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Correspondence

ACCURAL ACCOUNTING AND RESERVES IN TAX PRACTICE

Editor, The Journal of Accountancy:

SIR: May I ask the privilege of your columns to discuss briefly two points arising, one directly and the other indirectly, out of my paper* which was published in your October issue? Of these points the first relates to the origin of the expression "the accrual basis of accounting"; the other to the treatment of reserves in tax practice.

In my paper I implied that the expression "accrual accounting" had little if any currency among accountants prior to the development of the expression in tax practice. It has, however, been suggested to me that the phrase had been used for many years by economists, and it is I think due to your readers that the fact should be brought to their notice.

Professor H. C. Adams, in his *Public Finance*, published in 1898, uses the phrase and discusses the relative advantages of cash and accrual accounting for governmental purposes. Professor Adams does not seem to me to deal altogether satisfactorily with the question when items accrue, and the difficulty suggested in my paper as arising from the fact that to accrue may mean either "to grow up" or "to fall in," is indicated but not solved in his book. Thus, he regards taxes as accruing as assets to a government when they are assessed; interest he regards as accruing from day to day. Supposing then that a special annual tax be levied to meet interest on government debt, the income to the government (taxes) would be deemed to accrue on the day or days of assessment, but the expense to accrue from day to day. For the purposes of annual budgets the inconsistency would be of no great importance, but as soon as accounts are made up for a shorter period, or a balance-sheet is prepared, the inconsistent uses of the term "accrued" give rise to serious difficulties.

That the phrase "accrual accounting" even though used by economists in regard to government accounting, was not generally employed by accountants even in that limited sense is indicated by the proceedings at the first congress of accountants held in St. Louis in 1904. A series of papers on municipal accounting formed an important part of the programme at that congress, and the need for something more than "cash accounting" was one of the main points stressed in these papers; yet the alternative was nowhere, I think, described as a system of "accrual accounting." In the first paper Harvey S. Chase said:

"The fundamental basis of correct municipal accounting is now being thoroughly discussed from a true accounting standpoint as witnessed in the other papers presented at this meeting. This true accounting standpoint is of course revenue and expense in contradistinction to cash receipts and disbursements."

Indeed, the title of one of the papers, which was presented by Professor F. A. Cleveland, was "Revenues and expenses as distinguished from receipts and disbursements in municipal accounting."

It is interesting to note that speaking of commercial accounting Professor Adams said "Should we turn our attention from public" (i.e., governmental) "accounting to the best corporation accounting one will discover that 'earnings

* *Taxable Income and Accounting Bases for Determining It.*

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and expenses' have almost universally supplanted the older bookkeeping phrases of receipts and expenditures." Further evidence on this point is afforded by the correspondence between a number of accounting firms and the attorney general immediately prior to the enactment of the corporation excise-tax law of 1909. As opposed to the cash basis they advocated the basis of earnings and expenses and throughout the correspondence used the word "accrue" only in regard to interest. They spoke of income *earned*, expenses *incurred* and losses *sustained, and written off* and when they came to taxes they used no qualifying adjective at all, from which it might, perhaps, be inferred that they were not prepared to suggest any alternative to taxes paid.

A discussion of English authorities would, I am sure, lead to precisely the same result, and the economists must therefore be left to share with the bureau of internal revenue the credit or responsibility for giving currency to the phrase "accrual accounting." Incidentally, it is consoling to accountants, who are frequently criticized for adopting terminology for their own purposes without regard to practice in other fields of activity involving the same subject matter, to find that the economists apparently coined the phrase "accrual accounting" to meet a need without regard to the fact that accountants commonly used another term which if not quite so brief was at least clearer and more accurate.

It would, I believe, be an advantage if we should revert to the practice indicated by the correspondence with the attorney general, and restrict the use of the word "accrue" to interest and similar items which grow with the mere lapse of time, in which relation its sense is universally understood and agreed. In recent years its use has been extending in the same sense to items to which it is not properly applicable, and in other and ill-defined senses to still other items. This is particularly true, as pointed out in my paper, of tax practice and even the tax law has for many years provided for the deduction of taxes *accrued* as well as interest *accrued*.

Now, undoubtedly the legal and accounting usages of the phrase "taxes accrued" differ, even if lawyers do not differ as to its legal, and accountants as to its accounting, meaning. Much controversy has arisen on the question whether the term is used in the tax laws in its general legal sense, or in an accounting sense. It would be a distinct gain if accountants would cease to use the term "taxes accrued" in a sense altogether different from its legal meaning.

Consideration of possible alternatives brings me immediately to the second point on which I would like to comment in this letter. Probably the first alternative which would occur to most accountants would be "reserve for taxes" but the use of the word "reserve" in accounting practice must be admitted to be even more vague and inconsistent than any use of the word "accrue" that I have referred to. A reserve may be anything from segregated surplus to a mere accounting device for adjusting to a proper net value, assets which it is convenient to carry on the books at more than their actual value.

Accountants have recognized this unsatisfactory situation for many years but it must be conceded that they have done little or nothing to correct it. A perusal of the decisions of the board of tax appeals, however, suggests that the board does not sufficiently appreciate that the proper treatment of reserves can not be determined without enquiry into their nature and their effect on the accounts.

The point may be illustrated by a decision in the case of M. I. Stewart & Co.,

docket 473, decided September 30, 1925, on the question of reserves for discount. The board disposes of the question in effect by saying "Reserves are not allowable deductions from gross income unless specifically provided for by statute." True but irrelevant. A reserve for discount is a step in the computation of gross income, not a deduction therefrom. If a trader sells on December 31, 1924, goods which cost \$80.00 for a nominal price of \$100.00 less 2 % ten days, his gross income in that year from the transaction is but \$18.00. The impossibility of maintaining any other view becomes apparent if we assume the debt to be paid on January 1, 1925. How can it be argued in such a case that the trader made a profit of \$20.00 in 1924 and a loss of \$2.00 in 1925 (as the board's treatment implies) when he received exactly what he had a right to receive.

Correct accounting calls for determining income in such cases on the basis of taking accounts receivable at the sum, which if paid on December 31st would completely discharge the indebtedness. If through failure to pay promptly the debtors become obligated to pay more in the subsequent year, the forfeited discounts are income of that year. Whether such correct accounting is secured by taking the accounts receivable at their present value when created and taking up the discount as an asset, as, when and if, forfeited, or by setting up the accounts receivable immediately at their nominal sum on the one side and carrying a reserve on the other is immaterial. The so-called reserve is not a reserve but a mere accounting device the convenience of which is obvious. The board in such decisions as above quoted is misled by terminology, into taxing as gross income something which has not and may never become income.

The first essential to a correct disposition of so-called reserves in computing taxable income is to determine into which of various categories the reserves in question fall. If they are reservations made out of profits, the dictum of the board above quoted from the Stewart case applies to them. If, however, they are merely a part of the accounting mechanism for determining either the gross income earned or the expenses incurred, then the sole question is whether the method of accounting is such as correctly reflects income.

Yours truly,

GEORGE O. MAY.

New York, November 15, 1925.