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Accounting Questions: Treatment of Secret Reserves Under National Securities Acts, Federal Income Tax as a Expense

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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

TREATMENT OF SECRET RESERVES UNDER NATIONAL SECURITIES ACTS

Question: In view of the drastic provisions of the new securities acts, will an auditor be justified in tacitly approving (by ignoring) secret reserves?

Answer No. 1: It seems to us that the question propounded to you relating to the securities act is one which does not readily lend itself to a general answer.

Under section 11 of the securities act the accountant whose certification is given is charged with the responsibility of making a reasonable investigation and of forming the belief that the statements covered by his certificate are true and that there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Obviously, the word "material" infers that the accountant should exercise judgment in each individual case.

The term "secret reserves" is a very vague appellation and in the mind of the inquirer might mean either totally unnecessary reserves or provisions made tending to lean to the side of ultra-conservatism. If the accounts covered by the accountant's certificate contained so-called "secret reserves," and if the amounts of these reserves proved to be an important element in the statement of the accounts, then the failure to disclose such reserves would constitute, in the language of the securities act, an "omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Answer No. 2: It is our opinion that, apart altogether from the securities acts, an auditor is not justified in approving, even tacitly, secret reserves.

To state the principle is, we appreciate, easy enough, but its application to the particular circumstances of individual cases is not so simple. Discriminating judgment tempered by a sense of proportion must, of course, be exercised in distinguishing between the conservative provisions of prudent administration and secret reserves. If, however, after due deliberation the auditor considers

that, because of secret reserves, the accounts submitted do not fairly present the position, he should offer appropriate comment and exceptions in his report.

Answer No. 3: We wish to advise you that in our opinion the reasonable attitude which an auditor should adopt toward the existence or non-existence of secret reserves is well expressed on page 37 of the booklet promulgated by the American Institute under date of January 21, 1934, entitled *Audits of Corporate Accounts*, reading as follows:

"We think it well . . . to emphasize the fact that accounts must necessarily be largely expressions of judgment, and that the primary responsibility for forming these judgments must rest on the management of the corporation. And, though the auditor must assume the duty of expressing his dissent through a qualification in his report, or otherwise, if the conclusions reached by the management are in his opinion manifestly unsound, he does not undertake in practice and should not, we think, be expected to substitute his judgment for that of the management when the difference is not of major importance, when the management's judgment is not unreasonable and when he has no reason to question its good faith."

Obviously, the accountants may not ignore the existence of secret reserves when that existence is irrefutable. On the other hand, when there is reasonable ground for difference of opinion and divergence of judgment it may well happen that reserves which appear to be ultra conservative and, therefore, from the viewpoint of the accountant "secret reserves" may in fact not be such but, on the contrary, fully justified on the basis of the sound judgment of the management.

FEDERAL INCOME TAX AS AN EXPENSE

Question: We have a corporate client which entered into a contract with a large concern which furnished raw material, under which our client was guaranteed a net profit of 10 per cent. of a certain base figure. The contract provided that this net profit was to be determined by deducting from gross income all expenses and costs, except depreciation and reserves.

A loss resulted last year from operations, and the guarantee was effective. Our client by reason of the guaranteed profit, is liable for federal income taxes. The guarantor gives as its opinion that these federal income taxes should not be deducted before determining net profit, on the theory that federal income taxes are a reserve and properly chargeable to surplus.

Our client holds that the federal income tax is similar to any other tax and expense and is properly deductible in determining net income, even though it results in a computation of tax on tax paid in the guarantee.

Answer No. 1: The question is whether federal income tax is properly regarded as an expense in determining net profit in terms of a certain contract.

The contract does not specifically include federal income tax as an expense and, this being so, unless it may be deduced otherwise as a fair inference from the course of dealing evidencing the intent of the parties, it is our opinion that such tax is not to be equated with "any other tax," as the inquirer's client holds, and should not be brought into account in determining net income within the terms of the contract.

Answer No. 2: In our opinion the deduction of federal income tax is a legal matter depending on the actual working of the contract. However, in general, we consider that the federal income tax is a charge against a company's profits

and not an item of expense which should be taken into account in a cost plus contract and we do not consider it in the same light as other taxes.

Answer No. 3: The determination of this question, of course, is not a question of accounting principle but a question of the terms of the agreement between the parties. I assume, however, that the agreement is silent in respect to this item. In that case, my own opinion is that federal income tax does constitute an expense to be used in determining the net income. Unless specifically stated, federal income tax is a charge against income and not a factor in its determination.

The whole thing resolves itself in the question of the intent of the parties. It is not reasonable to suppose in the absence of a specific mention that it is the intention of one party to pay the income tax of the other.