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THE CURRENT national defense program and its widespread ramifications is probably the most significant factor influencing American business today. After a serious lapse in the maintenance of our Navy and Army following the World War, we have only recently realized the obsolescence and gross inadequacy of our military and naval equipment as a defense against the might and violence of modern warfare. The successive, seemingly resistless, collapse of nation after nation of Europe in recent months at the hands of the war machines of aggressor nations has brought us to the sudden, if belated, realization that not only is our sovereignty seriously threatened by the onward march of such aggressors, but we are utterly unprepared to defend ourselves against them at the present time. The national defense program is the current response to this unwelcome situation.

While the details of this vast program of national defense will undoubtedly be revised from time to time as the exigencies of the moment demand, the basic elements of the program at present comprise: (1) the setting up of administrative machinery to expedite and coördinate the functioning of the program; (2) large-scale production by private industry of warships, aircraft, tanks, guns, motorized equipment, and other armaments; (3) augmentation of the existing personnel of the Army and Navy through the compulsory draft and other means; (4) appropriation by Congress of billions of dollars for the cost of the program; (5) the levying of special taxes and increasing the public debt to finance these costs.

The speed with which this program is being launched may be indicated by the fact that in a very few months the National Defense Council has been established as an advisory group of experts; Congress has appropriated nearly ten billion dollars for armament purposes, the President has recently asked for an additional five billion dollars to strengthen every category of defense, and the end is not in sight. At the present time legislation has been passed authorizing conscription, new and additional taxes, and legislation is under consideration to extend the legal debt limit and to provide for advances to private industry for plant expansion.

This gigantic program for the immediate production of implements of war on a vast scale will naturally require the letting of many contracts with private industry by the Navy and War departments. Such contracts are subject to innumerable laws and restrictions imposed by the Government. In the first place, on all government contracts a bid must be submitted by the contractor on a standard government form which eventually becomes a part of the final contract. Then the government order, also on a standard form, will prescribe the hours to be worked per week on the contract, rates of pay, qualities of material, inspection by officials, time limits, penalties, etc. Fabrication of the article must conform to government process specifications and is subject to numerous inspections and tests by government representatives. Finally, payment of the contract price itself can be made only if covered by a Congressional appropriation and supported by the proper documentation.

In addition to the routine restrictions imposed upon all contractors with the

Government as noted above, there are many special laws regulating such contracts. The more important of these laws are the following:

(1) The federal eight-hour law of 1912, Walsh-Healey and Davis-Bacon acts, regulating the hours of labor and rates of wages on government contracts;

(2) Air Corps act of 1926, which classifies aircraft procurement procedures;

(3) Merchant Marine act of 1936, which limits to 10 per cent the profit on contracts in excess of $10,000 with the Maritime Commission for the construction, reconditioning, or reconstruction of merchant vessels;

(4) Harter-Sheppard act of 1940, authorizing the Army and Navy to award contracts for aircraft parts and accessories to the three lowest responsible bidders;

(5) Vinson-Trammel act and amendments thereto, regulating contracts for naval vessels and Army and Navy aircraft and limiting the profits thereon.

Of the foregoing laws, the Merchant Marine [1] and Vinson-Trammel acts have a very important influence upon corporate accounting, since they both require elaborate reports and calculations of profits on every contract issued thereunder. Although the possible future adaptation of armament equipment to merchant vessels may bring contracts under the Merchant Marine act into the classification of so-called war contracts, at the present time such contracts are considered as beyond the immediate scope of the national defense program. Therefore, the Vinson act and its several amendments will be the chief subject matter of this article and, unless otherwise specified, the term "act" shall henceforth be used to mean the Vinson-Trammel act and subsequent amendments thereto.

At the outset it should be noted that serious consideration is now being given in Congress to the outright repeal of those sections of the Vinson act and amendments thereto which specifically relate to excess profits, and the substitution therefor of a general excess-profits tax applicable to all corporations on all profits, whether derived from government contracts, sales of armaments or otherwise. [See editor's note on page 430.] Nevertheless, the Vinson act will still be applicable to income-taxable years beginning prior to 1940, and many of its other provisions regarding government war contracts may persist in one form or another. Therefore, it is the author's intention to outline briefly the provisions of the Vinson act and indicate some of the many accounting problems which may be encountered thereunder, without treating in detail the technical aspects of the subject.[2]

The Vinson Act

The so-called Vinson act, which was passed by Congress in 1934 [3] and subsequently amended during the years 1936,[4] 1939,[5] and 1940,[6] relates primarily to contracts made by the secretaries

[1] The provisions of this act are quite similar to those of the Vinson act which is discussed at length in this article. A detailed analysis of the provisions and interpretations of the Merchant Marine act is contained in the regulations thereunder promulgated by the United States Maritime Commission on May 4, 1939.

[2] Regulations interpreting the Vinson act, as amended by the act of April 3, 1939, may be found in Treasury Decision 4906 (in respect of Navy contracts completed in income-taxable years ending after April 3, 1939) and Treasury Decision 4909 (in respect of army aircraft contracts entered into after April 3, 1939) (I.R.B. 1939–27). No Treasury Department regulations or rulings under the act of June 28, 1940, have been promulgated at the date of this writing.

[3] Originally enacted as the Vinson-Trammel act on March 27, 1934 (48 Stat. L505; 34 U. S. C. 496).

[4] June 25, 1936 (49 Stat. 1926; 34 U. S. C. Sup. IV 496).

[5] National defense act, enacted April 3, 1939 (Public No. 18; 76th Cong.; 1st Sess.).

[6] June 28, 1940 (Public No. 671; 76th Cong.; 3rd Sess.).

of the Navy or War, as the case may be, for the construction and/or manufacture of complete naval vessels, Navy aircraft and Army aircraft or portions thereof.

Contracts for scientific equipment used for communication, target detection, navigation and fire control, and contracts of $25,000 [7] and under, are specifically exempt from the act.

This act is designed primarily to limit the profit on such contracts and subcontracts by requiring the contractor or subcontractor to agree to pay into the Treasury all profit in excess of 8 per cent (under the amendment approved June 28, 1940) of the contract prices of all such contracts as are completed within each income-taxable year. In determining such excess profit, the contracts must be segregated by the three major groups, *i.e.*, naval vessels, Navy aircraft and Army aircraft, but all contracts within a given group may be combined.

Thus, losses on Army aircraft contracts may be offset against profits on such contracts, but losses on contracts for naval vessels or Navy aircraft may not be offset against profits on Army aircraft contracts.[8]

The percentage of profit which may be retained by a contractor has been changed from time to time by frequent amendments to the act. For contracts entered into as a result of competitive bids after June 28, 1940, date of the most recent amendment to the Vinson act, the limit is 8 per cent for naval vessels and Navy or Army aircraft. On contracts entered into prior to June 28, 1940, the profit limit is 10 per cent for naval vessels and 12 per cent for Navy and Army aircraft. But Army aircraft contracts signed prior to April 3, 1939, are not subject to the Vinson act at all, while Navy aircraft contracts completed in taxable years ending prior to April 3, 1939, are subject to a 10 per cent profit limit. No provisions of the Vinson act apply to contracts entered into prior to March 27, 1934.

The 1940 amendment to the Vinson act [9] states that any profit in excess of 8.7 per cent of the *cost* of Vinson act contracts shall be considered to be profit in excess of 8 per cent of the *contract prices* thereof. This amendment also provides that, during the national emergency declared by the President on September 8, 1939, to exist, the fixed fee on Navy and War Department contracts in the form of "cost-plus-a-fixed-fee," shall not exceed 7 per cent of the estimated cost. Thus the profit on government war contracts is limited from the standpoint of both cost and contract price.

Net losses on contracts for *naval vessels*, or portions thereof, completed in a given income-taxable year may be applied as a reduction of the excess profit on such contracts completed within the next succeeding year. Net losses, as well as deficiencies in profits (amount by which limited per cent of contract prices exceeds actual profits), on contracts for *Navy or Army aircraft* or portions thereof, may be carried forward as reductions in the excess profits on such contracts during the next succeeding *four* years.

Another very important credit allowed against the amount of excess profit on contracts under consideration is the amount of federal income and excess-profits taxes, if any, paid or to be paid on the balance of such excess profit (after applying the net loss and deficiency of profit of prior years). Conversely, the excess profit on Vinson act contracts is not an allowable deduction for federal income-tax purposes.

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[7] For contracts entered into after June 28, 1940, and during the period of the national emergency declared, by the President on September 8, 1939, to exist; exemption is $10,000 for contracts entered into prior to that date.

[8] I. T. 3377 (1940–22–10273, p. 9).

[9] Approved June 28, 1940, and applicable to contracts entered into after that date.

The foregoing elements involved in the computation of excess-profit liability on contracts obtained as a result of competitive bids under the Vinson act are summarized in the following outline for such computation, it being understood that separate computations are necessary for naval vessels, Navy aircraft and Army aircraft:

Total contract prices of all contracts completed during the year.....		xxx
Less, Cost of performing above contracts.....		xxx
Net profit on contracts.....		xxx
Less:		
8 per cent of total contract prices (10 and 12 per cent if negotiated prior to June 28, 1940).....	xxx	
Net loss on similar contracts in prior years.	xxx	
Deficiency in profit from similar contracts in prior years.....	xxx	xxx
Excess profit for year...		xxx
Less, Credit for federal income taxes.....		xxx
Amount of excess profit payable to the United States		xxx

Since administration of the Vinson act is vested in the secretaries of the Navy, Army, and Treasury, the manufacturing spaces and books of account of the contractor are subject to inspection at all times by any person designated by these secretaries or by a duly authorized committee of Congress. Although the amount of excess profit payable to the Government is not a tax, as such, the assessment, collection, and subsequent adjustments of such excess profit are administered by the Treasury Department in the same manner as matters covered by the revenue acts in relation to federal income taxes.

Reports

Upon the completion of each contract subject to the act, the contractor must render a report to the Secretary of the Navy or Army, as the case may be, showing the total contract price, cost of performance, net income from the contract and per cent of net income to contract price.

This report must also contain statements regarding: (a) the allocation of indirect costs to the contract; (b) subcontracts made; (c) transactions with affiliates which might affect the excess profit.

Also, the contractor must file an annual report with the Collector of Internal Revenue, stating in respect of each Vinson act contract completed within the income-taxable year, the contract price, cost, and resulting profit or loss, followed by a summary of all such profits and losses and a calculation of the excess profit on all contracts of a given class.

A copy of the reports to the secretaries of the Navy and Army covering each completed contract must accompany this annual report to the Treasury Department.

The foregoing annual report must be filed with the Collector of Internal Revenue on or before the fifteenth day of the ninth month following the close of the contractor's income-taxable year, and the excess profit is payable at the same time, although it may be paid in quarterly instalments, if desired, in the same manner as federal income taxes.

At present, the revenue agents who examine federal income and excess-profits tax returns also examine reports on Vinson act contracts, although it is possible that a staff of special agents may be organized to make the latter examinations in the future. Likewise, the same procedure as to protests against proposed deficiencies in federal income taxes is applicable to revised excess-profit liability under Vinson act

contracts, and the Board of Tax Appeals has been held to have jurisdiction over such revisions.

Among the special problems which the contractor may be expected to encounter under the provisions of the Vinson act are those relating to: (a) contract price; (b) completion of contracts; (c) subcontracts; (d) cost of performance; (e) indirect costs and expenses; (f) depreciation of equipment and amortization of special facilities; and (g) credit for federal income taxes. These problems will be discussed briefly, in the order named, in the following paragraphs:

Contract Price

Although the most recent amendment to the Vinson act [10] recognizes and limits the profit on certain "cost-plus-a-fixed-fee" contracts, the act in general contemplates the letting of contracts by the Navy and War departments at definite prices, including whatever profit the contractor may happen to be fortunate enough to make on each contract. Of course, as outlined hereinbefore, the profit is limited by the requirement that any profit in excess of a stated percentage of the contract price be paid into the Treasury, although under this type of contract, it is possible for the contractor to incur a net loss on a given contract. Naturally, no rebate is allowed by the Government in cases of losses, other than the provision that such losses may be carried forward to reduce the excess-profit liability of subsequent years.

In determining excess profit on Vinson act contracts, the Treasury has advised [11] that total contract price shall represent original contract price, adjusted by the following: bonuses earned for bettering performance; penalties incurred for failure to meet contract guarantees; and trade or other discounts in excess of one per cent.

Although the contract prices of individual contracts or subcontracts are particularly significant in determining whether or not a given contract is subject to the excess-profit limitations of the law, many situations will arise where it will be difficult to ascertain whether the contract price is more or less than the exemption of $10,000 or $25,000, depending upon the date of the contract. Problems of this nature are discussed more fully in connection with subcontracts.

After the contract price has been determined, the contractor is faced with the problem of payment therefor by the Government. One of the reasons advanced for the serious lag in negotiating government war contracts under the national defense program has been the inability or reluctance on the part of contractors to finance the cost of performing contracts pending payment of the contract price by the Government under the usual prescribed methods. To remedy this situation, the recent amendment to the national defense act [12] provides that the Secretary of Navy or Secretary of the Treasury (in the case of Coast Guard contracts) may advance payments to contractors up to 30 per cent of the contract price and to make partial payments from time to time on the balance of the contract price up to the value of the work already performed. Such authorization is applicable, under the law, whenever, in the opinion of the President, such course would be in the interest of national defense during the national emergency declared by the President on September 8, 1939, to exist.

Another provision of this amendment,[13] designed to overcome the exist-

[10] Approved June 28, 1940 (Public No. 671; 76th Cong.; 3rd Sess.).

[11] Treasury Decisions 4906 and 4909 (I.R.B. 1939–27).

[12] Act of June 28, 1940 (Public No. 671; 76th Cong.; 3rd Sess.).

[13] *Ibid.*

ing inertia retarding the defense program, authorizes the Secretary of the Navy to negotiate contracts for the acquisition, construction, repair, or alteration of complete naval vessels or aircraft, or any portion thereof, and for machine tools and other similar equipment, with or without advertising or competitive bidding upon determination that the price is fair and reasonable. This section of the act also provides that deliveries of material under all Navy and Army contracts shall, in the discretion of the President, take priority over all deliveries for private account or for export.

It is thus becoming evident that the Government intends to relax some of the restrictions imposed upon private industry during normal times as a necessary means of making the vast national defense program effective; also, that the President's discretion is an influential factor in respect of some of these new procedures.

Completion of Contracts

While the law [14] specifically provides that excess profit shall be determined on all contracts of a given class completed within the income-taxable year, the Treasury Department [15] has interpreted the date of completion to be the date of delivery of the vessel, aircraft, or portion thereof covered by the contract or subcontract, unless otherwise determined jointly by the secretaries of the Navy or Army and the Secretary of the Treasury. Likewise, the Treasury has ruled [16] that "replacement of defective parts of delivered articles or the performance of other guarantee work in respect of such articles will not operate to extend the date of completion"; nor will a clause in a contract stating that for purposes of the act, the contract shall be considered complete upon final payment of the price thereof, alter the original interpretation that delivery date governs.[17]

The foregoing interpretations are quite general and still leave the contractor or subcontractor with the problem of determining at just what time the vessel or aircraft was delivered, especially in cases of partial delivery and where final inspection and acceptance are required by the Government. Therefore, the contractor will have to use his own judgment in determining date of completion of contracts until more definite Treasury rulings or court decisions have been rendered as a guide. Nevertheless, the problem of determining the date of completion of contracts is very significant, since the particular income-taxable year during which a given contract is considered as having been completed will influence the excess profit payable to the Government on that contract through the profits or losses on other contracts completed during the year, income-tax rates in effect, etc.

Subcontracts

Subcontracts and sub-subcontracts arising out of contracts subject to the Vinson act also come within the scope of the act if the contract prices exceed $25,000 ($10,000 if negotiated prior to June 28, 1940). The law states [18] that the contractor must agree to make no subdivisions of any contract or subcontract for the same articles for the purpose of evading the act and must obtain written agreements from all subcontractors stating that they will be bound by the same restrictions of law as are imposed upon the prime contractor. Failure to obtain such an agreement from a subcontractor will render the prime contractor liable for the excess-

[14] Sec. 3 (b) of the act of March 27, 1934, as amended.
[15] Treasury Decisions 4906 and 4909.
[16] *Ibid.*
[17] I. T. 3275 (C. B. 1939-1403).
[18] Sec. 3 (c and e) of the act of March 27, 1934.

profit liability of the subcontractor.[19] The Bureau of Internal Revenue has ruled [20] that the form of agreement by a subcontractor is not material, but there must be an agreement of record with the prime contractor (under seal where necessary) stating the amount of the subcontract award and that the subcontractor agrees to the provisions of section 3 of the Vinson act. A rubber stamp, properly authenticated, has been considered acceptable to the Bureau for this purpose.

The foregoing interpretation of the act by the Treasury Department has created many problems in connection with real or contingent liabilities of contractors for the excess profits of their subcontractors. Some prime contractors have adopted the practice of indicating on every purchase order that it relates to Vinson act contracts, leaving it up to the subcontractor to determine whether the provisions of the act are applicable to his case. Nevertheless, the contractor is required to include in his report to the Government, upon the completion of each contract, the name of each subcontractor thereunder and the object, date of completion, and amount of each subcontract.

Not only must the prime contractor be aware of all subcontracts required on government work, but also each vendor of materials and equipment must ascertain for himself whether his products are to be used on contracts subject to the act and whether the orders aggregate more than $25,000 ($10,000 on contracts signed prior to June 28, 1940) on a single contract, thereby making him liable for excess profits. In cases where orders from a given contractor exceed $10,000 or $25,000 in total but each order is less than that amount, the subcontractor must prove from the facts that each order is a bona fide separate and distinct contract in order to be exempt.

Both the contractor and subcontractor will find difficulty in complying with the law as contracts are revised, or purchases from subcontractors are increased over original estimates, or when contracts require the use of material in stock prior to the time of making the contracts. In many cases it will be difficult for a vendor to know whether his product, in a given case, will eventually be used in the construction of aircraft or naval vessels or how much of bulk sales to a given customer will be used on government work where manufacture of products with other outlets is also conducted by the vendee. The vendor of materials must have accurate analyses of sales by customers, products, periods, etc., and the vendee must maintain reliable stock records to enable them to determine their respective liabilities under the act.

The applicability of the Vinson act to subcontracts in specific cases has been indicated by the Treasury Department in several recent rulings. The following are typical examples of such rulings:

A private shipyard company making ships for the United States Navy under the Vinson act required condensers for use on its ships. Orders for these condensers in excess of $10,000 were placed with a manufacturer who in turn placed orders in excess of $10,000 each with a supplier of condenser tubes which were to be a component part of the condensers. In this case, the Treasury ruled that the shipyard company, manufacturer of condensers and supplier of condenser tubes were all subject to the act.

In another case, the Treasury held that a subcontractor was subject to the act where he received orders aggregating in excess of $10,000 for welding electrodes which would become a component part of a naval vessel or aircraft coming under the act. On the other hand, a subcontract in excess of $10,000

[19] Treasury Decisions 4906 and 4909.
[20] I. T. 3338 (I.R.B. 1939–49).

for plans and drawings in connection with a Vinson act contract was held not to be subject to the excess-profit limitation.

Likewise, machine tools purchased for installation as equipment aboard a naval vessel were held to be subject to the act, while the purchase of machine tools by the prime contractor for use in the construction of the naval vessel was not considered subject to the act.

Cost of Performance

Despite the many other interesting, if perplexing, problems created by the Vinson act, those relating to cost of performance are probably of most interest to accountants. According to the Treasury Department, the report required by the act to be made to the Secretary of War or Navy by a contractor or subcontractor upon the completion of each contract or subcontract, must contain, among other things, a statement of the cost of performing the contract and the manner in which indirect costs were determined and allocated to the contract. Likewise, the annual report to the Collector of Internal Revenue must state the cost of performing each contract completed during the year. Naturally, these requirements anticipate a cost system sufficiently elaborate to enable the contractor to properly determine the costs of each contract, although the Treasury has ruled [21] that a separate system of detailed accounts is not necessary if the contractor's accounting system clearly reflects the actual profit on contracts.

Regulations promulgated by the Treasury Department [22] outline in some detail the various elements of cost to be considered in determining the cost of performing Vinson act contracts. Such elements of cost are summarized as follows:

(1) Manufacturing cost, which is the sum of factory cost and other manufacturing cost.
(2) Miscellaneous direct expenses, such as cost of installation and construction, demonstration and testing expenses, traveling expenses, etc.
(3) General expenses, which are the sum of indirect engineering expenses and expenses of distribution, servicing, and administration.
(4) Guarantee expenses incurred after delivery of the article under contract.

Although the Treasury has stated that no definitions of the elements of cost are of invariable application to all contractors, it would be well for the contractor or subcontractor to follow, as far as possible, in his reports to the Government, the classification of costs outlined by the regulations. Also, particular attention should be paid to the many items of cost not allowed in determining profits on contracts, such as: interest incurred or earned; certain donations; entertainment expenses; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; expenses, maintenance, and depreciation of excess facilities vacated or abandoned; increases in reserves for contingencies, repairs, compensation insurance, and guarantee work; unreasonable compensation for services; premiums for life insurance on lives of officers; losses on investments and bad debts; federal and state income and excess profits taxes; special legal and accounting fees, etc.

Bonuses earned for bettering performance of contracts, penalties incurred for failure to meet guarantees thereunder, and trade or other discounts granted by a contractor or subcontractor are not considered as costs of contracts but, rather, as adjustments of the original contract price. Experimental and development expenses are not allowed as costs of contracts unless they are directly applicable to a given con-

[21] I. T. 3120 (C. B. 1937–2593).
[22] Treasury Decisions 4906 and 4909.

tract, in which case expenses incurred in prior years are also allowed.

In view of the many items not allowed as costs under the act, despite their general acceptance as such for general accounting purposes, the Vinson act contractor should make every effort to include as contract costs all items that are allowable, both direct and indirect. It may be preferable in some cases to charge travel expenses, engineering and executive salaries, special equipment, costs of plant rearrangement, and certain selling expenses, direct to a given contract, rather than include them as indirect expenses to be allocated to all contracts on some percentage basis. The Treasury regulations permit such a choice, provided the items are directly applicable to the contract and are excluded from other indirect expenses.

Although the Government disallowed selling expenses as costs of contracts for a considerable period of time, it now accepts all normal selling expenses except entertainment and certain minor items. Nevertheless, it will probably still be difficult to prove that certain advertising and branch sales office expenses are directly applicable to given contracts. As a final precaution, before rendering the required reports to the Government, the contractor should make a careful check of all charges to each contract, especially direct labor and material, to insure that all allowable costs have been considered, and recorded in the proper amounts.

Since many unallowable items of cost on Vinson act contracts are deductible for income-tax as well as general accounting purposes, contractors or subcontractors under the act may be required to render income-account reports on at least three different accounting bases: (1) for stockholders based upon generally accepted accounting principles; (2) for income-tax purposes; and (3) for Vinson act contracts. However, it may be possible to meet these report requirements without changing the accounting records currently in use, by means of work sheets adjusting the general trial balances to the amounts required for each of the special reports.

Indirect Expenses

The allocation of indirect costs and expenses to individual contracts is one of the most difficult accounting problems to be encountered in determining costs of government contracts. In addition to its proper share of general factory overhead, the cost of each contract should include an allocated portion of indirect engineering, administrative, bidding, general selling and servicing expenses. In this connection, the Treasury Department has stated [23] that no general rule for the allocation of indirect costs to contracts is applicable to all cases, but the proper proportion depends upon all the facts relating to the performance of each contract or subcontract. Nevertheless, the department has outlined [24] the following methods of allocation as acceptable in most cases.

(1) *Factory indirect expenses*—On the basis of the proportion which the direct productive labor applicable to the contract bears to total productive labor of each department or section during the period of performance of the contract;

(2) *Engineering indirect expenses*—On the basis of the proportion which the direct engineering labor applicable to the contract bears to total direct engineering labor of each department or section during the period of performance of the contract;

(3) *Administrative expenses*—On the basis of the proportion which the sum of the manufacturing cost and cost of installation and construction

[23] Treasury Decision 4906; Sec. 17.9 (j).
[24] *Ibid.*

attributable to each contract bears to the total of such costs during the performance of the contract;

(4) *Bidding, general selling and general servicing expenses*—On the basis of the proportion which the contract price bears to total sales, or on the same basis as outlined under (3) above.

While the foregoing suggestions of the Treasury Department may offer guidance to a contractor in the selection of methods for allocating costs to given contracts, he is not required to follow these particular methods and, in fact, should not adopt them in cases where a more equitable basis is available. In many cases, as in plants or departments of plants where the investment in machinery and equipment is large in proportion to labor costs, the allocation of manufacturing overhead on the basis of floor space, output or time may be more equitable than on the basis of relative direct labor costs. Where a concern has already adopted a satisfactory method or methods for allocating indirect costs to production, the management should endeavor to convince the Treasury Department at the outset of the relative merits of its particular methods, rather than attempt radical changes in methods or disregard the matter until the contract is completed.

After the nature of indirect expenses has been investigated and the methods of distributing them to production have been finally selected, the contractor is faced with the added problem of adjusting, from time to time, standard costs and overhead rates currently in use, in order to reflect changes in normal plant capacity, excess facilities, volume of production, rates of depreciation, etc., resulting from the increased business and changes in production schedules caused by government war contracts. This problem is especially pertinent in cases of overtime work and greatly accelerated production where the plant and equipment are subject to much greater wear and tear in a given period of time and the losses from such wear and tear are distributable over many more units of production; problems of accelerated depreciation are discussed under the following caption. It is interesting to note that, in recognizing "normal" or "standard" costs for the determination of the cost of performing government contracts, the Treasury Department has permitted variations in such costs and in rates of overhead, if necessary, over long-term contracts.

Depreciation of Equipment and Amortization of Special Facilities

Two very confusing problems which are currently being encountered by contractors in determining costs of aircraft and naval vessel contracts are: (1) depreciation of existing plant and equipment and (2) amortization of special facilities acquired primarily for the performance of war contracts. In both cases, the factor of obsolescence is very difficult to determine because the engineering features of war equipment are changing rapidly under the pressure for constant improvement in all phases of such equipment. Nevertheless, obsolescence must be considered in calculating the costs of contracts and the amounts taken must be supported by proper explanations of the bases used and their propriety in each case.

While depreciation is recognized as a very important item of cost of Vinson act contracts, the determination of such depreciation is complicated by the present expansion of overtime work and the increase in operating shifts brought about by the urgency of the defense situation. Since extra shifts naturally increase the wear and tear on machinery and equipment, provision should be made for accelerated depreciation thereon, either through higher annual rates or by depreciation based upon units of production. The Treasury Department has given sanction to this policy by stating in its rulings on the Vinson act that "in

making allowances for depreciation, consideration shall be given to the number and length of shifts." [25] Still, the burden of proof is upon the taxpayer, as always.

In the matter of special facilities, the Treasury regulations have provided for "depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract." [26] But, prior to the 1940 amendment to the Vinson act, such depreciation and obsolescence was ordinarily determinable only upon completion of a contract, and the equipment had to be scrapped at the conclusion of the particular contract in order that full costs could be charged to the contract. In most cases special equipment will have some residual value at the completion of a contract, although its future value to the contractor may be very questionable at the time the contract is completed.

Although the sudden increase in demand for armament equipment has found most manufacturers deficient in the tools and plant facilities necessary for its production, the acquisition of the needed equipment has proceeded at a slower pace than anticipated because many manufacturers have been uncertain regarding the amortization of such new equipment in connection with federal income taxes and excess-profits liability. They have not wanted to pay to the Government excess profits on contracts on which only a nominal portion of the cost of needed facilities could be considered as part of the cost of the contracts.

Recognizing the seriousness of the foregoing situation, the Secretary of the Treasury, in the fall of 1939, applied to Vinson act contracts the use of closing agreements,[27] as authorized by the Internal Revenue Code,[28] whereby the manner of treating the cost of special facilities in the computation of excess profits would be agreed upon in advance of the completion of Army or Navy war contracts. Under this procedure, the Treasury, upon certification in relation thereto by the Army or Navy, agrees to allow a fixed percentage of reasonable cost of such facilities in determining the cost of contracts.

The first such closing agreement,[29] signed by the Treasury with Colt's Patent Fire Arms Manufacturing Company, provided that the company, during the period of performance of the contract, might charge off as indirect factory expense, the cost of special tools, jigs, dies, fixtures, and gauges which had to be acquired to carry out the contract and were useful only for that purpose. The agreement also permitted the company to charge off annually, as general depreciation, 10 per cent of the cost of additional standard machinery, which the company had to install to perform the contract.

While the use of closing agreements seemed to be a step in the right direction, the acquisition of new plant facilities thereunder continued to progress at a retarded rate due to difficulties in arriving at satisfactory amortization rates and the fact that there was some question as to the legality of closing agreements as such in these cases. Therefore, the most recent amendment to the Vinson act [30] contained a clause which in effect incorporated into law the general principles of closing agreements as applied to war contracts. This amendment provides, among other things, that, during the national emergency declared by the President on September 8, 1939, to exist, the Secretary of War or the

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[25] Treasury Decision 4906; Sec. 17.9 (c).
[26] *Ibid.*
[27] Press Service No. 18–79, released by the Treasury, September 18, 1939.
[28] Section 3760.
[29] Press Service No. 19–53, released by the Treasury, December 4, 1939.
[30] Public No. 671; 76th Cong.; 3rd Sess.; Sec. 4. Approved June 28, 1940.

Navy, as the case may be, shall, subject to regulations prescribed by the President, certify to the Commissioner of Internal Revenue, upon whom such certification shall be binding, as to: (a) the necessity and cost of special additional equipment and facilities acquired to facilitate the completion of naval vessels or Army and Navy aircraft in private plants; and (b) the percentage of cost of such special additional equipment and facilities to be charged against each contract therefor. This percentage of cost is to be considered as a reduction of the contract price of each contract and will be applied against and reduce the cost or other basis of the special equipment as of the date of its installation.

The law also provides that the cost of the special additional equipment and facilities to be borne by the Government under each contract shall be reported to Congress every three months. Although official regulations and interpretations in respect of this amendment have not been promulgated at the date of this writing, it has been reported that this most recent provision for easing the burden on the contractor of new facilities and equipment, is still met with apathy by most contractors, and that the proposed new general excess-profits tax will permit amortization of special new equipment for defense orders over a five-year period. Thus, it is seen that the Government and private industry must coöperate in every respect in order to make the national defense program workable.

Credit for Federal Income Taxes

As mentioned in a previous section of this article, the amount of excess profit on Vinson act contracts completed in a given income-taxable year shall be reduced by the amount of federal income and excess-profits taxes paid or remaining to be paid on such excess profit. Ambiguity in the law and related Treasury decisions has rendered the determination of such tax credit very difficult.

In the first place, the question arises as to when, from an income-tax standpoint, all or part of the excess profit was earned. Should portions of the excess profit on long-term contracts be considered as earned during each of several years of performance, with varying income-tax rates and taxable income for each year, or is all the excess profit to be considered as earned during the last year of performance? Or is the answer determined by the manner in which such profit is reported in federal income-tax returns, *i.e.*, on the basis of partial completion, completed contracts, etc.? If all the excess profit is considered as earned during the year of completion of the contract, the many problems related to the determination of completion, as previously mentioned, assume even greater significance, since tax rates and other taxable income may vary greatly in different years.

Again, what part of the taxable income of a given year is represented by these excess profits—is it the first, last, or average income? Examples given in Treasury decisions presume that the excess profits are the first profits earned in the year of completion of the contracts, the income-tax credit being computed on the basis of the lowest tax brackets first. This method seems grossly unfair and not justified by the circumstances especially since similar computations in returns for unjust enrichment are based upon the difference between the tax on income with and without the questionable items, or an average tax.

After the amount of income-tax credit has finally been determined, any adjustments in income-tax returns which include all or part of the excess profit giving rise to such tax credit, should likewise be reflected in the income-tax credit for such excess profit on Vinson act reports. Thus, the contractor must first perform mathematical acrobatics to determine the amount of income-tax

credit allowable, and then he must carefully analyze every subsequent income-tax assessment or refund and apply the proportionate amount to the original tax credit.

General Summary

While accounting for income-tax purposes is divergent in many respects from generally accepted accounting for general corporation purposes, the type of accounting anticipated by the Vinson act and its related amendments is different in many instances from either of these two kinds of accounting. Certain items of cost recognized for general accounting purposes are not allowed as costs of government contracts; other costs are allowed for contracts which are not recognized for tax purposes; rates of depreciation on equipment and amortization of special facilities may be entirely different for each of these three purposes. Again, the period during which both income and expenses are recognized as having taken place may be entirely different under general accounting, income-tax and government war contract requirements. Thus, to all the problems and inconsistencies encountered through the differences between corporate and income-tax accounting must now be added still other differences in accounting principles and procedures prescribed for reports on government war contracts. Some of these differences from ordinary accounting are necessary in view of the specialized nature of government war contracts, but many others are simply the result of ill advised, arbitrary governmental regulations.

In addition to all the many problems of contract procedure, governmental reports, calculations of contract costs, and determination of excess profit on government war contracts, the contractor is faced with the very basic problem of estimating the amounts he should submit on each bid for government work. If he bids higher than his competitors, he will lose the contract. On the other hand, he must bid high enough to cover the costs of performance. But such costs are subject to great variations, especially in times like the present when large-scale wars are being fought all over the world. War inflation will certainly upset the cost estimates of contractors, while a business recession will have as important an effect on costs. These same abnormal conditions will distort considerably the standard costs, overhead rates, etc., used in calculating actual costs of contracts.

As mentioned at the outset of this article, legislation is now being prepared (at the date of publication it undoubtedly will have become an accomplished fact) for a general excess-profits tax which will virtually repeal the Vinson-Trammel act. [See editor's note on page 430.] The very problems which have been discussed in this article, and the limitation on profits under the act, have so hampered contractors and prospective contractors for war equipment that repeal of the Vinson act appears to be necessary if the governmental bonds on industry are to be loosened and the vast defense program is to go ahead at full speed. Designed to remove the doubts from manufacturers as to their liabilities to the Government from defense orders, the proposed new tax bill is expected to take the form of an excess-profits tax applicable to all industries. The tax will be based upon the profits of each corporation in excess of either its average profits of recent normal years or a fixed rate of return on invested capital. The law may be applicable to 1940 earnings, and is expected to permit amortization of the cost of new plant facilities over a five-year period. In any event, the amount payable to the Government is not expected to be based upon any complicated percentage of profit on individual contracts, as is now the case. Nevertheless, until the proposed new legislation is enacted and becomes effective, it will

still be necessary for contractors for naval vessels and Navy and Army aircraft to follow the elaborate provisions of the Vinson act, as amended, and even after that date there will be problems in connection with adjustments to Vinson act contracts completed prior to the effective date.

It has been the purpose of this article to briefly outline the general provisions of governmental regulations applicable to war contracts, especially in respect of excess-profit liability, and to indicate some of the many accounting and administrative problems encountered thereunder. There are undoubtedly many other such problems which only actual experience with government war contracts will reveal.

While this article has been directed largely to the problems of cost accounting under the Vinson act which, by the date of publication, may be repealed, the philosophy of cost developed under the act will continue to influence the determination of costs under the different types of government contracts arising out of the present emergency.

[NOTE.—Since the preparation of this article, the second revenue act of 1940 has been enacted—signed by the President October 8, 1940—repealing the Vinson act and levying an excess-profits tax.—*Editor.*]