, for example, the city’s fiscal year is from July 1st to the following June 30th. A company whose fiscal year is the calendar year will in this way charge the year 1940 with half of the taxes for the city’s fiscal year July 1, 1939, to June 30, 1940, and half of the taxes for the city’s succeeding fiscal year. Since the taxes are payable April 1st and October 1st, the account would ordinarily show no balance at June 30th and December 31st; there would be neither accrual nor prepayment to be included in the balance-sheet at those dates. In some cases it may be necessary to make modifications of this basis for federal income-tax purposes.

It may be argued that the entire amount of tax should logically be accrued by the lien date. Advocates of this procedure vary from those who would accrue the tax by charges to income during the year ending on the lien date to those who urge the setting up of the full tax liability on the lien date and charging the amount thereof to income during the subsequent year. However, the basis indicated in the preceding paragraph is held by the majority of accountants to be practically satisfactory so long as it is consistently followed.

Cash Basis

In the uncertain circumstances described some companies prefer to make no accruals of such taxes, but to record them as charges only as they are paid. Among the advantages of this basis are: (a) the amount is definitely ascertainable and not likely to require subsequent revision; (b) the method is acceptable for federal income-tax purposes, provided the method of reporting is on a cash basis (this basis, however, has very limited application among the larger business concerns); (c) the tax is thus related approximately to the period when governmental services are rendered; (d) the method is simple in application; (e) if consistently applied, it does not distort the income account over a period of years.

A number of disadvantages attach to the cash basis: (a) it does not recognize liabilities as they arise—it is not conservative; (b) it does not bring out the need to provide funds in advance of payment; (c) it is inconsistent if accounts are otherwise kept on an accrual basis; (d) it relies upon receipt of tax bills and payment dates, which may vary from year to year.

Distribution by Months

For internal accounting purposes, it may be desirable to spread the provision for property taxes throughout the fiscal year. This has in practice been accomplished in many ways, including the following:
(a) Equal monthly charges to income on the basis of the estimated total property taxes for the year, revised when the exact amount of taxes becomes known;

(b) Same as above, except that property taxes are combined with all other taxes (except income) and final adjustment is made at the end of the fiscal year in accordance with the facts then known;

(c) Monthly charges on the basis of units of production, the annual charge having been estimated and related to production for the year, adjusted at the end of the fiscal year in accordance with the facts then known.

The first method above is preferable to the others as the more simple to apply; it distributes the charge evenly among months of the year, and is not complicated by consideration of other taxes. It is interesting to note the following instructions applicable to the caption for taxes (listed under operating revenue deductions) as contained identically in the uniform systems of accounts for public utilities prescribed by the Federal Power Commission and the National Association of Railroad and Utilities Commissioners:

"B. This account shall be charged each month with the amount of taxes which are applicable thereto . . .

"C. When it is not possible to determine the exact amount of taxes, the amount shall be estimated and the estimate for the period charged to this account, and adjustments shall be made as the actual tax levies become known."

**TREATMENT IN FINANCIAL STATEMENTS**

**Balance-sheet**

The liability for real and personal property taxes, whether estimated or definitely known, should ordinarily be included as an accrued liability under current liabilities. Such liability is usually combined with other accrued taxes. Where estimates are subject to a substantial measure of uncertainty, the liability should be described as estimated.

It is not generally necessary to indicate the basis of providing for property taxes, but any change in the basis, and any special situation, if significant, require explanation in footnotes to the financial statements or in the auditor's certificate. In a review of 500 published financial statements for 1939 (see appendix), there was not a single instance in which the basis of providing for real or personal property taxes was mentioned.

**Income Statement**

Having discussed the accounting period to which real and personal property taxes should be charged, it is well to consider their treatment in the income statement.
Real and Personal Property Taxes

While it is sometimes proper to capitalize in property accounts the amount of real-estate taxes applicable to property being developed for use or sale, these taxes are generally regarded as an expense of doing business. They may be (a) charged to operating expenses; (b) shown as a separate deduction from income; or (c) distributed among the several accounts to which they are deemed to apply, such as factory overhead, rent income, selling or general expenses. The last method (c) is probably the most nearly correct one, although it is useful in such cases to indicate, by a footnote to the income statement, the total amount of taxes of all kinds so assigned to other accounts. Such a footnote might well show a tabulation of all taxes by classifications, giving the amount of each tax, accounts to which charged, and the total amount of all taxes charged to income during the period.

As a result of the condensed form of income statements appearing in published reports, the amount of real and personal property taxes, however charged in the accounts, is rarely shown separately in such statements. They are frequently combined with other taxes, but not with income taxes. Since there is an increasing tendency to expect income statements to indicate significant trends, for the light they may throw on future earning capacity, it may well be argued that an item growing as rapidly as taxes should be separately shown in the income statement.

Since the liability for property taxes must frequently be estimated at the balance-sheet date, it is often necessary to adjust the provision for the taxes of a prior year when the amount of them has been ascertained. These adjustments should ordinarily be made through the income statement, either in combination with the current year’s provision or as a separate item in the income statement. Such adjustments have at times been passed through the surplus account, but this practice should be discouraged.

Current Practice

The 1939 published annual reports of 500 American corporations were reviewed to determine the current practice in the treatment of taxes in financial statements. Real and personal property taxes were separately mentioned in only very few instances, so that the tabulation shown in the appendix reflects the treatment of taxes in general except federal income taxes.

There was some mention of taxes in most of the reports studied, usually without separate amounts shown for each of the many kinds of taxes. In most of the reports the president’s letter to stockholders contained textual comments and statistical data regarding taxes.
Accounting Research Bulletins

The tendency to give this information is perhaps attributable to a desire to call attention to the increasing tax burden rather than to an extension of accounting disclosure.

The uniform system of accounts for steam railroads prescribed by the Interstate Commerce Commission provides that the expense for taxes, including federal income taxes, be shown as a separate deduction from net revenue from railway operations, and the liability therefor as a separate liability under unadjusted credits. The uniform system of accounts prescribed by the Federal Power Commission for public utilities and licensees, on the other hand, provides that the expense for taxes be shown as a separate deduction under operating revenue deductions, while the corresponding liability is a separate item under current and accrued liabilities. The item is of special importance in the case of railroads, because of the magnitude of their real-estate accounts.

APPENDIX

Current Practice in Accounting for Taxes
(other than income taxes)

<table>
<thead>
<tr>
<th>Number of Reports</th>
<th>Combined with Other Items</th>
<th>Separate Amount</th>
<th>Total</th>
</tr>
</thead>
</table>

Balance-sheet Treatment:

**Assets:**

- Prepaid expenses or deferred charges ..................... 165 13 178
- Current assets .............................................. 12 12
- Tax claims (separate caption) .............................. 2 2

177 15 192

**Liabilities:**

- Current .................................................. 141 234 375
- Separate caption ............................................ 6 11 17
- Unadjusted credits (railroads) ............................... 3 20 23
- Reserves .................................................... 10 13 23
- Deferred .................................................... 3 3

160 281 441
Real and Personal Property Taxes

Number of Reports

<table>
<thead>
<tr>
<th>Combined with Other Items</th>
<th>Separate Amount</th>
<th>Total</th>
</tr>
</thead>
</table>

Balance-sheet Treatment (continued):
*Contingent Liabilities* (footnotes, in most cases without amounts) .................... 20

Income Statement Provisions:
Cost of goods sold or operating expenses .................... 24 32 56
Other deductions from income. 37 156 193
Adjustments on account of prior years:
Charges .................... 1 3 4
Credits .................... 9 9
Amount of taxes shown in footnote only .................... 5 5

Special Adjustments (in most cases applicable to prior years):
Through surplus accounts:
Charges .................... 5 21 26
Credits .................... 2 19 21
Through reserve accounts:
Charges .................... 2 2
Credits .................... 2 2

Amount of taxes for year mentioned in text of report only. 103 103

Note.—The foregoing tabulation is based upon a review of the 1939 published annual reports of 500 corporations whose securities are listed on the New York Stock Exchange or the New York Curb Exchange. In preparing this tabulation, no consideration was given to more than one tax item appearing under each caption in a single report. Income taxes, where mentioned, were considered as “other items.”
Accounting Research Bulletins

The statement entitled "Real and Personal Property Taxes" was adopted by the assenting votes of nineteen members of the committee. Two members did not vote.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

C. OLIVER WELLINGTON, Chairman
GEORGE O. MAY, Vice Chairman
GEORGE D. BAILEY
CARLTON G. BLOUGH
ARCHIBALD BOWMAN
LESLIE J. BUCHAN
GEORGE COCHRANE
CHARLES B. COUCHMAN
WILLIAM D. CRANSTOUN
JAMES L. DOHR
HENRY B. FERNALD
ARTHUR B. FOYE
ANSON HERRICK
HENRY A. HORNE
A. C. LITTLETON
WARREN W. NISSLEY

WILLIAM A. PATON
J. S. SEIDMAN
WALTER A. STAUB
J. HAROLD STEWART
A. W. TORBET

JOHN L. CAREY, Secretary
THE TERM "stock dividend" refers to the issuance, by a corporation, of additional shares of any class of its own capital stock to the presently existing stockholders of the same or a different class of shares without consideration moving from such stockholders to the corporation. Such a stock issue involves an increase in the legal capital of the corporation; a "split up" or division of issued shares into a greater number of shares of the same class without change in the aggregate amount of legal capital is therefore not regarded as a stock dividend. In addition, the term does not cover the distribution of shares in another corporation theretofore held as an investment, or the issuance to shareholders of rights to subscribe to additional shares.

The stock dividends with which this bulletin is concerned are those stock dividends, whether periodic or otherwise, which represent a capitalization of earned surplus and are issued in shares of common stock to the holders of like shares; such dividends may be designated as "ordinary" stock dividends. It is recognized that in some states there is statutory authorization for stock dividends, so-called, (a) without any addition to legal capital, or (b) by making a transfer of paid-in or other capital surplus, or of appreciation surplus, to legal or stated capital. Since these procedures have nothing to do with earnings or earned surplus and can only be justified as recapitalizations or adjustments of capital structure, they should be so designated and dealt with accordingly, with appropriate notice to the stockholders. In addition, the term "stock dividend" is commonly used to describe the issuance of preferred shares to the holders of common shares, common shares to the holders of preferred shares, and preferred shares to the holders of preferred shares. These situations are unusual, and they are not dealt with in this bulletin.

As used herein, the term "capitalization of earned surplus" refers to a transfer from earned surplus to capital account, whether the latter be designated as capital stock or capital surplus.

The discussion of corporate accounting for such stock dividends
Accounting Research Bulletins

herein is divided into two parts. The first deals with the problems of the issuing corporation. The second deals with the problems of the receiving corporation, but the accounting principles set forth herein would ordinarily also be applicable to the individual or other non-corporate stockholder.

I. Statement of Accounting Principles as to the Issuing Corporation

(1) Since an ordinary stock dividend implies a transfer, by the issuing corporation, of a portion of its earned surplus to the category of permanent capitalization represented by the capital-stock and capital-surplus accounts, the board of directors should:

(a) In declaring such a dividend first determine the aggregate amount to be transferred from earned surplus; such amount is within their discretion;

(b) In determining the number of shares to be issued in connection with the aforesaid transfer, observe the legal requirements as to the per-share amount to be capitalized, and the rules of accounting and corporate policy hereinafter set forth.

(2) The amount authorized by the directors to be so capitalized must be charged to earned-surplus account and credited to capital-stock account, or if appropriate, credited in part to capital-stock account and in part to capital-surplus account.

Discussion

In the accounts of the issuing corporation the stock dividend involves two basic and interrelated problems, as follows:

(a) The aggregate amount of earned surplus to be capitalized by the stock dividend, and

(b) The number of shares to be issued as the stock dividend.

In declaring a stock dividend it is the responsibility of the directors to determine both of these questions. In arriving at a decision on these matters, there are certain legal requirements which must be met by the directors, and in addition there are further requirements which should be met as a matter of proper accounting and corporate policy.

The aggregate amount of earned surplus to be capitalized is within the discretion of the board of directors. The legal requirements relate to the amount of such surplus per share which the directors must authorize to be transferred to capital-stock account. The corporate laws of the state of incorporation or the charter and by-laws of the corporation prescribe the amount which must be received per share
Corporate Accounting for Ordinary Stock Dividends

upon the issuance of shares of stock to make them "fully paid"; ordinarily the same amount of earned surplus must be capitalized per share in the case of a stock dividend to make the dividend shares "fully paid." Further, the statutes of some states contain specific provisions as to the amount per share to be capitalized in the case of a stock dividend.\(^1\) When the stock dividend is issued in par or stated-value shares, the amount per share that must be capitalized is ordinarily the par or stated value of the dividend shares. In the case of no-par shares, the amount per share is sometimes specified in the charter and sometimes left entirely to the discretion of the directors. It is also necessary to meet the requirements, if any, prescribed by any regulatory commission or other body to whose jurisdiction the corporation may be subject.

The legal requirements are in effect minimum requirements and do not prevent the capitalization of a larger amount of earnings per share. Because of the implications of the stock dividend, it is the opinion of this committee that there are further requirements inherent in proper accounting and corporate policy, as set forth hereafter, which should be observed by the directors when deciding upon the amount of earned surplus to be capitalized and the number of shares to be issued.

**Amount of Earned Surplus To Be Capitalized**

While the aggregate amount of earned surplus to be capitalized by the stock dividend, as distinguished from the number of shares to be issued, is within the discretion of the board of directors, proper corporate policy requires that in the case of regularly recurring stock dividends, the amount of earned surplus capitalized should not exceed the amount of current income, since such dividends are likely to be interpreted by the stockholders as notice that the corporation has current income which it is not desirable or practical to distribute in cash dividends. As used herein, the term "current income" refers to the income of the fiscal period in which the stock dividend is issued, or to the income of a comparatively small number of fiscal periods immediately preceding the date of the stock dividend. The charge to earned surplus with respect to such stock dividends should not be in

\(^1\) Pennsylvania Business Corporation Law, sec. 703, Illinois Business Corporation Law, sec. 41, Indiana General Corporation Act, sec. 12, Michigan General Corporation Act, sec. 22, California General Corporation Law, sec. 346-a. In at least one state (Ohio, General Corporation Law, sec. 8623-38) the law permits the issuance of stock dividends without capitalizing any earnings unless there are provisions in the charter to the contrary.

101
excess of the current income as thus defined after deducting any prior cash dividends and capitalizations by stock dividends within the indicated period.

A corporation which has increased, over a period of time, its working capital or its fixed assets by investing its accumulated income over such period may be desirous of reflecting the resulting condition in its legal capital by the issuance of a single stock dividend and the capitalization of a relatively large amount of earned surplus, accumulated over such period of time. If this be done the number of shares representing such transfer should be computed on the basis set forth in the next section of this bulletin, and at the time of issuance of the dividend shares the stockholders should be fully advised as to the facts so that the receipt of the stock dividend may not result in a misunderstanding, on the part of the recipient, as to the relationship between the stock dividend and the current income of the corporation.

**Number of Dividend Shares To Be Issued**

Proper accounting and corporate policy also require that the amount of income capitalized per share bear an appropriate relationship to the existing capitalization per share. Accountants now generally regard the capital-stock and the capital-surplus accounts as being in essentially the same category, i.e., capital, despite the fact that they are reported separately for legal and accounting purposes. The amount per share in the capital-stock and capital-surplus accounts combined, before the issuance of the stock dividend, should be maintained upon its issuance by capitalization of at least a like amount of earned surplus for each dividend share. The number of dividend shares should therefore not exceed the number determined by dividing the amount of earned surplus authorized to be capitalized by the total amount per share in the capital and capital-surplus accounts before the declaration of the stock dividend. The foregoing computation may be adjusted by the elimination from such capital surplus of any portion thereof not forming part of the book value of the common stock.

In addition to meeting the foregoing requirement the directors, in their study as to the number of shares to be distributed as a stock dividend, should take into consideration a fair market value per share for the increased number of shares to be outstanding after the stock dividend, and where such fair market value per share is substantially in excess of the amount per share of the combined capital-stock and capital-surplus accounts before the stock dividend, they should fix the number of dividend shares so that the amount charged to earned surplus per share will have a reasonable relationship to such fair market
value. Unless such relationship is maintained, the stockholder may believe that the market value of the dividend shares he receives represents his pro-rata share of the capitalized current income of the corporation, whereas the market value per share may be materially in excess of such capitalized income per share.

When the amount of earned surplus capitalized per share of dividend stock exceeds its par or stated value, the excess should be credited to capital surplus. There may also be cases involving no-par-value shares in which a portion of the credit should be made to capital surplus.

In the case of any stock dividend, the issuing corporation should inform its stockholders, by notice at the time of issuance, as to the amount capitalized per share and the aggregate amount thereof, as well as to the account or accounts to which such aggregate has been charged and credited, whether or not such notification is required by statute or regulation. In addition, the corporation should inform the stockholder as to the percentage by which the interest which he had in the corporation before the issuance of the stock dividend will be reduced if he should decide to dispose of his dividend shares.

II. STATEMENT OF ACCOUNTING PRINCIPLES AS TO THE CORPORATE RECIPIENT

(1) An ordinary stock dividend is not income from the corporation to the recipient in any amount.

(2) Upon receipt of such a dividend, the cost of the shares previously held should be allocated equitably to such shares and to the shares received as a stock dividend.

DISCUSSION

One of the basic problems of accounting is that of income determination. A complete discussion of this problem is obviously beyond the scope of this bulletin. Basically, income is a realized gain, and in accounting it is recognized, recorded, and stated in accordance with certain principles as to time and amount.

In applying the principles of income determination to the stockholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective stockholders in such income. Under conventional accounting procedure, the stockholder has no income solely as a result of the fact that the corporation has income; the increase in his
Accounting Research Bulletins

equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division or severance of corporate assets in the form of cash or its equivalent, the stockholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. Moreover, there is nothing that the stockholder can realize upon without parting with a portion of the interest in the corporation theretofore held by him. In the case of a stock dividend, there is no distribution, division, or severance; in fact, as a result of the stock dividend, that part of the earned surplus which was capitalized in connection therewith has been transferred to capital account and there is a definite implication that it will not be distributed to the stockholder.

The foregoing are important points in any discussion of the accounting principles to be recognized by the recipient of stock dividends, since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the stockholder as it accrues to the corporation, and prior to such a distribution, division, or severance; the acceptance of such arguments would require the abandonment of the "separate entity" theory of corporation accounting. It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries, or in the case where the stockholder is given a bona fide option to take cash or stock. A discussion of this problem is, however, also deemed to be beyond the scope of this bulletin.

The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.1 The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U. S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased... the proportional interest of each shareholder remains the same. The

only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

As against these basic facts, the arguments in favor of treating stock dividends as income are not convincing and, in the last analysis, as previously stated, are largely arguments in favor of recognizing corporate income, as it accrues to the corporation and before any distribution, division, or severance, as being income to the stockholder. Perhaps the atmosphere would be clarified if some term other than "dividend" were used in connection with the issuance of additional shares to represent the capitalization of earned surplus.

Since the ordinary stock dividend is not income to the recipient, it follows that a stockholder's interest in the corporation remains unchanged except as to the number of share units constituting such interest. The recipient should therefore regard the dividend as merely adding to the number of share units held. The cost of the shares previously held should be allocated equitably to such shares and to the shares received as a stock dividend. In the ordinary case, the allocation is made and the adjusted cost per share is determined by dividing the original cost by the aggregate holding including the dividend shares. When original shares or dividend shares are disposed of, a gain or loss is determined on the basis of the adjusted cost per share.

The statement entitled "Corporate Accounting for Ordinary Stock Dividends" was adopted by the assenting votes of fifteen members of the committee. Four members, Messrs. Buchan, Fernald, Seidman, and Torbet dissented. Two members did not vote.

Messrs. Buchan and Fernald dissent from the statement in so far as it deals with the treatment of stock dividends by declaring corporations. The committee having taken the position (with which they agree) that stock dividends are not income to the recipients in any amount, it is in their judgment unnecessary and inexpedient for the committee to express views in regard to the amount to be capitalized by the declaring corporation in respect thereof, except that the amount to be capitalized should be in accord with applicable law and corporate action pursuant to law.

Mr. Seidman dissents from that part of the statement which declares that market values are a factor in determining the amount to be charged against earned surplus by a corporation declaring a stock
dividend. It is his view that since a stock dividend is nothing more than the conversion of surplus to capital, the charge can only be based on the book values from which the amount of surplus is necessarily derived, just as in the case of a distribution of assets in kind where the market value is greater than the book value; also, that the injection of market values imposes an unnecessary burden on and creates an area of controversy as to the vast majority of corporations whose stock has no established market.

Mr. Torbet dissents from the statement unless the portions thereof dealing with (a) the number of shares to be issued and the amount to be capitalized and (b) the information to be included in notices to stockholders respecting the issuance of stock dividends are to be regarded as recommendations in relation to corporate accounting and fiscal policy and not as statements of accounting principles.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

C. OLIVER WELLINGTON, Chairman
GEORGE Q. MAY, Vice-chairman
GEORGE D. BAILEY
CARL B. BLOUGH
ARCHIBALD BOWMAN
LESLIE J. BUCHAN
GEORGE COCHRANE
CHARLES B. COUCHMAN
WILLIAM D. CRANSTOUN
JAMES L. DOHR
HENRY B. FERNALD
ARTHUR B. FOYE
ANSON HERRICK
HENRY A. HORNE
A. C. LITTLETON
WARREN W. NISSLEY
WILLIAM A. PATON
J. S. SEIDMAN
WALTER A. STAUB
J. HAROLD STEWART
A. W. TORBET

JOHN L. CAREY, Secretary
This bulletin supersedes Accounting Research Bulletin No. 11, "Corporate Accounting for Ordinary Stock Dividends," issued in September, 1941.

1. The term *stock dividend*, as used in this bulletin, refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term *stock split-up*, as used in this bulletin, refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This bulletin is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares, or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.
5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this bulletin. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. In applying the principles of income determination to the accounts of the shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income. Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division, or severance of corporate assets, the shareholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize upon without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.¹ The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

Stock Dividends and Stock Split-Ups

“A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased ... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones.”

9. Since a shareholder’s interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

AS TO THE ISSUER

Stock Dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation’s assets or its respective shareholders’ proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a “dividend” in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock divi-
dend is so great that it has, or may reasonably be expected to have, the
effect of materially reducing the share market value, the committee
believes that the implications and possible constructions discussed in
the preceding paragraph are not likely to exist and that the transac-
tion clearly partakes of the nature of a stock split-up as defined in
paragraph 2. Consequently, the committee considers that under such
circumstances there is no need to capitalize earned surplus, other
than to the extent occasioned by legal requirements. It recommends,
however, that in such instances every effort be made to avoid the use
of the word “dividend” in related corporate resolutions, notices, and
announcements and that, in those cases where because of legal re-
quirements this cannot be done, the transaction be described, for
example, as a “split-up effected in the form of a dividend.”

12. In cases of closely-held companies, it is to be presumed that the
intimate knowledge of the corporations’ affairs possessed by their
shareholders would preclude any such implications and possible con-
structions as are referred to in paragraph 10. In such cases, the com-
mittee believes that considerations of public policy do not arise and
that there is no need to capitalize earned surplus other than to meet
legal requirements.

13. Obviously, the point at which the relative size of the additional
shares issued becomes large enough to materially influence the unit
market price of the stock will vary with individual companies and
under differing market conditions and, hence, no single percentage
can be laid down as a standard for determining when capitalization of
earned surplus in excess of legal requirements is called for and
when it is not. However, on the basis of a review of market action in
the case of shares of a number of companies having relatively recent
stock distributions, it would appear that there would be few instances
involving the issuance of additional shares of less than, say, 20% or
25% of the number previously outstanding where the effect would not
be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will
in many cases, probably the majority, result in the capitalization of
earned surplus in an amount in excess of that called for by the laws
of the state of incorporation; such laws generally require the
capitalization only of the par value of the shares issued, or, in the
case of shares without par value, an amount usually within the
discretion of the board of directors. However, these legal require-
ments are, in effect, minimum requirements and do not prevent the
capitalization of a larger amount per share.
Stock Dividends and Stock Split-Ups

Stock Split-Ups

15. Earlier in this bulletin a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation’s representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

The statement entitled “Accounting for Stock Dividends and Stock Split-Ups” was adopted by the assenting votes of nineteen members of the committee, of whom two, Messrs. Knight and Calkins, assented with qualification. One member, Mr. Wilcox, dissented.

Mr. Knight assented with the qualification that he believes the bulletin should recognize the propriety of treating as income stock dividends received by a parent from a subsidiary. He believes the bulletin should have retained from the original Bulletin No. 11 the statement, “It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries, . . .”

Mr. Calkins approves part one of the bulletin, but believes part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the
shareholder may think otherwise. He believes it is inappropriate for
the corporate entity to base its accounting on considerations of pos-
sible shareholder reactions. He also believes that part two deals with
matters of corporate policy rather than accounting principles and
that the purpose sought to be served could be more effectively ac-
complished by appropriate notices to shareholders at the time of the
issuance of additional shares.

Mr. Wilcox dissents from the recommendations in this bulletin
both as to the recipient and the issuer. He believes that, with proper
safeguards, stock dividends should be regarded as marking the point
at which corporate income is to be recognized by shareholders, and
denies that the arguments favoring this view are in substance argu-
ments for the recognition of corporate income as income to the share-
holder as it accrues to the corporation. He believes that the argu-
ments regarding severance and maintenance of proportionate interest
are unsound, and cannot logically be invoked as they are in this bul-
letin, since they are widely ignored with respect to distributions
of securities other than common stock dividends. Mr. Wilcox be-
lieves the recommendations as to the issuer are inconsistent with
the rest of the bulletin, involve arbitrary distinctions, hamper or dis-
courage desirable corporate actions, result in meaningless segregation
in the proprietorship section of balance sheets, and serve no in-
formative purpose which cannot be better served by explanatory
disclosures. He therefore also dissents from the omission of require-
ments for information and disclosures which were contained in
the original Bulletin No. 11 issued in September, 1941.

NOTES

1. Accounting Research Bulletins represent the considered opin-
ion of at least two-thirds of the members of the committee on account-
ing 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. Opinions of the committee are not intended to be retroactive
unless they contain a statement of such intention. They should not
be considered applicable to the accounting for transactions arising
prior to the publication of the opinions. However, the committee
does not wish to discourage the revision of past accounts in an indi-
vidual case if the accountant thinks it desirable in the circumstances.
Opinions of the committee should be considered as applicable only to
items which are material and significant in the relative circumstances.

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.)
FOREWORD

In Accounting Research Bulletins Nos. 7 and 9 there were published reports of the committee on terminology. A further report of that committee is presented herewith. In it the committee recommends that the committee on accounting procedure should consider the feasibility of bringing about the elimination of the term “surplus” in published financial statements and the substitution of more informative designations. At a meeting of the committee on accounting procedure held in Detroit on September 15th, it was resolved to appoint a subcommittee to consider the feasibility of such a step, with a view to an early report to the full committee. Expressions of opinion on the subject from members of the Institute or others will be welcomed by the research department and the committee on terminology.

REPORT OF THE COMMITTEE ON TERMINOLOGY

ANNUAL REPORT, 1941

To the Council of the American Institute of Accountants:

Gentlemen:

In its report of May 14, 1940, the committee indicated its intention (subject to the approval of the Council subsequently given) of undertaking discussion of specialized accounting uses of a number of terms. It may be well to emphasize at this time that the committee welcomes criticisms of its bulletins and also suggestions from members of the Institute or others for modifications of existing practice whenever that would tend to a better understanding of accounts. In the report above mentioned, the committee said: “A question may no doubt be raised whether all such uses are necessary or expedient or whether some should be abolished” (page 54).

In this report the committee proposes to discuss the uses of the word “surplus.” Nowhere in accounting, perhaps, is the conflict between
the concepts of cost and value as the bases of accounting reflected more strikingly than in the uses of this term.

The report of the committee on terminology of 1931 listed a number of terms, in which the word "surplus" was included. It recognized two broad classifications — earned surplus and capital surplus. The latter it regarded as comprising paid-in surplus, designated surplus, and revaluation surplus.¹

The reappraisal of assets and the revaluation surplus often associated therewith were clearly reflections of the value concept of balance sheets and accounting. If the "value" of the assets of a corporation and of the enterprise carried on by it increased, the increase might be recognized in the books and produce a capital surplus, an appraisal surplus, or a revaluation surplus. While both the practice and the terminology are now discredited, their influence on the public thinking is still felt.

The emphasis has, however, shifted to another of the subdivisions of capital surplus recognized by the committee of 1931. If the value of an enterprise declines, a corporation may be able to reacquire some of its own capital stock at less than par or the legal capital paid in upon the issue thereof and by retiring such stock may reduce its legal capital by a sum exceeding the amount expended. If so, according to current usage a paid-in surplus is created.² This is clearly a reflection of the cost or investment concept of the balance sheet and accounting. A part of what was paid in as legal capital has ceased to be legal capital, without having been withdrawn.

In its report of May 13, 1941, this committee expressed regret that the term "earned surplus" had superseded the earlier "undivided profits," though it accepted with a minor change a definition of earned surplus proposed by a special committee of the Institute in 1930 (see Bulletin No. 9, page 75).

The committee now suggests that the use of the term "surplus" in relation to a discount on acquisition by a corporation of its own securities may be misleading. A large discount on a company's common stock usually implies a decline in the value of the enterprise. The term "surplus" can be applied to it only on the assumption that it has no more defining significance than the famous "Rest" in the balance sheet of the Bank of England. Indeed, it is hardly too much to say that the word "surplus" as currently used is generally either non-descrip-

¹ See also Capital Surplus and Corporate Net Worth, by R. P. Marple, Ronald Press, 1936.
Report of the Committee on Terminology
tive or mis-descriptive, since in the public mind it has a connotation of value. The committee suggests that the general abandonment of the use of the term would be a major step towards making the proprietor-ship section of the balance sheet more significant. It would lead to the substitution of really descriptive specific titles for uninformative classifications.

To illustrate, paid-in surplus today commonly reflects (a) amounts by which the sums paid in on original issues of capital stock exceeded the legal capital created thereby, or (b) amounts by which the sums paid out on reacquisition and retirement of capital stock fell short of the legal capital represented by the stock retired. Clearly the two classes of items have very different significance.

The term "net worth," once widely employed, is fading from use as the fact becomes more generally recognized that a balance sheet does not purport to reflect and could not usefully reflect the value of the enterprise or of equity interests therein. The word "surplus" might well follow it into disuse. An excess over legal capital paid in on an issue of stock could then be classified as "capital," which is what accounting considers it to be (see Bulletin No. 11). The fiction that a decline in the value of an enterprise followed by a redemption of a part of the stock of the owning corporation gives rise to a surplus, would then no longer be accepted.

The committee recognizes that the present usage is well intrenched, however desirable its elimination may be. It suggests that the committee on accounting procedure might be asked to consider and report upon:

(a) the feasibility of bringing about a general discontinuance of the use of the word "surplus"; and
(b) designations which might be substituted in the proprietor-ship section of the balance sheet and which would make it clear that balances in this section reflect investment rather than value and would emphasize the distinctions between (1) legal capital, (2) capital in excess of legal capital, and (3) undivided profits.

Respectfully submitted,

GEORGE O. MAY, Chairman
GEORGE D. BAILEY
WILLIAM D. CRANSTOUN

September 15, 1941
1. In January, 1942, the committee on accounting procedure issued Accounting Research Bulletin No. 13, *Accounting for Special Reserves Arising Out of the War*. In October, 1946, it issued Bulletin No. 26 concerning the accounting for the use of these special war reserves.

2. The committee is of the opinion that, in the light of subsequent developments of accounting procedures, these bulletins should no longer be relied upon as a basis for the establishment and use of reserves.

*The statement entitled “Limitation of Scope of Special War Reserves” (No. 13-Addendum) was unanimously adopted by the twenty-one members of the committee.*

**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. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be
considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1950-1951)

PAUL K. KNIGHT, Chairman
FREDERICK B. ANDREWS
FRANK S. CALKINS
H. A. FINNEY
RUSSELL H. HASSLER
THOMAS G. HIGGINS
JOHN B. INGLIS
JOHN A. LINDQUIST

EDWARD J. McDEVITT
LESLIE MILLS
MAURICE E. PELOUBET
JOHN PEOPLES
HATCHER A. PICKENS
JOHN W. QUEENAN
JAMES A. RUNSER
WALTER L. SCHAFFER

VIRGIL S. TILLY
C. OLIVER WELLINGTON
WILLIAM W. WERNTZ
EDWARD B. WILCOX
KARL R. ZIMMERMANN

CARMAN G. BLOUGH,
Director of Research
RESERVES CONSIDERED IN THIS BULLETIN

The reserves considered in this bulletin are limited to those which are provided as a result of the present war and which would not otherwise be required. While other accounting problems arising out of the war are referred to, the bulletin is primarily concerned with the treatment of such reserves in the financial statements of organizations which are substantially engaged, directly or indirectly, in production for war purposes, or are materially affected by conditions growing out of the war.

SUMMARY STATEMENT

(1) The committee has previously stated in effect \(^1\) that it is plainly desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation. In applying this principle to special reserves for war costs and losses, experience during and following the first world war and recent well-defined social trends should be taken into account.

The charges for which the reserves have previously been created should be applied against the appropriate reserves, and any unused portion thereof should be dealt with in accordance with general practice relating to corrections of estimates made in prior years.\(^1\)

(2) Where reserves are created for possible war costs and losses the amount of which is not presently determinable and which do not come within paragraph (1), the committee suggests that the provision be shown in the income statement as a deduction from the income for the period computed on the usual basis. The purpose and amount of such reserves should be shown as clearly as possible in the financial statements.

When the costs and losses of this nature are later determined they should be brought into the income statement, but it is desirable that

---

\(^1\) Accounting Research Bulletin No. 8.
this should be done in such a way as not to obscure the results for the period then current.

(3) Where reserves of the second group (paragraph (2) above) are relatively large it may be undesirable to use the term "net" income in relation to any figure in the income statement of either the period in which the reserves are made or the period in which the costs or losses are ascertained and brought into account. In such cases, the following procedures might well be adopted:

I. In the period in which the reserves are created:
   (a) Prepare the income statement to show the balance of income remaining after providing for all reasonably determinable costs and losses as required in (1) above.
   (b) Deduct from such balance provisions coming within the scope of (2) above.
   (c) State the remainder as the amount of income transferred to earned surplus.

II. In the period in which the costs or losses are determined and brought into account:
   (d) Prepare the income statement to show the balance of income remaining after providing for all reasonably determinable costs and losses of the period then current.
   (e) Show as separate charges in the income statement those items related to prior periods for which provision was made in I(b) above.
   (f) Show, as a credit in the income statement, a transfer from the reserves created under I(b) above to the extent that they have been applied against the items in II(e) above.
   (g) State the remainder as the amount of income transferred to earned surplus.

(4) It is not permissible to create reserves for the purpose of equalizing reported income. Reserves for the purpose of dividend equalization may be provided only by charges against earned surplus; no charges may be made thereagainst except for dividends or for transfers back to earned surplus.

---

**Discussion**

The object of this bulletin is to present recommendations for meeting war conditions in a manner consistent with accounting principles previously established. The existing situation presents in acute form the problem of reconciling two basic accounting objectives: \(^1\) first, that of bringing charges as nearly as may be into the same accounting

Accounting for Special Reserves Arising Out of the War

period as the revenue against which they are fairly applicable, and secondly, that of basing accounting entries as far as possible on objective evidence or on estimates of a reasonably definitive character. In general, the committee believes that the first of these objectives should be regarded as the more essential; but this conclusion does not warrant the presentation of figures in which amounts determined with a reasonable degree of accuracy and in accordance with accepted accounting principles are combined indistinguishably with others representing mere conjecture.

Limitations of Current Financial Statements

While many items in financial statements are determinable with substantial accuracy, others involve estimate or approximation and require the exercise of informed judgments within a comparatively wide range of reasonableness. There is increasing recognition of the fact that the significance of periodic financial statements is limited accordingly. The tentative character of such statements is accentuated under war conditions because of the change in methods of doing business and because accounting measurements are largely dependent on the course and duration of the war. Current financial statements are, therefore, necessarily less indicative of such things as earning capacity, ability to pay taxes, and capital value than statements prepared under normal conditions.

This committee has in the past 1 emphasized the dangers of attaching undue importance to a single figure such as “net income per share.” It feels that today the danger is so great as to make undesirable in many cases the presentation of a figure designated without qualification as net income. Suggestion is therefore made of the special form of income presentation set forth in paragraph (3) of the Summary Statement. It is recognized that other procedures may be desirable, in the judgment of management and the independent auditor, to reflect the circumstances peculiar to various types of business enterprises or further changes in business conditions.

The committee has also recommended 2 extension of the practice of including comparative statements in the annual reports of corporations. Under existing conditions, with pronounced changes in the nature of business transactions and other altered circumstances, in many cases current statements of income may not be fairly comparable with those of prior periods; it may be desirable to emphasize the lack

1 Accounting Research Bulletin No. 8, p. 64.
2 Accounting Research Bulletin No. 6.
of comparability in the presentation of financial statements in such cases.

Special War Reserves

An appendix to this bulletin contains a list of typical items for which reserves may be needed. Corporate management and accountants should give careful consideration to these and similar items in order to decide upon the necessity or advisability of providing therefor.

In its first bulletin, the committee said: "The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties." On the basis of experience in and after the first world war and with the expectation that there will be similar adjustments and dislocations of business after the present war, the utilitarian concept of accounting should prompt accountants and others to encourage the establishment of special reserves for costs and losses arising out of the war.

Recognition of the necessity of such reserves is important, not only in the interests of the business enterprise, but in the interest of the national economy as a whole. The government might well take account of this fact in its fiscal policies generally and in respect of taxation. It would be wise on the part of the government to give consideration to the recognition of provisions of this kind as deductions in the determination of taxable income, subject to necessary safeguards in regard to the ultimate disposition thereof. Such a policy would tend to make taxable income more nearly reflect real income, since these reserves are intended to give recognition to costs and losses related to the war period which are real, though in many cases they cannot now be definitely measured.

It is to be noted that reserves for many of the items listed in the appendix have the effect of reducing the stated amount of fixed assets, while other items, such as restoration of facilities or separation allowances, will require expenditure of funds in the future. It should be emphasized that the creation of reserves for items of the latter kind does not, of itself, provide funds to meet the expenditures. Such expenditures can be made only from funds of the corporation available at the time. The creation of the reserve serves an essential purpose, however, in indicating the necessity of conserving assets rather than paying dividends.

1 Accounting Research Bulletin No. 1, p. 1.
Accounting for Special Reserves Arising Out of the War

ACCOUNTING TREATMENT OF SPECIAL WAR RESERVES

The committee has stated that "over the years it is plainly desirable that all costs, expenses, and losses of a business, . . . be charged against income." ¹ Applying this principle to present-day conditions, war-time revenues should be charged with all reasonably determinable costs and losses fairly applicable thereto. Specific charges in the income statement should, however, have a reasonable basis of measurement and of allocation to fiscal periods. It will be difficult in some cases to follow this general rule in view of the uncertainty as to the duration of the war and the course of post-war adjustment. Much will depend on the judgment of the management in the circumstances of each particular case, and margins of error will doubtless be greater than in normal times.

While no attempt is made in this bulletin to classify specific reserves, they fall, for accounting purposes, into two groups: (a) those reserves or parts of reserves which must be provided in order to conform to accepted principles of accounting, and (b) those additional reserves or parts of reserves created in the discretion of management as a matter of conservative business administration, but which are not presently determinable within the limits necessary for definitive accounting statement.

Reserves for such items as accelerated depreciation and accelerated obsolescence, amortization of emergency facilities, and deferred maintenance, will ordinarily fall in the first group. Reserves for such items as separation allowances to employees (where there is no legal obligation to make payment or no established policy) and losses due to excess capacity after the war will ordinarily fall in the second group. Some reserves may fall in part in each group. Doubts as to proper classification should be resolved in favor of inclusion in the first group.

Items in the first group should be deducted in arriving at any figure described as net income; items in the second group should be shown as extraordinary deductions from net income. If the alternative recommended in paragraph (3) of the Summary Statement is adopted, items in the first group should be treated as proposed in I(a) thereof; items of the second group should be shown as in I(b) thereof.

Disposition of Reserve Balances

Charges, in the case of reserves of the first group mentioned above, should be made against the reserves and any unrequired balance should be included as a separate item in the income statement after

¹ Accounting Research Bulletin No. 8, p. 64.
operating profits or, in exceptional cases, as a credit to earned surplus. Charges against reserves of this kind should be limited to those for which the reserves were provided.

Charges, in the case of reserves of the second group, should ordinarily be shown in the income statement according to the usual rules of classification, and an equivalent amount of the reserve shown as an extraordinary credit. Any unrequired balances should be transferred to earned surplus. Where charges of this kind are relatively large, the accounting procedure may well be such as is indicated in paragraph (3) of the Summary Statement.

**Equalization Reserves**

It has long been established in accounting that reserves may not be used for the purpose of arbitrarily equalizing the reported income of different accounting periods. Reserves for dividend equalization have no relation to the determination of income, and such reserves should be created only by charges to earned surplus. No charge may be made thereto except for dividends or for amounts returned to earned surplus.

**APPENDIX**

**PURPOSES FOR WHICH RESERVES MAY BE PROVIDED**

1. Accelerated depreciation of facilities as a result of intensive use and of operation by less experienced personnel.
2. Accelerated obsolescence of facilities due to intensive research during the war in an effort to increase productive efficiency.
3. Amortization of the cost of rearrangement and alteration of existing facilities which will probably be rearranged in the post-war period.
4. Amortization of the cost of additional facilities acquired, the usefulness of which is expected to be substantially reduced at the termination of the war.
5. Losses which may be sustained at the end of the war in the disposal of inventories useful only for war purposes, or in the adjustment of purchase commitments then open, including any

---

1 Accounting Research Bulletin No. 8.
2 This list suggests certain costs and losses arising out of the war for which reserves must or may be provided, as discussed in this bulletin. It does not include all such costs and losses, and no attempt has been made to distinguish the items for which provision is discretionary.
Accounting for Special Reserves Arising Out of the War

amounts which may be paid for the cancellation of such commitments.

(6) Losses which may be sustained in the disposal of inventories not necessarily applicable to war production, due to decline in the price level, which, on the basis of past experience, usually follows a pronounced rise in prices.

(7) Repairs and maintenance deferred as a result of pressure for war production.

(8) Restoration or alteration of facilities to peacetime production at the end of the war, if it is reasonable to assume that such restoration or alteration will then be made.

(9) Separation allowances which may be paid to employees who are discharged at the termination of the war.

(10) Losses from destruction of property as a result of the action of armed forces or from seizure thereof by the enemy.

(11) Decline in the useful value of plant and equipment due to excess capacity resulting from war construction.

The statement entitled "Accounting for Special Reserves Arising Out of the War" was adopted by the assenting votes of twenty members of the committee. One member did not vote.

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, not 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.)
This bulletin deals with the reporting of United States Treasury Tax Notes in the balance sheet of the purchaser.

SUMMARY STATEMENT

(1) The usual procedure of showing the notes in the current asset section of the balance sheet is obviously proper, and especially should they be so shown if, at the date of the balance sheet, or at the date of the report of the independent auditor, there is evidence of intent to use the notes for other purposes or if such presentation is required under accounting definitions of applicable bond indentures or preferred stock agreements.

(2) Since the tax notes were presumably purchased with the intent that they be used for the payment of federal income and excess profits taxes, it is also good accounting practice that they be shown as a deduction from the accrued liability for such taxes in the current liability section of the balance sheet. The full amount of the accrued liability should be shown, and the tax notes should be deducted therefrom in an amount equal to their tax payment value at the balance-sheet date.

DISCUSSION

United States Treasury Tax Notes, Tax Series A-1943 and B-1943, have been authorized and issued under a “Tax Savings Plan” for the stated purpose of making it easier for taxpayers to meet the increasing taxes required by the National Defense Program. Taxpayers may purchase the notes while income is accruing for use as a medium of payment of the income and excess profits taxes subsequently falling due. The notes are issued in the name of the purchaser; they cannot be transferred or used as collateral. They may be redeemed at the purchase price on or before maturity; no advance
Notice of redemption is required as to Series A while Series B may be redeemed sixty days after date of issue on thirty days’ notice. After three months from date of issue, but not before January 1, 1942, the notes may be surrendered by the purchaser to a collector of internal revenue in payment of current or back federal income and excess profits taxes. The tax-payment value increases, beginning January 1, 1942, from month to month to maturity.

The plan under which the notes are issued is designated by the United States Treasury Department as a “Tax Savings Plan”; the purchase of such notes is, as a practical matter, a temporary investment, at a low yield, in securities which are designed to be used as tax-paying media. It is clearly proper that they be treated like any other temporary investments and that as such they be shown in the current asset section of the balance sheet.

In making the purchase it is obviously the intention of the purchaser to use the notes to pay the taxes since he receives no interest or other advantage unless the notes are so used; some purchasers will doubtless view the transaction as being, to all intents and purposes, an advance payment of the tax. On the basis of this practical aspect of the situation, and in the absence of evidence of a contrary intent, or requirements under applicable bond indentures or preferred stock agreements, it is permissible, and in accordance with good accounting practice, that the notes be shown in the current liability section of the balance sheet (to the extent of the accrued liability for such taxes) as a deduction therefrom. The full amount of the accrued liability should be shown with a deduction for the tax payment value of the notes at the date of the balance sheet.

Having purchased the notes for the purpose of discharging his tax liability, it is possible that the purchaser may, as a result of changed circumstances, decide to use the notes for other purposes. In this situation, i.e., if at the date of the balance sheet or at the date of the independent auditor’s report, there is evidence that the original intent has been changed, the notes should be shown in the current asset section of the balance sheet. In addition, the notes should be so shown if required under applicable bond indentures or preferred stock agreements.

It is a general rule of accounting that the offsetting of assets against liabilities in the balance sheet is improper and it is recognized that the purchase of the tax notes is not, technically, a payment or discharge of the tax liability. It is not intended that the permissible accounting procedure of showing the notes as a deduction from the tax liability is to be interpreted as in any way relaxing or modifying the
general rule against offsetting. However, if accounting is to be of maximum usefulness in the conduct of business, recognition must be given to the practical aspect of the situation. On this basis the purchase of the notes may be treated as in substance a prepayment of the tax. The deduction from the tax liability is permissible because of the peculiar circumstances attendant upon the purchase of the notes, and is not to be construed as warranting offset accounting in other situations.

So long as it is the intent of the purchaser to use the notes in payment of the tax they should be shown at their tax-payment value. The increment should be reflected as interest in the income statement but it is not intended that this recommendation be interpreted as in any way relaxing or modifying the general rule against recognition of income based on mere intent. Ordinarily this increment would be relatively immaterial so that the purchaser may defer recognizing it as income until the notes are applied in payment of taxes due. Where there is evidence of changed intent they should be stated at the purchase price, i.e., the surrender value.

Mr. Paton qualifies his assent with the opinion that the bulletin should state definitely that the inclusion in assets is the preferred practice and that treatment as offset to accrued tax liability is permissible only where there is clearly no danger of resulting misunderstanding with respect to financial position.

Mr. Winter dissents on the ground that he finds nothing in the present problem to warrant a departure from the generally accepted rule of accounting that the offsetting of assets against liabilities in the balance sheet is improper.

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
Accounting Research Bulletins

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

WALTER A. STAUB, Chairman
GEORGE D. BAILEY
CARMAN G. BLOUGH
ARCHIBALD BOWMAN
LESLIE J. BUCHAN
WILLIAM D. CRANSTOUN
WILLIAM EYRE
ARTHUR B. FOYE

STEPHEN GILMAN
ANSON HERRICK
HENRY A. HORNE
GEORGE O. MAY
WARREN W. NISSLEY
WILLIAM A. PATON
MAURICE E. PELOUBET
J. S. SEIDMAN

J. HAROLD STEWART
A. W. TORBET
EDWARD B. WILCOX
T. DWIGHT WILLIAMS
SIDNEY G. WINTER

JOHN L. CAREY, Secretary
This bulletin deals with financial statements of contractors or subcontractors who are affected by the provisions of the War Profits Control Act.

SUMMARY STATEMENT

In the financial statements of contractors or subcontractors who are subject to the provisions of the War Profits Control Act indication should be given of the possibility of renegotiation thereunder of government contracts or subcontracts. In some cases a reserve, shown as a deduction in the income account, may be desirable, but probably in most cases, particularly at the present stage, a footnote to the financial statements will accomplish the purpose of disclosure.

DISCUSSION

In dealing with the problem of accounting for special reserves arising out of the war the committee on accounting procedure emphasized the necessity of providing, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues. In so doing the committee recognized the limited significance of income statements prepared currently to cover comparatively short periods of time and pointed out that the tentative character of such statements is accentuated under war conditions. Various kinds of war reserves were considered and accountants were urged to encourage their establishment, not only in the interests of the business enterprise, but in the interests of the national economy as a whole. It was further suggested that the government might well give consideration to the necessity for such reserves in its fiscal policies generally, and particularly in respect of taxation.

War Profits Control Act

The tentative character of current financial statements has been further accentuated as a result of the "renegotiation" or "war profits

---

1 Accounting Research Bulletin No. 13.
control” provisions of the Sixth Supplemental National Defense Appropriation Act, 1942, approved April 28, 1942.\(^2\)

Under Sec. 403 (b) of that Act the War Department, Navy Department, and Maritime Commission are authorized and directed to insert in any contract for an amount in excess of $100,000 thereafter made:

1. a provision for renegotiation of the contract price at a period when the profits can be determined with reasonable certainty,
2. a provision for the retention or recovery by the United States of any portion of the contract price which is found to represent excessive profits, and
3. a provision requiring the contractor to insert similar provisions in each subcontract in excess of $100,000.

Under Sec. 403 (c) these departments are authorized and directed, wherever in their opinion excessive profits have been realized, or are likely to be realized from any contract with such departments or from any subcontract thereunder, to require the contractor or subcontractor to renegotiate the contract or subcontract prices and to retain or recover any portion of such prices found to represent excessive profits. Renegotiation is defined in the Act so as to include the refixing by the Secretary of the Department of the contract price. This section is applicable to all contracts and subcontracts made after April 28, 1942, and to all contracts and subcontracts theretofore made if final payment thereon was not made prior to April 28, 1942.

Under Sec. 403 (d) these departments, in renegotiating any contract or subcontract, are directed not to make any allowance for any salaries, bonuses, or other compensation in excess of a reasonable amount or for any excessive reserves set up or any costs incurred which are excessive and unreasonable.

Under Sec. 403 (e) the departments are given the right to demand of any contractor having contracts subject to the Act, statements of actual costs of production and such other financial statements at such times and in such form and detail as they may require; wilful failure or refusal to furnish such information, or knowingly furnishing of any such statement which is false or misleading in any material respect, are made penal offenses.

Under Sec. 403 (h) the foregoing provisions remain in force during the continuance of the war and for three years after its termination.

The Congress refrained from setting up standards by which the

\(^2\) See Appendix A.
The Renegotiation of War Contracts

reasonableness or excessive character of profits may be determined. There is apparently no limitation on the number of times a contractor may be required to "renegotiate" and no finality to any renegotiation except the limitation of three years after the termination of the war. There is no definition of the term subcontractor. The precise relation between price fixing under the Office of Price Administration, and renegotiation under the War Profits Control Act, is not established. The Act contemplates redetermination of cost as well as the limitation of profit, so that a corporation's estimate of profit may be subject to revision under either of these heads. Indications are that, in general, the provisions of T.D. 5000, or the "Explanation of Principles for Determination of Costs Under Government Contracts" issued by the War and Navy Departments, may be used as a guide in determining the admissibility of costs claimed by the contractor, despite their obvious limitations for profits-control purposes, though no pronouncement on this question has been made. Many elements are apparently being regarded as relevant, such as relation of profit to sales price and to invested capital, overall results, etc., and the weight assigned to different elements is not uniform.

To the difficulties heretofore existing in the determination of the costs, charges, and losses properly deductible from revenues in the income statement, there is added the difficulty that the revenues themselves are indeterminate.

Problems of Administration

It is too early to determine how the law will operate in practice. Manifestly it presents problems of great difficulty and importance to corporations and accountants. Price adjustment boards have been set up in the War and Navy Departments and in the U. S. Maritime Commission, but as yet no indications of the general policies to be followed or of the criteria of the reasonableness of profit have been made public by them. The situation will perhaps be somewhat clarified before the end of the calendar year, when it will assume major importance for accountants.

The committee proposes to reconsider the subject later in the year. In the meantime, the problem affects corporations which publish interim statements, and both corporations and their independent auditors in the case of the considerable number of companies which have fiscal years other than the calendar year. The committee believes that a preliminary bulletin is therefore opportune.
Delivery of goods sold under contract is normally regarded as the test of realization of profit or loss. This is so because in ordinary circumstances such a transaction results in a transfer of property and the profit or loss taken up is objectively determinable, with substantial accuracy.

A question may be raised whether the latter condition is fulfilled and if so, how the profit is to be measured, when the contract price is subject to renegotiation, and particularly where it is highly probable that renegotiation and readjustment will take place.

It seems clear that attribution of the profits as finally determined to the period in which contracts were performed and deliveries made is the appropriate treatment. Deferment of credit for profit until final determination under the contract would lead to artificial results and would not reflect income in accordance with the essential facts. Still more unreasonable would it be to attribute to the period of delivery profits based on the terms of the original contract and to treat readjustments of price resulting from renegotiation as a loss in the period of redetermination.

The view to be taken of contract price adjustments for tax purposes is of crucial importance. In a letter addressed to the chairman of the Naval Affairs Investigating Committee dated September 16, 1941, the Treasury Department stated its position in regard to certain refunds of excessive profits made by contractors to the United States Government. The Department's view was that the refund should be regarded as reducing the original contract price and that the necessary adjustments should be made in the taxable year or years in which the original contract price was includable in income. This ruling is manifestly sound in principle, and an equitable correlation of renegotiation and taxation, though it may not always be simple in application. It is not altogether clear that it is mandatory under existing tax laws and decisions. If the ruling is to be relied on for the purpose of obtaining such correlation, it should be established beyond question. The right to apply the results of any redetermination of contract prices to the taxable period in which the contract income, as originally determined, was reported, and to secure a refund of income and excess-profits taxes paid, should be assured to the taxpayer up to a

---

3 See Appendix B.
The Renegotiation of War Contracts
date subsequent to the completion of renegotiation notwithstanding
any statute of limitations.

Corporate reporting practice does not ordinarily contemplate
indefinite postponement of income determination for completed
fiscal periods. As a rule, the determination is made as best it can be
upon the basis of the information available within a few weeks or
months after the end of the period. Unless equitable correlation be-
tween renegotiation and taxation is positively assured, the elements
of uncertainty may under existing conditions so far outweigh the
elements capable of reasonably precise ascertainment that it might
be desirable to issue financial statements as provisional, and attach
explanations of the nature of the uncertainties which make definite
presentation impossible.

Presumably, most corporations subject to the renegotiation law
will also be subject to excess-profits taxes. If proper correlation of
renegotiation and such taxes is assured, the uncertainty in regard
to the computation of net income will be greatly mitigated.  

Renegotiation and Financial Statements

Where government contracts or subcontracts subject to the pro-
visions of the Act constitute a substantial part of the business of a
corporation, the uncertainties resulting from the possibilities of rene-
gotiation will usually be such that appropriate indication of the exist-
ence thereof should be given in the financial statements.

It is impossible to lay down general rules for the guidance of inde-
pendent accountants which could be applied satisfactorily in all
cases. Here, as elsewhere in accounting, there must be an exercise of
judgment which should be based on experience and reached upon a
clear view of the objective to be attained. That objective is to pre-
sent the fairest possible financial statements, and at the same time to
make clear uncertainties that limit the significance of such state-
ments. In some cases a reserve, shown as a deduction in the income
account, may be desirable, but probably in most cases, particularly at
the present stage, a footnote to the financial statements will accom-
plish the purpose of disclosure.

It has been suggested that correlation be obtained by inserting in the renegotiated
contracts a provision that amounts refunded to the government, or amounts by which
the original contract price is reduced, be offset by the amount of tax which the con-
tractor has paid on the overpayments made by the government, thus eliminating the
necessity of reopening income-tax returns of prior years. Par. 0412, Rewrite Bulletin,
July 1, 1942, p. 145, Commerce Clearing House 421.
APPENDIX A

RENEGOTIATION PROVISIONS OF SIXTH SUPPLEMENTAL NATIONAL DEFENSE APPROPRIATION ACT, 1942
(Public Law 528, 77th Congress, approved April 28, 1942.)

Sec. 403

(a) For the purposes of this section, the term "Department" means the War Department, the Navy Department, and the Maritime Commission, respectively; in the case of the Maritime Commission, the term "Secretary" means the Chairman of such Commission; and the terms "renegotiate" and "renegotiation" include the refixing by the Secretary of the Department of the contract price. For the purposes of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) The Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department (1) a provision for the renegotiation of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty; (2) a provision for the retention by the United States or the repayment to the United States of (A) any amount of the contract price which is found as a result of such renegotiation to represent excessive profits and (B) an amount of the contract price equal to the amount of the reduction in the contract price of any subcontract under such contract pursuant to the renegotiation of such subcontract as provided in clause (3) of this subsection; and (3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (A) a provision for the renegotiation by such Secretary and the subcontractor of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty, (B) a provision for the retention by the United States or the repayment to the United States of any amount of the contract price of the subcontract which is found as a result of such renegotiation, to represent excessive profits, and (C) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by or repaid to the United States.

(c) The Secretary of each Department is authorized and directed, whenever in his opinion excessive profits have been realized, or are likely to be realized, from any contract with such Department or from any subcontract thereunder, (1) to require the contractor or subcontractor to renegotiate the contract price, (2) to withhold from the contractor or subcontractor any amount of the contract price which is found as a result of such renegotiation to represent excessive profits,
and (3) in case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor, to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States. All amounts recovered under this subsection shall be covered into the Treasury as miscellaneous receipts. This subsection shall be applicable to all contracts and subcontracts hereafter made and to all contracts and subcontracts herebefore made, whether or not such contracts or subcontracts contain a renegotiation or recapture clause, provided that final payment pursuant to such contract or subcontract has not been made prior to the date of enactment of this Act.

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable. For the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred, each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each Department shall have the right to demand of any contractor who holds contracts with respect to which the provisions of this section are applicable in an aggregate amount in excess of $100,000, statements of actual costs of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who wilfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any such statement containing information which is false or
misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the Department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

(f) The authority and discretion herein conferred upon the Secretary of each Department, in accordance with regulations prescribed by the President for the protection of the interests of the Government, may be delegated, in whole or in part, by him to such individuals or agencies in such Department as he may designate, and he may authorize such individuals or agencies to make further delegations of such authority and discretion.

(g) If any provision of this section or the application thereof to any person or circumstance is held invalid, the remainder of the section and the application of such provision to other persons or circumstances shall not be affected thereby.

(h) This section shall remain in force during the continuance of the present war and for three years after the termination of the war, but no court proceedings brought under this section shall abate by reason of the termination of the provisions of this section.

APPENDIX B

SPECIAL RULING STATING POSITION OF THE TREASURY DEPARTMENT REGARDING REFUNDS OF EXCESS PROFITS ON WAR CONTRACTS

(Extract from a letter dated September 16, 1941 from D. W. Bell, Under Secretary of the Treasury, to Hon. Carl Vinson, Chairman, Naval Affairs Investigating Committee, House of Representatives)

Reference is made to your letter of August 21, 1941 in which you request a statement as to the position of the Department with respect to the taxation, either by income tax or gift tax, of any refund of profits made by contractors to the United States Government as a result of exorbitant profits derived from various contracts entered into by the Navy Department for the furnishing of materials and the rendering of services.

Your letter indicates that it has been claimed by at least one of these contractors that it was advised not to renegotiate its contracts and refund to the Government all profits in excess of 10 percent because by so doing it would face a tax penalty, either through paying or having paid income taxes on the profits received or through being forced to pay a gift tax on any refund.
The Renegotiation of War Contracts

It is the view of the Department that under the circumstances presented any refunds to the Government resulting from adjustments of such excessive profits serve merely to reduce the original contract price of the materials furnished and the services rendered. Accordingly, in computing income for Federal income tax purposes, the original contract price should be reduced by the amount of any refund of such excessive profits applicable thereto, provided that the original contract is modified in writing so as to indicate the reduced price. The necessary adjustment should be made in the taxable year or years in which the original contract price, with respect to which the refund is applicable, is includable in income. Only the net amount received will therefore be reflected in income.

In view of the foregoing and because the gift tax is not deemed to be applicable it is the view of the Department that any refunds made to the Government, under the circumstances described above, will not subject the contractors concerned to any tax penalty.

The statement entitled "The Renegotiation of War Contracts" was adopted by the assenting votes of eighteen members of the committee. Three members, Messrs. Torbet, Wilcox, and Winter, dissented.

Messrs. Torbet, Wilcox, and Winter agree with the conclusions set forth in the Summary Statement but object to inclusion in this bulletin of any interpretation of the War Profits Control Act and of matters relating to taxation, as being outside the sphere of this committee's activities.
While this bulletin was in process of printing, a letter from Randolph E. Paul, Assistant to the Secretary of the Treasury, to United States Senator Arthur H. Vandenberg, dated August 5, 1942, came to the committee's attention, the text of which is as follows:

Reference is made to the enclosed letter received by you from Mr. John Lovett, of the Michigan Manufacturers' Association, Detroit, Mich., dated July 27, 1942.

Mr. Lovett refers to the situation involving renegotiation of Government contracts, and suggests that there should be legislation authorizing the reopening of a taxpayer's Federal income and excess-profits tax return where subsequent to the filing of such return the taxpayer is required to repay a portion of its profits pursuant to a renegotiation.

In such case it is the position of the Bureau of Internal Revenue that under existing law the amount of such taxes may be allowed as a credit or offset against the taxpayer's liability for repayment of excessive profits. The Bureau will advise the War Department, Navy Department, or Maritime Commission, as the case may be, of the amount of such taxes attributable to the amount of any excessive profits to be repaid pursuant to a renegotiation arrangement. Such Departments and Commission plan, so I am informed, to allow such taxes as a credit or offset against the liability for repayment of excessive profits. For example, if the excessive profits amount to $100,000 and the taxpayer has paid a tax thereon of $40,000, the Department conducting the renegotiation will require the contractor to pay into the Treasury only the net amount of $60,000. Under these circumstances the taxpayer will in effect secure the relief which Mr. Lovett has in mind, and it will not be necessary to reopen the tax return. In any case where deemed necessary, a closing agreement under the provisions of section 3760 of the Internal Revenue Code may be entered into for the purpose of definitely fixing the method of treatment for tax purposes. Such agreement will, of course, be binding both upon the taxpayer and the Bureau. Accordingly, it is believed that this procedure will afford the taxpayer adequate relief without legislation. It will provide a more flexible procedure, readily adaptable to variations in specific cases, than would be afforded by rigid statutory rules.

The subject matter of the letter will require study, and any conclusions reached by the committee will be included in any further bulletin which may be issued later in the year (see page 125 of this bulletin). Attention is also called to footnote 4 on page 127 hereof.
The Renegotiation of War Contracts

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.)
FOREWORD

THE 1942 ANNUAL REPORT of the committee on terminology deals with "depreciation" and is presented herewith. The committee on accounting procedure has authorized publication of this report as an accounting research bulletin, but it should not be regarded as a formal pronouncement of that committee. The research department and the committee on terminology will welcome suggestions and comments on the contents of this report from members of the Institute and others.

REPORT OF THE COMMITTEE ON TERMINOLOGY
ANNUAL REPORT, 1942

TO THE COUNCIL OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

DEPRECIATION

Pursuing its policy of discussing terms used in accounting in specialized senses, the committee on terminology in this report considers the word "depreciation."

It must be admitted that the use of the term in accounting is unsatisfactory, since it is applied in its normal sense to some assets, such as marketable securities, and in a specialized sense to others, such as fixed-capital assets. Moreover, the specialized sense differs not only from the colloquial sense but also from the sense in which the term is used in engineering, and is far removed from the root-meaning of the word itself. Therefore, if reluctance to accept temporary inconvenience in order to achieve permanent clarification stands in the way of the substitution of a more descriptive term, it may be said that the profession at least owes it to the public to define with reasonable precision and clarity the meaning of the word when used as a term of art in accounting.
This seems the more desirable in that the concept of depreciation, which in recent years has won increasing acceptance from the courts and commissions, is essentially the concept which has long been upheld by the accounting profession, often against strong opposition. Today all accountants and many laymen know in a general way what depreciation means in accounting for fixed assets, but there is no authoritative pronouncement from which the public can ascertain what is implied when an accountant says that, in his opinion, “a reasonable allowance for depreciation has been made.”

The committee does not submit such a definition but offers suggestions as to the form which it might take and invites comments and criticisms from members of the Institute and others interested.

Published Definitions

As a preliminary it may be helpful to cite a number of recent American definitions. The following have been selected, and are given here rather than in an appendix because they will serve to illustrate the points which will arise in the later discussion. A single English definition has been added:

1. Webster’s New International Dictionary (1940):
“Depreciation charge: (Accounting). An annual charge to cover depreciation and obsolescence, usually in the form of a percentage, fixed in advance, of the cost of the property depreciated.” [The rest of the definition deals with methods.]

2. United States Supreme Court, in Lindheimer v. Illinois Bell Telephone Company, 292 U. S. 151 (1934):
“Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence. Annual depreciation is the loss which takes place in a year.”

3. National Association of Railroad and Utilities Commissioners, Report of Special Committee on Depreciation, “Depreciation Principles and Methods” (1938), pp. 8–10:
“. . . depreciation, as applied to depreciable utility plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of utility plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in some cases, the exhaustion of natural resources.”

136
Service value in turn is defined as "the difference between the original cost and the net salvage value of utility plant . . ."

"Sec. 19.23 (1)—1. Depreciation: A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep."

5. Robert H. Montgomery, Auditing Theory and Practice (1940), page 477:
"To accountants fixed assets represent an investment in physical property, the cost of which, less salvage, must be charged to operations over the period of the useful life of such property. Hence, fixed assets are really in the nature of special deferred charges of relatively long service life, the absorption of which is called by the distinctive name ‘depreciation.’"

6. W. A. Paton, Essentials of Accounting (1938), page 530:
"‘Depreciation’ has come to be used particularly to designate the expiration of the cost or value of buildings and equipment in the course of business operation. . . ."

7. Dawson’s Accountant’s Compendium, London (1930), page 174:
"Depreciation: The term is used in accountancy to represent the shrinkage in cost price or value of any particular property, buildings, machinery, plant, etc., (1) arising from wear, tear, and breakages as a consequence of its employment in trading or for manufacturing purposes; (2) by mere effluxion of time; (3) by becoming unsuitable for the required purpose whether from obsolescence or otherwise; or (4) from any other cause."

Collectively, these definitions clearly show that in accounting for tangible fixed assets, depreciation is used in a specialized sense and not to describe downward changes of value regardless of their causes. This fact is sometimes obscured by the use of the word "value" in definitions; upon this point reference may be made to the discussion of the
accounting uses of the word “value” at pages 75–76 of Accounting Research Bulletin No. 9.

These definitions treat depreciation, broadly speaking, as a money cost or loss due to exhaustion of usefulness. The term is sometimes used to describe the exhaustion itself; however, it seems desirable to emphasize the money-cost or loss concept as the primary if not the sole accounting meaning of the term. “Depreciation” corresponds to “wages” rather than to “labor.”

Some if not all of the definitions also recognize that the whole cost of exhaustion of usefulness is not included within the term “depreciation.” However, there is not complete unanimity as to what should be excluded.

Exhaustion is constantly being restored in part as well as retarded by current maintenance, and it is generally recognized that in defining depreciation there must be an exclusion from the costs or losses from exhaustion in respect of costs chargeable to maintenance. Immediately, a question arises whether the exclusion should be the cost of exhaustion which is, in fact, restored by current maintenance, or the cost of the exhaustion which would be restored by adherence to an established standard of maintenance. The definitions of the Supreme Court and the National Association of Railroad and Utilities Commissioners accept the former alternative, and the Treasury definition, while not explicit, is apparently similar in intent. However, depreciation schemes are normally formulated on the basis of assuming a standard of maintenance, and charges thereunder are not as a rule varied as maintenance rises or falls.

It is probably correct to say that if in a single period maintenance is either materially above or materially below the standard assumed in formulating the depreciation scheme, the excess or deficiency should be treated in accounting as outside the scope of depreciation, but that a change of maintenance policy or of a classification of maintenance charges would call for the reconsideration of the depreciation scheme.

**Causes of Exhaustion**

Exhaustion of usefulness may result from causes of materially different character, some physical, others functional and others possibly financial, some operating gradually, others suddenly. The Supreme Court’s definition of depreciation includes the words “all the factors causing the ultimate retirement of the property.” It, however, lists these factors and those mentioned are all gradual in operation. The Treasury’s list of factors is similarly restricted. The NARUC definition is in terms more comprehensive but introduces a new exception. It
includes “causes which are known to be in current operation and against which the utility is not protected by insurance.”

Turning to consideration of the causes specifically enumerated in these three definitions—wear and tear, decay, inadequacy, and obsolescence are included in all three, though the Treasury speaks only of “obsolescence due to the normal progress of the art.” The Supreme Court and the Treasury recognize no other causes, but the NARUC adds “action of the elements,” “changes in the art,” “changes in demand,” and “requirements of public authorities.”

Action of the elements may be either gradual or sudden, and the NARUC definition, by including losses from premature retirements due to storms, fires and floods if not covered by insurance, seems clearly to extend the concept of depreciation from one of a long-term deferred charge (see definition 5) to something more in the nature of self-insurance. Such an extension of the scope of depreciation would seem to be more justifiable if the term is considered in relation to a group of properties collectively than if it is applied to relatively small separate units of property. In respect of a group of units as an aggregate, the losses from such causes over a period of years may be reasonably foreseeable, while in the case of single units they are not. However, the inclusion under depreciation of losses due to sudden and violent action of the elements may be questioned especially by those who oppose attempts to smooth out reported profits artificially.

“Changes in the art” may be regarded as one cause of obsolescence, and the inclusion of these words in the definition as a redundancy. “Changes in demand” is more inclusive than “inadequacy.” It would presumably cover the losses due to superfluity of capacity, which seems likely to become of even greater importance than inadequacy in the post-war period. “Requirements of public authorities” may perhaps be regarded as an inclusion deemed particularly applicable to utilities and not necessarily relevant to private industrial operations.

In industrial accounting, depreciation conforms more closely to the definitions of the Supreme Court and the Treasury than to that of the NARUC. The costs or losses in this field which provisions are designed to cover are generally limited to those which are not restorable by current maintenance and are (a) gradual in their nature, (b) due to physical or functional causes, and (c) reasonably foreseeable.

Exhaustion of Useful Life—Unprofitability

Whether the meaning of the term is broad enough or should be broadened so as to include losses due to causes of a financial character is a question of present importance. Certainly the probabilities as to
Accounting Research Bulletins

post-war earning capacity should be taken into account in determining what should be deducted from sales or revenues in respect of war plants in determining profits during the war period as well as in fixing the value of the plants when the war is ended. It may be questioned, however, whether the term "depreciation" would be interpreted so as to include this element in the absence of clear language in the governing law or contract.

The question whether depreciation as an accounting term should in normal times be so interpreted as to include a decline in profitability to a subnormal standard such as has occurred in relation to much railroad property is one of great theoretical interest and does not seem to have been adequately discussed. Some accounting authorities hold that property which has become worthless should have been written off against gross revenue at or before the time when it became worthless. Furthermore, it is being increasingly emphasized that worth, apart from salvage value, depends mainly on future earning capacity. Since the object of an enterprise is to make profits, it may be argued that it is illogical and erroneous to write off property which is still earning profits, though of an obsolete type, but not to write off property that though up-to-date in type is not earning profit and is not likely to do so. However, if this kind of loss is to be provided for it should perhaps be under some other head than depreciation.

Accounting and Engineering Usages

The point is interesting because of its bearing on the relation between accounting and engineering concepts of depreciation. It is quite clear that the two professions use the word in materially different senses, though in neither case have the senses been clearly defined. In the engineering field, for instance, observed depreciation and depreciation computed on the basis of comparison with the most efficient substitute differ as much from one another as from the accounting concept.

The broad distinction between the senses in which the word is used in the two professions is, no doubt, that the accounting concept is one of systematic amortization of cost (or other initial basis) over the period of useful life, while the engineering approach is one of valuation. It is perhaps true to say that the accounting use of the term is not greatly concerned with the extent of the usefulness from time to time so long as usefulness continues, while the extent is a major factor in engineering concepts of depreciation.

Whether it is correct to say, as the NARUC definition suggests, that the accounting use contemplates something in the nature of a self-
insurance premium for future accidental losses may be an arguable question.

Accountants have long recognized that the word is ill-adapted to the use made of it in accounting for fixed assets and have sought to bring about the use of more descriptive language. This was done, for instance, in the framing of the income-tax laws of 1916 and 1918. In 1916, the word “depreciation” which had appeared in the 1909 and 1913 Acts was discarded and there was substituted a phrase, which, with an addition to provide explicitly for the inclusion of obsolescence, became in 1918 and has since remained “a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.” However Treasury Regulations still speak of the allowance “for convenience” as one of depreciation. Possibly the effort at clarification might have been more successful if the deduction had been defined as being for the “amortization of the cost or other tax basis of property used in the trade or business over its useful life, estimated with due regard for obsolescence.” It might now be well for the Institute to put forward a definition of depreciation framed in some such terms and accompanied by a statement that the word is a term of art in the profession with a sense differing materially from both colloquial and engineering usages.

Depreciation—A Loss or a Cost

The terms “loss” and “cost” have different significances in accounting, and “depreciation” as now conceived would seem to be a cost rather than a loss (see definition 6). Yet the NARUC, though in its report it speaks of depreciation as a cost of operation (page 8) uses the word “loss” in its definition. By so doing and by use of the expression “service value” it tends to obscure the fact that depreciation is not a valuation figure, though elsewhere in its report it emphasizes this fact. Similar criticisms apply to other definitions that have been published.

Allocation

If it is agreed that depreciation is a cost, to be allocated to a number of accounting periods, the question remains upon what principle is the allocation to be made? Here, the line between definition and accounting procedure is approached.

The various methods of computing depreciation in use obviously rest on materially different basic assumptions. The fact that methods are employed which produce as widely different allocations as (a) the

\[ \text{1See The Journal of Accountancy, Vol. XLIX (March, 1930), page 165.} \]
diminishing balance method; (b) the sinking-fund method; and (c) a unit-cost method, emphasizes the truth that the allocation bears no close relation to changes in value and does not attempt to measure the exhaustion which actually takes place within a given period—an important truth that is not always fully understood. All that the various methods have in common (which is all that could be embodied in a definition) is that they are designed to distribute the estimated total depreciation incurred or to be incurred during the useful life of a unit or group of units over that life in a systematic and equitable manner.

Depreciation and Replacement

It may be desirable to point out that depreciation is only indirectly related to replacement. It contemplates the amortization of the cost of existing property—not anticipation of the cost of replacing it as a replacement reserve might do. Whatever may be the merits of these two approaches to the determination of the proper charges to operations in respect of property which has a limited life and must be replaced if operations are to continue, it must be recognized that they differ. In one case changes in price levels are reflected in the new capital-asset account; in the other, they are reflected in operating charges.

Expiration

As some of the definitions above quoted indicate, such terms as “expired cost” and “expired outlay” are sometimes employed in defining depreciation. These terms seem inapt and likely to confuse. Costs and outlays do not expire though the benefits which they produce do, and expiration is a sudden event whereas gradualness is the essential quality of depreciation.

Conclusion

The sort of definitions to which the considerations herein set forth seem to lead would be somewhat as follows:

Depreciation is used as a term of art in accounting to describe a cost to an accounting unit inherent in the use of instruments of production, such as buildings, machinery, etc. It includes generally so much of the cost arising from the gradual exhaustion of physical or functional usefulness of such property as is reasonably foreseeable and is not restorable through current maintenance. It includes the cost of exhaustion due to wear and tear, decay, obsolescence, inadequacy, and superfluity (and possibly requirements of public authorities). It may also include exhaustion due to violent action of the elements, or to accidents which cause
Report of Committee on Terminology

premature retirement, where it is applied to groups of units large enough to make such losses over a period of years reasonably foreseeable. It does not include losses which may result from unforeseeable or abnormal causes.

The term may be used to describe either an accumulated cost or the cost allocated to an accounting period in accordance with accepted accounting procedures. Variations in methods of allocation are permitted by good accounting practice but any method to be acceptable must provide for the distribution of the estimated total depreciation cost during the useful life of the property to which the amount relates, over accounting periods in a systematic and equitable manner.

Depreciation is always closely related to a maintenance policy that is assumed to be in force in respect of the property to which it relates. It may also be affected by the policies pursued in respect of insurance, where it is so applied to cover losses against which insurance is or might be carried.

Respectfully submitted,

GEORGE O. MAY, Chairman
WILLIAM D. CRANSTOUN
WALTER A. STAUB

September 28, 1942
Post-War Refund of Excess-Profits Tax

This Bulletin deals with the reporting, in financial statements, of the post-war refund of excess-profits tax provided for in section 250 of the Revenue Act of 1942.

SUMMARY STATEMENT

(1) In the balance sheet the amount of excess-profits tax payable (without deduction for the so-called post-war credit provided by section 780 (a), as limited by section 783 (c) of the Internal Revenue Code, which sections were added by section 250 of the Revenue Act of 1942) should be shown as an accrued liability in the current liability section; the amount of such post-war credit, representing the right to receive government bonds or the par value of government bonds received therefor, should be shown, at least as long as they remain non-negotiable, as a non-current asset.

(2) In the income statement, effect should be given to the full amount of excess-profits tax, the amount of the post-war credit under section 780 (a), and the amount of the debt-retirement credit under section 783, if any, with appropriate disclosure as to each such amount.

(3) If it is desired to utilize the amount of the post-war credit as, in effect, a reserve for post-war contingencies, this result should be accomplished by separate action under rules relative to such reserves set forth in Accounting Research Bulletin No. 13.

DISCUSSION

Under section 250 of the Revenue Act of 1942 (adding sections 780-783 to the Internal Revenue Code) the Secretary of the Treasury is authorized and directed to establish a credit (hereinafter referred to as the post-war credit) to the account of each taxpayer for each taxable year ending after December 31, 1941 (except in the case of a taxable year beginning in 1941 and ending before July 1, 1942), and not be-
Accounting Research Bulletins

ginning after the cessation of hostilities, in an amount equal to 10 per
cent (subject to limitation in 1942 in the case of certain fiscal year com-
panies) of the taxpayer’s excess-profits tax. This credit is to be applied
to the purchase of bonds issued under authority of the Second Liberty
Bond Act.

The bonds bear no interest; they are not negotiable or transferable
by sale, exchange, assignment, pledge, hypothecation or otherwise
before the end of the war. After the date of cessation of the war the
bonds will be negotiable and transferable and will be redeemable at
the option of the United States. The bonds mature in from two to five
years after the termination of the war, depending upon the taxable
year in which they were acquired.

Under section 783, the taxpayer may currently take a credit (here-
inafter referred to as the debt-retirement credit), subject to certain
limitations as to amount, against current excess-profits taxes for in-
debtedness retired during the taxable year, and to the extent that
such debt-retirement credit is taken, the post-war credit is corre-
spondingly reduced.

In its report on the Revenue Bill of 1942 the Senate Finance Com-
mittee indicated that these provisions were deemed desirable “in
order to encourage efficient and economical corporate management
under the stress of war economy and to provide a fund that will be
available for the conversion of production facilities after the war to
peacetime demands,” thus implying that the 10 per cent credit con-
stitutes a partial return of excess-profits tax to the corporation. The
credit is referred to as a “refund” of excess-profits taxes to be made
after the war. The Finance Committee further explains that the debt-
retirement credit makes it possible for taxpayers with heavy tax com-
mittments to “use their post-war credit currently rather than wait until
the termination of the war to meet such commitments.”

The basic question is whether the post-war credit should be cur-
rently recognized in the income statement as reducing the amount of
excess-profits tax properly chargeable in the current period or whether
recognition should be deferred to the accounting period in which the
bonds become negotiable or in which they mature.

In support of the latter alternative it may be urged that the full
amount of the excess-profits tax must be paid now; that no funds will
be or can in any way be made available until the post-war period; and
that the time when the bonds will become negotiable or mature is un-
certain and the amount of credit should not, therefore, be treated as an
asset in its full amount if at all.

It is recognized that the last-mentioned argument has some theo-
Post-War Refund of Excess-Profits Tax

retical validity. However, the same argument might be applied to other assets which it is not customary to discount; and since the discount in this case would be relatively small, the committee does not believe that a meticulous insistence on this point is desirable. The committee does not believe that the uncertainties of the post-war period warrant deferment. These uncertainties should as far as possible be taken care of under the rules of Accounting Research Bulletin No. 13. Clearly, the needed reserves will vary in different cases.

While the full amount of the excess-profits tax is presently payable and therefore must be shown as a current liability, the post-war credit is currently determinable and unconditional as to its ultimate use. The argument for reflecting it currently in the income account is strengthened by the fact that taxpayers are given the credit currently for debt retirement.

Balance-sheet Presentation

The amount of excess-profits tax presently payable should be shown as a current liability in the balance sheet since it is an obligation requiring cash payments within a short period of time. In arriving at that amount the debt-retirement credit may be deducted from the gross amount of the tax but no deduction is permissible for the post-war credit. The amount of the latter, representing government bonds at par, or the right to receive such bonds, should manifestly be shown as a non-current asset at least so long as the bonds remain non-negotiable.

Income-statement Presentation

Effect should be given in the income statement to the gross amount of the excess-profits tax, the debt-retirement credit, if any, and the post-war credit, with adequate disclosure as to the amount of each, in order that such statement may be reasonably informative. No single rule can be established as to what constitutes adequate disclosure under the circumstances of various cases. Ordinarily a showing of the gross amount of the tax with a deduction for credits will be satisfactory; if the net amount of tax payable is shown in the statement, disclosure may take the form of a footnote. Where the post-war credit is substantial in relation to what net income would be if no such credit were allowable, it may be useful to show income after taxes but before the credit and to add the credit before arriving at the final balance transferred to earned surplus. The precise method of disclosure is left to the exercise of judgment by the corporation and the independent auditor on the basis of the surrounding circumstances.
The statement entitled "Post-War Refund of Excess-Profits Tax" was adopted by the assenting votes of twenty members of the committee. One member, Mr. Towns, dissented.

Mr. Towns dissents on the ground that it would be more appropriate to have the credit made to deferred income than to the income account or to surplus, since the asset cannot be sold, used in the business, or used as collateral for two years or more.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE

WALTER A. STAUB, Chairman
GEORGE D. BAILEY
ARCHIBALD BOWMAN
WILLIAM D. CRANSTOUN
WILLIAM EYRE
STEPHEN GILMAN
ANSON HERRICK
HENRY A. HORNE

PAUL K. KNIGHT
EDWARD A. KRACKE
GEORGE O. MAY
WARREN W. NISSELY
WILLIAM A. PATON
MAURICE E. PELOUBET
HIRAM T. SCOVILL
FRANCIS SMALL

JACKSON W. SMART
CHARLES H. TOWNS
EDWARD B. WILCOX
T. DWIGHT WILLIAMS
SIDNEY G. WINTER

JOHN L. CAREY, Secretary
This bulletin supplements Bulletin No. 2 as to the treatment of the unamortized discount and issue cost and the redemption premium on bonds refunded (hereinafter referred to as unamortized discount).

SUMMARY STATEMENT

Where unamortized discount on bonds refunded is written off in full in the year of refunding, it is sound accounting to show such charges as a deduction in the income statement in the year of refunding in harmony with the treatment required for income tax purposes. Where any write-off is made through surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise, and there should be shown as a deduction (as hereinafter described) in the income statement for the year of refunding an amount at least equal to such reduction in current taxes.

If the alternative of spreading unamortized discount over a future period is adopted, a charge should be made (as hereinafter described) in the income statement in the year of refunding equal to the reduction in current income tax resulting from the refunding.

DISCUSSION

In Bulletin No. 2 the committee approved alternative treatments of unamortized discount and issue cost and redemption premium on bonds refunded. One alternative was an immediate write-off by a charge in the income statement or to earned surplus.

In Bulletin No. 8 in which the committee pointed out the advantages of a combined statement of income and surplus, it said: "It (the committee) does not here undertake to define proper charges against earned surplus. . . . It approves the current tendency to discourage such charges wherever possible."

A decision to write off the unamortized discount in the year of refunding is based upon the view that these items represent a cost, the benefit from which has expired during the year, or a loss sustained.
Accounting Research Bulletins

Such costs or losses are normally shown as deductions in the income statement.

Unamortized discount is deductible for tax purposes in the year in which refunding takes place and in no other year. If rates are high, charging the entire unamortized discount to surplus and the reduced income tax to income may result in serious distortion.

The committee believes that where the alternative of immediate write-off is accepted, the preferable course will in many cases be to make the charge in the income statement, but that in all cases there should be charged in the income statement (as hereinafter described and in addition to any amount of regular amortization) an amount at least equal to the reduction of current taxes to which the refunding gives rise—otherwise, the anomalous result would be produced that a loss recognized as such would have the effect of increasing the net income reported for the year.

Under the other alternative, the amount of the unamortized discount is regarded not as a realized loss but as a cost which produces a continuing benefit and which should be carried forward and spread over a future period.\(^1\) However, in this case also the reduction in current income taxes resulting from the allowance of these items as a tax deduction is a material fact (unless the amount is relatively insignificant). Accordingly, where this approach is adopted, the committee believes that there should be deducted (as hereinafter described and in addition to any amount of regular amortization) in the income statement of the year of refunding an amount equal to the reduction in current income tax resulting from the refunding, and to treat only the balance as the portion of the cost which is apportionable over a future period.

One method of accomplishing the result required by the two preceding paragraphs would be to charge a portion of the unamortized discount equal in amount to the reduction of income tax, in the income statement of the period in which the benefit of tax reduction is reflected. Another method would be to create a reserve for future taxes by a charge in the income statement equal in amount to such tax reduction. The second method (which is based on recognition of the fact that the immediate reduction of tax is effected only at the price of the loss of a future deduction in respect of a cost which is still carried on the books and will be chargeable to income in future years) has considerable theoretical justification, but the first is simpler and has the sanction of a number of regulatory bodies.

\(^1\) Accounting Research Bulletin No. 2, pp. 15–16.
Unamortized Discount and Redemption Premium on Bonds Refunded

The statement entitled "Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)" was adopted by the assenting votes of fifteen members of the committee, as it was constituted at the time of the 1942 annual meeting of the Institute. Three members, Messrs. Gilman, Seidman, and Torbet, dissented. Three members did not vote.

The dissenting members point out that the situation covered in this bulletin is only one of many instances in which accounting for general corporate purposes may differ from accounting for income taxes, and they, therefore, feel that there is no justification for singling out unamortized discount for special consideration. They are of the opinion that adjustment should not be made in the income statement to reflect differences between corporate and tax accounting, because the income for the period would thereby be misstated; that reference to such differences by a footnote would ordinarily constitute adequate disclosure.

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. 7, 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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1941-1942)

WALTER A. STAUB, Chairman
GEORGE D. BAILEY
CARMAN G. BLOUGH
ARCHIBALD BOWMAN
LESLIE J. BUCHAN
WILLIAM D. CRANSTOUN
WILLIAM EYRE
ARTHUR B. FOYE

STEPHEN GILMAN
ANSON HERRICK
HENRY A. HORNE
GEORGE O. MAY
WARREN W. NISSLEY
WILLIAM A. PATON
MAURICE E. PELOUBET
J. S. SEIDMAN

J. HAROLD STEWART
A. W. TORBET
EDWARD B. WILCOX
T. DWIGHT WILLIAMS
SIDNEY G. WINTER

JOHN L. CAREY, Secretary

153
This Bulletin deals with accounting problems arising under cost-plus-fixed-fee contracts, hereinafter referred to as CPFF contracts.¹

SUMMARY STATEMENT

(1) Fees under CPFF contracts may be credited to income on the basis of such measurement of partial performance as will reflect reasonably assured realization. One generally acceptable basis is delivery of completed articles. The fees may also be accrued as they are billable, under the terms of the agreement, unless such accrual is not reasonably related to the proportionate performance of the aggregate work or services to be performed by the contractor from inception to completion.

(2) Where CPFF contracts involve the manufacture and delivery of products, the aggregate amount of reimbursable costs and fee is ordinarily included in appropriate sales or other revenue accounts. Where such contracts involve only services, or services and the supplemental erection of facilities, only the fee should ordinarily be included in revenues.

(3) Unbilled costs and fee under such contracts are ordinarily receivables rather than advances or inventory, but should preferably be shown separately from billed accounts receivable.

(4) Offsetting of government advances on CPFF contracts against amounts due from the government on such contracts is permissible only to the extent that such items may under the terms of the agreement be offset in settlement, but a more desirable procedure in most cases will be to offset the advance against the receivable only if that is the treatment anticipated in the normal course of business transactions under the contract. In case of offset, the amounts offset should be adequately disclosed.

¹The discussion herein is subject to such modification as may be required under censorship rules. See, for instance, statement of War Department, Bureau of Public Relations, October 28, 1942.
Procurement of war matériel is being extensively effected by the use of CPFF contracts (a) for the manufacture and delivery of various products, (b) for the construction of plants and other facilities and (c) for management and other services. Under these agreements the contractors are reimbursed at frequent intervals for their expenditures and in addition are paid a specified fixed fee. Payments on account of fee (less 10% which is withheld until completion) are made from time to time as specified in the agreement, usually subject to the approval of the contracting officer. In most cases the amount of such payments is, as a practical matter, determined by the ratio of expenditures made to the total estimated expenditures rather than on the basis of deliveries or on the percentage of completion otherwise determined.

The agreements provide that title to all material applicable thereto vests in the government as soon as the contractor is reimbursed for his expenditures or, in some cases, immediately upon its receipt by the contractor at his plant even though not yet paid for. The contractor has a custodianship responsibility for these materials, but the government has property accountability officers at the plant to safeguard government interests.

The contracts are subject to cancellation and termination by the government, in which event the contractor is entitled to reimbursement for all expenditures made and an equitable portion of the fixed fee.

The government frequently makes advances of cash as a revolving fund or against the final payments due under the agreement.

There are a large number of CPFF contracts now in effect. Additional contracts are being made from time to time. The method of compensating the contractor and the financial and other relationships between the contractor and the government under most of these contracts are generally similar. It is manifestly desirable that the results of such contracts should be reflected in the financial statements of contractors with such degree of uniformity as may be practicable in view of the terms of agreements or surrounding circumstances. The committee believes, therefore, that a research bulletin on this subject will serve a useful purpose.

Major Accounting Problems

There are a number of basic accounting problems common to all CPFF contracts. This bulletin deals with four problems which appear to be the most important, as follows:
Accounting Under Cost-Plus-Fixed-Fee Contracts

(1) When should fees under such contracts be reflected in the contractor's income statement?

(2) What amounts are to be included in sales or revenue accounts?

(3) What is the proper balance-sheet classification of unbilled costs and fee?

(4) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

1. When should fees under such contracts be reflected in the contractor's income statement?

This committee has heretofore stated that income is a realized gain and in accounting it is recognized, recorded and stated in accordance with certain principles as to time and amount; that profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that the collection of the sales price is not reasonably assured; that delivery of goods sold under contract is normally regarded as the test of realization of profit or loss.

In the case of manufacturing, construction or service contracts, profits are not ordinarily recognized until the right to full payment has become unconditional, i.e., when the product has been delivered and accepted, when the facilities are completed and accepted, or when the services have been fully and satisfactorily rendered. This accounting procedure has stood the test of experience and should not be departed from except for cogent reasons.

It is, however, a generally accepted accounting procedure to accrue revenues under certain types of contracts, and thereby recognize profits, on the basis of partial performance, where the circumstances are such that aggregate profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro rata recognition of profit as the work progresses, if the total profit and the ratio of performance to date to complete performance can be reasonably computed and collection is reasonably assured. Depending upon the circumstances such partial performance may be established by deliveries, expenditures or percentage of completion otherwise determined. This rule is frequently applied to long-term construction and other similar contracts; it is also applied in the case of contracts involving deliveries in installments or the performance of services. However, the rule should be dealt

---

2 Accounting Research Bulletin No. 11.
3 Accounting Research Bulletin No. 1.
4 Accounting Research Bulletin No. 15
with cautiously and not applied in the case of partial deliveries and uncompleted contracts, where the information available does not clearly indicate that a partial profit has been realized after making provision for possible losses and contingencies.

CPFF contracts fall within the basic principles of both the foregoing procedures, and have characteristics of both. The risk of loss is practically negligible, the total profit is definite, and the contractor is performing his obligations since, even on cancellation, pro rata profit is still assured. CPFF contracts are quite like the type of contracts upon which profit has heretofore been recognized on partial performance, and accordingly have at least as much justification for accrual of fee before final delivery as those cited.

The basic problem in dealing with CPFF contracts is the measure of partial performance, i.e., whether revenues thereunder should be accrued under the established rules as to partial deliveries or percentage of completion otherwise determined, or whether, in view of their peculiar terms with respect to part payments, the objective determination of amounts billable by continuous government approval, and the minimum of risk carried by the contractor, the fee should be accrued as it is billable.

Ordinarily it is permissible to accrue the fee as it becomes billable. The outstanding characteristic of CPFF contracts is reimbursement for all proper costs and the payment of a fixed fee for the contractor's efforts. Delivery of the finished product may not have its usual legal significance because title passes to the government prior thereto and the contractor's right to partial payment becomes unconditional in advance thereof; deliveries are not necessarily, under the terms of the agreement, evidence of the progress of the work or the contractor's performance. Amounts billable indicate reasonably assured realization, subject to renegotiation, because of the absence of a credit problem and minimum risk of loss involved. The fee appears to be earned when allowable costs are incurred or paid and the fee is billable. Finally, accrual on the basis of amounts billable is ordinarily not a departure from existing rules of accrual on the basis of partial performance, but rather a distinctive application of the rule for determining percentage of completion.

While it is permissible to accrue the fee as it becomes billable, judgment must be exercised, in the circumstances of each case, as to whether such method of accrual is preferable to those of the usual rules of delivery or of percentage of completion otherwise determined. While

---

*Accounting Research Bulletin No. 15.
Accounting Under Cost-Plus-Fixed-Fee Contracts

the approval of the government as to amounts billable would ordinarily be regarded as objective evidence, factors may exist which suggest an earlier or later accrual. Such factors would include the indications of substantial difference between the estimated and final cost so that available data should be examined; preparatory or tooling-up costs may have been much more than estimated; raw material needs may have been greatly and unduly anticipated by advance purchases, or delays in delivery schedules or other evidence may suggest that costs are exceeding estimates. While such factors are normally considered by the government and in case of serious doubt, billings for fees may be temporarily adjusted to safeguard against too early proportionate payment, consideration of such factors of doubt cannot be left entirely to the government, particularly when any substantial lag exists between expenditures and billings and audit thereof. In such cases, the presumption may be that the fee will not be found to be billable, when presented, and conservatism in accrual will be necessary. In some cases, excess costs may be indicated to such an extent that accrual of fee before actual production would appear unwise. In such cases the usual rule of deliveries or percentage of completion may be a more appropriate method of accruing fees.

There are further questions as to whether the fee may be accrued as it is billed rather than as it becomes billable and whether accrual should be on the basis of the full fee or 90% thereof. As to the first question, it seems obvious that when accrual in relation to expenditures is otherwise suitable, it should be on the basis of amounts billable since delays in billing, largely due to the clerical processes involved, should not affect the income statement. As to the second question, accrual on the basis of 100% of the fee is ordinarily preferable since, while the payment of the balance depends on complete performance, such completion is to be expected under ordinary circumstances. Care must be exercised, of course, to provide for possible non-realization where there is doubt as to the collection of claimed costs or of fee thereon.

2. What amounts are to be included in sales or revenue accounts?

This problem is whether sales or revenue as reported in the income statement should include reimbursable costs and the fee, or the fee alone. To a great extent the answer to this question depends upon the terms of the contract and upon judgment as to which method gives the more useful information.

Some CPFF contracts are obviously service contracts, under which the contractor acts solely in an agency capacity, whether in the erection of facilities or the management of operations. These would appear
to call for inclusion in the income statement of the fee alone. In the case of supply contracts, however, the contractor is more than an agent. For instance, he is responsible to creditors for materials and services purchased; he is responsible to employees for salaries and wages; he uses his own facilities in carrying out his agreement; his position in many respects is that of an ordinary principal. In view of these facts, and the desirability of indicating the volume of his activities, it would appear desirable to include reimbursable costs in sales or revenues during the accounting period in which the fee is reflected in the income statement.

3. **What is the proper balance-sheet classification of unbilled costs and fee?**

The principal reason for unbilled costs at any date is the time usually required, after the receipt of material or the incurring of expenditure for labor, etc., for assembly of the data for billing. The right to bill usually exists upon expenditure or accrual, and that right is unquestionably a receivable rather than an advance or inventory. Nevertheless, there is some difference in character between billed items and unbilled costs and a distinction should be made between them on the balance sheet.

4. **What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?**

In statements of current assets and liabilities, amounts due to and from the same person are ordinarily offset where, under the law, they may be offset in the process of settlement, i.e., collection or payment. On the other hand, advances received on contracts are usually shown as liabilities unless the amounts are definitely regarded as payments on account of contract work in progress, in which event they are often shown as a deduction from the related asset. The question is therefore presented whether various items, debit and credit, identified with CPFF contracts may be offset where the same person, the government, is the debtor and creditor in each case. Clearly, under the practice of offsetting accounts due to and from the same person, the advance by the government on a CPFF contract may properly be offset against the amount due from the government on that contract. On the other hand, the funds received through the advance usually constitute a revolving fund, and it is not until performance of the latter part of the contract that the advance becomes a partial payment. In such circumstances, it would seem to be a more desirable procedure in most cases to follow the normal course of the business transaction and to offset the advance
Accounting Under Cost-Plus-Fixed-Fee Contracts

against the account only when that is the anticipated business treatment. In any case, amounts offset should be clearly disclosed.

The statement entitled “Accounting Under Cost-Plus-Fixed-Fee Contracts” was adopted by the assenting votes of twenty members of the committee. One member did not vote.

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.)
FOREWORD

The 1943 annual report of the committee on terminology continues the discussion of "depreciation" which was commenced in the 1942 report. The committee on accounting procedure has approved the definition suggested by the committee on terminology and has authorized the publication of its report as an accounting research bulletin. As in the past, the committee on terminology and the research department will welcome suggestions and comments from members of the Institute and others on the matters discussed in this report and on the appended definition.

REPORT OF THE COMMITTEE ON TERMINOLOGY
ANNUAL REPORT, 1943

To the Council of the American Institute of Accountants:

Gentlemen:

Depreciation

In its report of October, 1942, the terminology committee discussed the nature of depreciation and outlined the sort of definition to which its discussion seemed to point. It deliberately refrained from any attempt to formulate a definition and, instead, invited comments and suggestions.

The response to this invitation was less extensive than had been hoped. However, the committee received from the chief accountant of the Federal Power Commission a criticism of the discussion and a copy of a definition which was under consideration by the National Association of Railroad and Utilities Commissioners. The chairman of this committee immediately offered to publish the proposed definition with comments, but suggested alternatively that the Institute should be given an opportunity to comment on the NARUC committee's report as a whole in advance of its publication. This suggestion was favorably received by the chairman of the NARUC com-
In the event, the Institute, in common with other bodies, was given only the briefest opportunity to consider the draft report and it was impossible, in the time of not more than a week that was allotted, to call a meeting of either the committee on accounting procedure or the committee on terminology to deal formally with the matter. This committee, therefore, felt that it was desirable to continue its own activities independently.

In the September issue of *The Journal of Accountancy*, a further attempt to elicit comments was made through the publication of a suggested definition, criticisms of which were invited. A considerable number of letters have been received and various shades of opinion expressed. The committee particularly desires to acknowledge receipt of helpful and constructive criticism from the chief accountant of the Securities and Exchange Commission.

The committee believes that the best procedure would be to take as the initial subject of definition, "depreciation accounting," and to go on to describe the various senses in which the words "depreciate" and "depreciation" are used in connection with such accounting.

Depreciation accounting is clearly a special technique (like cost accounting or accrual accounting). It can be sharply distinguished from the replacement system, the retirement system, the retirement reserve system, and the appraisal system, all of which have been employed in American accounting during the last half century in dealing with the same subject matter. Depreciation accounting, like accrual accounting and cost accounting, may take one of a number of different forms. The term is broadly descriptive of a type of process, not of an individual process, and only the characteristics which are common to all processes of the type can properly be reflected in a definition thereof. These common characteristics are, that a cost or other basic value is allocated to accounting periods by a rational and systematic method which, however, does not attempt to relate the sum allocated to an accounting period, to either the occurrences affecting the length of life or the changes in value of the property within the period. Definitions which imply that "depreciation for the year" is a measurement, expressed in monetary terms, of the physical deterioration or of the decline in value within the year, or, indeed, of anything that actually occurs within the period, are unacceptable. The annual charge is an allocation to the year of a proportionate part of a total cost or loss estimated with reference to a longer period. Depreciation accounting has other characteristics which, however, it may be unnecessary to mention in a primary definition.

Definitions along such lines indicate the technical usage of the word "depreciation" in accounting and prepare the way for further
definitions, the most important of which is, perhaps, the expression “annual depreciation” or “depreciation for the year.” The Supreme Court, after defining depreciation, added: “Annual depreciation is the loss which takes place in a year.” This statement is not applicable to the term “annual depreciation” as used in accounting. In that usage, annual depreciation, or depreciation for the year, is the portion of the estimated total depreciation that is allocated to the year, and as already noted, this amount has no necessary relation to either the occurrences within the year or the changes in value during the period.

In its last report, this committee said that the word “depreciation” was sometimes used to connote the causes that give rise to a cost or a loss, but suggested that its primary use should be to describe the cost or loss rather than the cause thereof. An examination of current accounting literature shows that the words “depreciate” and “depreciation” are used in a variety of senses—thus the word “depreciate” is used in a transitive sense to indicate that property is dealt with by a depreciation process rather than by some other method of accounting, just as “accrued” has come to be used in a transitive sense. “Depreciation” is used to describe the act of depreciating in the transitive sense as well as the phenomenon of depreciating in the intransitive sense. It is used in the income account to describe a charge made, or in the balance-sheet to describe an accumulated balance in respect of property still carried on the books.

Questions have been raised as to the description in a definition of the property accounts to which depreciation accounting is applicable. In the definition submitted for criticism by the Research Department the expression “instruments of production or distribution” was used. Correspondents have raised interesting questions on this point. It has been suggested, for instance, that depreciation accounting may be applied to a building held for sale. It may be questioned whether a building held for sale is a proper subject for depreciation accounting or whether the treatment thereof should not be covered by the rules governing investments and similar assets held for sale. In that event the word “depreciation” would be applicable to it only in the sense of a fall in value, since the most approved basis for carrying it would be cost or market value whichever is lower. Only so long as the building is regarded as an instrument of production or distribution would depreciation accounting seem to be properly applicable to it.

A number of questions have been raised regarding the expressions “provision for depreciation” and “estimated depreciation.” An objection to the expression “provision for depreciation” is that commonly urged against the use of the word “provision”—that to many it
implies that something more has been done to provide for depre-

ciation than merely to make an accounting entry. An objection may

be made to the word "estimated" on the grounds that it may encour-

age the belief that the charge represents an attempt to express in

monetary terms the effect of occurrences within the year, whereas the

charge is only an allocation of an estimated cost or loss in respect of

a longer period.

Much of the confusion and many of the misapprehensions that

have arisen in respect of depreciation accounting would, as the com-

mittee's report of last year suggested, be obviated by the substitution

of some such word as "amortization" for "depreciation." The use

of the latter word to describe a fall in value is so widespread and

so well justified by the root meaning of the word that it is unreason-

able to expect that the technical accounting use of it will result in

the complete abandonment of the use of the word in the popular

sense, even in accounting.

The committee suggests for adoption by the committee on account-

ing procedure the attached definition and comment.

The committee has also given much consideration to the use of

the terms "current assets" and "current liabilities." Wartime pol-

icies, such as that reflected in the V loan, have created new problems

in this field. At the same time, covenants relating to the maintenance

of net current assets exist which provide that the amount thereof

shall be determined in accordance with accepted accounting prin-

ciples: therefore, changes in practice should not be lightly made.

The committee concluded that the best approach to the problem

would be to publish an extended discussion of the subject and invite

comment thereon. Mr. Herrick undertook to prepare such a memo-

randum, which has now been completed and will appear in an early

number of The Journal of Accountancy. The committee hopes that

comments upon this article will be freely submitted, in which both

the immediate and long-run aspects of the problem will be consid-

ered. It hopes that in the light of criticism it may be possible to

make specific suggestions in a later report.

Respectfully submitted,

George O. May, Chairman
Anson Herrick
Walter A. Staub

October 18, 1943
APPENDIX

DEPRECIATION ACCOUNTING

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets 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. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

Note.—This method of accounting may be contrasted with such systems as the replacement, the retirement, the retirement reserve, and the appraisal methods of recognizing the fact that the life of tangible capital assets is limited.

The words depreciate and depreciation are used in various ways in connection with depreciation accounting. The verb is used in a transitive as well as in an intransitive sense (cf., the use of accrue in accrual accounting); the noun is used to describe not only the process but also a charge resulting from the process or the accumulated balance of such charges. It is also used to describe the exhaustion of life which gives rise to the method of accounting.

In all these uses, the meaning of the word is sharply distinguished from the sense of "fall in value" in which the word is employed in common usage and in respect of some assets (e.g., marketable securities) in accounting.
This bulletin supplements Accounting Research Bulletin No. 15 issued in September, 1942, and deals further with the financial statements of contractors and subcontractors who are affected by the provisions of the War Profits Control Act (Section 403 of Public Law 528, 77th Congress, as amended).

SUMMARY STATEMENT

(1) Since renegotiation proceedings have now been conducted over a considerable period of time, it is to be expected that many companies, particularly those which have completed renegotiation proceedings for a prior year, will be in a position to make reasonable provision for renegotiation refunds in their current financial statements, in accordance with the long recognized accounting principle that provision should be made in financial statements for all liabilities that can be reasonably estimated.

(2) Where such provision is made, there should be disclosure in the financial statements, by footnote or otherwise, of the basis upon which it is made. It is recognized that by reason of changed conditions, a settlement made in the preceding year may not, in some cases, be indicative of the amount refundable in respect of the current year, and the provision made should take account of this possibility. If, however, the provision is materially less than the amount which would be indicated on the basis of a prior year's settlement, the reasons therefor and the approximate effect of the difference upon the net income were a refund required on the same basis for the current year, should be stated, except as hereinafter provided.

(3) Where a provision is not made, a statement to that effect should be set forth in a footnote, together with appropriate disclosure of the reasons therefor and of the company's renegotiation status. If a settlement has been effected for a prior year, such disclosure should, except as hereinafter provided, include a statement of the approximate effect upon the net income were a refund required on the same basis for the current year.

(4) The information required under paragraphs (2) and (3)
above in respect of the effect of applying the basis of a prior year’s settlement to the current year, may be omitted if there is substantial reason to believe that misleading inferences might be drawn therefrom. In such cases, however, a statement should be made why the basis used for the prior year is not applicable to the current year.

(5) Provision for renegotiation refunds should be included in the balance-sheet as a current liability. In the income statement such provision should preferably be made as a deduction from sales, with the income and excess-profits tax and postwar refund computed accordingly. However, because of the interrelation between renegotiation refunds and income and excess-profits taxes, the provision may be set forth in the financial statements in conjunction with the provision for taxes, either as separate items or as a combined amount.

(6) If the renegotiation refund required to be paid for any year is different from the provision made therefor in the financial statements originally issued for such year, the difference should be included in the current income statement unless such inclusion would result in distortion, in which event the adjustment may be made through earned surplus. Where earned surplus is thus charged or credited the reported results of the preceding year should be appropriately revised. The committee believes that this can best be done by presenting a revised income statement for the prior year, either in conjunction with the current year’s financial statements or otherwise, and it urges that this procedure be followed.

**DISCUSSION**

In September, 1942, this committee issued Accounting Research Bulletin No. 15, entitled “The Renegotiation of War Contracts.” The summary statement of that bulletin reads as follows:

“In the financial statements of contractors or subcontractors who are subject to the provisions of the War Profits Control Act indication should be given of the possibility of renegotiation thereunder of government contracts or subcontracts. In some cases a reserve, shown as a deduction in the income account, may be desirable, but probably in most cases, particularly at the present stage, a footnote to the financial statements will accomplish the purpose of disclosure.”

Prior to the issuance of that bulletin the committee, on several occasions, had stated in effect that it is plainly desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods.
Renegotiation of War Contracts

with reasonable approximation.\footnote{Accounting Research Bulletins Nos. 8 and 13.} In applying this rule to the possibility of renegotiation refunds the committee felt that, under the then existing circumstances, provision through the medium of a reserve would not ordinarily be feasible and that fair disclosure seemed to be all that could be required in most cases. The committee indicated, however, that it proposed to consider the subject further at a later date.

Provision for Renegotiation Refunds

Since the issuance of Bulletin No. 15 many corporations have completed renegotiation proceedings; published and other data with respect to such proceedings are available to corporations and to accountants; and the developments in connection with such proceedings have in a measure reduced the area of uncertainty with respect to refunds. This is particularly true of corporations which have completed renegotiation proceedings for prior years or which have progressed in renegotiation discussions to a point where differences of opinion as to the total refund to be made are not likely to be great. The committee believes, therefore, that the circumstances now surrounding the matter of renegotiation are such that Accounting Research Bulletin No. 15 should be amplified and that in many cases the accounting treatment of possible renegotiation refunds should be based upon the established accounting principle that provision should be made in the financial statements for all liabilities, including reasonable estimates for liabilities accrued but not accurately determinable. Under this principle, provision should be made for possible renegotiation refunds wherever the amount of such refunds can be reasonably estimated.

In addition to such provision, disclosure should be made, by footnote or otherwise, of the basis used in determining the amount thereof, as for instance, the prior years' experience of the contractor or of similar contractors, renegotiation discussions relating to the current year, etc. Such disclosure is essential if stockholders or other interested parties are to be fairly informed as to the company's status under the renegotiation law. It is recognized that by reason of changed conditions the results of a prior year's settlement may not, in some cases, be indicative of the amount refundable in the current year and the provision made should take account of this possibility. Nevertheless, if the provision is made in an amount materially less than that which would be indicated if the basis of a prior year's settlement were applied to the current year, there should be included, except as hereinafter provided, a statement as to the approximate
Accounting Research Bulletins

effect of the difference upon the net income and the reasons for provision of the lesser amount. There is a presumption that refund will have to be made on a basis no more favorable than that applied in the preceding year; the statement should, therefore, indicate clearly why it is believed that the presumption does not apply.

The committee recognizes that there may be cases in which misleading inferences might be drawn from disclosure of the approximate effect upon net income of the difference between the provision made and the amount indicated on the basis of a prior year's settlement. The facts with respect to products, methods of manufacture, selling prices, volume, etc., may differ materially in the current year as compared with those of the prior year. In such cases, if there is substantial reason to believe that misleading inferences might be so drawn, disclosure of the effect of the difference on net income may be omitted.

Disclosure Where No Provision Is Made

It is recognized that there will be cases where reasonable provision for renegotiation refunds cannot be made. Such situations may exist where renegotiation proceedings for the current year or a preceding year have not been completed or where the basis of settlement for preceding years is believed not to be applicable to the current year. They may exist despite the fact that proceedings for a prior year resulted in a determination that no refund was required. If, however, for any reason, provision is not made, a statement as to the reason why no provision is made, together with appropriate disclosure of the pertinent facts with respect to the company's renegotiation status, should be incorporated in a footnote. In those cases where a settlement has been made in a preceding year, appropriate disclosure requires the inclusion of: (a) a statement of why such basis is not believed to be applicable and (b) a statement, except as hereinafter provided, of the approximate effect on the current net income were a refund required on the same basis for the current year. Even though it is not conceded that the basis of such settlement is applicable to the current year, disclosure as to the approximate effect of substantially similar treatment in the current year is ordinarily essential to a fair understanding of the company's renegotiation status.

As indicated above, there may be cases in which there is substantial reason to believe that misleading inferences might be drawn from disclosure of the effect on net income were a refund required on the basis of a prior year's settlement, in which event such information may be omitted. The committee feels, however, that any such omission must be justified by the facts, which should be clearly set forth.
Renegotiation of War Contracts

Financial Statement Presentation

Provision for renegotiation refunds should be included in the balance-sheet among the current liabilities.

With respect to the income statement, this committee has heretofore stated that profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sales price is not reasonably assured. While renegotiation refunds are commonly referred to as involving a refund of "excessive profits," the provisions of the statute indicate that renegotiation involves an adjustment of the original contract or selling price. Since a provision for renegotiation refund indicates that the collection, or retention, of the selling price is not reasonably assured, the committee believes that the provision should preferably be shown in the income statement as a deduction from sales. Because of the interrelationship of renegotiation and income and excess-profits taxes, the provision for such taxes, including the postwar refund of excess-profits tax, should then be computed accordingly.

The amount refundable is, however, frequently a net amount, i.e., allowance is made for any income and excess-profits taxes which may have been paid or assessed thereon. As an alternative, therefore, the provision for refund may be shown as a charge in the income statement, separately from the provision for such taxes, or in combination therewith. The provision may be shown in the net amount refundable or in the amount of the price reduction with appropriate adjustment of the tax provision.

Renegotiation Refunds for Prior Years

A further question arises where a renegotiation refund applicable to a particular year is made in an amount materially different from the provision made in the financial statements originally issued for such year. The committee has heretofore indicated that it approves the tendency to discourage charges to earned surplus even though such charges involve the correction of estimates made in prior years. It suggests, therefore, that the difference between the provision made and the renegotiation refund should be shown as a separate item in the current income statement, unless such inclusion would result in a distortion of the current income, in which event the adjustment may be made through earned surplus. Where the adjustment is made through earned surplus, however, there should be appropriate disclosure of the effect of the adjustment on the prior year's net income.

---

2 Accounting Research Bulletin No. 1.
3 Accounting Research Bulletins Nos. 8 and 13.
The committee believes that this can best be done by presenting a revised income statement for the prior year, either in comparative form in conjunction with the current year's financial statements or otherwise, and it urges that this procedure be followed.

The statement entitled "Renegotiation of War Contracts (Supplement)" was adopted by the assenting votes of twenty members of the committee. One member, Mr. Towns, dissented.

Mr. Towns dissents as to those portions of the bulletin which imply that the results of renegotiation for a prior year provide a basis for the amount of a provision for renegotiation for a current period; he believes that a prior year's results do not constitute such a basis because (aside from other factors of uncertainty) they have been derived from the judgment of individuals, which may be different in a future decision, rather than from any reasonably definite and continuing formula.

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.)

4 See Accounting Research Bulletin No. 6.
FOREWORD

Like earlier reports, this report of the committee on terminology is published in the form of an accounting research bulletin for the information of members of the Institute and others.

REPORT OF THE COMMITTEE ON TERMINOLOGY

MIDYEAR, 1944

TO THE COUNCIL OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

DEPRECIATION

The definition of depreciation suggested in the committee's report of October 18, 1943, was approved by the committee on accounting procedure and the report was circulated to the membership of the Institute as Accounting Research Bulletin No. 20. It has elicited considerable comment, and one suggestion has been made to which effect might perhaps advantageously be given in a revision of the definition. It is that a specific reference should be made to salvage, and the point could be covered by inserting the words "less salvage (if any)" after the words "tangible capital assets" in the definition. As amplified the definition would read:

Depreciation accounting is 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. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.
A number of suggestions have been made as to the description of the annual charge for depreciation in financial accounts. After considering the various comments received, your committee suggests that it would be helpful to describe the annual charge as "depreciation allocated to the year" in order to emphasize the fact that depreciation accounting is a process of allocation.

Two members of the NARUC committee on depreciation submitted comments on your committee's definition. An opportunity to deal with these suggestions arose in the form of a request for comments on the tentative report of the NARUC committee, and the opportunity was availed of. The letter, dated January the 28th, addressed by the chairman of the committee on accounting procedure to the chairman of the NARUC committee, deals at length with the definition of depreciation. It is the strong feeling of your committee on terminology that straight-line depreciation has sufficient practical merits in given situations to justify its adoption and that it is neither necessary nor desirable to claim for that method characteristics, such as being factual, which it does not possess.

Your committee's definition of depreciation has become particularly timely in view of the current problem, in the public-utility field, of dealing with companies which have, with regulatory approval, used the retirement-reserve method. If such companies are now required to use depreciation accounting, it is important that careful consideration be given to the manner of effecting the change, and this necessitates a clear understanding of the true import of the depreciation charge; your committee is following developments in this respect and hopes to cover the matter in its next report.

**Current Assets and Liabilities**

The article prepared by Mr. Herrick, to which reference was made in the last report, appeared in the January, 1944, issue of *The Journal of Accountancy* and the April *Accounting Review* carries an article by Stephen Gilman in which he suggests an abandonment of the "current" groupings. It seems desirable that the committee on accounting procedure consider whether or not there should be either some modification of present practice or a fundamental change in classification.

It seems evident that bankers, lawyers, and others who are called upon to deal with the question, find difficulty in defining current assets and liabilities satisfactorily, and are apt to rely on the procedure of requiring that they shall be determined in accordance with
Report of the Committee on Terminology

generally accepted accounting principles. If accounting views on the question change materially thereafter, important questions are likely to arise as to whether the reference to the accounting principles in such cases is to be interpreted as referring to the principles recognized at the date when the contracts were made, or the principles recognized at the later time when effect was being given to them.¹

A pronouncement by the accounting procedure committee on the subject would be helpful and timely.

CONSISTENCY

Numerous suggestions have been made to your committee that it discuss the word “consistent” as used in the phrase “in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.” In particular, an indication has been sought of your committee’s views on the question of the relation between consistency and comparability. In your committee’s view the phrase quoted from the standard form of certificate implies consistency in the principles employed and the manner of their application. In relation to similar situations, it does not call for the same treatment of a given element in the accounting if the situation with respect to that element has materially changed. Consistency, in its judgment, does not assure comparability except in so far as comparability may be attained by accounting methods.

An illustration may be found in the problem of the proper treatment of renegotiation at the end of 1942 and at the end of 1943. The governing principle is that the accounts should reflect all liabilities which can be estimated with a reasonable degree of approximation. At December 31, 1942 the amount of the liability was, in most cases, wholly uncertain and the application of the principle did not, therefore, require provision in the accounts for the liability, but only an appropriate note of its existence.²

At the end of 1943 the elements of liability were in many cases reasonably ascertainable. Where this was so, the accounting principle above cited called for inclusion of the liability among current

¹ An interesting discussion of a similar question, such as the meaning of the word “minerals” when used in an old statute which is being applied today, is contained in the chapter on Law and Language which appears in Lord MacMillan’s Law and Other Things.

² See Accounting Research Bulletin No. 15.
liabilities in financial statements. If, therefore, a company made no specific provision for renegotiation in 1942, but made such provision in 1943, it was not applying different accounting principles in the two years, nor applying any principle in two different manners. Whether the difference in treatment may have so seriously affected the comparability of the two statements that fair disclosure may call for a statement on this point, is another matter. Your committee has noted with satisfaction the number of cases in which corporations have restated the accounts for 1942 in order to overcome the lack of comparability which would have otherwise existed.

Your committee does not feel that the subject of “consistency” should be dealt with solely as a matter of terminology; it suggests that it be given further consideration by the auditing and accounting procedure committees.

Respectfully submitted,

GEORGE O. MAY, Chairman
ANSON HERRICK
WALTER A. STAUB

May 8, 1944
This bulletin deals with a number of accounting problems which arise currently in the reporting of income and excess-profits taxes (hereinafter referred to as "income taxes") in financial statements. The problems arise largely where (a) material items entering into the computation of taxable income are not reflected in the income statement and (b) material items included in the income statement are not reflected in the computation of taxable income. The bulletin does not purport to cover the entire subject of the treatment of these taxes in such statements.

SUMMARY STATEMENT

(1) Income taxes are an expense which should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated.

(2) Where an item resulting in a material increase in income taxes is credited to surplus, the portion of the current provision for income taxes which is attributable to such item should be applied in reduction of the credit to surplus and taken up as a credit in the income statement, specifically disclosed and appropriately described, either as a deduction from the aggregate current provision for income taxes or as a separate credit.

(3) Where an item resulting in a material reduction in income taxes is charged to surplus, the amount of the reduction should be applied against the charge to surplus and included as a charge in the income statement, specifically disclosed and appropriately described, either as an increase in the provision for income tax allocated to income included in the income statement, or as a portion of the item in question equal to the tax reduction resulting therefrom.

(4) Where an item resulting in a material reduction in income taxes is charged to or carried forward in a deferred-charge account,
or charged to a reserve account, it is desirable to include a charge in the income statement of an amount equal to the tax reduction in the manner set forth in paragraph (3) hereof. If it is impracticable to apply such procedures the pertinent facts should be clearly disclosed.

(5) Additional income taxes for prior years, or additional provisions therefor, should be included in the current income statement and, if material, should be shown separately. Refunds of such taxes, and provisions therefor no longer required, should be similarly treated as credits.\(^1\)

(6) Amounts of income taxes paid in prior years which are refundable to the taxpayer as a result of the “carry-back” of losses or unused excess-profits credits, should be included in the income statement of the year in which the loss occurs or the unused excess-profits credit arises, provided that, if the amount is material, the net income resulting from the operations of the year should be shown without the inclusion thereof, and the amount should thereafter follow in the income statement as a separate item.\(^1\)

(7) Where material amounts of losses or unused excess-profits credits of prior years are carried forward into the current tax return, the operating results for the current year should preferably be shown without inclusion of the tax reduction resulting therefrom, i.e., the current provision for income taxes should be computed and shown in the income statement without the benefit of such “carry-forward,” and the amount of the tax reduction should be shown in the income statement as a separate item.\(^1\)

(8) The provision for income taxes, or the portion thereof allocated to current income, may be included at the end of the income statement, immediately preceding the showing of net income for the period, or it may be appropriately classified as an operating expense.

(9) Provisions for income taxes for the current and prior years should generally be classified in the balance-sheet as current liabilities. Claims for refund under the “carry-back” provisions of the Internal Revenue Code may be shown as current assets if collection is reasonably assured.

\(^1\) In connection with paragraphs (5), (6), and (7) hereof, the charges and credits may be made directly to surplus if misleading inferences might be drawn from their inclusion in the income statement.
Accounting for Income Taxes

(10) Where credits are made to surplus, directly or through the income statement, of significant amounts as to which, because of differences in accounting methods, no income tax has been paid or provided for, disclosure should be made. If a tax is likely to be paid thereon, provision should be made therefor on the basis of an estimate of the amount thereof.

DISCUSSION

In view of the substantial increase during recent years in the number of taxes to which business is subject and in the rates and amount thereof, it is obvious that taxes are an item of major importance in statements of income, and that if such statements are to be of the maximum usefulness to readers, the facts with respect to taxes must be clearly set forth. The most important taxes are those based on income. The committee, therefore, has considered a number of problems of current importance arising in connection with such taxes which it believes should be dealt with in the manner hereinafter set forth.

Allocation of Income Taxes

Basic difficulties arise in connection with income taxes where there are material and extraordinary differences between the taxable income upon which they are computed and the income reported in the income statement under generally accepted accounting principles. Provisions may be made in the income statement which are not deductible in the tax return, as in the case of special war reserves; deductions may be taken in the tax return which are not included in the income statement, as in the case of charges against a reserve created in a prior period; gains subject to income tax may not be included in the income statement, as in the case of gain on the sale of property credited to surplus; credits in the income statement may not be subject to taxation, as in the case of a restoration of an unwanted reserve to income. As a result of such transactions the income tax legally payable may not bear a normal relationship to the income shown in the income statement and the accounts therefore may not meet a normal standard of significance. The committee believes that the solution of these problems is to be found in part at least by an application to income taxes of the principle of allocation.

In some cases the transactions result in gains; in others, they re-
sult in losses or net costs. Sometimes the reduction of tax is a major
if not the predominant motive for the transaction. If all the effects
of the transactions (including their effect on income tax) were re-
lected in the income statement the income would, of course, be in-
creased where the transactions result in a gain, and reduced where
they result in a loss or net cost. But where the effects are not all re-
lected in the income statement, and that statement indicates only the
income tax actually payable, exactly the opposite effect is produced:
where the special transactions result in a gain, the net income is re-
duced; and where they result in a loss, or net cost, the net income is
increased. Such a result is not only repugnant to common sense but
can readily be shown to be contrary to the principles of allocation
which lie at the root of all accounting.

Financial statements are the result of allocations—of receipts, pay-
ments, accruals, and other financial events and transactions. Many
of the allocations are necessarily based on assumptions, but no one
suggests that allocations based on imperfect criteria should be aban-
donned in respect of expenses other than income taxes, or even that
the method of allocation should always be indicated in footnotes.
Income taxes are an expense that should be allocated, when necessary
and practicable, to income and other accounts, as other expenses are
allocated. What the income statement should reflect under this head,
as under any other head, is the expense properly allocable to the in-
come included in the income statement for the year. For instance, an
item in an income statement, “Taxes other than income taxes—$N,”
does not imply that $N was the amount of such taxes paid or
accrued during the year but that $N is the amount of such taxes
properly chargeable in the income statement in respect of the year.
The total taxes paid may have been $N plus $M, the latter amount
having been charged to other accounts. A part may have been charged
to capital-asset accounts (e.g., real estate taxes on uncompleted con-
struction, social-security taxes on construction payroll, or import
duties on machinery); a part to a deferred charge account (e.g., stamp
taxes in connection with an issue of bonds); a part to inventories
(e.g., import duties on unused goods); or a part to surplus (e.g.,
stamp taxes on a sale where the profit was carried to earned surplus).

As a matter of accounting principle, similar treatment of taxes that
are measured by a statutory concept of net income is equally called
for, and in many cases allocation is necessary if the income statement
is to meet a normal standard of significance. This is true irrespective
Accounting for Income Taxes

of whether the income statement be regarded as a historical statement or a measure of earning capacity.

In cases in which the transactions not reflected in the income statement increase the income tax payable by an amount that is substantial and is determinable without difficulty, as in the case of a gain credited to surplus, an allocation of income tax between accounts is commonly made. Objection to allocation in other cases, as for instance the case of a loss charged to surplus, must, therefore, be on the ground that such allocations increase the tax chargeable in the income statement beyond the amount of the tax payable, or on the ground that the amount attributable to accounts other than income is not reasonably determinable.

The committee sees no objection to an allocation which results in the division of a given item into two parts one of which is larger than the item itself and is offset by the smaller. This consideration is especially persuasive where it is apparent that a reduction in income taxes was a major if not the predominant purpose of the transaction which has not been reflected in the income statement.

The argument that the effect of the special transactions on the amount of tax is not identifiable is usually without substantial merit. The difficulties encountered in allocation of the tax are not greater than those met with in many other allocations of expenses. In most cases, at least, the amount of income taxes to be allocated to the income statement should be the amount that would have been payable if the transactions in question had not occurred. It has also been suggested that allocation would require a determination of the effect on the tax of every separate transaction. No such need arises; all that is necessary in making an allocation is to consider the effect on taxes of those special transactions which are not reflected in the income statement.

The cases that are likely to call for allocation are those in which transactions which affect the income tax in a substantial manner are reflected in (a) surplus accounts; (b) deferred-charge accounts; (c) reserve accounts. Methods of implementing the allocation principle in these instances are set forth below.

Credits to Surplus

The committee has heretofore considered the general question of charges and credits to surplus and their effect on the income state-
Accounting Research Bulletins

ment and the presentation of earning capacity; it has approved the current tendency to discourage such charges and credits; it has called attention to the advantages of the combined statement of income and surplus in dealing with the problem; and it has suggested that in some circumstances revised income statements be issued. The committee recognizes, however, that in exceptional cases allocations may be made of charges and credits as between current income and surplus, and it believes that where such allocations are made of material items, the treatment of income taxes should follow as closely as possible the line of allocation of such charges and credits.

Where an item, resulting in a material increase in income taxes, is credited to surplus, the portion of the current provision for income taxes which is attributable to such item should, under the principle of allocation, be correspondingly charged. The committee suggests, however, that the provision for income taxes be shown in the income statement in full, and the portion thereof charged to surplus either be deducted from the amount of the tax or be shown as a separate credit item. The first of these is illustrated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for income taxes</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less portion thereof allocated to taxable gain in</td>
<td></td>
</tr>
<tr>
<td>statement of surplus</td>
<td>200,000</td>
</tr>
<tr>
<td>Balance</td>
<td>$ 800,000</td>
</tr>
</tbody>
</table>

Charges to Surplus

Where an item resulting in a material reduction in income taxes is charged to surplus, the principle of allocation may be applied in the income statement in either one of two ways: (a) the current provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be legally due for the year being indicated) or (b) a charge may be included for a portion of such item equal in amount to the tax reduction resulting therefrom. In either case the amount charged to surplus would be reduced accordingly.

2 Accounting Research Bulletin No. 8.
3 Accounting Research Bulletin No. 21.

188
**Accounting for Income Taxes**

The first method may be illustrated by presentation in the income statement as follows:

Provision for income taxes $1,000,000
(The estimated tax liability is $800,000 by reason of a reduction of $200,000 in taxes resulting from a loss on condemnation of real estate. This loss has been charged to surplus and the related tax reduction has been treated as an offset thereto.)

The second method may be illustrated by the inclusion of separate items in the income statement, as follows:

Provision for income taxes $ 800,000
Portion of loss on condemnation of real estate equal to tax reduction attributable thereto (remainder charged to surplus) 200,000

**Deferred-Charge and Reserve Accounts**

The committee believes that the principle of allocation applies also in the case of deferred-charge and reserve accounts where a material tax reduction results from an item not reflected in the income statement.

With respect to deferred charges, the deduction for tax purposes in a given year of an item which is carried to, or remains in a deferred-charge account, will involve a series of charges in future income statements for amortization of the deferred charge, and these charges will not be deductible for tax purposes. Unless appropriate allocations are made, the net result will be to increase artificially the net income in the first year and to decrease it artificially in later years. The committee, therefore, recommends in such cases that a charge be made in the income statement of an amount equal to the tax reduction in the manner set forth above with respect to charges to surplus, that a corresponding credit be made in the deferred-charge account and that amortization charges thereafter be based on the net amount. This procedure in substance has been recommended by the committee where bonds are refunded and the entire balance of unamortized discount and debt expense with respect thereto is deducted in the tax return for the period in which refunding occurs, while it is spread over future periods in the income statement.\(^4\)

\(^4\) Accounting Research Bulletins Nos. 2 and 18.
Accounting Research Bulletins

Where an item resulting in a material reduction in income taxes is charged to a reserve account, the principle of allocation may be applied in the income statement in three ways: (a) the current provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be legally due for the year being indicated), or (b) a charge may be included for a portion of such item equal in amount to the tax reduction resulting therefrom, or (c) the item in question may be charged in the income statement and a portion of the reserve equal in amount to the excess of such item over the related tax reduction credited in the income statement. In the case of either (a) or (b) the amount of the tax reduction will be reflected in the reserve or other appropriate account.

Where it is not practicable to adopt the foregoing procedures with respect to charges to deferred-charge and reserve accounts the pertinent facts should be clearly disclosed. Neither allocation nor disclosure is necessary, however, in the case of differences between the tax return and the income statement where there is a presumption that they will recur regularly over a comparatively long period of time.

Amortization of Emergency War Facilities

An outstanding example of difference between the tax return and the income statement arises where emergency war facilities are depreciated at normal rates in the income statement and at the special amortization rate in the income-tax return. Where the resulting reduction in current income tax is material the committee believes that a portion of the excess of the amortization over normal depreciation (equal in amount to the tax reduction resulting therefrom), should be included in the income statement either as additional depreciation or as a special charge and credited to an appropriate reserve or other account.

Additional Taxes and Refunds

An examination of current practices with respect to additional assessments (or refunds) of income taxes of prior periods and adjustments in provisions therefor, indicates that the prevailing treatment is fairly evenly divided between charging or crediting such items to surplus and including them in the income statement. The tendency seems to be toward the latter treatment.
Accounting for Income Taxes

The committee has heretofore considered the general question of corrections of estimates made in prior years, and, as indicated above, it approves the current tendency to discourage charges and credits to surplus. It suggests that such corrections should be included in the income statement unless they are so large as to be likely to produce distorted interpretations of the statement; in the latter event they may be charged or credited to surplus with indication as to the period to which they relate.

Carry-back of Losses and Unused Excess-Profits Credits

Where taxpayers are permitted to carry back losses or unused excess-profits credits, and thus become entitled to a refund of taxes paid in prior years, a question arises whether the amount refundable is to be regarded as applicable to the year in which the tax was originally accrued or to the year in which the loss occurred or the unused excess-profits credit arose. The committee believes that as a practical matter, in the preparation of annual income statements, amount refundable should be included in the latter year. While claims for refund of income taxes should not ordinarily be included in the accounts prior to approval by the taxing authorities, a claim based on the carry-back provision, while not an allowable offset against the tax to be paid, presumably has as definite a basis as the computation of income taxes for the year; such claim should, therefore, be included in the income statement as indicated above. The committee recommends, however, that the income statement for that year indicate the results of operations before application of the claim for refund, which should then be shown as a final item before the amount of net income for the period; but if there is substantial reason to believe that misleading inferences might be drawn from such inclusion, the claims may be credited to surplus.

Carry-forward of Losses and Unused Excess-Profits Credits

Where taxpayers are permitted to carry forward losses or unused excess-profits credits, the committee believes that as a practical matter, in the preparation of annual income statements, the resulting tax reduction should be reflected in the year to which such losses or

---

5 Accounting Research Bulletin No. 8.
unused credits are carried. The committee recommends, however, that the income statement for that period indicate the results of operations without inclusion of such reduction, which should be shown as a final item before the amount of net income of the period; but if there is substantial reason to believe that misleading inferences might be drawn from such inclusion, the tax reduction may be credited to surplus.

Position of Income Taxes in the Income Statement

It has been customary for companies other than utilities to show the provision for income taxes at the end of the income statement, immediately preceding the showing of net income for the period. In addition it has been customary for such companies to indicate “net income before income taxes” in order to emphasize the effect of such taxes on net income. The committee believes that the term “net income before income taxes” has unfortunate implications, and urges that the word “net” be eliminated therefrom.

The committee also recognizes that income taxes may properly be classified as operating expenses.

Income Taxes in the Balance-Sheet

Accrued income taxes for the current or prior periods should be classified in the balance-sheet as current liabilities, even though they may not have to be paid within one year (or such other period as is used to determine current liabilities) due to delays in final adjustment and settlement. Provisions for such taxes may, however, be excluded from current liabilities if the liability is considered to be merely contingent. Where there is doubt as to the amount of the tax liability, the accrual should include such amounts as appear to be reasonable on the basis of the evidence available. The existence of proposed additional assessments which are disputed by the taxpayer, should be disclosed by footnote or comment unless provision is made therefor.

Claims for refunds based on the carry-back provisions of the law may be shown as current assets if collection is reasonably assured.

Disclosure of Certain Differences Between Taxable and Ordinary Income

If credits of significant amounts are made to surplus (directly or through the income statement) as to which, because of differences
Accounting for Income Taxes

in accounting methods, no income tax has been paid or provided for, appropriate disclosure should be made, and if a tax is likely to be paid thereon, provision should be made for the estimated amount of such tax. This rule applies, for instance, to profits on instalment sales or long-term contracts which are deferred for tax purposes, and to cases where unrealized appreciation of securities is taken into the accounts by certain types of investment companies.

The statement entitled “Accounting for Income Taxes” was adopted by the assenting votes of eighteen members of the committee, as it was constituted at the time of the 1944 annual meeting of the Institute. Mr. Peloubet dissented. Mr. Towns dissented from paragraphs (6), (7), (8), and (9) of the summary statement and the related discussion. Mr. Cranstoun dissented from paragraphs (1), (3), and (4) of the summary statement and the related discussion.

Mr. Peloubet dissented because “the bulletin is a mandatory directive to the profession to apply an entirely novel method of allocation to an expenditure, the amount of which is almost never certain when first included in accounting statements. No expense other than federal income and profits taxes is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. The usual method is to allocate a total expense ratably to given accounts or transactions on a consistent basis. The presentation of accounts on an ‘as if’ or ‘giving effect to’ or other hypothetical basis is often proper and useful but is not a substitute for accounts prepared on the basis of present facts. The consistent application of the bulletin to reserves would be difficult and confusing, requiring the use of charges or credits net of a tax, the amount of which was not known with any certainty. The principal objection to the bulletin is its mandatory character. It is a valuable service to point out the possibility of abuses inherent in the present tax situation. It is equally valuable to indicate a means of curing such abuses. The application of such means and methods, however, is a matter for the judgment of the individual practitioner in individual cases.”

Mr. Towns dissented “with respect to those parts of paragraphs (6) and (7) which require showing separate income-tax items in the in-
come statement for benefits resulting from 'carry-backs' and 'carry-forwards' because, in view of other requirements, this will result in such complexity in the income statement, in numerous cases, that he believes the information can usually be more appropriately and clearly presented in a note; with respect to paragraph (8), because he is not convinced of the advisability of providing for the optional classification of income taxes there outlined and believes that, if such provision is to be made, it would be preferable to have a more complete presentation, with adequate statement of reasons; with respect to paragraph (9), because he believes that the paragraph, to be adequate, should require that collection of claims for refund be expected within a period of time appropriately related to the time for payment of current liabilities, if the claims are to be included as current assets."

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.)

Committee on Accounting Procedure (1943-1944)

WALTER A. STAUB, Chairman
GEORGE D. BAILEY
WILLIAM H. BELL
ARCHIBALD BOWMAN
GEORGE COCHRANE
CHARLES B. COUCHMAN
WILLIAM D. CRANSTOUN
STEPHEN GILMAN
ANSON HERRICK
HENRY A. HORNE
PAUL K. KNIGHT
GEORGE O. MAY
WILLIAM A. PATON
MAURICE E. PELOUBET
HIRAM T. SCOVILL
JACKSON W. SMART
MAURICE H. STANS
CHARLES H. TOWNS
R. S. WILLCOX
JOHN H. ZEBLEY, JR.
JAMES L. DOHR,
Director of Research

194
“TAX REDUCTIONS” IN STATEMENTS OF INCOME

The Use of Certain Procedures Suggested by Accounting Research Bulletin No. 23 in Statements Filed with the Securities and Exchange Commission

A Statement by the Research Department of the American Institute of Accountants

The purpose of this statement is to draw attention to those conclusions of the Securities and Exchange Commission expressed in its Accounting Series Release No. 53 which relate to procedures recommended by the Institute’s committee on accounting procedure in Accounting Research Bulletin No. 23 for the treatment of material items entering into the computation of taxable income which are not reflected in the income statement.

Accounting Research Bulletin No. 23, issued in December, 1944, deals with certain accounting problems of reporting income and excess-profits taxes in financial statements. As stated in that bulletin, special problems of reporting income taxes arise “where there are material and extraordinary differences between the taxable income upon which they are computed and the income reported in the income statement under generally accepted accounting principles. . . . In some cases the transactions [which are the cause of the differences] result in gains; in others they result in losses or net costs. Sometimes the reduction of tax is a major if not the predominant motive for the transaction. If all the effects of the transactions (including their effect on income tax) were reflected in the income statement the income would, of course, be increased where the transactions result in a gain, and reduced where they result in a loss or net cost. But where the effects are not all reflected in the income statement, and that statement indicates only the income tax actually payable, exactly the opposite effect is produced: where the special transactions result in a gain, the net income is reduced; and where they result in a loss, or net cost, the net income is increased.”

1 Bulletin No. 23 emphasizes the fact that it deals only with material and unusual situations. The committee noted that “Neither allocation nor disclosure is necessary, however, in the case of differences between the tax return and the income statement where there is a presumption that they will recur regularly over a comparatively long period of time.”

2 Accounting Research Bulletin No. 23, pp. 185-186.
A Statement by the Research Department

Among the problems discussed in Bulletin No. 23 are those arising in situations in which items resulting in a material reduction in income taxes were charged to surplus or to deferred-charge accounts. The Bulletin states that in those situations the tax effect of such items may be displayed in the income statement in either one of two ways: "(a) the current provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be legally due for the year being indicated) or (b) a charge may be included for a portion of such item equal in amount to the tax reduction resulting therefrom." In either case the amount charged to surplus or to deferred-charge accounts would be reduced accordingly. These alternative methods of presentation in the income statement are illustrated as follows:

Method (a)

"The first method may be illustrated by presentation in the income statement as follows:

"Provision for income taxes $1,000,000
(The estimated tax liability is $800,000 by reason of a reduction of $200,000 in taxes resulting from a loss on condemnation of real estate. This loss has been charged to surplus and the related tax reduction has been treated as an offset thereto.)"

Method (b)

"The second method may be illustrated by the inclusion of separate items in the income statement, as follows:

"Provision for income taxes $800,000
Portion of loss on condemnation of real estate equal to tax reduction attributable thereto (remainder charged to surplus) 200,000"

The effect upon net income resulting from the application of either method is the same.

The Securities and Exchange Commission does not consider the two methods equally acceptable. In its Accounting Series Release No. 53, "In the Matter of 'Charges in Lieu of Income Taxes,'" the Commission states its opinion regarding the treatment of "tax reductions" resulting from certain items not reflected in the income statement. The Commission’s discussion of its conclusions was developed by using the facts relating to a registration statement filed by a public
utility company in which a material reduction of income taxes was attributable to items charged to surplus and to a deferred-charge account. In its conclusions 1 and 3, the Commission rejects the first of the two methods of presentation suggested in Accounting Research Bulletin No. 23. It seems implicit, however, in the Commission's Release that it accepts the results reached by the second of the alternative methods suggested. The Commission states:

"It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes."

In its conclusion 4, the Commission recognizes the propriety of a similar procedure where losses are deducted for tax purposes. In the course of the discussion of the progress of the case reviewed in the Release, the Commission states that it directed its staff to advise the registrant to the effect

"That no objection would be raised to the inclusion in the income statement of an item of $4,148,050 representing so much of the refunding expenses and of the loss on disposition of property as was equal to the estimated reduction in income taxes attributable thereto, the remainder of both these items being charged directly to surplus; provided, however, (a) that the caption for the item indicate clearly the nature and amount of the item being charged off and (b) that the special charge be excluded from operating expenses and shown as a deduction from gross income."

[Reference by the Commission to "operating expenses" relates to that classification of accounts by a public utility company.]

Furthermore, in Exhibit D of the Release, there is shown a condensed certified statement of the company's income as finally amended, in

---

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws. . . .

3. The use of the caption 'Charges or provisions in lieu of taxes' is not acceptable."  


4. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off."  

Accounting Series Release No. 53, p. 11.
which the following item is displayed as a charge in the income statement immediately preceding the final figure reported as net income:

"Special charges of those portions of premium and expenses on redemption of bonds ($2,091,177) and of loss on sale of property ($2,056,873) which are equivalent to resulting reduction in Federal excess profits taxes ........................................ $4,148,050"

The Commission recognizes the importance of drawing attention to such special charges and their effect upon the presentation of income. In the case discussed in the Release the registrant, in one of its amendments, included the statement "before special charges below" in captions of the income statement, as follows:

"Total operating expenses and taxes (before special charges below)"
"Net operating revenues (before special charges below)"

The staff of the Commission objected to this presentation and the parenthetical statements were removed in the final amendment filed by the registrant. However, the Commission reports its disagreement with its staff on this matter as follows:

"In transmitting to the registrant our views on the income statement as set forth in the third amendment, the staff indicated that the use of the words 'before special charges below' in the several captions mentioned above was objectionable. We do not believe this position to be wholly sound. We feel that the existence of large special and unusual transactions ought properly to be forcefully brought to the attention of the reader of the statement. We feel also that the use of appropriate qualifying words such as 'see special charges' in connection with the pertinent captions is an appropriate means of warning the reader of the existence of such items as were present in this case."

NOTE: As published in The Journal of Accountancy for February, 1946, this statement included an exhibit presenting the Securities and Exchange Commission's summary of its conclusions expressed in Accounting Series Release No. 53. To simplify the format of the present statement, that exhibit has been omitted and the pertinent conclusions of the Commission are herein presented as text material or footnotes.

T

his bulletin deals with some of the problems involved in accounting for certain types of assets classified by accountants as intangibles, including those acquired by the issuance of securities as well as those purchased for cash. Such assets may be purchased or acquired separately at a specified price or consideration, or may be purchased or acquired, together with other assets, for a lump-sum price or consideration, without specification by either the seller or the purchaser at the time of purchase, of the portion of the total price which is applicable to the respective assets thus acquired. The bulletin does not deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise.

The intangibles herein considered may be broadly classified as follows:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration).

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

(c) The excess of a parent company’s investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter’s books at the date of acquisition, in so far as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary. This class of asset may represent intangibles of either type (a) or type (b) above or a combination of both.

The intangibles described above will hereinafter be referred to as type (a) and (b) intangibles, respectively.

SUMMARY STATEMENT

(1) The initial carrying value of all types of intangibles should be cost, in accordance with the generally accepted accounting prin-
principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

(2) The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness.

(3) The cost of type (b) intangibles may be carried continuously unless and until it becomes reasonably evident that the term of existence of such intangibles has become limited, or that they have become worthless. In the former event the cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness or, if such charges would result in distortion of the income statement, a partial write-down may be made by a charge to earned surplus, and the balance of the cost may be amortized over the remaining period of usefulness. If an investment in type (b) intangibles is determined to have become worthless, the carrying value should be charged off either in the income statement or to earned surplus as, in the circumstances, may be appropriate.¹ In determining whether an investment in type (b) intangibles has become, or is likely to become worthless, it is proper to take into account any new and related elements of intangible value, acquired or developed, which have replaced or become merged with such intangibles.

(4) Where a corporation decides that a type (b) intangible may not continue to have value during the entire life of the enterprise, it may amortize the cost of such intangible despite the fact that there are no present indications of such limited life which would require reclassification as type (a), and despite the fact that expenditures are being made to maintain its value. In such cases the cost may be amortized over a reasonable period of time, by systematic charges in the income statement. The procedure should be formally approved, preferably by action of the stockholders, and the facts should be fully disclosed in the financial statements. Such amortization is within the discretion of the corporation and is not to be regarded as obligatory.

(5) There is a presumption, when the price paid for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at date of acquisition, that the parent company, in effect, placed a value greater than

¹ Other problems arising from partial loss of value of type (b) intangibles are not dealt with herein. See discussion, page 199.
Accounting for Intangible Assets

book value on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. If practicable there should be an allocation of such excess as between tangible and intangible property and any amount allocated to intangibles should be further allocated to determine a separate cost for each type (a) intangible and for at least the aggregate of all type (b) intangibles. The amounts so allocated to intangibles should thereafter be dealt with in accordance with paragraphs (1), (2), (3), and (4) hereof.

(6) In connection with the foregoing procedures, the committee recognizes that in the past it has been accepted practice to eliminate type (b) intangibles by writing them off against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus.

DISCUSSION

In dealing with the intangible assets herein considered, important questions arise as to the initial carrying value of such assets, the amortization of carrying value where their term of existence is definitely limited or problematical, and the adjustment of carrying value where there is a substantial and permanent decline in the value of such assets. These questions involve basic accounting principles of balance-sheet presentation and income determination. The committee believes that the accounting for intangibles has heretofore been regarded as being of relatively minor importance; accounting practices with respect thereto have varied greatly. The present bulletin is designed to promote a fuller consideration of the relation of intangibles to income and earned surplus.

Initial Carrying Value

The committee has heretofore taken the position that the accounting for tangible fixed assets should normally be based on cost\(^2\), which may be defined generally as the price paid or consideration given to acquire the asset in question. Attention is now directed to the fact that the same principle is applicable to intangibles.

The committee has considered two further problems which may arise in the determination of the cost of intangibles. Since intangibles are frequently acquired in exchange for securities, the com-

\(^2\) Accounting Research Bulletin No. 5.
committee points out that in the case of non-cash acquisitions cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

The second problem arises in cases where a group of intangibles or a mixed aggregate of tangible and intangible property is acquired for a lump-sum price or consideration. It is essential in such cases that an allocation of the aggregate cost be made as between tangible and intangible property, and it is manifestly desirable that the cost of intangibles be further allocated to determine a separate cost for each type (a) intangible so acquired and for the aggregate, at least, of all type (b) intangibles.

Amortization Accounting

The cost of tangible assets having a limited term of usefulness is dealt with by depreciation accounting, which the committee on terminology has defined as a system of amortization which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit (which may be a group of assets) in a rational manner. In like manner the cost of intangible assets having a limited term of usefulness should be dealt with under amortization accounting. To this end the committee has classified intangibles as between type (a) which includes those having a term of existence limited by law, regulation, or agreement, or by their nature; and type (b) which includes those as to which there is, at the time of acquisition, no evidence of limited life. The committee recognizes that there may be cases in which it is difficult to make such a classification.

The cost of intangibles classified as type (a) should be amortized by systematic charges in the income statement over the period benefited. If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or if such increased charges would result in distortion of the income statement a partial write-down may be made by a charge to earned surplus.

The intangibles classified as type (b) may be carried continuously at cost unless and until it becomes reasonably evident that their term of existence has become limited, or that they have become worthless. In the former event they should be reclassified as type (a) and thereafter amortized by systematic charges in the income

*Accounting Research Bulletin No. 22.
Accounting for Intangible Assets

statement over the estimated remaining period of usefulness. If that period of amortization is relatively short so that misleading inferences might be drawn as a result of the inclusion of substantial charges in the income statement, a partial write-down may be made by a charge to earned surplus and the balance of the cost may be amortized over the remaining period of usefulness.

In the event of complete loss of an investment in type (b) intangibles, a charge should be made either in the income statement or to earned surplus as, in the circumstances, may be appropriate.

In determining whether an investment in type (b) intangibles has or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business, and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

Partial Loss of Value

The committee recognizes that changes in general economic conditions and changes affecting the business of a particular company may have an important effect on the value, at a given time, of its intangibles. It further recognizes the difficulty of determining whether adverse changes are temporary or permanent. The problems arising as a result of such partial loss of value (as contrasted with total loss of value discussed above), which are also applicable to tangible assets (such as, loss of commercial value of tangible capital assets not covered by depreciation accounting), are not dealt with herein but are in their broader aspects presently under consideration by the committee. Attention is drawn however, to Rule No. 2, adopted by the membership of the Institute in 1934, which provides that "capital surplus, however created, should not be used to relieve the income account of the current or future years of charges that would otherwise fall to be made thereagainst."

Discretionary Amortization of Intangibles

If a corporation decides to amortize the cost of a type (b) intangible, as to which there is no present indication of limited existence or loss of value, by systematic charges in the income statement, such procedure is permissible despite the fact that expenditures are being made to maintain its value. The plan of amortization should be reasonable; it should be based on all the surrounding circum-

stances including the basic nature of the intangible and the expenditures being currently made for development, experimentation, and sales promotion. Where the intangibles are important income-producing factors and are being currently maintained by advertising or otherwise, the period of amortization should be reasonably long. The procedure should be formally approved, preferably by action of the stockholders, and should be fully disclosed in the financial statements. The committee believes that such amortization should be entirely within the discretion of the corporation and should not be regarded as mandatory.

**Intangibles in Consolidation**

Where a parent corporation has made a stock investment in a subsidiary, at a cost in excess of its equity in the net assets of the subsidiary as shown by its books at the date of acquisition, the parent corporation may have (a) paid amounts in excess of book value for specific assets of the subsidiary or (b) paid for the general goodwill of the subsidiary. If practicable, such an excess should be divided as between tangible and intangible assets, and the amount allocated to intangibles should be further allocated as between each type (a) intangible and the aggregate, at least, of all type (b) intangibles. The amounts so allocated should thereafter be dealt with in accordance with the rules hereinbefore set forth.

**Write-off Where There Is No Evidence of Loss of Value**

In adopting the procedures set forth above the committee recognizes that in the past it has generally been considered proper to eliminate the cost of type (b) intangibles from the accounts, in whole or in part, by a charge against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. In addition the matter of charges to capital surplus requires further consideration and is part of the general problem of surplus accounting on the study of which the committee is presently engaged.

The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus. It points out that the reduction of the investment, upon which the responsibility and accountability of management is based, may give rise to misleading inferences if subsequent earnings are compared with the reduced base.
Accounting for Intangible Assets

The statement entitled "Accounting for Intangible Assets" was adopted by the assenting votes of eighteen members of the committee, as it was constituted at the time of the 1944 annual meeting of the Institute. Mr. Willcox dissented. Mr. Stans dissented from paragraph (5) of the summary statement and the related discussion. Mr. Zebley dissented from paragraphs (5) and (6) of the summary statement and the related discussion.

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.)

Committee on Accounting Procedure (1943-1944)

Walter A. Staub, Chairman
George D. Bailey
William H. Bell
Archibald Bowman
George Cochrane
Charles B. Couchman
William D. Cranston
Stephen Gilman
Anson Herrick
Henry A. Horne
Paul K. Knight
George O. May
Warren W. Nisley
William A. Paton
Maurice E. Peloubet
Hiram T. Scovill
Jackson W. Smart
Maurice H. Stans
Charles H. Towns
R. S. Willcox
John H. Zebley, Jr.

James L. Dohr,
Director of Research
This bulletin deals with some of the problems involved in accounting for fixed-price war supply contracts terminated, in whole or in part, for the convenience of the government. It does not deal specifically with terminated cost-plus-a-fixed-fee contracts nor with contracts for facilities or services, although the conclusions reached herein may serve as guides for the accounting applicable to such special contracts. Contracts terminated for default of the contractor are not considered because it is expected that their number will be relatively small and because the accounting problems arising therefrom are different.

Except where the text of this bulletin clearly indicates otherwise, the term “contractor” is used to denote either a prime contractor or a subcontractor, and the term “contract” to denote either a prime contract or a subcontract.

**SUMMARY STATEMENT**

(1) The profit of a contractor on a fixed-price supply contract terminated for the convenience of the government accrues as of the effective date of termination.

(2) For the preparation of financial statements subsequent to termination, those parts of the termination claim which are reasonably determinable should be recorded; when the aggregate amount of the undeterminable elements is believed to be material, full disclosure with respect thereto should be made by footnote or otherwise.

(3) Under ordinary circumstances, the termination claim should properly be classified as a current asset and separately disclosed in the financial statements unless relatively small in amount.

(4) Advance payments received on the contract before its termination may be shown on the contractor’s financial statements subsequent to termination as a deduction, appropriately explained, from the amount of the claim receivable. Loans negotiated on the security of the termination claim, however, should be recorded as current liabilities.

(5) All of the contractor’s own cost and profit elements included in the termination claim should preferably be accounted for as a
sale, and separately disclosed if material in amount. The costs and expenses chargeable to the claim may then be given their usual classification in the accounts.

(6) When items of inventory, the costs of which are included in the termination claim, are subsequently reacquired by the contractor, the reacquisition value of those items should be recorded as a purchase and applied, together with other disposal credits, against the termination claim receivable.

(7) So called "no-cost" settlements—those in which the contractor waives the right to make a claim—result in no transaction which could be reflected in sales. The costs applicable to the contract may be given their usual classification in the accounts; the inventory retained should not be reflected as a purchase but should be accounted for according to the usual methods and standards applicable to inventories.

DISCUSSION

The termination of war contracts "for the convenience of the government" is intended to adjust the production of war materials to the varying requirements of the military services. Since terminations transfer active contracts in process of execution into claims in process of liquidation, they, like contract renegotiations and cost-plus-a-fixed-fee contracts,1 may have important effects on the financial statements of war contractors.

Congress, the Director of Contract Settlement, and the procurement agencies of the government have prescribed the basic policies and principles to be applied in the treatment of war contractors affected by terminations. Uniform termination articles have been adopted for use in war contracts; the Contract Settlement Act of 19442 has set the official pattern for termination settlement procedures; standard settlement proposal forms have been prepared to assist contractors in making their claims; joint regulations3 have been issued by the War and Navy Departments as instructions to contracting officers and as guides to contractors in termination procedures; and an accounting manual4 has been prepared by those departments.

The Institute's committee on termination of war contracts has followed closely the developments within the governmental agencies relating to accounting examinations of termination settlements by government personnel, and its committee on auditing procedure has

---

1 Accounting Research Bulletins Nos. 15, 19, and 21.
2 Public Law 395, 78th Congress, 2d session, approved July 1, 1944.
3 Joint Termination Regulation issued November 1, 1944.
4 Joint Termination Accounting Manual of the War and Navy Departments issued November 1, 1944, and appended to the Joint Termination Regulation.
Accounting for Terminated War Contracts

given consideration to the work of the independent certified public accountant in termination matters.®

Problems involved in the accounting for terminated war contracts are similar to other problems created by the war in that they have arisen so quickly that it has not been possible to develop generally accepted accounting procedures by experience. The committee has considered a number of the special problems involved in accounting for such terminated contracts and has reached the conclusions expressed in the Summary Statement. The considerations underlying these conclusions are discussed in the following paragraphs.

When Profit Accrues

An important problem involved in accounting for the effect of terminations is that of determining the time at which profit resulting therefrom should be recognized. This problem is similar to that described in previous bulletins on renegotiation® and cost-plus-a-fixed-fee contracts® in that it involves the accruing at a specific date of an element of profit the original measurement of which may be difficult and will require informed judgment, and the final amount of which may not be determined until some future period.

It has been argued that profit from terminated contracts might be recognized at (a) the effective date of termination, (b) the date of final settlement, or (c) some intermediate date, such as when the claim has been finally prepared or filed. However, the contractor acquires, at the effective date of termination, the right to receive payment on the terminated portion of the contract. Furthermore, the effective date of termination is the one which is the most objectively determined for the accrual of such profit.

Under the accrual basis of accounting, revenues and expenses are recognized, to the fullest extent possible, in the period to which they relate. Profit on a contract of sale is ordinarily taken into account upon delivery or performance. However, it is "a generally accepted accounting procedure to accrue revenues under certain types of contracts, and thereby recognize profits, on the basis of partial performance, where the circumstances are such that aggregate profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured."® Thus, the accrual of profit under a cost-plus-a-fixed-fee contract is recognized as the fee becomes billable rather than when it is actually billed. Under the Contract Settlement Act of 1944, upon termination of a contract, the contractor acquires a

® Statement on Auditing Procedure No. 20.
® Accounting Research Bulletins Nos. 15 and 21.
® Accounting Research Bulletin No. 19.
® Ibid.
claim for fair compensation; the government reserves the option of acquiring any of the inventories for which the contractor makes claim under the terminated contract. Except to effect settlements and to protect and dispose of property, the expenses of which are reimbursable, the contractor need perform no further service under a terminated contract in order to enforce his claim. It follows that any profit arising out of such a contract accrues at the effective date of termination and, if the amount can be reasonably ascertained, it should be recorded at that time.\(^9\)

**Determination of Claim**

The practical application of the accrual principle to the accounting for terminated war contracts rests upon the possibility of making a reasonable estimate of the amount of the termination claim prior to its final determination by settlement. This involves two principal considerations: (1) whether the costs of the contractor can be determined with reasonable accuracy, and (2) whether the amount of profit to be realized can be estimated with sufficient approximation to justify inclusion in the accounts.

The Contract Settlement Act of 1944 sets forth in general terms the costs and expenses which are to be taken into account in determining fair compensation. It also specifies that, to the extent that the methods and standards established by the contracting agencies for determining fair compensation require accounting, “they shall be adapted, so far as practicable, to the accounting systems used by war contractors, if consistent with recognized commercial accounting practice.” On the other hand, certain types of costs not allowable in termination claims are enumerated in the Act. Substantially similar provisions with more extensive explanation are contained in the Statement of Principles for Determination of Costs Upon Termination of Government Fixed-Price Supply Contracts.\(^10\) As contemplated in the Act, the Director of Contract Settlement has issued various regulations interpreting the Act and setting forth uniform policies and procedures to be followed in termination. The Termination Cost Memorandums\(^11\) issued in this manner provide

\(^9\) While it is recognized that accounting procedures applicable to the preparation of federal income-tax returns are not always acceptable for other business purposes, it should be noted that accrual of income from terminated contracts at the date of termination is required by the United States Treasury Department. Treasury Decision 5405, approved September 22, 1944, provides that compensation from termination of contracts, as defined in the Contract Settlement Act of 1944, or similar contracts, constitutes income for the taxable year in which falls the effective date of the termination. (See also Bureau of Internal Revenue Mimeograph No. 5766 issued November 1, 1944.)

\(^10\) Originally approved by the Joint Contract Termination Board December 31, 1943, and revised in Office of Contract Settlement Regulation No. 5 issued September 30, 1944, which deleted the most controversial aspects of the Statement.

Accounting for Terminated War Contracts

explanation of the cost factors and of the treatment to be accorded various types of costs in claims of contractors.

While the total claim, and particularly the profit allowance, is subject to negotiation, the uniform termination articles provide for a formula settlement allowing definite percentages of profit based on costs in the event of the failure of negotiations. This in effect fixes a minimum expectation of profit allowance since the formula percentages have also been recognized by regulation[12] as a basis of negotiating settlement in the event of the failure of the parties to agree on any other basis. The same regulations give other guides for the estimation of a fair profit allowance, which in some cases may be greater than the amount computed by the formula percentages. When the contractor, because of lack of prior negotiation experience or uncertainty as to the application of the principles of these regulations to a particular case, is unable to determine a more appropriate profit allowance, he may accrue the minimum amount determined by the formula percentages.

The profit which will be included in the accounts of the contractor upon termination will be the difference between (a) the amount of his recorded claim and (b) the total of the inventory, deferred and capitalized items, and other costs applicable to the terminated contract as they are currently reflected in his accounts. This profit may exceed the amount specified as profit in the claim because costs applicable to the terminated portion of the contract may be allowable in the claim even though they may have been properly written off as incurred in prior periods.

There will be some cases where it will be impossible to make a reasonable estimate of a termination claim in time for reflection in the financial statements of the period in which the termination occurs. In such cases, effect may be given in the statements to those parts of the termination claim which are determinable with reasonable certainty, and disclosure by footnote or otherwise should indicate the status of the remainder.

When the contractor's claim includes items of known controversial nature it should be stated at the estimated collectible amount. When a particular termination claim is so uncertain in amount that it cannot be reasonably estimated, it is preferable not to give effect to the claim in the financial statements; but if the aggregate amount of such claims is material, the circumstances should be disclosed on statements issued prior to the removal of the uncertainty. In an extreme case involving undeterminable claims, consideration should

[12] Regulation No. 7 of the Office of Contract Settlement issued October 5, 1944 especially paragraphs 5c (2) and 5d.
be given to delaying the issuance of financial statements until more nearly adequate data are available.

**Presentation in Financial Statements**

Termination has the effect of converting an active contract in process into a claim, or, from an accounting standpoint, from inventories and other charges into an account receivable. In the case of this receivable, the claim arises in the regular course of business; it is part of the working capital; and, under the provisions of the Contract Settlement Act of 1944 for guaranteed loans and partial payments, it may be expected in large part to be collected within a relatively short time. Therefore, the termination claim should be classified as a current asset, unless there is an indication of extended delay, such as serious disagreement indicating probable litigation, which would preclude it from this classification.

Although a claim may be composed of several elements representing amounts for reimbursable items of special equipment, deferred charges, inventories, and other items, as well as claims for profit, it is preferable to record the termination claim in one account. When the aggregate of termination claims is material it should be disclosed separately from other receivables. If significant in amount, it is desirable to segregate claims directly against the government from claims against other contractors.

One of the stated objectives of the Contract Settlement Act of 1944 is to assure to all contractors adequate financial assistance in the form of partial payments and guaranteed loans from the time of termination until final settlement of their claims. Partial payments are, of course, to be recorded as reductions of the termination claim receivable. Termination loans, on the other hand, are definite liabilities to third parties, even though guaranteed in whole or in part by the government, and accordingly should be shown as liabilities on the balance-sheet, with appropriate cross reference to the related termination claim or claims. When a terminated contract is one on which advance payments had previously been received, the financial statements of the contractor issued prior to final collection of the termination claim ordinarily should reflect any balance of those advances disclosed as deductions from the claim receivable. Financial statements issued prior to the recording of the termination claim should disclose, by footnotes or otherwise, the relationship of such liabilities to a possible termination receivable.

Ordinarily, a termination will result in the cessation of a con-
Accounting for Terminated War Contracts

tractor’s activity through which materials or services have been supplied under a war contract and of the related transactions which have been reflected in the contractor’s income accounts as sales and cost elements. In effect, termination policies and procedures provide a basis upon which the contractor’s costs in process may become the elements of a final sale under the terminated portion of the contract. Accordingly, the amount of the contractor’s termination claim representing his cost and profit elements should be treated as a sale and the costs and expenses chargeable to the claim given their usual classification in the income statement. Because these termination sales are of a special type, their financial results should not be appraised in the same manner as are those of regular sales and they should, if material in amount, be separately disclosed in the income statement. Any items which the contractor chooses to retain without claim for cost or loss are, of course, not sold but remain as inventory or deferred charges in the contractor’s accounts.

Claims of Subcontractors

The term “subcontractor’s claims” as used in connection with terminated war contracts refers to those obligations of a contractor to a subcontractor which arise from the subcontractor’s costs incurred by transactions which were related to the contract terminated but which did not result in billable materials or services being transferred to the contractor prior to termination. Other obligations of a contractor to a subcontractor, arising through transactions by which materials or services of the subcontractor have been furnished or supplied to the contractor, are considered to be liabilities incurred in the ordinary course of business and are not included in the term “claims of subcontractors.”

The uniform termination articles provide that, following the termination of a contract, the contractor shall settle, with the approval or ratification of the contracting officer when necessary, all claims of subcontractors arising out of the termination; and that the contractor shall be paid, as part of his settlement, the cost of settling and paying claims arising out of the stoppage of work under subcontracts affected by the termination. While a contractor ordinarily is liable to his subcontractors or suppliers for such obligations, the amounts of their claims approved by the government are collectible by the contractor as elements of his termination claim, and payment to the subcontractor often may not be made before the settlement of the contractor’s claim. The filing of subcontractors’ claims is often beyond the control of the contractor and the amount of such claims may not be known to him until some time following the termination date. In that interval, the contractor may collect
for his own costs and charges in advance of a determination of his subcontractors' claims and their settlement.

The possibility of loss to a contractor through failure to recover the amount of his liability on subcontractors' claims apparently would arise principally from overcommitments, errors in ordering, and similar causes. Specific provisions in the accounts of the contractor should be made when losses due to such causes are known or anticipated.

Although the principle that liabilities shall not be offset against assets in the financial statements is generally approved by accountants, there is not a general agreement relative to the accounting treatment to be accorded subcontractors' claims which are expected to be fully recoverable. To the extent that a subcontractor's claim is considered to be unrecoverable no difference of opinion exists; the liability must be recorded and provision made for any contemplated loss. The difference of opinion arises with respect to those subcontractors' claims which are deemed to be fully recoverable.

Some accountants believe that the effect of the termination articles coupled with the Contract Settlement Act of 1944 is to establish a relationship between the claim of the subcontractor and the resulting right of the contractor under his own termination claim which is different from an ordinary commercial relationship and justifies their omission from the accounts. Recoverable subcontractors' claims are thus said to be in the nature of contingent liabilities analogous to commitments, which are customarily omitted from the accounts except where a loss is anticipated, and to notes receivable discounted. Both of these may be disclosed in the financial statements without recording them as assets and liabilities. Even when contingent liabilities are recorded, it is customary accounting practice to show them on the balance-sheet as deductions from the related contingent assets so that no effect upon financial ratios and relationships results.

Other accountants believe that the nature of an obligation to a subcontractor is that of an ordinary liability even though it may arise through the termination of a war contract, and that the contractor's termination claim receivable, although related to the subcontractor's claim, is to be accounted for independently as an asset. This group believes that all claims for subcontractors, to the extent that they are reasonably ascertainable, should be recorded in the accounts and displayed on the contractor's balance-sheet as current liabilities, and that the amounts recoverable by the contractor should be included in his termination claim receivable. To the extent that the amounts of subcontractors' claims are not reasonably determinable, disclosure with respect thereto in the financial statements is believed to be adequate.
Accounting for Terminated War Contracts

Because of the merits and prevalence of these alternative views, no preference is expressed at this time for either position. If, after further experience with termination settlements, it becomes apparent that one of these procedures is substantially more desirable and useful than the other, a supplementary statement to that effect may be issued.

Disposal Credits

Disposal credits are amounts deducted from the contractor's termination claim receivable by reason of his retention, or sale to a third party, of some or all of the termination inventory for which claim was made. In the case of items retained, whether as scrap or for use by the contractor, the amount of the credit is determined by agreement between the contractor and a representative of the government. The sale of items of inventory by the contractor is likewise subject to approval by the government, except as permitted by regulation. Since the amount of the contractor's termination claim, as already indicated, is properly recorded as a sale, any elements included in that claim for items of inventory retained by the contractor are, in effect, reacquired by him and should be treated as purchases at the agreed value. Amounts received for items sold to a third party with the approval of the government are collections for the account of the government and should be applied in reduction of the claim receivable. Obviously inventories or other items that will be retained by the contractor after termination without claim for loss with respect thereto should not be included as an element of the termination claim.

"No-Cost" Settlements

A contractor whose contract is terminated may prefer to retain the termination inventory for use in other production or to dispose of it at his own risk. For these or other reasons the contractor may prefer to make no claim against the government or a higher-tier contractor. In the case of such "no-cost" settlements, there is no sale of inventory or other items to the government, and, therefore, no occasion to accrue any profit arising out of the termination. The costs otherwise applicable to the contract should be given their usual treatment in the accounts. Items of inventory or other property retained, having been previously recorded, will, of course, require no charge to purchases but should be treated in accordance with the usual procedures applicable to such assets.16

16 Bureau of Internal Revenue Mimeograph No. 5766 issued November 1, 1944

211
Accounting Research Bulletins

The statement entitled "Accounting for Terminated War Contracts" was unanimously adopted by the twenty-one members of the committee.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1944-1945)

George D. Bailey, Chairman Paul K. Knight Maurice H. Stans
William H. Bell George O. May Victor H. Stempf
Henry T. Chamberlain Warren W. Nissley Cyril Talbot
M. C. Conick William A. Paton C. Oliver Wellington
James L. Dohr Maurice E. Peloubet John H. Zebley, Jr.
Anson Herrick Walter L. Schaffer
Harry E. Howell
Lincoln G. Kelly

212
1. In January, 1942, the committee on accounting procedure issued Accounting Research Bulletin No. 13, Accounting for Special Reserves Arising Out of the War. In October, 1946, it issued Bulletin No. 26 concerning the accounting for the use of these special war reserves.

2. The committee is of the opinion that, in the light of subsequent developments of accounting procedures, these bulletins should no longer be relied upon as a basis for the establishment and use of reserves.

   The statement entitled “Limitation of Scope of Special War Reserves” (No. 26-Addendum) was unanimously adopted by the twenty-one members of the committee.

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. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not
be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1950-1951)

Paul K. Knight, Chairman
Frederick B. Andrews
Frank S. Calkins
H. A. Finney
Russell H. Hassler
Thomas G. Higgins
John B. Inglis
John A. Lindquist
Edward J. McDevitt
Leslie Mills
Maurice E. Peloubet
John Peoples
Hatcher A. Pickens
John W. Queenan
James A. Runser
Walter L. Schaffer
Virgil S. Tilly
C. Oliver Wellington
William W. Werntz
Edward B. Wilcox
Karl R. Zimmermann
Carmen G. Blough,
Director of Research

215-B
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 incurrence 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 reconverted for peacetime operations as well as the nonproductive or stand-by expenses of that period of reconversion.

*"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
Accounting for the Use of Special War Reserves

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
Accounting Research Bulletins

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
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.)
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
Accounting Research Bulletins

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

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.
Emergency Facilities

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.”

226
Emergency Facilities

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
Accounting Research Bulletins

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.)

Committee on Accounting Procedure (1945-1946)

George D. Bailey, Chairman
William H. Bell
Henry T. Chamberlain
M. C. Conick
James L. Dohr
Marquis G. Eaton
Anson Herrick
John B. Inglis

Paul K. Knight
Edward J. McDevitt, Jr.
Warren W. Nissley
William A. Paton
Maurice E. Peloubet
Charles S. Rockey
Walter L. Schaffer
Harold B. Simpson

Maurice H. Stans
Cyril Talbot
Edwin H. Wagner, Jr.
C. Oliver Wellington
Edward B. Wilcox

Carmen G. Blough
Director of Research
INTRODUCTION

1. Accounting for reserves and their presentation in financial statements involve problems that are both numerous and complex. Since complete solution of all the relevant problems has not been considered possible at an early date, the committee has deemed it wise to separate the problems for individual treatment. The first steps were taken when the committee dealt with reserves arising out of the war.1 As another step, consideration is given in this bulletin to general contingency reserves which may be set up by management but which are not required at the time under generally accepted accounting principles and whose purposes are not specific. The committee has left for future consideration and possible definitive treatment many aspects of reserves including inventory reserves, reserves for specific but undisclosed contingencies, and the general use of the term “reserve” in financial statements. These are now being studied by the committee.

DISCUSSION

2. The purpose of the committee in the issuance of this bulletin is to establish criteria which will promote sound accounting procedures for the treatment of general contingency reserves and lead to greater uniformity in reporting net income. The committee believes the action taken in this bulletin is in accordance with the current trend of accounting thinking and practice. In reaching this conclusion consideration has been given to the declining use of general purpose contingency reserves as charges to income and to the general recognition that their use may either arbitrarily reduce income or be the means of shifting income from one year to another.

3. When a reserve is provided by a charge to income, the amount recorded as net income for the period is correspondingly reduced. If the provision is not properly chargeable to current revenues, net

---

1 Accounting Research Bulletins Nos. 13 and 26.
income for the period is understated by the amount of the provision. If such a reserve should then be used to relieve the income of subsequent periods of charges that would otherwise be made there-against, the income of such subsequent periods would be thereby overstated. When a reserve is used in this manner, profit for a given period may be significantly increased or decreased by mere whim.

When this practice is followed the integrity of financial statements is impaired and they tend to be misleading and of doubtful value. The committee is therefore of the opinion that general contingency reserves, such as those created:

(a) for general undetermined contingencies, or
(b) for a wide variety of indefinite possible future losses, or
(c) without any specific purpose reasonably related to the operations for the current period, or
(d) in amounts not determined on the basis of any reasonable estimates of costs or losses,

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

RECOMMENDED PROCEDURES

4. Accordingly it is the recommendation of the committee that, as to general contingency reserves described in paragraph 3:
(a) Provisions for such reserves should not be included as charges in determining net income.
(b) When such a reserve is set up it should be created preferably by a segregation or appropriation of surplus; it may be created by an appropriation of net income but this is less desirable.
(c) If such a reserve is created by an appropriation of net income, the net income should first be determined and so designated, after which the reserve provision should be deducted and clearly captioned as an appropriation of net income and the final figure should be so captioned as to clearly indicate that it is not the entire net income.
(d) Costs or losses should not be treated as charges to such reserves and no part of such a reserve should be transferred to income or in any way used to affect the determination of net income for any year.

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

3 This paragraph also applies to general contingency reserves set up in prior years.
Accounting Treatment of General Purpose Contingency Reserves

(e) When such a reserve or any part thereof is no longer considered necessary it should be restored to surplus, either directly (the preferable treatment) or after the determination of net income, in the income statement, in such a way as to indicate clearly that it is not income.

The statement entitled "Accounting Treatment of General Purpose Contingency Reserves" was unanimously adopted by the twenty-one members of the committee. Messrs. Dohr, Herrick, Stans, and Wellington assented with qualification.

Mr. Dohr does not agree that an appropriation of income is less desirable than a segregation of surplus. He believes that appropriations included at the foot of the income statement are helpful in indicating the disposition made of current income.

Messrs. Herrick, Stans, and Wellington assent to the bulletin, but do not approve the recommendation that there may be included on the income statement after the determination of net income either charges for the creation or increase of general purpose contingency reserves (as permitted in paragraph 4(b)) or credits for the restoration of any part of such a reserve no longer considered necessary (as permitted in paragraph 4(e)). They feel that, even with complete disclosure and clear and unmistakable wording, the inclusion on the income statement of either charges or credits for general contingency reserves will be confusing to the reader and that such charges or credits, if made, should be reported only on the surplus statement.

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.)

4 This paragraph also applies to general contingency reserves set up in prior years.

233
Accounting Research Bulletins

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.)

Committee on Accounting Procedure (1946-1947)

George D. Bailey, Chairman
William H. Bell
Samuel J. Broad
Henry T. Chamberlain
M. C. Conick
James L. Dohr
Fred J. Duncombe
Anson Herrick

David Himmelblau
John B. Inglis
Paul K. Knight
Edward J. McDevitt, Jr.
Warren W. Nissley
William A. Paton
Maurice E. Peloubet
Charles S. Rockey

Walter L. Schaffer
Maurice H. Stans
Virgil S. Tilly
Edwin H. Wagner, Jr.
C. Oliver Wellington

Carmen G. Blough
Director of Research
INTRODUCTION

Whenever the operation of a business includes the ownership of a stock of goods, it is necessary for adequate financial accounting purposes that inventories be properly compiled periodically and recorded in the accounts.¹ Such inventories are required for the statement of financial position and for the periodic measurement of income.

This bulletin deals with the general principles applicable to the pricing of inventories of mercantile and manufacturing enterprises. Its conclusions are not directed to or necessarily applicable to non-commercial businesses or to regulated utilities.

STATEMENT 1

The term "inventory" is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in the process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Discussion

The term "inventory" embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process) and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes the long-term assets subject to depreciation accounting, or any goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item be classified as part of the inventory. Raw materials and

¹ Prudent reliance upon perpetual inventory records is not precluded. Cf. Statements on Auditing Procedure No. 1, p. 6, American Institute of Accountants.
supplies purchased for production may be used or consumed for the
collection of long-term assets or other purposes not related to pro-
duction, but the fact that inventory items representing a small
portion of the total may not be absorbed ultimately in the production
process does not require separate classification. By trade practice,
operating materials and supplies of oil-producing companies are
usually treated as inventory.

STATEMENT 2

A major objective of accounting for inventories is the
proper determination of income through the process of
matching appropriate costs against revenues.

Discussion

An inventory has financial significance because revenues may be
obtained from its sale, or from the sale of the goods or services in the
production of which it is used. Normally such revenues arise in a
continuous repetitive process or cycle of operations by which goods
are acquired and sold, and further goods are acquired for additional
sales. In accounting for the goods in the inventory at any point of
time, the major objective is the matching of appropriate costs against
revenues in order that there may be a proper determination of the
realized income. Thus, the inventory at any given date is in effect a
residual amount remaining after the matching of absorbed costs with
concurrent revenues. This residual is appropriately carried to future
periods provided it does not exceed an amount properly chargeable
against the revenues expected to be obtained from ultimate disposi-
tion of the goods carried forward. In practice, this residual amount
is determined by the process of pricing the articles comprising the
inventory.

STATEMENT 3

The primary basis of accounting for inventories is cost,
which has been defined\(^2\) generally as the price paid or consid-
eration given to acquire an asset. As applied to inventories,
cost means in principle the sum of the applicable expendi-
tures and charges directly or indirectly incurred in bringing
an article to its existing condition and location.

Discussion

In keeping with the principle that accounting is primarily based
on cost, there is a presumption that inventories should be stated at
cost. The definition of cost as applied to inventories is understood to

\(^2\) Accounting Research Bulletin No. 24, Summary Statement (I).
mean acquisition and production cost, and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, except for the portion of general and administrative expenses that may be clearly related to production, it is generally accepted accounting practice to include such items as period charges and to exclude them from inventory costs (product charges). Selling expenses constitute no part of inventory costs. It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

**STATEMENT 4**

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as “first-in first out,” “average,” and “last-in first-out”); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

**Discussion**

The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. Ordinarily, under those circumstances, the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development and general acceptance of several assumptions with respect to the flow of cost factors to provide practical bases for the measurement of periodic income. These methods recognize the variations which exist in the relationships of costs to sales prices

---

3 In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.
under different economic conditions. Thus, where sales prices are promptly influenced by changes in reproductive costs, an assumption of the "last-in first-out" flow of cost factors may be the more appropriate. Where no such cost-price relationship exists, the "first-in first-out" or an "average" method may be more properly utilized. In other situations a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. Standard costs, if adjusted at reasonable intervals to reflect current conditions, are acceptable. In some cases, the business operations may be such as to make it desirable to apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

Although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry.

STATEMENT 5

A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market."

Discussion

Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at "cost or market, whichever is lower." This provides a practical means of measuring utility, and thereby determining the amount of the loss to be recognized and accounted for in the current period.
As used in the phrase "lower of cost or market," the term "market" means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Discussion

The rule "cost or market, whichever is lower" is intended to provide a means of measuring the residual usefulness of an inventory expenditure. The term "market" is therefore to be interpreted as indicating utility on the inventory date and may be thought of in terms of the equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction. In applying the rule, however, judgment must always be exercised and no loss should be recognized unless the evidence indicates clearly that a loss has been sustained. There are therefore exceptions to such a standard. Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

Because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule. It should be applied realistically in the light of the objectives expressed in this bulletin and with due regard to the form, content and composition of the inventory. The committee considers, for example, that the retail inventory method, if adequate markdowns

4 The terms "cost or market, whichever is lower" and "lower of cost or market" are used synonymously in general practice and in this bulletin. The committee does not express any preference for either one of the two alternatives.
Accounting Research Bulletins

are currently taken, accomplishes the objectives herein. It also recognizes that, if a business is expected to lose money for a sustained period, the inventory should not be written down to offset a loss inherent in the subsequent operations.

STATEMENT 7

Depending on the character and composition of the inventory, the rule of "cost or market, whichever is lower" may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

Discussion

The purpose of reducing inventory to "market" is to reflect fairly the income of the period. The most common practice is to apply the "lower of cost or market" rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to "market" may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the "cost or market, whichever is lower" rule to the total of the items included in such major categories may result in the most useful determination of income.

When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of "cost or market, whichever is lower" may be applied directly to the totals of the entire inventory, rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year.

To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying the "lower of cost or market" to the individual items comprising the excess should be followed. This would also apply in cases in which the items enter into the production of unrelated products or products having a material variation in the
Inventory Pricing

rate of turnover. Unless an effective method of classifying categories is practicable, the rule of “cost or market” should be applied to each item in the inventory.

When substantial and unusual losses result from the application of the rule of “cost or market, whichever is lower,” it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as “cost of goods sold.”

STATEMENT 8

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on income.

Discussion

While the basis of stating inventories does not affect the over-all gain or loss on the ultimate disposition of inventory items, any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss. Because of the common use and importance of periodic statements, a procedure adopted for the treatment of inventory items should be consistently applied in order that the results reported may be fairly allocated as between years. A change of such basis may have an important effect upon the interpretation of the financial statements both before and after that change, and hence, in the event of a change, a full disclosure of its nature and of its effect, if material, upon income should be made.

STATEMENT 9

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

Discussion

It is generally recognized that income accrues only at time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordi-
narily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. In cases in which such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the fact of the use of such basis should be fully disclosed in the financial statements.

**STATEMENT 10**

Accrued net losses on firm purchase commitments of goods for inventory, measured in the same way as are inventory losses, should be recognized in the accounts. The amounts thereof should, if material, be separately disclosed in the income statement.

**Discussion**

The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

*The statement entitled “Inventory Pricing” was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Tilly, assented with qualification. Two members, Messrs. Paton and Peloubet, dissented.*

Mr. Tilly assents to the bulletin, but disagrees with that part of Statement 6 and the related discussion which provides for a write-down below cost in certain cases solely because replacement cost is lower, when the realizable value (selling price less cost to complete and sell) is higher. He believes that cost is a proper measure of the amount to be carried forward, irrespective of the cost to replace, provided cost does not exceed the net realizable value.

Mr. Peloubet dissents because in his opinion it is ordinarily preferable to carry inventory at not less than recoverable cost, and particularly in the case of manufactured or partially manufactured
Inventory Pricing

goods which can be sold only in finished form. He recognizes that the application of the cost or market valuation basis necessitates the shifting of income from one period to another, but objects to unnecessarily accentuating this shift by the use, even limited as it is in this bulletin, of reproduction or replacement cost as "market" when such cost is less than net selling price.

Mr. Paton opposes the issuance of this bulletin because he objects to the (1) retention of the phrase "cost or market," as confusing, and to the emphasis laid on that approach, (2) requirement that excess of actual cost over replacement cost (or a portion of this excess) be charged to current revenue even if there is no expectation that a loss will be suffered on disposition, (3) requirement that the prospective "normal profit" be estimated and used in determining inventory value in certain cases, (4) apparent acceptance of the theory that replacement cost is significant to owners and managers when prices are falling but deserves no notice in accounts or statements when prices are advancing, (5) requirement that current revenues be charged with possible future losses that may be related to outstanding purchase orders.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1946-1947)

GEORGE D. BAILEY, Chairman
WILLIAM H. BELL
SAMUEL J. BROAD
HENRY T. CHAMBERLAIN
M. C. CONICK
JAMES L. DOHR
FRED J. DUNCOMBE
ANSON HERRICK

DAVID HIMMELBLAU
JOHN B. INGLIS
PAUL K. KNIGHT
EDWARD J. McDEVITT, JR.
WARREN W. NISLEY
WILLIAM A. PATON
MAURICE E. PELOUBET
CHARLES S. ROCKEY

WALTER L. SCHAFFER
MAURICE H. STANS
VIRGIL S. TILLY
EDWIN H. WAGNER, JR.
C. OLIVER WELLINGTON

CARMAN G. BLough
Director of Research
1. The working capital of a prospective borrower has always been of prime interest to grantors of credit; and frequently working capital has been the subject, in bond indentures, credit agreements, and preferred stock agreements, of provisions restricting corporate actions with respect to its reduction or impairment. Many such contracts forego precise or uniform definitions and merely provide that current assets and current liabilities shall be determined in accordance with generally accepted accounting procedures. Considerable variation and inconsistency exist, however, in current practice with respect to their classification and display. In this bulletin the committee discusses the nature of current assets and current liabilities with a view to developing criteria as an aid to a more useful presentation thereof in financial statements.

2. The committee believes that, in the past, definitions of current assets have tended to be overly concerned with immediate or forced liquidation values. The discussion which follows takes cognizance of the tendency in recent years for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtor's ability to pay in case of liquidation. It should be reemphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business. Accordingly, this statement represents a departure from any narrow definition or strict “one year” interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

3. Financial position, as it is reflected by the records and accounts from which the statement is prepared, is revealed in a presentation of the assets and liabilities of the enterprise. These assets and liabilities in statements prepared by manufacturing, trading, and service

---

1 See “Examination of Financial Statements,” page 2, published by the American Institute of Accountants.
enterprises, are generally classified and segregated and, if logically classified, summations or totals of the "current" or "circulating" or "working" assets and of related obligations, designated as "current liabilities," will permit the ready determination of working capital. Working capital, sometimes called net working capital, is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations to be incurred and liquidated within the ordinary operating cycle of the business. If the conventions and procedures of accounting relative to the identification and presentation of current assets and liabilities are made logical and mutually consistent, an analysis of the amount, basis of valuation, and composition of such assets and liabilities and their relation to the total assets or capital employed may provide valuable data for credit and management purposes by furnishing a reliable indication of current financial status and affording a sound basis of comparison from year to year with due regard to the increase or decrease of the net amount of current assets and current liabilities. It is recognized that there may be exceptions, in special cases, to certain of the inclusions and exclusions as set forth in this bulletin. When such exceptions occur, however, they should be accorded the treatment merited in the particular circumstances under the general principles outlined herein.

4. For accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash, (b) merchandise or stock on hand, or inventories of raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts, (c) trade accounts, notes, and acceptances receivable, (d) receivables from officers (other than for loans and advances), employees, affiliates, and others if collectible in the ordinary course of business within a year, (e) installment or deferred accounts and notes receivable if they conform to normal trade practices and terms within the business, (f) marketable securities representing the investment of cash available for current operations, and (g) prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle.

5. The ordinary operations of a business involve a circulation of capital within the current asset group. Cash, when expended for
Current Assets and Current Liabilities—Working Capital

materials, finished parts, operating supplies, labor and other factory services, is accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an "operating cycle." A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within such time period. However, where the period of the operating cycle is in excess of twelve months, such as in the tobacco, distillery, and lumber businesses, the longer period should be used.2

6. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts; (b) investments in securities, whether marketable or not, or advances, which have been made for purposes of control, affiliation, or other continuing business advantage; (c) receivables arising from unusual transactions, such as the sale of capital assets or advances to affiliates, officers, or employees, which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) balances representing the unamortized or unallocated costs of services received or to be received which are fairly chargeable to the operations of several years, such as debt discount and expenses or bonus payments under a long-term lease.

7. The term current liabilities is used principally to identify and designate debts or obligations, the liquidation or payment of which is reasonably expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, as in the case of payables incurred in the acquisition of materials

2 While the illustrations that have been used apply to industrial concerns, the same principles generally apply to other concerns.

3 Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes should also, under this concept, be excluded from current assets. However, where such funds are considered to offset maturing debt which has properly been set up as a current liability, they may be included within the current asset classification.
and supplies to be used in the production of goods or in providing services to be offered for sale, collections received in advance of the delivery of goods or performance of services, and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, or royalties. Other liabilities the regular and ordinary liquidation of which is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, and agency obligations arising from the collection or acceptance of cash or other assets for the account of a third party. Income taxes should be included as current liabilities even though the entire amount may not be payable within twelve months.

8. This concept of current liabilities would include operating reserves which are expected to be required to cover expenditures within the year. Operating reserves properly provide for known obligations (a) the amount of which can only be determined approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific party or parties to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The classification, however, is not intended to include a contractual obligation falling due at an early date which is expected to be refunded, or debts the funds for liquidation of which have been accumulated in accounts of a type not properly classified as current assets. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property

4 Examples of such current liabilities are obligations resulting from advance collections on ticket sales, the delivery of services for which will normally be made in the ordinary course of business. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of such transactions are the issuance of a long-term warranty or the advance receipt by lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

5 In further elaboration of this concept, loans secured by life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as security for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the belief that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation would be excluded from current liabilities.

6 See also Accounting Research Bulletin No. 23.

7 There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given. CF Note 8.
Current Assets and Current Liabilities—Working Capital

obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date.

9. The monetary values at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of reserves for uncollectible accounts, are effectively stated at the amount of cash estimated as realizable. However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value. The basis for carrying inventories has been stated by the committee previously. Accordingly, it is important that the amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance-sheet date, and for the various classifications of inventory items, the basis upon which their amounts are stated.

The statement entitled “Current Assets and Current Liabilities—Working Capital” was unanimously adopted by the twenty-one members of the committee.

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

8 See Accounting Research Bulletin No. 29.
from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

Committee on Accounting Procedure (1946-1947)

<table>
<thead>
<tr>
<th>George D. Bailey, Chairman</th>
<th>David Himmelblau</th>
<th>Walter L. Schaffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>William H. Bell</td>
<td>John B. Inglis</td>
<td>Maurice H. Stans</td>
</tr>
<tr>
<td>Samuel J. Broad</td>
<td>Paul K. Knight</td>
<td>Virgil S. Tilly</td>
</tr>
<tr>
<td>M. C. Conick</td>
<td>Warren W. Nisley</td>
<td>C. Oliver Wellington</td>
</tr>
<tr>
<td>James L. Dohr</td>
<td>William A. Paton</td>
<td></td>
</tr>
<tr>
<td>Fred J. Duncombe</td>
<td>Maurice E. Peloubet</td>
<td></td>
</tr>
<tr>
<td>Anson Herrick</td>
<td>Charles S. Rockey</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Director of Research</td>
</tr>
</tbody>
</table>
1. Reserves designed to set aside a part of current profits to absorb losses feared or anticipated in respect to inventories on hand, or in connection with future purchases, are the subject of this bulletin. Charges to provide, either directly or by use of a reserve, for obsolescence, deterioration, or similar losses, or for reducing an inventory to market, or for reducing an inventory to a recognized basis such as last-in first-out or its equivalent in accordance with an announced change in policy to be consistently followed thereafter, are regarded as proper charges to income, and are not under consideration in this bulletin. The committee has already dealt with reserves arising out of the war,¹ and with general purpose contingency reserves.²

2. The committee has previously³ recognized the character of the income statement as a tentative installment in the long-time financial results, and is aware of the tendency to exaggerate the significance of the net income for a single year. Nevertheless, there still exists the responsibility for determining net income as fairly as possible by sound methods consistently applied, and the duty to show it clearly.

3. In accomplishing this objective, it has been deemed desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.⁴ In applying this rule, inventories on hand or contracted for should be priced in accordance with principles recently stated by the committee.⁵ When

¹ Accounting Research Bulletins Nos. 13 and 26.
² Accounting Research Bulletin No. 28.
³ Accounting Research Bulletin No. 8, p. 64.
⁴ Accounting Research Bulletin No. 13, p. 111.
⁵ Accounting Research Bulletin No. 29.
such an inventory which has been priced in accordance with those principles is further written down by a charge to income, either directly or through the use of a reserve, current costs are not properly matched with applicable revenues and future charges are correspondingly reduced. This process may result in the shifting of profits from one period to another without accounting justification. The committee is on record that reserves should not be created for the purpose of equalizing reported income.\(^6\)

4. It has been argued that losses which will have to be taken in periods of receding price levels have their origins in periods of rising prices, and that, therefore, reserves to provide for future price declines should be created in periods of rising prices by charges against the operations of those periods. Computations of reserves of this kind have to be made on the basis of assumptions as to what future price levels will be, what quantities will be on hand if and when a major price decline takes place, and finally, whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. When estimates of this character are charged to current costs, amounts representing mere conjecture are combined with others determined with a reasonable degree of accuracy.\(^7\)

5. The committee is therefore of the opinion that inventory reserves, such as those created:

(a) for possible future inventory losses on inventories not on hand or contracted for, or

(b) without regard to any specific loss reasonably related to the operations of the current period, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles.\(^8\)

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year.

6. The committee is also of the opinion that if a reserve of the

\(^6\) Accounting Research Bulletin No. 13, p. 112.
\(^7\) Accounting Research Bulletin No. 13, p. 113.
\(^8\) See particularly Accounting Research Bulletin No. 29.
Inventory Reserves

type described in paragraph 5 is set up: (1) it should be created preferably by a segregation or appropriation of surplus, (2) no costs or losses should be charged to it and no part of it should be transferred to income or in any way used to affect the determination of net income for any year, and (3) the reserve should be restored to surplus when it is no longer considered necessary. The committee recognizes a. proper, though less desirable, the alternative procedure of (a) setting up such a reserve by an appropriation of net income so reported in the income statement that the final figure would clearly indicate that it is not the entire net income, and (b) of showing the subsequent return of such a reserve at the foot of the income statement after the determination of net income for the period in such a way as to clearly indicate that it is not income.

The statement entitled "Inventory Reserves" was adopted by the assenting votes of nineteen members of the committee. Two members, Messrs. Dohr and Knight, dissented.

Mr. Dohr dissents for the following reasons: "(1) The position taken by the committee in this bulletin cannot be reconciled with its approval of the last-in first-out method of inventory accounting. (2) The committee characterizes the reserves in question as 'speculative guesses,' 'mere conjecture,' and 'future' inventory losses," and in his opinion "this precludes any argument." He believes "there may be cases where reserves, objectively determined, may be appropriate despite the fact that they would not come within the ambit of Bulletin No. 29." (3) He "can think of no circumstances in which it would be appropriate to bring an unused reserve into the disposition section at the foot of the income statement."

Mr. Knight dissents because he believes "traditional accounting practices are clearly inadequate to cope with existing extraordinary price inflation and subsequent substantial deflation that appears inevitable based on past experience. Obviously reserve provisions made capriciously to equalize profits between years must be condemned. It seems equally plain, however, that accounting rules should not force business to report inventory profits as unqualifiedly realized in the face of conviction that such profits will never be realized. Neither should business be forced to adopt the involved last-in first-out method as the only means of eliminating such profits. This extraordinary price situation requires sensible tolerance in making objective tests of business judgments exercised in good faith and a realistic consideration of substance rather than technical adherence to form."

257
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.)

Committee on Accounting Procedure (1946-1947)

<table>
<thead>
<tr>
<th>Members</th>
<th>Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>George D. Bailey, Chairman</td>
<td>David Himmelblau</td>
</tr>
<tr>
<td>William H. Bell</td>
<td>John B. Inglis</td>
</tr>
<tr>
<td>Samuel J. Broad</td>
<td>Paul K. Knight</td>
</tr>
<tr>
<td>Henry T. Chamberlain</td>
<td>Edward J. McDevitt, Jr.</td>
</tr>
<tr>
<td>M. C. Conick</td>
<td>Warren W. Nibley</td>
</tr>
<tr>
<td>James L. Dohr</td>
<td>William A. Paton</td>
</tr>
<tr>
<td>Fred J. Duncombe</td>
<td>Maurice E. Peloubet</td>
</tr>
<tr>
<td>Anson Herrick</td>
<td>Charles S. Rockey</td>
</tr>
<tr>
<td></td>
<td>Walter L. Schaffer</td>
</tr>
<tr>
<td></td>
<td>Maurice H. Stans</td>
</tr>
<tr>
<td></td>
<td>Virgil S. Tilly</td>
</tr>
<tr>
<td></td>
<td>Edwin H. Wagner, Jr.</td>
</tr>
<tr>
<td></td>
<td>C. Oliver Wellington</td>
</tr>
<tr>
<td></td>
<td>Carmen G. Blough</td>
</tr>
<tr>
<td></td>
<td>Director of Research</td>
</tr>
</tbody>
</table>
1. For a number of years the committee has studied the form and content of financial statements and has considered the means by which they may be made more useful for the purposes they are designed to serve. As a result of this inquiry, and taking cognizance of the expanded public use of corporate financial data, the committee believes it appropriate to issue this statement

(a) citing briefly the viewpoints with respect to the principal debatable area of the income statement, and

(b) recommending criteria for use in identifying material extraordinary charges and credits which may or should be excluded from the determination of net income.

2. In dealing with the problem of selecting the most useful form of income statement, the danger of understatement or overstatement of income must be recognized. An important objective of income presentation should be the avoidance of any policy of income equalization.

3. The committee directs particular attention to certain facts which serve to emphasize that the word “income” is used to describe a general concept, not a specific and precise thing. Initially, it is important to iterate that the income statement is based on the concept of the “going-concern.” It is at best an interim report. Profits are not fundamentally the result of operations during any short period of time. Allocations as between years of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement.

4. It must also be recognized that the ultimate distinction
between “operating” income and charges and “non-operating” gains and losses, terms having considerable currency in the accounting profession, has not been made. The former are generally defined as recurrent features of business operation, more or less normal and dependable in their incidence from year to year; the latter are generally considered to be irregular and unpredictable, more or less fortuitous and incidental. The committee is also mindful that the term “net income” has been used indiscriminately and often without precise, and most certainly without uniform, definition in the financial press, investment services, annual reports, prospectuses, contracts relating to compensation of management, bond indentures, preferred stock dividend provisions, and in many other places.

5. In the committee’s view, the above facts with respect to the income statement and the income which it displays, make it incumbent upon readers of financial statements to exercise great care at all times in drawing conclusions from them.

6. The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion. On the one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the “all-inclusive” income statement. On the other hand, a different concept places its principal emphasis upon the relationship of items to the operations, and to the year, excluding from the determination of net income any material extraordinary items which are not so related or which, if included, would impair the significance of net income so that misleading inferences might be drawn therefrom. This latter concept would require the income statement to be designed on what might be called a “current operating performance” basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement.

7. Proponents of the “all-inclusive” type of income statement insist that annual income statements taken for the life of an enterprise should, when added together, represent total net income. They emphasize the dangers of possible manipulation of annual earnings if material extraordinary items may be omitted in the determination of income. They also assert that, over a period of years, charges resulting from extraordinary events tend to exceed the credits, and their omission has the effect of indicating a greater earning performance than the corporation actually has exhibited.
They insist that an income statement including all income charges or credits arising during the year is simple to prepare, is easy to understand, and is not subject to variations resulting from the different judgments that may be applied in the treatment of individual items. They argue that when judgment is allowed to enter the picture with respect to the inclusion or exclusion of special items, material differences in the treatment of borderline cases will develop and that there is danger that the use of "distortion" as a criterion may be a means of rationalizing the normalization of earnings. With full disclosure of the nature of any special or extraordinary items, this group believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.

8. Those who favor the "all-inclusive" income statement largely presume that those supporting the "current operating performance" concept are mainly concerned with establishing a figure of net income for the year which will carry an implication as to future earning capacity. Having made this presumption, they contend that income statements should not be prepared on the "current operating performance" basis because income statements of the past are of only limited help in the forecasting of the earning power of an enterprise. This group also argues that items reflecting the results of unusual or extraordinary events are part of the earnings history of the corporation, and accordingly should be given weight in any effort to make financial judgments with respect to the company. Since a judgment with respect to the financial affairs of the corporation should involve a study of the results of a period of prior years, rather than of a single year, this group believes that the omission of material extraordinary items from annual income statements is undesirable as it would tend to cause them to be overlooked in such a study.

9. On the other hand, those who advocate the "current operating performance" type of income statement generally do so because they are mindful of the particular business significance which a substantial number of the users of financial reports attach to the income statement. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. Furthermore, they contend it is difficult at best to report in any financial statement sufficient data to afford a sound basis upon which the reader who does not have an intimate knowledge of the facts can make a well considered classification. They consider it self-evident that management and the independent auditors are in a stronger position
than outsiders to determine whether there are unusual and extraordinary items which, if included in the determination of net income, may give rise to misleading inferences with respect to current operating performance. Relying on the proper exercise of professional judgment, they discount the contention that neither managements nor the independent auditors, due to the absence of objective standards to guide them, have been able to decide consistently which extraordinary charges and credits should be excluded in determining earning performance. They admit it is hazardous to place too great a reliance on the net income as shown in a single annual statement and insist that a realistic presentation of current performance must be taken for what it is and should not be construed as conveying an implication as to future accomplishments. The net income of a single year is only one of scores of factors involved in analyzing the future earnings prospects or potentialities of a business. It is well recognized that future earnings are dependent to a large extent upon such factors as market trends, product developments, political events, labor relationships, and numerous other factors not ascertainable from the financial statements. However, this group insists that the net income for the year should show as clearly as possible what happened in that year under that year's conditions, in order that sound comparisons can be made with prior years and with the performance of other companies.

10. The advocates of this "current operating performance" type of statement join fully with the so-called "all-inclusive" group in asserting that there should be full disclosure of all material charges or credits of an unusual character, including those attributable to a prior year, but they insist that such disclosure should be made in such a manner as not to distort the figure which represents what the company was able to earn from its usual or typical business operations under the conditions existing during the year. They point out that many companies, in order to give more useful information concerning their earning performance, make it a practice to restate the earnings of a number of prior years after adjusting them to reflect the proper allocation of items not related to the years in which they were first reported. They believe that material extraordinary charges or credits may often best be disclosed as direct adjustments of surplus. They point out that a charge or credit in a material amount representing an unusual item not likely to recur, if included in the computation of the company's annual net income, may be so distorting in its results as to lead to unsound judgments with respect to the current earning performance of the company.

11. The committee has previously indicated¹ that, in its opinion,

¹ See Accounting Research Bulletins Nos. 8 and 23.
Income and Earned Surplus

it is plainly desirable that over the years all profits and losses of a business be reflected in net income, but at the same time has recognized that, under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of the net income of a single year, even though they clearly affect the cumulative total of income for a series of years. In harmony with this view, it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;

(d) The write-off of a material amount of intangibles, such as the complete elimination of goodwill or a trademark;

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.

Adjustments resulting from transactions in the company's own capital stock, amounts transferred to and from accounts representing a

---

2 See Accounting Research Bulletin No. 23 with respect to the allocation of income taxes.
3 To the extent that the recommendations contained in this statement are in conflict with those contained in summary statement (5) and the footnote thereto in Bulletin No. 23, this Bulletin supersedes that Bulletin.
4 To the extent that the recommendations contained in this statement are in conflict with Bulletin No. 18, this Bulletin supersedes that Bulletin.
12. Consideration has been given to the method of presentation of the extraordinary items that are excluded in the determination of net income under the criteria set forth in the preceding paragraph. Some would carry all such charges and credits directly to the surplus account with complete disclosure as to their nature and amount. Others would report most of those items at the bottom of the income statement immediately following the amount of net income and include them in the determination of the amount carried to surplus. The committee expresses no preference for either of these methods, but is of the opinion that, regardless of the form of presentation, the amount of net income should be clearly and unequivocally designated.

13. In its deliberations concerning the nature and purpose of the income statement, the committee has been mindful of the disposition of even well-informed persons to attach undue importance to a single net income figure and to "earnings per share" shown for a particular year. The committee directs attention to the undesirability in many cases of the dissemination of information in which major prominence is given to a single figure of "net income" or "net income per share." However, if such income data are reported (as in newspapers, investors' services, and annual corporate reports), the committee strongly urges that any determination of "income per share" be related to the amount reported as net income, and that where charges or credits have been excluded from the determination of net income, the corresponding total or per share amount of such charges and credits also be reported separately and simultaneously. In this connection the committee earnestly solicits the cooperation of all organizations, both governmental and private, engaged in the compilation of business earnings statistics from annual reports.

The statement entitled "Income and Earned Surplus" was adopted by the assenting votes of eighteen members of the committee, of whom one, Mr. Himmelblau, assented with qualification. Three members, Messrs. Chamberlain, Paton, and Stans, dissented.

Mr. Himmelblau assents with the qualification that when the figure designated as "net income" precedes special charges and credits

---

*Neither of these methods precludes the use of the combined statement suggested in Accounting Research Bulletin No. 8.*
in the income statement, the caption should be expanded to read “net income before special charges and credits”; he believes the more specific description is needed to prevent the phrase being quoted separately from its context in which case misleading inferences may arise. Likewise, he believes the balance after special charges and credits should be given an adequate descriptive title.

Messrs. Chamberlain, Paton, and Stans dissent from the conclusions of this bulletin because they believe that the so-called “all-inclusive” concept provides the proper measure of net income and best serves the public interest because it is least subject to reader misinterpretation. They believe that all of the aims of both schools of thought described herein can be accomplished by a two-section form of income statement in which net operating income is segregated from the non-operating gains or losses and the sum of the two sections is reported as “net income for the year.” They are willing to accept the criteria in subparagraphs (a) to (e) of paragraph 11 for the purpose of establishing the items to appear in the second section of such an income statement. However, Mr. Chamberlain points out that with respect to the first of the criteria, his concept of the all-inclusive statement calls for the return of unused special purpose reserves in the year in which it is first determined that the reserves are not needed; also, he is opposed to the elimination of general contingency reserves through the income account on the ground that their creation did not properly give rise to an income charge. Subject to this explanation of his views with respect to subparagraph (a) of paragraph 11, Mr. Chamberlain joins Messrs. Paton and Stans in contending that recognized gains and losses of the types described are part of the business history and should not be permitted to be carried to a separate surplus statement but should be included in the income account, in juxtaposition to the operating result. They believe that the bulletin will not materially reduce the present number of surplus charges and credits, a practice which they condemn on the ground that it results in incomplete historical reporting and thereby tends to hinder public understandability of 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
Accounting Research Bulletins

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.)

Committee on Accounting Procedure (1946-1947)

GEORGE D. BAILEY, Chairman
WILLIAM H. BELL
SAMUEL J. BROAD
HENRY T. CHAMBERLAIN
M. C. CONICK
JAMES L. DOHR
FRED J. DUNCOMBE
ANSON HERRICK

DAVID HimmELBLAUF
JOHN B. INGLIS
PAUL K. KNIGHT
EDWARD J. McDEVITT, JR.
WARREN W. Nissley
WILLIAM A. PATON
MAURICE E. PELoubet
CHARLES S. ROCKEY

WALTER L. Schaffer
MAURICe H. STANS
VIRGIL S. TILLY
EDWIN H. WAGNER, JR.
C. OLIVER WELLINGTON

CARMAN G. Blough
Director of Research

266
The committee on accounting procedure recently authorized the issuance of a statement to members of the Institute dealing with the propriety of charging to current income (a) amounts in excess of depreciation based on cost of plant facilities to provide for their replacement at higher prices, and (b) a portion of the cost of currently acquired new facilities representing part or all of the excess of current construction costs over an estimated "reasonable" cost. The committee now deems it appropriate to issue that statement as a research bulletin. The statement of the committee follows:

1. "The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

2. "The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

3. "When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

4. "It has been suggested in some quarters that the problem be
Accounting Research Bulletins

met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

5. "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

6. "The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

The statement entitled "Depreciation and High Costs" was adopted by the assenting votes of twenty members of the committee, of whom one, Mr. Wellington, assented with qualification. Mr. Paton did not vote.

Mr. Wellington assents to the bulletin but does not approve the statement that changes in accounting and financial reporting should be postponed until the dollar is stabilized at some level. He believes that the depreciation of the dollar is already so great as to call for recognition thereof in the accounts expressed in dollars. In his opinion the price level is rarely believed to be stable, and waiting for stability may again and again be advanced as a reason for no recognition of changes that have already taken place.
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.)

Committee on Accounting Procedure (1946-1947)

GEORGE D. BAILEY, Chairman
WILLIAM H. BELL
SAMUEL J. BROAD
HENRY T. CHAMBERLAIN
M. C. CONICK
JAMES L. DOHR
FRED J. DUNCOMBE
ANSON HERRICK

DAVID HIMMELBAU
JOHN B. INGLIS
PAUL K. KNIGHT
EDWARD J. McDEVITT, JR.
WARREN W. NISLEY
WILLIAM A. PATON
MAURICE E. PELOUBET
CHARLES S. ROCKEY

WALTER L. SCHAEFFER
MAURICE H. STANS
VIRGIL S. TILLY
EDWIN H. WAGNER, JR.
C. OLIVER WELLINGTON

CARMAN G. BLOUGH
Director of Research
FOREWORD

The members of the committee on accounting procedure have approved as an objective the recommendation of the committee on terminology made herein with respect to the use of the term "reserve" in accounting, and have authorized its publication. The statements herein contained, however, are not to be regarded as formal pronouncements of the committee on accounting procedure.

USE OF THE TERM "RESERVE"

The term reserve is used in accounting in a variety of different and somewhat conflicting senses. As a result clarity of thought and accuracy of expression are impaired and an adequate understanding of financial statements on the part of users is made more difficult than is necessary. In addition the variations in balance-sheet classification and presentation of the so-called reserves contribute to the confusion and make comparisons difficult. It is suggested that the current uses of the term may be reviewed and that recommendations may be made as to acceptable definition and to limitations on usage which will serve to make the financial statements more readily understood.

In dealing with financial matters the term reserve is commonly used to describe specific assets which are held or retained for a specific purpose. This is the sense in which the term is employed, for instance, in our banking system, which derives its name from the fact that member banks are required to maintain deposits with the central or reserve banks. The term is also used to indicate such assets as oil and gas properties which are held for future development. These usages present no problem in accounting where the assets in question are described according to their nature or referred to as funds or deposits for specific purposes.
In current accounting practice the term *reserve* is used in four senses, as follows:

1. The term is used to describe (a) a deduction which is made from the face amount of an asset in order to arrive at the amount which it is expected will be realized, as in the case of a reserve for uncollectible accounts, or (b) a deduction which is made from the cost or carrying value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense reserves are customarily referred to as valuation reserves, and are usually deducted in the asset section of the balance-sheet.

2. The term is used to indicate (a) an estimate of an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) an approximation of the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) an estimate of a liability or loss which is sufficiently likely to occur to require recognition, as in the case of a reserve for self-insurance. These reserves are included in the liability section of the balance-sheet, in a section immediately below the ordinary liabilities, or in the proprietary section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is required to meet future payments under policies.

3. The term is sometimes used, although not in accordance with the best practice as generally recognized, to indicate a variety of charges set forth in the income statement, including estimated losses as a result of uncollectible accounts and other causes, depreciation, depletion, amortization, probable losses, specific contingencies, and similar items. It is to be noted here that the term refers to the charge by means of which a reserve (in the credit sense) is created.

4. The term is used to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense a reserve is frequently referred to as an appropriation of retained earnings.

The dictionaries define the term *reserve* generally and in substance in its etymological sense, as something held or retained for a purpose, frequently for emergencies. It is apparent therefore that
Use of Term "Reserve"

the broad usage referred to, in the second paragraph of this memorandum, is one which clearly reflects the general understanding of the term, i.e., specific assets held or retained for some purpose. It is also apparent, however, that the occasions for usage in this sense are distinctly limited, and that where specified assets are segregated and held for some purpose they may be described for accounting purposes by the use of such terms as fund, deposit, temporary investments, etc. While the general characterization of these items as reserves is acceptable usage, it is not involved in the problem of definition within the field of accounting.

The first accounting usage of the term set forth above seems clearly contrary to the commonly accepted meaning of the term. A so-called reserve for bad debts or for depreciation does not in itself involve a retention or holding of assets, identified or otherwise, for any purpose. Its function is rather to indicate a diminution or decrease in an asset due to a specified cause; the use of the so-called reserve in this area is essentially a part of a process of measurement. In the recent amendment of the British Companies Act the British accountants appear to have been troubled by the various uses of the term reserve and as a result of their recommendations it is now provided that the so-called reserve of this type shall be described as a provision. It may well be doubted whether this is an improvement, because any provision must of necessity and in the final analysis be made by the allocation or segregation of assets. While it seems clearly advisable to drop the term reserve in this area, it should be replaced by terms which indicate the measurement process, i.e., such terms as "less estimated uncollectibles," "less estimated losses in collection," "less amortization to date," etc.

The second of the four accounting usages set forth above is also contrary to the generally accepted meaning of the term. It may be argued, of course, that the statement of any liability in the balance-sheet is an indication that a portion of the assets will be required for its discharge. In this sense the statement may be regarded as a provision or reserve. It is clearly preferable, however, to regard the statement as indicating the obligation itself which is a deduction necessary to arrive at proprietary investment or net assets. The items in this area described as reserves might better be designated in some such way as "estimated liabilities" or "liabilities of estimated amount."

The third of the four usages set forth above involves different considerations since it is a matter of the income statement rather than the balance-sheet. In a sense a charge of this nature in the income statement, e.g., a charge for depreciation, is a "reserve" in so far as it indicates that cash or other assets received by way of reve-
nues is, to the extent indicated, to be used or devoted to a special purpose. It seems clear, however, that the basic purpose in the making of these charges is one of income measurement and that the designation of such charges as costs, expenses or losses, i.e., elements in the measurement of income, is clearly more understandable than the designation of reserves. The description of these charges as reserves or provisions suggests not only that the function of depreciation accounting is one of replacement, but in addition leads to the suggestion that the provision be based upon estimated future cost. It seems desirable accordingly that the use of the term reserve in the income statement be discontinued.

The generally accepted meaning of the term reserve corresponds fairly closely to the last of the four usages set forth above, i.e., the indication of an amount of unidentified or unsegregated assets held or retained for a specific purpose. While retention of assets for a variety of purposes is an important phase of corporate management and finance, the retention does not ordinarily involve a segregation. It is suggested that this meaning may well be adopted as the primary significance of the term in accounting and that other uses of the term be discontinued. It is interesting to note that in the 1947 revision of the British Companies Act, the British accountants succeeded in securing a limitation of the term to this area.

To summarize, it is recommended that the use of the term reserve in accounting be limited to the last of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes and that the use of the term in the balance-sheet, in describing deductions from assets or provisions for particular liabilities and in the income statement be discontinued.

Committee on Terminology
James L. Dohr, Chairman
William H. Bell
Alvin R. Jennings
1. In Accounting Research Bulletins Nos. 28, 31, 32, and 33, two alternative methods of displaying items excluded from the determination of net income are indicated as being acceptable. Under the first of these methods, the excluded items are displayed in the surplus statement; under the second they are shown in the income statement after the amount designated as net income. Since the issuance of those bulletins, charges and credits displayed in accordance with the second method have been included in many income statements in a manner and with wording which has occasioned misconceptions as to whether the earnings for the period were the amounts captioned as net income or were the final and more prominent amounts shown on the income statements after the deduction or addition of such charges and credits.

2. The committee believes the possibility of misconception in this respect will be minimized by the adoption of the first method in all cases. Accordingly it recommends that the net income for the period be shown henceforth without deductions or additions of items which are properly excluded from the determination of net income. These items consist primarily of charges and credits with respect to (a) general purpose contingency reserves, discussed in Accounting Research Bulletin No. 28, (b) inventory reserves, discussed in Accounting Research Bulletin No. 31, (c) extraordinary items, which, if included, would impair the significance of net income, discussed in Accounting Research Bulletin No. 32, and (d) excessive costs of fixed assets and annual appropriations in contemplation of replacement of productive facilities at higher price levels, discussed in Accounting Research Bulletin No. 33.

3. The committee’s recommendation is not intended to preclude or discourage the use of the combined statement of income and earned surplus recommended in Accounting Research Bulletin No. 8, provided the figure of net income is followed immediately by
the surplus balance at the beginning of the period; or is it intended to preclude the use of a separate statement showing the disposition of net income, if practicable. The committee is also of the opinion that deduction of the single item of dividends from net income on the income statement would not be subject to misconception.

The statement entitled "Presentation of Income and Earned Surplus" was adopted by the assenting votes of nineteen members of the committee, of whom four, Messrs. Duncombe, McDevitt, Stans, and Paton, assented with qualification. Two members, Messrs. Bell and Lindquist, dissented.

Messrs. Duncombe, McDevitt, and Stans assent to the bulletin but dissent from the requirement that charges and credits of the type referred to in clause (c) of paragraph 2 must appear only in the surplus account. They believe that charges and credits which would be excluded from the determination of net income under the criteria in Bulletin 32 should be permitted to appear "... at the bottom of the income statement immediately following the amount of net income ... [including] them in the determination of the amount carried to surplus," in accordance with paragraph 12 of that bulletin. They also believe that the portions of this present bulletin which are inconsistent therewith should be changed accordingly. Mr. Paton assents to the Bulletin but does not agree with the implication that it is improper to charge depreciation to revenues on the basis of replacement cost, as found in the reference to Bulletin 33.

Mr. Bell dissents because he does not "believe that the developments of the last few months are sufficiently important to cause the committee to change its previously well-considered utterances on the subject." He states that, in assenting to Bulletin 32, he considered that the principal consideration was adequate disclosure, and objects to this bulletin because he believes it substitutes rigidity for reasonable flexibility.

Mr. Lindquist dissents from clauses (b), (c), and (d) of paragraph 2. He joins Messrs. Duncombe, McDevitt, and Stans in their objection to clause (c). He believes that permission to display on the income statement appropriations of earnings such as those contemplated in clauses (b) and (d) should not be denied since there is ample protection in adequate disclosure and proper captions.
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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1947-1948)

SAMUEL J. BROAD, Chairman
JOHN N. AITKEN
WILLIAM H. BELL
HOMER L. DALTON
THOMAS M. DICKERSON
JAMES L. DOHR
FRED J. DUNCOMBE
J. P. FRIEDMAN

PAGES OF INCOME AND EARNED SURPLUS

ANSON HERRICK
THOMAS G. HIGGINS
DAVID HIMMELBLAU
JOHN B. INGLIS
PAUL K. KNIGHT
JOHN A. LINDQUIST
EDWARD J. McDEVITT
WILLIAM A. PATON
MAURICE E. PELOUBET
WALTER L. SCHAEFFER
MAURICE H. STANS
VIRGIL S. TILLY
C. OLIVER WELLINGTON
CARMAN G. BLOUGH
Director of Research
1. When costs incurred under pension plans are based in part on services performed prior to the adoption of the plan, the problem arises whether that portion of the costs which are attributable to such services are applicable to the past or to the present and future periods and, accordingly, whether they should be charged to income. This bulletin deals with the accounting treatment of such costs arising out of past services when incurred under pension plans involving payments to outside agencies such as insurance companies and trustees.

2. The committee has undertaken a statement on this subject at this time because of the trend toward expansion of pension plans to cover a wider and much larger group of employees, often at substantially increased costs, and in order to narrow the area of difference in the accounting treatment accorded in actual practice to annuity costs based on past services. Self-administered and informal plans which do not require payments to outside agencies are not specifically dealt with because of their special features and lack of uniformity. The principles set forth herein, however, are generally applicable to those plans as well.

3. Charges with respect to pension costs based on past services have often been made to surplus on the grounds that such payments are indirectly compensation for services and, since the services upon which the payments are computed were performed in the past, the compensation should not be permitted to affect any period or periods other than those in which the services involved were performed. In other cases all annuity costs based on past services have been charged to income in the period of the plan’s inauguration as a current cost of originating the plan. In still other cases the position has been taken that a pension plan cannot bring the anticipated benefits in the future unless past as well as future services are given recognition and,
accordingly, annuity costs based on past services have been spread over a period of present and future years. The last method is the one permitted under provisions of the Internal Revenue Code.*

4. The committee believes that, even though the calculation is based on past services, costs of annuities based on such services are generally incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole and, therefore, should be charged to the present and future periods benefited. This belief is based on the assumption that although the benefits flowing from pension plans are intangible, they are nevertheless real. The element of past services is one of the important considerations of most pension plans and costs incurred on account of such services contribute to the benefits gained by the adoption of a plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations.

5. The committee, accordingly, is of the opinion that:

(a) Costs of annuities based on past services should be allocated to current and future periods; provided, however, that if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year.

(b) Costs of annuities based on past services should not be charged to surplus.

6. The committee does not intend that its recommendations shall require (a) a change in policy calling for charges to income rather than charges to reserves previously provided, or (b) that any recognition be given in the accounts of current or future periods to pension costs written off prior to the issuance of this bulletin.

* See IRC Sec. 23 (p) (1) (A).
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.)

Committee on Accounting Procedure (1947-1948)

Samuel J. Broad, Chairman
John N. Aitken
William H. Bell
Homer L. Dalton
Thomas M. Dickerson
James L. Dohr
Fred J. Duncombe
J. P. Friedman
Anson Herrick
Thomas G. Higgins
David Himmelblau
John B. Inglis
Paul K. Knight
John A. Lindquist
Edward J. McDevitt
William A. Paton
Maurice E. Peloubet
Walter L. Schaffer
Maurice H. Stans
Virgil S. Tilly
C. Oliver Wellington
Carmen G. Blough
Director of Research
INTRODUCTION

1. The practice of granting to officers and other employees options to purchase or subscribe for shares of the corporation's capital stock has been followed by a considerable number of corporations. These options generally are a part of the corporation's cost of the services of officers and other employees, and should be accounted for as such. The amounts involved are sometimes substantial and omission of such costs from the corporation's income accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given in this bulletin to the accounting treatment of stock options involving compensation.

2. Stock options granted by corporations to their officers and other employees are presumed to be a form of compensation for services unless it is clear that they are granted primarily (a) for the purpose of raising capital or (b) to promote widespread ownership of the corporation's stock among its employees. In either of these situations, the statements made herein are not intended to apply. No differentiation is made in this bulletin as to the nature of compensation. Salaries, wages, inducements, incentives, and similar terms are all considered to be descriptive of compensation.

3. A stock option involving compensation usually arises out of an agreement between an employer corporation and an officer or other employee (hereinafter referred to as the grantee) stipulating that at a specified time or during some determinable period, at the grantee's election, and usually upon the fulfillment by the grantee of certain conditions, the corporation will issue shares of its capital stock to the grantee at a stated price. The agreement usually contains provisions specifying the period of time, or conditions, if any, which must elapse or be met, before the option may be exercised, the time the option expires, the price to be paid for the shares, and
a variety of circumstances relating to the issuance of the option. It is recognized that stock options may be granted pursuant to, or even in the absence of, an announced corporate policy and without formal agreement. Although in such cases certain problems regarding the agreement date may not arise, the accounting procedures recommended herein are applicable.

**ACCOUNTING PROBLEMS**

4. The two principal accounting problems involved in the issuance of the type of stock options here considered are (a) the selection of the date on which the compensation is deemed to have accrued and (b) the manner in which it should be measured. Customarily, compensation is due upon performance of a service agreed upon. If compensation is paid in cash, the work is usually first performed for a stipulated period. The charge accrues during the period and payment falls due at the end of the period. In the case of compensation paid in stock as a bonus at the end of a period, the amount of the compensation is not definitely determined until the end of the period. In such cases, the amount of the compensation would be the fair value of the bonus shares at the end of the period, although there might be a recording of estimated accrual during the period.

5. In the case of options to purchase shares, the time of accrual and the amount of the compensation are not always clear. There may be as many as four dates to be considered: (a) the date of the option agreement, (b) the date when the option right becomes the property of the grantee, (c) the date on which the grantee may first exercise the option, and (d) the date the option is exercised by the grantee.

**DATE OF OPTION AGREEMENT**

6. The agreement to grant an option of the character dealt with herein states the terms under which the option will be issued. At the date of the agreement the services contemplated usually have not been performed by the grantee and no accountable obligation has been incurred by the corporation. Argument has been advanced that the worth to the corporation of the right to receive the services of the grantee should be measured as of the date of the agreement on the ground that a corporation would not purchase services without knowing the price it must pay. This argument loses much of its force when it is noted that a corporation does not always know in advance its costs for all services, as when, for example, compensation
Accounting for Compensation in the Form of Stock Options

is to be calculated as a percentage of profits. The committee, therefore, believes that the date of the agreement is not *per se* the date as of which the amount of compensation involved in the option should be measured.

**DATE OPTION RIGHT BECOMES THE PROPERTY OF THE GRANTEE**

7. The committee believes the date on which the option right becomes the property of the grantee is the proper date as of which to measure the value of the option. Upon that date the grantee has met all conditions precedent to receiving the option, and the corporation then has an unqualified obligation under the agreement. While this date may not coincide with the date on which the grantee may first exercise his option, the committee believes this to be the date as of which the corporation should ordinarily measure compensation resulting from the option agreement. It should be recognized that the date of the option agreement may coincide with the date at which the option right becomes the property of the grantee.

**DATE GRANTEE MAY FIRST EXERCISE THE OPTION**

8. The committee believes the date on which the grantee may first exercise the option is not the date as of which to measure the value of the option, unless that date happens to coincide with the date the option right becomes the property of the grantee. The fact that the date the grantee may first exercise the option differs from the date on which it becomes his property in no way changes the grantee's right to the option nor does it change in any way the corporation's obligation under the agreement. If this date follows the date on which the option right becomes the property of the grantee, it merely defers the time when the grantee may exercise the option. Such deferment could, however, affect the value of the option as of the date the option right becomes the property of the grantee.

**THE DATE EXERCISED**

9. The date when the option is exercised has been advocated as both the date of accrual and the time for measurement of the value of the option. Use of this date is supported by two principal arguments.

---

1 Treasury Department regulations provide for recognition of compensation as of the date the option is exercised to the extent the fair value of the property exceeds the amount paid therefor.
First, only then will it be known whether or not the option will be exercised. Second, the value of the option to the grantee cannot be determined until he exercises it, and since the value to the grantee should be the equivalent of the compensation paid by the corporation, such cost should be determined as of the date the option is exercised.

10. An effective answer to the arguments in the preceding paragraph is that the corporation at the time of giving to the grantee the property right inherent in the option has then given valuable consideration for the grantee's services. If the grantee delays exercise or sale of his unrestricted right, he is speculating for his own account. If he does not exercise his option, he is in the position of having made a contribution to the corporation to the extent of the consideration given to him in the form of the option.

**MANNER OF MEASUREMENT**

11. When property is given for services, the cost of those services would be determined by their fair value or by the fair value of the property given, whichever is the more clearly evident.\(^2\) While the market price of the shares will usually be an important factor and often the principal factor in determining fair value, market value is not necessarily conclusive evidence. However, there is a presumption that the value of the option should be measured by deducting the price payable by the grantee from the fair value of the shares on the date the option right becomes the property of the grantee. The amount so determined should, in most cases, represent substantially what the corporation could have realized in excess of the option price by sale of the shares on that date. When the agreement contains provisions which defer the date when the option may first be exercised, or which prevent the option from being sold or transferred, the value of the option may be less.

**OTHER CONSIDERATIONS**

12. When treasury shares are used by the corporation to fulfill the option agreement, the compensation is to be measured in the same way as if unissued shares had been used.

13. The entry to be made on the books should be a charge against the income account for the value of the option and a credit to an account similar to the account to which subscriptions for capital

\(^2\) See Accounting Research Bulletin No. 24, p. 196.
Accounting for Compensation in the Form of Stock Options

stock should be credited. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the agreement, the period over which the charge against income should be apportioned must be selected on the basis of the existing circumstances.

14. Until the option is exercised or expires, the existence of such option agreements and the rights outstanding under such agreements should be disclosed with appropriate explanation in the corporation's financial statements.

The statement entitled "Accounting for Compensation in the Form of Stock Options" was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Wellington, assented with qualification. Two members, Messrs. Himmelblau and Lindquist, dissented.

Mr. Wellington assents to the bulletin but believes the value of the option, and the compensation, should be measured at the date of the option agreement, at which time he believes there has been a meeting of minds as to value, rather than at the date the option right becomes the property of the grantee.

Mr. Himmelblau dissents because he believes the bulletin should require that, whenever an employee fails to exercise his option, the credit should be to earned surplus as would be the case in an adjustment of any other liability. He also objects to the bulletin because it fails to distinguish between stock options intended to be "bargain purchases" and those intended to be "compensation."

Mr. Lindquist dissents from the requirement that an accounting should be made before the option is exercised. He believes that until all of the acts up to and including the delivery of the optioned shares have been performed, the option is no more than a commitment on the part of the grantor of the option to deliver shares upon demand of the grantee. In his opinion, to require an accounting before the option is exercised, is to demand the accounting of a transaction that has not become, and may never become, completed.
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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1947-1948)

SAMUEL J. BROAD, Chairman
JOHN N. AITKEN
WILLIAM H. BELL
HOMER L. DALTON
THOMAS M. DICKERSON
JAMES L. DOHR
FRED J. DUNCOMBE
J. P. FRIEDMAN

ANSON HERRICK
THOMAS G. HIGGINS
DAVID HIMMELBLAUF
JOHN B. INGLIS
PAUL K. KNIGHT
JOHN A. LINQUIST
EDWARD J. McDEVITT
WILLIAM A. PATON

MAURICE E. PELOUBET
WALTER L. SCHAFFER
MAURICE H. STANS
VIRGIL S. TILLY
C. OLIVER WELLINGTON
CARMAN G. BLOUGH
Director of Research
TO THE MEMBERS OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

The committee on accounting procedure has reached the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to meet it. It has solicited and considered hundreds of opinions on this subject expressed by businessmen, bankers, economists, labor leaders and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.

The committee, therefore, reaffirms the opinion it expressed in Accounting Research Bulletin No. 33, December 1947.

Any basic change in the accounting treatment of depreciation should await further study of the nature and concept of business income.
American Institute of Accountants

The immediate problem can and should be met by financial management. The committee recognizes that the common forms of financial statements may permit misunderstanding as to the amount which a corporation has available for distribution in the form of dividends, higher wages, or lower prices for the company's products. When prices have risen appreciably since original investments in plant and facilities were made, a substantial proportion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of a year as at the beginning.

Stock holders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings.

Four of the twenty-one members of the committee, Messrs. Broad, Paton, Peloubet and Wellington, dissented from the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions. They believe further that inflation has proceeded to a point where original dollar costs have already lost their practical significance and that where depreciation is an important element of cost the advantages which would result from a basic change in accounting treatment outweigh the possible disadvantages which have been advanced against it.

For the
COMMITTEE ON ACCOUNTING PROCEDURE

By Samuel J. Broad

Chairman
INTRODUCTION

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given in this bulletin to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.1

2. For convenience, this bulletin will discuss primarily the problems of compensation raised by stock option plans. However, the com-

1 Bulletin 37, "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of the present bulletin and its expansion to include stock purchase plans was prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, the Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.
mittee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

**RIGHTS INVOLVING COMPENSATION**

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

**RIGHTS NOT INVOLVING COMPENSATION**

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

**TIME OF MEASUREMENT OF COMPENSATION**

6. In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This problem involves selection of the date as of which measurement of any ele-
ment of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan; (b) the date on which an option is granted to a specific individual; (c) the date on which the grantee has performed any conditions precedent to exercise of the option; (d) the date on which the grantee may first exercise the option; (e) the date on which the option is exercised by the grantee; and (f) the date on which the grantee disposes of the stock acquired.

7. Of the six dates mentioned two are not relevant to the question considered in this bulletin—cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed. 2

8. The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the option he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

9. The date on which the grantee may first exercise the option will generally coincide with, but in some cases may follow the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special problems differing from those to be discussed in the next paragraph.

10. There remains to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the “amount” of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be

---

2 This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.
subject to some difference of opinion but it would appear that
the date on which an option is granted to a specific individual would
be the appropriate point at which to evaluate the cost to the em-
ployer, since it was the value at that date which the employer may be
presumed to have had in mind. In most of the cases under discussion,
moreover, the only important contingency involved is the continu-
ance of the grantee in the employment of the corporation, a matter
very largely within the control of the grantee and usually the main
objective of the grantor. Under such circumstances it may be assumed
that if the stock option were granted as a part of an employment con-
tract, both parties had in mind a valuation of the option at the date
of the contract; and accordingly, value at that date should be used as
the amount to be accounted for as compensation. If the option were
granted as a form of supplementary compensation otherwise than as
an integral part of an employment contract, the grantor is nevertheless
governed in determining the option price and the number of
shares by conditions then existing. It follows that it is the value of the
option at that time, rather than the grantee's ultimate gain or loss on
the transaction, which for accounting purposes constitutes whatever
compensation the grantor intends to pay. The committee therefore
concludes that in most cases, including situations where the right to
exercise is conditional upon continued employment, valuation should
be made of the option as of the date of grant.

11. The date of grant also represents the date on which the cor-
poration foregoes the principal alternative use of the shares which it
places subject to option, i.e., the sale of such shares at the then pre-
vailing market price. Viewed in this light, the "cost" of utilizing the
shares for purposes of the option plan can best be measured in rela-
tion to what could then have been obtained through sale of such
shares in the open market. However, the fact that the grantor might,
as events turned out, have obtained at some later date either more
or less for the shares in question than at the date of the grant does not
bear upon the measurement of the compensation which can be said
to have been in contemplation of the parties at the date the option
was granted.

MANNER OF MEASUREMENT

12. Freely exercisable option rights, even at prices above the cur-
rent market price of the shares, have been traded in the public mar-
kets for many years, but there is no such objective means for measur-
ing the value of an option which is not transferable and is subject to
such other restrictions as are usually present in options of the nature
here under discussion. Although there is, from the standpoint of the
grantee, a value inherent in a restricted future right to purchase
Stock Option and Stock Purchase Plans

shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the fair value of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price below the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.

13. While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence. Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.

OTHER CONSIDERATIONS

14. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

3 Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.
15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

The statement entitled "Accounting for Compensation Involved in Stock Option and Stock Purchase Plans" was adopted by the assenting votes of nineteen members of the committee, of whom two, Messrs. Mason and Smith, assented with qualification. One member, Mr. Knight, did not vote.

Mr. Mason assented only under the assumption that if an option lapses after the grantee becomes entitled to exercise it, the related compensation shall be treated as a contribution by the grantee to the capital of the grantor.

Mr. Smith assented to the bulletin but deprecates the failure to recommend disposition of the credit arising from compensation charges in the case of lapsed options. He believes that the failure of the committee to do so is not in the best interest of the profession generally, and may lead to diverse treatments inimical to good accounting practice.

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. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.
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.)
Disclosure of Long-Term Leases in Financial Statements of Lessees

1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements. In buy-build-sell-and-lease transactions, the purchaser of land builds to his own specifications, sells the improved property, and simultaneously leases the property for a period of years. Similar transactions are the sale and lease of existing properties or the lease of properties to be constructed by the lessor to the specifications of the lessee. The lessee ordinarily assumes all the costs and obligations of ownership (such as taxes, insurance, maintenance and repairs) except for payment of any mortgage indebtedness on the property.

2. There are many variations in such types of transactions. For example, some leases contain an option for acquisition of the property by the lessee, while other leases contain a requirement that the lessee purchase the property upon expiration. In some the price to be paid upon repurchase is related to the fair value of the property or the depreciated book value; in others it is an arbitrary amount with little or no relation to the property's worth, or a nominal sum. Some leases provide for a high initial rental with declining payments thereafter or for renewal at substantially reduced rentals.

3. It has not been the usual practice for companies renting property to disclose in financial statements either the existence of leases or the annual rentals thereunder. One of the effects of the long-term lease as a substitute for ownership and mortgage borrowing is that neither the asset nor any indebtedness in connection with it is shown on the balance-sheet. This has raised the question of disclosure in

---

1 The Securities and Exchange Commission, however, in Note 5 to Rule 12-16 of Regulation S-X dealing with supplementary profit and loss information, requires disclosure in a schedule, if significant in amount, of "... the aggregate annual amount of the rentals upon all real property now leased to the person and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases," and the minimum annual amount if the rentals are conditional.
financial statements of the fixed amounts payable annually thereunder.

4. Although the types of sell-and-lease arrangements referred to in paragraph 1 differ in many respects from the conventional long-term lease\(^2\), the principles of disclosure stated herein are intended to apply to both. This bulletin does not apply to short-term leases, or to those customarily used for oil and gas properties.

5. The committee believes that material amounts of fixed rentals and other liabilities maturing in future years under long-term leases and possible related contingencies are material facts affecting judgments based on the financial statements of a corporation; and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder, irrespective of whether the leases are considered to be advantageous or otherwise. Accordingly, where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

(a) disclosure should be made in financial statements or in notes thereto of

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable, and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

6. A lease arrangement is sometimes, in substance, no more than an installment purchase of the property. This may well be the case when the lease is made subject to purchase of the property for a nominal sum or for an amount substantially less than the prospective fair value of the property; or when the agreement stipulates that the rental payments may be applied in part as installments on the purchase price; or when the rentals obviously are so out of line with rentals for similar properties as to negative the representation that the rental payments are for current use of the property and to create

---

\(^2\) The conventional lease, a straight tenure contract between the owner of property and a lessee, generally does not involve buying, building and selling of property by the lessee, or special repurchase arrangements.
Disclosure of Long-Term Leases in Financial Statements of Lessees

the presumption that portions of such rentals are partial payments under a purchase plan.

7. Since the lessee in such cases does not have legal title to the property and does not necessarily assume any direct mortgage obligation, it has been argued that any balance-sheet including the property as an asset and any related indebtedness as a liability would be incorrect. However, the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, then the “leased” property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

The statement entitled “Disclosure of Long-Term Leases in Financial Statements of Lessees” was unanimously adopted by the twenty-one members of the committee.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1948-1949)

SAMUEL J. BROAD, Chairman
FREDERICK B. ANDREWS
WILLIAM H. BELL
FRANK S. CALKINS
THOMAS M. DICKERSON
JAMES L. DOHR
GEORGE P. ELLIS
J. P. FRIEDMAN
ANSON HERRICK
THOMAS G. HIGGINS
DAVID HIMMELBLAU
JOHN B. INGLIS
PAUL K. KNIGHT
JOHN A. LINDQUIST
EDWARD J. McDEVITT
WILLIAM A. PATON
MAURICE E. PELOUBET
WALTER L. SCHAFFER
VIRGIL S. TILLY
C. OLIVER WELLINGTON
EDWARD B. WILCOX
CARMAN G. BLOUGH, Director of Research

293
FOREWORD

The committee on accounting procedure has approved as an objective the recommendation of the subcommittee on terminology made herein with respect to the discontinuance of the use of the term "surplus" in accounting, and has authorized its publication. The statements herein contained, however, are not to be regarded as pronouncements of the committee on accounting procedure.

RECOMMENDATION OF SUBCOMMITTEE ON TERMINOLOGY

In a report of the committee on terminology, issued in September, 1941, as Research Bulletin No. 12 (Special), it was recommended that consideration be given to the feasibility of a general discontinuance of the use of the word surplus in accounting. Since that time there has been extensive discussion of the proposal, and some companies have used other terms in their financial statements. The present subcommittee on terminology of the committee on accounting procedure has considered the matter and its conclusions are set forth herein.

A factor of primary importance in the balance-sheet presentation of the stockholders' equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, which is conventionally divided further, largely on the basis of source, as follows:

1. Capital stock, representing the par or stated value of the shares.¹

¹ In some states the term "capital stock" has been replaced by the term "stated capital" which represents the par or stated value of shares, or the consideration received upon the issuance of shares.
2. Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value\(^2\), or (b) capital contributed other than for shares.

3. Earned surplus, representing accumulated earnings or the remainder of such earnings at the balance-sheet date.

While the terms *capital surplus* and *earned surplus* have been widely used, they are open to serious objection.

1. The term *surplus* has a connotation of excess, overplus, residue or "that which remains when use or need is satisfied" (Webster), whereas no such meaning is intended where the term is used in accounting.

2. The terms *capital* and *surplus* have established meanings in other fields, such as economics and law, which are not in accordace with the concepts which the accountant seeks to express in using those terms.

3. The use of the term *capital surplus* (or as it is sometimes called, *paid-in surplus*) gives rise to confusion. If the term *surplus* is intended to indicate capital accumulated by the retention of earnings, i.e., retained income, it is not properly used in the term *capital surplus*. Further, if the term *surplus* is intended to indicate a portion of the capital, there is an element of redundancy in the term *capital surplus*.

4. If the term *capital stock* (and in some states the term *capital surplus*) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms *surplus* or *earned surplus* of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, "available for dividends."

It seems highly desirable, therefore, that an effort be made to find terms more nearly connotative of the ideas which are sought to be expressed.

In seeking such terms consideration should be given primarily to the sources from which the proprietary capital was derived. In addition regard should be had for certain types of events which may

---

\(^2\)This classification includes such items as capital transferred from capital stock account as a result of the reduction of par or stated value, and credits resulting from transactions in the corporation's own stock.
Discontinuance of the Use of the Term "Surplus"

have occurred in the history of the corporation. Thus a quasi-reorganization in which a "new start" has been made, may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, while that part of capital now conventionally described as earned surplus would include only earnings retained thereafter and would be "dated" accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must be dealt with as a transfer of capital accumulated by retention of earnings to the category of restricted capital for purposes of subsequent presentation. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

RECOMMENDATION

In view of the foregoing the subcommittee recommends that, in the balance-sheet presentation of the stockholders' equity:

1. The use of the term surplus (whether standing alone or in such combination as capital surplus, paid-in surplus, earned surplus, appraisal surplus, etc.) be discontinued.

2. The contributed portion of proprietary capital be shown as:
   (a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.
   (b) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, reduction in par or stated value of shares after issuance, or transactions by the corporation in its own shares), and capital received other than for shares, whether from shareholders or others.

3. The term earned surplus be replaced by terms which will indicate source, such as retained income, retained earnings, accumulated earnings, or earnings retained for use in the business. In the case of a deficit, the amount will be shown as a deduction from contributed capital with appropriate description.

4. In connection with 2 (b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained
income appropriated as a reserve nevertheless remains part of retained income, and any reserves which are clearly appropriations or segregations of retained income, such as reserves for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders' equity.

5. Where there has been a quasi-reorganization, retained income should thereafter be "dated," and where, as a result of a stock dividend or a transfer by resolution of the board of directors from unrestricted to restricted capital, the amount of retained income has been reduced, the presentation thereafter should indicate that the amount shown is the remainder after such transfers.

6. Any appreciation included in the stockholders' equity other than as a result of a quasi-reorganization should be designated by such terms as excess of appraised or fair value of fixed assets over cost or appreciation of fixed assets.

SUBCOMMITTEE ON TERMINOLOGY
JAMES L. DOHR, Chairman
FREDERICK B. ANDREWS
WILLIAM H. BELL
1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on in a single corporation the previously conducted businesses, the accounting to give effect to the combination will vary depending upon whether there is a continuance of the former ownership or a new ownership. This statement has been prepared (a) for the purpose of differentiating between these two types of corporate combinations, the first of which is designated herein as a *pooling of interests* and the second as a *purchase*, and (b) to indicate the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a pooling of interests and a purchase is to be found in the attendant circumstances rather than in the legal designation as a merger or a consolidation, or legal considerations with respect to availability of net assets for dividends, or provisions of the Internal Revenue Code with respect to income taxes. In a pooling of interests, all or substantially all of the equity interests in predecessor corporations continue, as such, in a surviving corporation which may be one of the predecessor corporations, or in a new one created for the purpose. In a purchase, on the other hand, part or all of the ownership of the acquired corporation is eliminated. A plan or firm intention and understanding to retire capital stock issued to the owners of one or more of the corporate parties, or substantial changes in ownership occurring immediately before or after the combination, would also tend to indicate that the combination is a purchase.

3. Other factors to be taken into consideration in determining whether a purchase or a pooling of interests is involved are the relative size of the constituent companies and the continuity of management or power to control the management. Thus, a purchase may be indicated when one corporate party to a combination is quite minor.

---

1. When the shares of stock in the surviving corporation that are received by the several owners of one of the predecessor companies are not substantially in proportion to their respective interests in the predecessor company, a new ownership or purchase of such company is presumed to result.
in size in relation to the others, or where the management of one of the corporate parties to the combination is eliminated or its influence upon the management of the surviving corporation is quite small. Other things being equal, the presumption that a pooling of interests is involved would be strengthened if the activities of the businesses to be combined are either similar or complementary. No one of these factors would necessarily be determinative, but their presence or absence would be cumulative in effect.

4. When a combination is deemed to be a purchase the assets purchased should be recorded on the books of the acquiring company at cost, measured in money or the fair value of other consideration given, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

5. When a combination is deemed to be a pooling of interests, the necessity for a new basis of accountability does not arise. The book values of the assets of the constituent companies, when stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform basis, should be carried forward; and retained incomes of the constituent companies may be carried forward. If one party to such a combination had been acquired as a subsidiary by another such party prior to the origin of a plan of combination, the parent’s share of the retained income of the subsidiary prior to such acquisition should not be included in the retained income account of the pooled companies.

6. Due to the variety of conditions under which a pooling of interests may be carried out it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, the aggregate of stated capital of the surviving corporation in a pooling of interests may be either more than, or less than, the total of the stated capital of the predecessor corporations. In the former event the excess should be deducted first from the aggregate of any other contributed capital (capital surplus), and next from the aggregate of any retained income (earned surplus) of the predecessors; while in the latter event the difference should appear in the balance-sheet of the surviving corporation as other contributed capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

The statement entitled "Business Combinations" was unanimously adopted by the twenty-one members of the committee. Messrs. Andrews, Paton, and Wellington assented with qualification.

Messrs. Andrews, Paton, and Wellington qualify their assent be-
cause they believe Paragraph 5 is misleading in so far as it fails to make clear that any adjustment of asset values or of retained income which would be in conformity with generally accepted accounting principles in the absence of a combination would be equally so if effected in connection with a pooling of interests.

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.)

Committee on Accounting Procedure (1949-1950)

Samuel J. Broad, Chairman
Frederick B. Andrews
Frank S. Calkins
James L. Dohr
George P. Ellis
H. A. Finney
J. P. Friedman
Thomas G. Higgins
John B. Inglis
Paul K. Knight
John A. Lindquist
Edward J. McDevitt
Leslie Mills
William A. Paton
Maurice E. Peloubet
John W. Queenan
James A. Runser
Walter L. Schaffer
Virgil S. Tilly
C. Oliver Wellington
Edward B. Wilcox
Carmen G. Blough
Director of Research
1. In part (c) of paragraph 2 of Accounting Research Bulletin No. 35, issued in October, 1948, the committee recommended that extraordinary items omitted from the determination of net income pursuant to Accounting Research Bulletin No. 32 should be displayed in the surplus statement* and not as deductions from or additions to the item of net income in the income statement. In its revised Regulation S-X issued in December, 1950, the Securities and Exchange Commission made provision in item 17 of Rule 5-03 for the addition to or deduction from net income or loss, at the bottom of the income statements filed with the Commission, of items of profit and loss given recognition in the accounts during the period and not included in the determination of net income or loss.

2. The committee's purpose in issuing Bulletin No. 35 was to prevent misconceptions as to whether the earnings for the period were the amounts designated as net income or were the final and often more prominent amounts shown on the income statements after the deduction or addition of items excluded from the determination of net income. The committee believes this purpose will best be served if reports to stockholders continue to display such items in accordance with the recommendation contained in Bulletin No. 35. The change in Rule 5-03, however, does not affect the determination of the amount to be reported as net income or earnings for the year and, in the committee's view, the additions or deductions at the foot of the income statement after determination of net income are equivalent to direct credits or charges to earned surplus.

* In Bulletin No. 39 the committee published as an approved objective a recommendation of the subcommittee on terminology that in balance-sheet presentation the use of the term "surplus" be discontinued. The committee believes that further experimentation with substitutes for the term is desirable in financial statements prepared for the general public. However, the committee plans to continue to use the term "surplus" in its bulletins as being a technical term that is well understood among accountants to whom the bulletins are directed.
The committee is, therefore, of the opinion that either the forms of presentation recommended in Bulletin No. 35 or the form required by Regulation S-X may be regarded as acceptable, and that it is permissible for a company to use one form in one statement and a different form in another like statement covering the same fiscal period.

3. Where, in harmony with the provisions of Regulation S-X, additions to or deductions from net income are displayed at the bottom of the income statement, care should be taken that the figure of net income is clearly and unequivocally designated so as not to be confused with the final figure in the income statement. The caption of the final figure should be descriptive of what it represents, such as “net income and special items,” “net income and refund of 1945 excess profits taxes,” “net loss and special items,” or “profit on sale of subsidiary, less net loss.” Any representation of earnings for the year or of earnings per share should be based upon the amount designated as net income.

4. Nothing herein should be interpreted as indicating any change in the committee’s opinion that items mentioned in parts (a), (b), and (d) of paragraph 2 of Bulletin No. 35, consisting of charges and credits with respect to general purpose contingency reserves, inventory reserves, excessive costs of fixed assets, and annual appropriations in contemplation of replacement of productive facilities at higher price levels, should be displayed as charges or credits in the surplus statement and should not be shown in the income statement.

The statement entitled “Presentation of Income and Earned Surplus (Supplement to Bulletin No. 35)” was adopted by the assenting votes of the twenty-one members of the committee, of whom one, Mr. Wellington, assented with qualification.

Mr. Wellington approves the use of the form of statement provided in Rule 5-03 of Regulation S-X in financial statements filed with the Securities and Exchange Commission, but does not approve any departure in other financial statements from the recommendations in Bulletin No. 35.
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. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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.)
CERTIFICATES OF NECESSITY

1. Section 124A of the Internal Revenue Code, which was added by the Revenue Act of 1950, provides for the issuance of certificates of necessity under which all or part of the cost of so-called emergency facilities may be amortized over a period of 60 months for income tax purposes. In many cases, the amounts involved are material, and companies are faced with the problem of deciding whether to adopt the 60-month period over which the portions of the cost of the facilities covered by certificates of necessity may be amortized for income tax purposes as the period over which they are to be depreciated in the accounts.

2. Thinking on this question apparently has become confused because many so-called percentage certificates have been issued covering less than the entire cost of the facility. This fact, together with the fact that the probable economic usefulness of the facility after the close of the five-year amortization period is considered by the certifying authority in determining the percentage covered by these certificates, has led many to believe that the percentage used represents the Government's conclusion as to the proportion of the cost of the facility that is not expected to have usefulness at the end of five years.

3. In some cases, it is apparent that the probable lack of economic usefulness of the facility after the close of the amortization period must constitute the principal if not the sole basis for determining the percentage to be included in the certificate. However, it must be recognized that the certifying authority has acted under orders to give consideration also to a variety of other factors to the end that the amount certified may be the minimum amount necessary to secure expansion of industrial capacity in the interest of national defense during the emergency period. Among the factors required to be considered in the issuance of these certificates, in addition to loss of useful value, are (a) character of business, (b) extent of risk assumed (including the amount and source of capital employed, and the potentiality of recovering capital or retiring debt through tax savings or pricing),
Accounting Research Bulletins

(c) assistance to small business and promotion of competition, (d) compliance with Government policies (e.g., dispersal for security), and (e) other types of incentives provided by Government, such as direct Government loans, guaranties and contractual arrangements.

DEPRECIATION CONSIDERATIONS

4. The argument has been advanced from time to time that, since the portion of the cost of properties covered by certificates of necessity is amortized over a five-year period for income tax purposes, it is necessary to follow the same procedure in the accounts. Sound financial accounting procedures do not necessarily coincide with the rules as to what shall be included in "gross income," or allowed as a deduction therefrom, in arriving at taxable net income. It is well recognized that such rules should not be followed for financial accounting purposes if they do not conform to generally accepted accounting principles. However, where the results obtained from following income tax procedures do not materially differ from those obtained where generally accepted accounting principles are followed, there are practical advantages in keeping the accounts in agreement with the income tax returns.

5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as 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

6. The committee is of the opinion that from an accounting standpoint there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or a longer period than would be proper if no certificate of necessity had been issued. Estimates of the probable useful life of a facility by those best informed in the matter may indicate either a shorter or a longer life than the statutory 60-month period over which the certified portion of its cost is deductible for income tax purposes.

7. In determining the proper amount of annual depreciation with respect to emergency facilities for financial accounting purposes, it must be recognized that a great many of these facilities are being

¹ Accounting Research Bulletins Nos. 16, 20, and 22.
Emergency Facilities

acquired primarily for what they can produce during the emergency period. To whatever extent it is reasonable to expect the useful economic life of a facility to end with the close of the amortization period the cost of the facility is a proper cost of operation during that period.

8. In determining the prospective usefulness of such facilities it will be necessary to consider their adaptability to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions, and the fact that no deductions for depreciation of the certified portion will be allowable for income tax purposes in the post-amortization years if the company elects to claim the amortization deduction. The purposes for which emergency facilities are acquired in a great many cases are such as to leave major uncertainties as to the extent of their use during the amortization period and as to their subsequent usefulness—uncertainties which are not normally encountered in the acquisition and use of operating facilities.

9. Consideration of these factors, the committee believes, will in many cases result in the determination of depreciation charges during the amortization period in excess of the depreciation that would be appropriate if these factors were not involved. Frequently they will be so compelling as to indicate the need for recording depreciation of the cost of emergency facilities in the accounts in conformity with the amortization deductions allowable for income tax purposes. However, the committee believes that when the amount allowed as amortization for income tax purposes is materially different from the amount of the estimated depreciation, the latter should be used for financial accounting purposes.

10. In some cases, certificates of necessity cover facilities which the owner expects to use after the emergency period in lieu of older facilities. As a result the older facilities may become unproductive and obsolete before they are fully depreciated on the basis of their previously expected life. In such situations, the committee believes depreciation charges to income should be determined in relation to the total properties, to the end that sound depreciation accounting may be applied to the property accounts as a whole.

**RECOGNITION OF INCOME TAX EFFECTS**

11. In those cases in which the amount of depreciation charged in the accounts on that portion of the cost of the facilities for which certificates of necessity have been obtained is materially less than the amount of amortization deducted for income tax purposes, the amount of income taxes payable annually during the amortization period may be significantly less than it would be on the basis of the income reflected in the financial statements. In such cases, after the
close of the amortization period the income taxes will exceed the amount that would be appropriate on the basis of the income reported in the statements. Accordingly, the committee believes that during the amortization period, where this difference is material, a charge should be made in the income statement to recognize the income tax to be paid in the future on the amount by which amortization for income tax purposes exceeds the depreciation that would be allowable if certificates of necessity had not been issued. The amount of the charge should be equal to the estimated amount by which the income tax expected to be payable after the amortization period exceeds what would be so expected if amortization had not been claimed for income tax purposes in the amortization period. The estimated amount should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.

12. In accounting for this deferment of income taxes, the committee believes it desirable to treat the charge as being for additional income taxes. The related credit in such cases would properly be made to an account for deferred income taxes. Under this method, during the life of the facility following the amortization period the annual charges for income taxes will be reduced by charging to the account for deferred income taxes that part of the income tax in excess of what would have been payable had the amortization deduction not been claimed for income tax purposes in the amortization period. By this procedure the net income will more nearly reflect the results of a proper matching of costs and revenues.

13. There are those who similarly recognize the necessity for giving effect to the amount of the deferred income taxes but who believe this should be accomplished by making a charge in the income account for additional amortization or depreciation. They would carry the related credit to an accumulated amortization or depreciation account as a practical means of recognizing the loss of future deductibility of the cost of the facility for income tax purposes. If this procedure is followed the annual charges for depreciation will be correspondingly reduced throughout the useful life of the facility following the amortization period. Although this procedure will result in the same amount of net income as the procedure outlined in paragraph 12, and therefore may be considered as acceptable, the committee regards the paragraph 12 procedure as preferable. In any circumstances, there should be disclosure of the procedures followed.

The statement entitled "Emergency Facilities—Depreciation, Amortization, and Income Taxes" was adopted unanimously by the twenty members of the committee.
Emergency Facilities

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. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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.)

COMMITTEE ON ACCOUNTING PROCEDURE (1952-1953)

Paul K. Knight, Chairman
Frederick B. Andrews
Frank S. Calkins
H. A. Finney
Roy Godfrey
Thomas G. Higgins
John A. Lindquist
Perry Mason

Edward F. McCormack
John Peoples
Maurice E. Peloubet
John W. Queenan
Walter L. Schaffer
C. Aubrey Smith
C. Oliver Wellington
William W. Werntz

Edward B. Wilcox
Raymond D. Willard
Robert W. Williams
Karl R. Zimmermann

Carmen G. Blough
Director of Research