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**The Evolution
of Reserve
and Provision
Accounting
in the UK,
1938-50**

**Researchers:
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**THE EVOLUTION OF RESERVE AND
PROVISION ACCOUNTING IN THE
UK, 1938-50**

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FOREWORD

This report considers the evolution of reserve and provision accounting in the UK between 1938-50. Reserve and provision accounting has traditionally been seen as a method of smoothing results. During this period, there were major changes and developments in reserve and provision accounting, many of which are still evident in today's financial statements.

The study focuses on the accounting practices of 21 companies, selected from the 100 largest industrial enterprises in Great Britain in 1948. The report firstly considers the regulatory influences that affected the nature and practice of reserve and provision accounting during the period. This included changes in tax legislation, a series of recommendations on accounting principles issued by the Institute of Chartered Accountants in England and Wales and the Companies Acts 1947-48.

The report then looks at the presentational changes that took place over the period, before concentrating on the more quantifiable changes in reserve and provision accounting.

The report also analyses the use of secret reserves, finding that two-thirds of the sample companies used some level of secret reserve accounting, suggesting a desire to manage profit levels. Secret reserves were effectively then prohibited by the Companies Acts 1947-48.

Finally, the report concludes on the findings of the research, identifying the major changes in reserve and provision accounting during the period. These changes included: distinguishing between distributable and non-distributable reserves; disclosure of shareholders' funds; separate disclosure of provisions; the abolition of secret reserves; and the disclosure of cost, accumulated depreciation and net book value of fixed assets.

The authors also consider contemporary developments in reserve and provision accounting, linking these developments to the guidelines and regulatory regimes existing in 1950.

In addition to providing a detailed analysis of changes in accounting, the report provides an insight into the success of voluntary self-regulation compared to a mandatory approach. In this case, although the voluntary recommendations brought some improvement in practice, it was not until the Companies Acts 1947-48 that there was wide-spread compliance.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER). The Research Committee of the Institute of Chartered Accountants of Scotland has also been happy to support this project, and hope that the report will add to our understanding of past financial reporting practices and the impact of voluntary and mandatory approaches to regulation.

The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that this project will provide an insight into the development of accounting practice.

David Spence
Convener of Research Committee

April 2007

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EXECUTIVE SUMMARY

Reported annual profit figures represent an unspecified weighted combination of the cash and credit transactions entered into by a business during an accounting year and of the partly discretionary year-end adjustments. Many of these adjustments take the form of transfers to and from reserves and provisions. Public awareness of the extent of the discretion available to those producing the annual accounts was heightened by the Royal Mail case of 1931 (*Rex v Kysant and another*).

The Companies Acts of 1947-48 made major changes to the treatment of reserves and provisions in company financial statements. In particular, they provided definitions of, and requirements for, the treatment of reserves and provisions in general and also prevented companies (other than those in the banking, insurance and shipping industries) from carrying secret reserves on their published balance sheets. As a consequence, any such reserves established during the war years were necessarily released onto published balance sheets. This provides a unique opportunity to observe the levels of secret reserve accounting from published sources. Further, because of the preference of reporting companies to avoid undue publicity concerning their secret reserves, the area also provides an opportunity to observe and analyse the range of technical 'solutions' provided to meet this problem.

These effects and responses are not well understood at present, despite the importance of the Companies Acts of 1947-48 to the evolution of reserve and provision accounting, because of the comparative lack of empirically based work in this area. The research paper accordingly seeks to identify patterns in discretionary accounting approaches to reserve and provision accounting across the period 1938-50.

The drawing of conclusions about observable differences in treatment is, however, complicated by changes during the period in both the regulatory regime and in the economic circumstances. In the early part of the period, reporting companies were subject to the limited requirements of the legislation of 1928-29. The statutory position was transformed both by the changes in wartime taxation and by the legislation of 1947-48. Moreover, during the Second World War and immediate post-war years, accounting practices were influenced both by the Institute of Chartered Accountants in England and Wales' (ICAEW) war-time Recommendations on Accounting Principles and by the publication in June 1945 of the report of the Cohen Committee on Company Law Amendment, which trailed many of the forthcoming requirements of the 1947-48 Acts (see Maltby, 2000).

Changes in the economic position of the set of companies as a whole over time were of course considerable, as the period 1938-50 covers the immediate pre-war period, the years of military conflict and state controls and the early years of post-war re-construction and adjustment. The effects of these changes on the reporting practices of the individual companies will, however, have been limited by the consistent composition of the sample set across the chosen period.

There was, in fact, a considerable increase in the importance of both capital (including share premium reserves) and revenue reserves across the period 1938-50, which rose from 2.7 and 12.7% of total assets (respectively) in 1938 to 19 and 23.7% in 1950, at a time when the monetary value of total assets was also rising rapidly. The composition of the growing volume of reserves also changed markedly, with a rapid growth in share premium accounts, following the requirement in the Companies Act 1947 (s.72) that premiums on the issue of shares be transferred thereto, and in the use of specified (i.e. non-general) revenue reserves.

The period also saw a significant evolution in the means of accounting for reserves and provisions. The position in 1938 was that:

- reserves were only grouped or classified on a minority of balance sheets;
- there was no distinction in the balance sheet between capital and revenue reserves;
- there was no distinction between reserves and provisions, with the terms often being used interchangeably;
- provisions for contingencies, taxation and others matters were usually included in the figure for creditors; and
- few companies disclosed the cost of, or accumulated depreciation on, their fixed assets, although a significant proportion of companies did identify the year's depreciation charge.

By the end of the period in 1950, the position had altered significantly, so that:

- reserves were uniformly grouped on balance sheets, along with information on share capital, so as to give the amount of shareholders funds;
- the distinction between non-distributable capital reserves and distributable revenue reserves was made apparent;
- Recommendation N.6 (ICAEW, 1944-57) and the Companies Acts 1947-48 had established a distinction between reserves and provisions that was generally followed in the presentation of financial statements;
- the separate disclosure of a number of provisions under the current liabilities heading was the norm;
- secret (hidden or inner) reserves had been effectively abolished, except for companies in the banking, insurance and shipping industries; and
- the cost, accumulated depreciation and net book value of classes of fixed assets were uniformly shown on company balance sheets.

As far as capital reserves are concerned, companies in the sample generally took a prudent and conservative approach to the need to retain funds in their businesses. Realised profits on fixed asset sales and other non-trading items, and sometimes even post-war refunds of Excess Profits Tax, although legally distributable, were frequently credited to a capital reserve account.

The disclosure of capital reserves under a separate heading, although advocated by Recommendation N.6 (ICAEW, 1944-57), was not widely adopted until the Companies Acts 1947-48 came into force.

The significant inflationary pressures in the post-war period, allied to the sensible advice in Recommendation N.12 (ICAEW, 1944-57), led to a growing realisation that funds needed to be retained in separate capital reserves against the increasing cost of replacing fixed assets, an approach consistent with the legal distinction between 'fixed capital' and 'circulating capital' (Buckley 1949). This materially contributed to the growth in capital reserves, other than share premium accounts, from 3.2% of total assets in 1945 to 12.5% in 1950.

Revenue reserves grew more evenly over the period, from 12.7% of total assets in 1938 to 18.3% in 1945 and then to 23.7% in 1950, with their composition also changing. General reserves, the general reserve and the profit and loss account, declined as a proportion of total reserves across the war years, from 70.9% in 1938 to 42.7% in 1945. While specified revenue reserves increased sharply across the same period but then fell back in relative terms during the post-war years as contingency arrangements became less necessary and voluntary appropriations to revenue reserve for additional depreciation were abandoned.

As far as the accounting treatment of revenue reserves was concerned, there was greater consistency in the distinctions drawn between reserves and provisions from 1945 onwards, in response to Recommendation N.6 (ICAEW, 1944-57) and the Report of Cohen Committee (Board of Trade, 1945) and to the requirements of the Companies Acts 1947-48, with the abandonment of 'reserves' whose titles, such as investment

reserve, bad debt reserve, stocks or fuel crisis, suggest that they were, in effect, provisions.

Within this general pattern of increased conformity, there were significant variations in the treatment of potential taxation liabilities, arising from the use of the prior year basis for the assessment of business income tax. An increasing number of companies set aside funds to meet the eventual liability from 1943 onwards, either in order to comply with the advice in Recommendation N.3 (ICAEW, 1944-57) or as a means of absorbing profits that would otherwise, given dividend restrictions, have increased the level of retained profits. However, it was not until the Companies Acts 1947-48 came into force that provisioning, whether as reserve, provision or deferred liability, became the norm. Following the introduction of initial allowances on the acquisition of various classes of fixed assets from April 1946, the area of controversy over accounting for taxes was widened to include tax deferral or equalisation accounting. By 1950, 43% of companies in the sample provided for timing differences in a deferred tax account, generally as a reserve but otherwise as a provision or deferred liability.

Towards the end of the period 1938-50 there were also major changes in the way that provisions were accounted for on company balance sheets. Previously, provisions were as likely to be called 'reserves' as 'provisions'. Thus, in both 1938 and 1944 approximately equal numbers of companies used each term to refer to amounts set aside within creditors and it was not until the Companies Acts 1947-48 that this practice ceased. It was also minority practice until the passing of the legislation for companies to disclose provisions as separate balance sheet items, with most companies including their provisions within 'omnibus' current liability items.

The presentation of profit allocations also changed markedly. In 1944, after the publication of Recommendation N.5 ('Inclusion in the accounts of proposed profit allocations'; ICAEW, 1944-57), 86% of sample companies showed the impact of proposed profit allocations on

their balance sheets, even though they still awaited the formal approval of their shareholders, compared with only a third of companies in 1938.

In terms of volume, however, provisions other than tax and depreciation were never more than of modest significance and only amounted to as much as 5% of total assets in 1950. Provisions for taxation tended to grow across the period, particularly in the war years, although this is difficult to quantify because of limited disclosures and because of changing perspectives on how best to account for both current and future taxation.

By far the most important provision was depreciation. At the start of the period under review, all companies distinguished their investments from other fixed assets. Almost half of the sample companies showed the depreciation charge and split their physical fixed assets into different classes, but only two companies disclosed their accumulated depreciation provisions. The level of information provided on depreciation gradually increased, although less than half the sample companies disclosed the cost of their fixed assets, or the accumulated depreciation provisions thereon until the legislation of 1947-48. Thereafter, accumulated provisions for depreciation could be seen to account for around a third of the cost (or valuation) of fixed assets of the sample companies before falling to 22% in 1950.

The reclassification of secret reserves as reported reserves took place in the period 1945-48, with most reclassifications occurring before, rather than after, the provisions of the new Companies Acts were in place.

It is clear that secret reserves were more often included within creditors than deducted from assets and that the amounts involved in the former practice were twice as large as the latter. The release of secret reserves accordingly involved the disaggregation of omnibus items within current liabilities more often than it involved the breaking down of previously provided asset figures. Companies that made public their formerly secret reserves in the period 1945-48 did not draw attention to the matter but most gave the necessary

information with reasonable clarity. Where this was not the case, the restatement of comparative figures was the most common accounting device used to mask the accounting reclassifications concerned.

Although the ability to transfer amounts into and out of secret reserves materially reduces the level of trust that can be placed in published financial statements and threatens to distort the pattern of profitability over time, the amounts involved have not always been as large as the subject's notoriety would suggest. The amount of secret reserves reclassified in the period 1945-48 represented almost 10% of the total reserves of the companies studied, although the differential effect was much greater. Two-thirds of companies used some level of secret reserve accounting, half of whom had secret reserves of more than 30% of their total reserves, consistent with the period of the First World War and its aftermath (Arnold, 1996). The results suggest that the desire of many companies to manage profit levels across a period of considerable commercial uncertainty proved stronger than any criticisms evoked by the Royal Mail case of 1931 or expressed as part of the subsequent debate within the profession.

The results also suggest that, although the voluntary self-regulatory approach improves reporting practices, especially where compliance is not too onerous, a mandatory approach to the specification of generally accepted accounting principles may be necessary for their consistent adoption.

CHAPTER ONE

INTRODUCTION

Financial statements signal the effectiveness with which a given business has used the assets at its disposal and provide reliable information to shareholders on the effectiveness with which directors have discharged their traditional 'stewardship' role. The 'profit' of a business can be used to assess profitability, and the relationship between profit and the value (or sometimes the amortised cost) of the assets employed in the business.

The accounting process identifies the profit made by a given business during an accounting period, normally a year, by adjusting the underlying operating cash flows for changes in the level of credit provided by, or to, the business and, in accordance with the accruals convention, by adjusting the income statement and balance sheet of the business in order to reflect anticipated changes, particularly losses, in net asset book values at the end of the accounting period.

The most important book entries are provisions, amounts set aside by way of charges against profit to allow for anticipated diminutions in the value of assets or expected losses. These are not underpinned by transactions between the business and actors in the outside world and thus provide considerable scope for the exercise of personal discretion. Once provisions have been determined, the residual claim of the shareholders on corporate net assets, after recognising all prior claims and anticipated losses, can then be shown on the balance sheet under the heading of 'shares and reserves'. Although all reserves are part of shareholders interests, they are often subdivided on the balance sheet in order to signal variations in their ability to support future distributions, whether for legal reasons or because of the intentions of the directors.

Despite, or perhaps because of, the importance of the distinction between provisions and reserves to the profit measurement process, the area was scarcely regulated at all until the 1940s. Accordingly, it represented a thoroughly confused area of practice until that time and has continued to present problems to the present day, as recognised by the issue of accounting standards SSAP 18, FRS 12, IAS 10 and IAS 37.

Regulatory and other influences, 1925-50

In the second quarter of the twentieth century, following on from the Companies Act of 1908, there were further Acts in 1928-29 and 1947-48. The earlier of these, the Acts of 1928-29, were widely viewed as disappointing in their scope and have been described as an 'unduly tentative measure' (Edwards, 1989).

The Companies Act 1929 made no reference to provisions and, although recognising that directors might set aside sums into reserves to meet contingencies, equalise dividends or for any other proper purpose (s. 93), required directors to report only the amount they proposed to carry to the reserve accounts shown in the balance sheet (s. 123).

The legislation of 1928-29 substantially ignored the subject of secret (hidden, or inner reserves), despite the importance it had achieved over the years of, and following the First World War, partly because of the support of the Law Society and the Institute of Chartered Accountants in England and Wales (ICAEW) for the practice as a 'sound and pervasive business policy' in their evidence to the Greene (Company Law Amendment) Committee of 1925 (Edwards, 1979).

The prosecution of Lord Kylsant in the 'Royal Mail' case (*Rex v Kylsant and another*) of 1931, was a key case in the evolution of secret reserve accounting, and his subsequent imprisonment attracted considerable public attention. Lord Kylsant was found guilty, not of secret reserve accounting, but of publishing a prospectus for debenture stock in 1928, which 'he knew to be false in a material particular', but he

was found not guilty of two charges relating to the publication of annual reports (for 1926 and 1927). Nonetheless, the publicity that the case attracted may well have helped gradually to change the attitude of the accounting profession towards reserve and provision accounting. The process was, nonetheless, slow: the ICAEW, in particular, 'continued to take a very cautious view of changes to the legislation' through the 1930s. It took counsel's advice that the legal position remained unchanged by the decision in the Royal Mail case, and decided not to give its members any general advice based thereon (Edwards, 1979, Maltby, 2000).

From December 1942, however, the ICAEW issued a number of Recommendations on Accounting Principles, several of which related to the treatment of reserves and provisions, notably Recommendation N.6 which, in October 1943, provided the first authoritative basis for distinguishing reserves from provisions. The terms 'reserve' and 'provision' were, at that time, 'regarded as interchangeable' (ICAEW, 1944-57) and the ICAEW's Recommendation N.6 ('Reserves and provisions': ICAEW, 1944-57) argued that a distinction should be drawn between reserves, which had been appropriated from profits for retention in the company, and provisions to cover specific commitments, liabilities, known contingencies and reductions in asset values. N.6 and N.8 ('Form of the balance sheet and profit and loss account': ICAEW, 1944-57) also recommended that revenue reserves, which were regarded as distributable, be distinguished from capital reserves, which were not normally regarded as available for distribution, an approach subsequently upheld in the Companies Acts 1947-1948. Also in 1943, the Cohen Committee on Company Law Amendment was established, which was to have a considerable input into the Companies Acts of 1947-48 (see Maltby, 2000; Bircher, 1988a and 1988b; Noguchi and Edwards, 2004).

The Acts of 1947-48 made major alterations to the financial reporting practices and disclosures of limited liability companies, requiring companies to circulate, and file with the Registrar of Companies, a

profit and loss account as well as a balance sheet, both of which were to be audited. The Acts also made consolidated accounts the specified and audited form of group reporting. The new Act also: defined and distinguished reserves and provisions; required that the cost or valuation of, and aggregate depreciation charged on, fixed assets be shown; that provisions for depreciation and the charge for the year be separately disclosed; and effectively outlawed the practice of secret reserve accounting (except in the case of banking, insurance and shipping companies).

Practices concerning reserves and provisions, 1900-50

Profit measurements have long been, and are still seen as, an important indicator of business performance. The treatment of reserves and provisions are central to the identification of business profit and loss and still present problems to the reporting accountant. This research accordingly identifies the main changes in reserve and provision accounting practice in the UK across the period 1938-50, as a result of war-time pressures, professional initiatives and the introduction of the Companies Acts 1947-48. This research is based on empirical corporate data of the period.

Legislative requirements for disclosure do not fully define accounting practices, since the law provides a minimum standard for compliance that can be voluntarily augmented at the discretion of reporting firms. The attitude of company boards to the voluntary disclosure of additional information is, of course, likely to be influenced both by the level of required disclosure and by the circumstances of the time.

Before the legislation of 1947, there was plenty of scope for voluntary disclosure but circumstances often militated against this; in the unusual circumstances of the First World War, when wage restraint had been bargained against profit control, profit levels were a politically sensitive subject and companies were reluctant to disclose their true levels of

profit or even to define their tax payments, which would indicate the actual profit levels. During the period from 1919-39 there were two sharp slumps, in 1919-20 and in 1929, and long periods of economic stagnation, and difficult circumstances in which company directors might not have felt able to provide information that would indicate the real difficulties under which their firms were operating. During the Second World War, from 1939-45, although the government was quick to introduce new taxes on profits and introduce price controls, thereby reducing public concerns over profiteering, circumstances were still difficult.

The legislation of 1947-48 was therefore bound to have a major effect on company practice, after a long period of permissive corporate legislation and circumstances that might have been expected to inhibit voluntary disclosure on any real scale. Although there are several surveys of accounting practices across the period 1938-50, none of these really focused on the changes in reserve and provision accounting.

Contribution to knowledge

There were good reasons to expect considerable changes in the accounting treatment of reserves and provisions during the period 1938-50, given the economic pressures of war-time, the issuing of a new set of Recommendations on Accounting Principles by the ICAEW and the introduction of the Companies Acts 1947-48. However, the actual effects of these changes have been poorly understood to date, partly because of a comparative lack of empirically-based work in this area. This study accordingly attempts to identify changes in the range and quantity of provision and reserve accounting and in the level and forms of disclosure.

The use of legislation to prevent companies, other than those in the banking, insurance and shipping industries, from continuing to carry secret reserves, also meant that previously established secret reserves

were necessarily released onto published balance sheets. This provides a unique opportunity to observe the levels of secret reserve accounting in operation at this time, from published sources, and to compare this with available evidence on the incidence of secret reserve accounting at the time of the First World War.

Further, because reporting companies can be expected to try to avoid undue publicity for their secret reserve releases, the area also provides an opportunity to observe and analyse the range of technical 'solutions' that were provided to meet this problem.

Reserve accounting is a device central to financial reporting and profit measurement and reserve and provision accounting practices in the period 1938-50 represent an important part of the development of financial reporting. An analysis of these practices provides useful information on how the accounting profession responded to increased public interest in the type of information it was providing. Further, because the exercise of discretion in arriving at profit figures is one of the most central functions within the area of financial reporting, the collection of properly quantified and analysed data on the way that reserve and provision accounting developed during the years between the Royal Mail case of 1931 and the legislative removal of a material part of that discretion in 1948 is of importance.

Prior research in the area

There has not been any prior research that really addresses the questions identified in this study, although several papers address related matters. Arnold and Matthews (2002) provide a broad survey of reporting practices in the period 1920-50, while Bircher (1988a and 1988b), Maltby (2000) and Noguchi and Edwards (2004) examine various aspects of the process whereby the accounting disclosure requirements of the Companies Acts 1947-48 were formulated.

Provisions fall into two main groups: firstly amounts written off or retained by way of providing for depreciation, renewals or diminutions in the value of assets; and secondly, retentions to provide for any known liability whose amount cannot be established with any real accuracy.

The major item in the first group is depreciation. Edwards' (1989) research into the practices of companies in the iron and steel industry concluded that: 'the systematic depreciation of fixed assets did not become a widespread practice until after 1940', that the total omission of a depreciation charge was not uncommon and that, when deductions were made, they were often lump sum appropriations of profit rather than more specifically calculated charges against those profits.

The most important item in the second group is taxation. Disclosure levels for taxation were generally low for much of the earlier part of the twentieth century. During the First World War taxation had been very poorly disclosed as companies were cautious about revealing their practices in the face of the difficulties of estimating their liability to the new war taxes and of public concerns over profiteering. Most companies made prudent estimates of their tax liabilities and in some cases the prudence was so exaggerated, it functioned as a form of secret reserve accounting. In other cases the caution was unintentional and resulted from unexpected changes in tax legislation immediately after the war. Nonetheless, disclosures were poor, encouraging those who used the financial reports to underestimate the effects of post-war trading difficulties on current operating results (see Arnold 1991; 1997; Arnold and Matthews, 2002).

As reserves are residual items, often taken after the making of proper provisions, they have less often been the subject of research studies, with the notable exception of secret reserve accounting. The undisclosed understatement of net worth resulting from the excessive writing-down of assets, the overstatement of provisions and liabilities and/or the writing-off of additions to fixed assets as expenses, are an extreme form of prudence that enables profit smoothing on an heroic scale.

At the start of the twentieth century, secret reserve accounting was confined largely to the banks, although its gradual extension to the manufacturing sector was evidenced by the unsuccessful attempt of the directors of the Birmingham Small Arms Co. Ltd in 1906 to establish formal powers to hold inner reserves (Newton v Birmingham Small Arms). Secret reserve accounting was a common practice during the First World War and businesses such as Boots, P & O, Imperial Tobacco, J. Lyons, G.K.N. and John Summers were certainly still carrying secret reserves during the 1920s (Chapman, 1974; Napier, 1991; Edwards, 1989; Edwards and Boyns, 1994). More generally, using the archival records of thirty major UK quoted companies, Arnold found that about two-thirds of these companies used secret reserves to some extent across the period 1900-24, a third of whom used them to an important extent (Arnold 1996 and 1997).

Although the accounting profession generally saw their use as ‘in certain cases desirable and in many cases essential’ (Kitchen, 1979; see also Edwards, 1979), public awareness of the practice was seemingly quite low until the Royal Mail case of 1931, in which Lord Plender, a former President of the Institute of Chartered Accountants in England and Wales, said in evidence that it was:

quite usual for large commercial and industrial companies to set aside out of an unusually prosperous year sums to secret reserves (Brooks, 1933).

These comments and Kyslant’s subsequent conviction provided strong evidence of the widespread use of secret reserves, (Hastings, 1962; Yamey, 1979) although more recent research by Ashton (1986) and Arnold (1991) has suggested that the case really concerned the non-disclosure of tax repayments and other ‘special credits’ or receipts of the periods concerned, rather than the utilisation of the profits of previous periods by means of covert transfers to and from reserves.

Sample companies

A sample for examining the nature of reserves and provision accounting was sought that would be broadly representative of the British economy of the time¹. The reporting practices concerning reserve and provision accounting of publicly-quoted and unquoted companies are likely to differ, but the accounting practices of major companies have a public significance far beyond that of smaller companies. This study accordingly focuses on the accounting practices of 21 companies drawn from the 100 largest industrial enterprises in Great Britain in 1948, as defined by the market value of their shares (Chandler, 1990). The sample was confined to companies that were subject to the general regulatory requirements of the time and the annual composition of the sample was held as constant as possible, despite the organisational changes in the corporate sector that took place within the period, so that general conclusions could be drawn about the disclosure practices of the time.

The paper copies of registered documents filed with, and retained by, Companies House, Cardiff were carefully investigated. If the major quoted companies had merely complied with the minimum legal requirements of the 1929 Act, no satisfactory data could have been constructed, since the Act only required companies to file a certified balance sheet but no profit and loss account or notes thereto. In fact, most large companies made information available to their shareholders beyond the requirements of the legislation and then simply filed their published accounts at Companies House.

Initially, the database at Companies House, Cardiff was scrutinised for the listings of the 100 largest industrial enterprises in Great Britain in 1948, as defined above. In eight cases, the company records were either held in Scotland or Northern Ireland and in a further 54 instances, the detailed files could not be traced, largely because of the level of corporate merger activity, both in the period 1938-50 and subsequently. This left 38 companies whose files could be accessed and in 21 cases the

files yielded a set of published accounts across the period 1938-50², as shown in Appendix one.

The twenty-one companies, as listed in Appendix two, were spread across eleven industrial sectors. The intention to hold the composition of the sample as constant as possible, despite the organisational changes that took place within the period and the limitations of accessing data more than fifty years later, may have imposed some form of 'survival' bias. Certainly, a sample could not be randomly selected from the total population of the reporting companies of the time and this may have had some effect on the conclusions that can be reached. On the other hand, the data was acquired by means of a consistent search process across an objectively defined set of companies without selection bias. The twenty-one cases were accordingly seen as providing a sufficiently representative sample to address the research questions and provide a basis both for the production of quantified data and for a more qualitative analysis, using case-by-case specifics.

Summary

This research identifies patterns in discretionary accounting for reserves and provisions across the period 1938-50. Conclusions about observable differences in treatment are, however, complicated by changes during the period in both the regulatory regime and in the economic circumstances.

In the early part of the period, reporting companies were subject to the limited requirements of the legislation of 1928-29. The statutory position was transformed both by the changes in wartime taxation and by the legislation of 1947-48. Moreover, during the war and immediate post-war years, accounting practices were influenced both by the ICAEW's war-time Recommendations on Accounting Principles and by the publication in June 1945 of the report of the Cohen Committee

on Company Law Amendment, which trailed many of the forthcoming requirements of the 1947-48 Acts (see Maltby, 2000).

Changes in the economic position of companies as a whole over time were, of course considerable, as the period 1938-50 covers the immediate pre-war period, the years of military conflict and state controls and the early years of post-war re-construction and adjustment. The effects of these changes on the reporting practices of the individual companies will, however, have been limited by using the same sample of companies across the chosen period.

ENDNOTES:

1. The data set, consisting of the paper copies of published profit and loss accounts and balance sheets and notes thereto for the sample set companies, is available on request to other researchers.
2. With the exception of Ford Motors accounts for 1950.

CHAPTER TWO

THE REGULATORY REGIME

This chapter considers the regulation and professional influence that affected the nature and practice of reserve and provision accounting during the period 1938-50.

Companies Act 1929

The Companies Act of 1929 empowered directors to set aside such sums as they thought proper to reserve before recommending a dividend. Any such reserves, at the discretion of the directors, could be applied to meet any contingencies, provide for dividend equalisation or for any other proper purpose (s.93). They were also required to produce a directors' report identifying the amounts they proposed to carry to any reserve fund, general reserve or reserve account shown specifically in the balance sheet (s.123).

The legislation made no reference, however, to provisions and required only that the directors provide:

Such particulars as are necessary to disclose the general nature of the liabilities and assets of the company and distinguish between the amounts respectively of fixed assets and floating assets and ... state how the value of fixed assets has been arrived at (s. 124).

Changes in tax legislation

Until the passing of the Finance Act 1937, companies paid income tax on their statutory profits at the full standard rate. Assessment for income tax on company profits was normally on a preceding year basis (Finance Act 1926, s. 29) and the amounts payable were due on or before 1 January in the year of assessment. In 1937, however, the increasing cost of the government's national defence programme resulted in the introduction of a new tax, known as the National Defence Contribution (NDC), chargeable on the profits of all trades and businesses.

The NDC was originally imposed for the five years ending on 31 March 1942, but the Finance Act 1942 instead provided for its continuation (s. 36). The Finance Act 1946 changed the name of the tax from the NDC to the 'Profits Tax' from 1 January 1947, but narrowed its scope to the profits of limited companies and incorporated societies alone, before further changes were made to its scope and basis in the Finance Act 1947 (s. 25). This Profits Tax was levied initially on profits of the period 1 January 1947 to 30 September 1949 at 25% on distributed profits and 10% on retained profits.

With the onset of war, the Finance Act (No.2) 1939 created a new tax, the Excess Profits Tax (EPT), levied on the excess profits of trades and businesses over and above their 'standard profits' (s. 12). The new EPT was clearly intended as an alternative to NDC, rather than an additional imposition, as can be seen from the statement that, over the three-year period to 31 March 1942, total tax payable either through EPT or NDC should be at least as large as the NDC payable if there had been no EPT (s. 19). In effect where the EPT was equal to or above this minimum, EPT, and not NDC, was payable. The NDC had, since 1937, been assessed on 12 month accounting periods and been payable one month from the date of assessment (Finance Act 1937, s. 24) and the EPT applied identical rules to its assessment and payment. EPT was charged on excess profits within the period from 1 April 1939 to 31

March 1940 at 60%, then at 100% until 31 December 1945, when it was again levied at a rate of 60% until 31 December 1946, after which it ceased (The Accountant, 15 March 1947).

The Finance Act (No. 2) 1945 provided for a post-war refund of part of the EPT paid in the period from 1 April 1940 to 31 December 1945 (s. 43). The refund was to be the amount by which the EPT paid (at a rate of 100%) exceeded the amount of EPT and NDC that would have been payable had the rate of EPT been 80% (s. 40). There were also further requirements that the refunds be used for developing and re-equipping the business, rather than 'distributed by way of dividend or cash bonus or capitalised for the benefit of shareholders'. There is, of course, a potential contradiction in the phrase 'capitalised for the benefit of shareholders' since capitalisation, although possibly 'legitimising' additional cash disbursements as dividends, is in itself entirely consistent with and supportive of the retention and allocation of funds available for distribution to business development and re-equipment purposes. Expenditure after 1 April 1945 could, however, be claimed in principle as development and re-equipment payments and the refund process was to be overseen by a new body, the Excess Profits Tax Refunds Advisory Panel (s. 42; s. 50 (4)).

For much of the period under review, no allowance or deductions from taxes could be made for the depreciation of fixed assets, although wear and tear allowances were available for plant and machinery. This changed considerably in April 1946, after which date allowances were available for capital payments on, for example, industrial buildings, plant and machinery, mines, oil wells, agricultural and forestry and patents. Further, the allowance for the main categories of expenditure on industrial buildings and plant and machinery now had two parts: an initial allowance at a high rate in the year of acquisition, to be followed by a writing down allowance at a lower rate in subsequent years (Finance Act (No. 2) 1945, s. 18). The introduction of initial allowances at rates (10% for buildings and 20% for plant and machinery) in excess of the

company's normal depreciation rate in 1946 raised, for the first time, the prospect that provisions for current tax liabilities might not fully provide for the eventual liability, although this was itself contingent upon future investment decisions and capabilities and on the direction of changes in future rates of tax allowance. The spectre of deferred taxation estimation was thus brought into being by the post-war government's decision to use the tax system to channel corporate expenditure into areas seen as consistent with national re-construction priorities.

For much of the period 1938-50, therefore, companies were providing for their Income Tax and either NDC or EPT liabilities (or EPT credits or refunds from 1946) in the face of considerable uncertainties as to whether NDC or EPT applied, how the definition of 'standard profits' for EPT purposes was calculated and the admissibility of particular payments as development expenditures. Thus, the amount of each tax that was actually required to be paid in the near future, or at some later date, or which might reasonably be expected to be refunded was uncertain. These uncertainties were further increased by the fact that NDC and EPT were allowable deductions for Income Tax purposes in the accounting period in respect of which they were payable and that, where the NDC or EPT assessment was adjusted for a past year, the Income Tax assessment based on the accounts affected were also adjusted, irrespective of the normal six-year time limit (Finance Act (No.2) 1945, s. 43). Post-war refunds of EPT were also chargeable to Schedule D income tax (The Accountant, 16 March 1946).

Recommendations on Accounting Principles

The introduction of a series of changes to the tax system during the Second World War persuaded the ICAEW to adopt a more active approach to the definition of 'good' accounting practice, through the publication of a series of recommendations on accounting principles (see ICAEW, 1944-57), which were not done in consultation with the other

bodies (Zeff, 1972). Twelve recommendations were published in the period from December 1942 until January 1949, half of which related directly to the treatment of reserves and provisions.

These Recommendations were: N.1 Tax reserve certificates (December 1942); N.2 War damage contributions, premiums and claims (December, 1942); N.3 Treatment of taxation in accounts (March 1943, addendum May 1948); N.4 Treatment in accounts of income tax deductible from dividends payable and annual charges (March 1943); N.5 Inclusion in accounts of proposed profit appropriations (March 1943); N.6 Reserves and provisions (October 1943); N.7 Disclosure of the financial position and results of subsidiary companies in the accounts of holding companies (February 1944); N.8 Form of the balance sheet and profit and loss account (July 1944); N.9 Depreciation of fixed assets (January 1945); N.10 The valuation of stock-in-trade (June 1945); N.11 Excess profits tax post-war refunds (July 1946); and N.12 Rising price levels in relation to accounts (January 1949).

Professional recommendations influenced the standard that could be expected of a competent auditor but were not as deterministic as company law. The Accountant explained that it was necessary to bear in mind that the Recommendations were:

not hard and fast rules which will be appropriate in every case and that the accountant always has an individual responsibility towards his clients (12 December 1942).

Two of the Recommendations were relatively modest in scope. Recommendation N.5 recommended that all proposed profit allocations should be provided for in the accounts, even though they technically awaited shareholder approval, to enable the balance of undistributed profits carried from one period to another to be tracked more easily. N.9 recommended that provisions for depreciation only included 'that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use'. N.9 also recommended that:

depreciation should be applied on a consistent basis; aggregate provisions for depreciation, amortisation and depletion should appear as deductions from the cost of fixed assets; and that amounts set aside for obsolescence which could not be foreseen, or for possible increases in the cost of replacement, should be viewed as a matter of financial prudence and transferred to capital reserves.

Perhaps the most influential of the ICAEW's recommendations on accounting principles during the 1940s was N.6. The committee that drafted the recommendation were doubtless well aware of the extent to which the public standing of accountants had been damaged by the Royal Mail case of 1931 and the document criticised the tendency for the terms 'reserve' and 'provision' to be used almost interchangeably which, taken in conjunction with the non-disclosure of some reserves, made it difficult or even impossible for those reading the accounts to 'form a true appreciation of the financial position of a company'.

The ICAEW Recommendation N.6 recommended instead that:

- reserves and provisions be distinguished from one another, with the former reflecting amounts set aside from profits and surpluses which were not needed to meet any specific liability, contingency or commitment or to provide depreciation on assets;
- reserves be disclosed in the balance sheet, with revenue reserves shown separately from capital reserves;
- provisions be used to cover amounts charged against profits or other surpluses to meet specific requirements whose amount could be estimated closely, or specific commitments to known contingencies and accumulated depreciation where the amounts involved could not be ascertained with substantial accuracy;
- fixed assets be shown in the balance sheet at cost, with deductions for provisions for depreciation and diminution in value shown separately; and

- material movements in reserves and provisions be fully disclosed, including their release when they have proved unnecessary, except where such disclosure would clearly be detrimental to the interests of the company.

The wide-ranging Recommendation N.8 additionally defined reserves as:

Amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.

Current liabilities and provisions were to be:

...classified to disclose their nature and amount including, inter alia, (a) trade liabilities, bills payable and accrued charges; (b) bank loans and overdrafts; (c) other short-term loans; (d) interest accrued on debentures and long-term liabilities; (e) provisions for current taxation (as in Recommendation N.3); (f) provisions to meet specific commitments or contingencies where the amounts involved cannot be determined with substantial accuracy (as in Recommendation N.6); and (g) provisions for proposed dividends.

Fixed assets were to be shown under appropriate headings:

Such as (a) goodwill, patents and trade-marks; (b) freehold land and buildings; (c) leaseholds; (d) plant machinery and equipment; (e) investments acquired and intended to be retained for trade purposes; where practicable, fixed assets in existence at the date of the balance sheet were to be shown at cost, separately from the aggregate provisions for depreciation (and diminution in value) up to that date.

Disclosures in the profit and loss account were to include:

(a) the charge for fixed asset depreciation and amortisation; (b) the income tax, NDC and EPT tax charges; (c) credits or charges in respect of provisions, other than those for specific requirements where the amounts could be accurately estimated; and (d) reserves made or released.

During the inter-war period, taxation charges had often been poorly disclosed (Arnold and Matthews, 2002) and Recommendation N.3 (and its addendum in May 1948) accordingly called for 'the incidence of taxation and its effect on profits and on the financial position disclosed by the balance sheet' to be made clear to shareholders.

There were, however, a number of technical problems. Although assessments of liability for NDC and EPT were based on the profits of the accounting period under review, the liability for income tax was normally assessed on a preceding year basis.¹ The linkage between the reported profits according to the published accounts and the legal liability to taxation was thus somewhat distant. Typically, at the date of the balance sheet which concluded an accounting period, the company's liability to taxation would be based upon the profits of the previous accounting year. At the balance sheet date, there would be no known liability to taxes based upon the profits reported in the current year's accounts, even if it was highly likely that, in a year's time, the next tax liability would be based upon the accounting profits in question. Further, the objection to anticipating the likely future tax liability was no mere legalism; the rates of tax might change in the following year and, if the company were to make losses or to cease trading, the tax charge would then not be based on the preceding year's profits.

In the face of these problems, in 1943 the ICAEW recommended that the income tax charge should be based on the profits earned during the current accounting period, even if it did not yet legally constitute a liability, that revenues received less tax should be recorded gross and

the tax accounted for in arriving at the tax charge, and that there should be disclosure of:

- the charge to income tax, NDC and EPT;
- the bases of the charge for income tax and any additional provision;
- where material, the extent to which taxation charges had been affected by losses or other adjustments;
- whether the EPT charge encompassed the full liability of the group or whether it included offsets for provisions and charges created in subsidiary companies; and
- any amounts set aside for the estimated future liability to income tax in respect of fiscal years subsequent to the balance sheet date.

Any provisions for, or in excess of, the estimated future liability to income tax in respect of the fiscal year commencing after the date of the balance sheet were not, however, to be included with current liabilities but were to be either 'grouped with reserves or separately stated as a deferred liability and suitably described' (ICAEW, 1944-57, 10 (5)).

In May 1948, after obtaining counsel's advice on the wording of the Companies Acts, the ICAEW then published an addenda recommending that any allocation of profit to meet future income tax could not be treated as a liability and that, accordingly, such amounts should not be described as a provision, nor treated as a deferred liability, but instead must be grouped with reserves (see also Companies Act, 1947, Part IV, Schedule 1, para. 1(1) (a)).

The continuation of quite high levels of inflation into the post-war period, and the consequently greater impact of high levels of profit taxes, led the ICAEW to express their concern at the risks of under-capitalisation and to amplify the advice they had given in previous recommendation N.12, by suggesting that amounts allocated to finance the replacement

of fixed and current assets, should be treated as appropriations of profit to capital reserve.

Report of the Cohen Committee

The Committee on Company Law Amendment, more generally known as the Cohen Committee, was set up in 1943 to consider and report on the major amendments they thought should be made to the Companies Act 1929. The committee reported in June 1945 and called for a far higher level of disclosure than was required at the time, ostensibly to accord with a 'wakening social conscience' in society generally but also so as to be seen to remedy, however belatedly, the most obvious deficiencies of the 1929 Act. In the committee's opinion, this would require the segregation of reserves from provisions, their detailed disclosure in the published accounts and the provision of far more information on the bases on which the various estimates had been made. Above all, the profit and loss account was brought 'right into the middle of the corporate map' (Parkinson, 1945).

The report's approach was generally well received and was to prove highly influential. In 1950, Edey stated that most of its recommendations on accounting matters were 'embodied in the 1947 Act' (1950) and, more recently, Maltby found that the Companies Act 1947 'closely followed the recommendations of the Cohen Committee' (2000).

Although some have claimed that the Companies Act of 1947 was part of a post-war response to a national emergency that created an ethos of greater social responsibility, Maltby (2000) argues that it is better understood as a 'successful attempt by the accounting profession to retain jurisdiction over accounting disclosure'. Far from being part of a 'mood of collectivism and common endeavour', the new measures instead represented a victory for the proponents of better information for shareholders and more rational capital markets.

Companies Acts 1947-48

The Acts of 1947 and 1948 represented a milestone in the evolution of financial reporting by UK listed companies. Although the Companies Act 1929 was the first to regulate the contents of balance sheets, it was the Companies Act 1947 that required every balance sheet of a company to give a true and fair view of the state of affairs of the company at the end of its financial year and every profit and loss account to give a true and fair view of the profit or loss of that company for the financial year.

The Act defined reserves and provisions, made it obligatory for companies to 'classify their reserves, provisions, liabilities and fixed and current assets under headings appropriate to the company's business' and, for the:

first time in the history of company legislation, Parliament prescribed the minimum information to be disclosed in the profit and loss account and also added considerably to the particulars to be included in the balance sheet (Kettle, 1947).

The provisions regulating the form and content of both balance sheets and profit and loss accounts were set out in the First Schedule of the 1947 Act, which came into operation on 1 July 1948, before the disclosure requirements of the preceding Acts were consolidated in the Eighth Schedule of the 1948 Companies Act.²

Reserve and provision accounting were particularly affected. The Companies Act 1929 made no reference to provisions and although it recognised that directors might set aside sums into reserves for meeting contingencies, equalising dividends or any other proper purpose (s.93), it only required directors to report the amount that they proposed carrying to the reserve accounts shown in the balance sheet (s. 123).

In contrast, the Companies Act 1948 included:

- a definition of reserves, distinguishing between capital and revenue reserves. Under the Act, a provision was:

‘any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be established with substantive accuracy’;

a reserve was ‘not the above’;

a capital reserve was not to ‘include any amount regarded as free for distribution through the profit and loss account’ and a revenue reserve was ‘any reserve that is not a capital reserve’ (Schedule VIII, s.27.1).

- a definition of provisions, noting that any excess of provisions, over that deemed by the directors to be reasonably necessary for the purpose, was to be treated as a reserve (VIII s. 23 (1) and (2));
- requirements to disclose separately the aggregate amounts of capital reserves, revenue reserves and provisions, other than those related to depreciation, renewals and diminution in the value of assets. The Board of Trade adopted powers to waive the requirement where it could be shown that it was not in the public interest or prejudiced the company concerned (VIII s. 6);
- requirements to distinguish fixed from current assets (VIII s.4 (2)) and to disclose the net amount of fixed assets with details of their cost or valuation and the aggregate amount provided or written off since they were acquired or valued to allow for their depreciation

or diminution in value. Where the figures relating to the period before 1 July 1948 could not be obtained without unreasonable expense or delay, the book value at that date could be treated as if it were a valuation of those assets (VIII s. 5 (1); *The Accountant*, 31 January 1948);

- requirements to disclose the source of increases to capital reserves, revenue reserves or provisions (other than those related to depreciation, renewals and diminution in the value of assets) and of the application of such reserves and provisions where there was a reduction in their value (VIII s. 7); and
- requirements to disclose, in the profit and loss account, the charge for depreciation, renewals or diminution in value of fixed assets, the charge for UK income tax and other UK taxation on profits, and the movements in reserve account (VIII s.12.1).

The new legislation greatly increased the clarity with which taxation was presented in the financial statements, although some complications remained. The profit and loss account was to show the amount of the charge for UK income tax and other UK taxes on profits and a note was to be attached to both the profit and loss account and the balance sheet stating the basis on which the income tax charge and amount set aside, respectively, were computed.

The wording of the legislation, that the profit and loss account should show the 'amount of the charge for UK income tax and other UK taxation on profits (Companies Act 1948, Schedule VIII para. 12 (1c)) left an important ambiguity (in the context of the use of the preceding year basis for income tax purposes) over the precise meaning of the word 'profits'. In May 1948 the ICAEW took counsel's advice and resolved the ambiguity, recommending that amounts of future income tax based upon the current years accounting profit could not be a liability and

accordingly should be grouped with reserves. Not all practitioners found this persuasive (see *The Accountant* 7 February 1948).

The Companies Act 1947 (s.72) had earlier required companies which issued shares at a premium to transfer the premiums to a share premium account. This was to be viewed by the company as part of its paid up share capital, except where it was used to issue bonus shares, write off preliminary expenses or provide for premiums payable on the redemption of preference shares or debentures. The section applied retrospectively to all shares issued at a premium, although only to the extent that any such premiums were still an identifiable part of the company's reserves, since there had previously been 'no statutory provision preventing the distribution of share premiums as dividend' (Buckley, 1949; see also *The Accountant* 22 November 1947).

The Companies Acts 1947-48 thus attempted to regularise reserve and provision accounting and ensure that profits were not distorted by excessive provisions, that proper distinctions were made between capital reserves, those not available for future distribution to shareholders, and revenue reserves and that movements on reserves were made transparent. It also effectively abolished the carrying of secret reserves, except for companies in the banking, insurance and shipping industries, and thus made the manipulation of reported profit more difficult.

ENDNOTES:

1. In the early years of the life of a businesses there were detailed rules governing a transition from taxing profits on an actual year basis to the normal preceding year basis (and vice versa in the last years of that business).
2. The new requirements not only applied to accounting periods that ended on or after 1 July 1948 but also to sets of accounts made up to a date prior to 1 July 1948 but presented to their company's general meeting on or after that date (*The Accountant*, 29 May 1948).

CHAPTER THREE

THE PRESENTATION OF RESERVE AND PROVISION ACCOUNTING, 1938-50

The difficult and highly uncertain circumstances of the period 1938-50 greatly increased the scope of reserve and provision accounting and increased the likelihood of profit manipulation or smoothing.

The 'presentation' of reserves and provisions refers to the way that the information is arranged and ordered. Accordingly, this chapter discusses the various presentational changes that took place during the period under examination, while the next chapter provides a quantitative analysis of the content changes in reserve and provision accounting.

The grouping of reserves under a separate heading became a majority practice before it was legally necessary, encouraged by the publication of ICAEW Recommendations N.6 and N.8 in 1943-44, but it took the legislation of 1947-48 to bring about any widespread differentiation between revenue and capital reserves, as can be seen from Table 3.1. The earliest companies to distinguish their capital and revenue reserves were: Lever Bros (1942), ICI (1945), Dunlop, GKN and Staveley (1946). Shell did not separate capital from revenue reserves until 1950. The sample is slightly reduced in 1940, 1941 and 1943 as Spillers only produced accounts for 1940-42 and 1943-44 which consisted of a profit and loss account for each of the years but balance sheets only for 1942 and 1944. The delay between issuing accounts reflects the company's problems in operating under control conditions and even these accounts were provisional as regards the figures for flour milling which had not been finalised with the Ministry of Food (Chairman's statement, Accounts for years 1940-42).

Table 3.1 Reserve groupings

19XX	38	39	40	41	42	43			46	47	48	49	50
	%	%	%	%	%	%	%	%	%	%	%	%	%
Reserves grouped under a separate heading	33	33	40	50	60	60	71	76	81	90	100	100	100
Revenue/capital reserves distinguished					5	5	5	10	24	29	81	95	100

Capital reserves

The treatment and recognition of reserves in published accounts of limited companies connect closely with the legalities of dividend payments. Under company law, the directors of a company have the power to transfer profits to reserves for any purpose they consider appropriate and to carry forward separately any profits they do not consider prudent to pay out as dividends. Dividends were generally to be paid out of profits, although profits were not defined very precisely.

Some definition was provided by case law, wherein distinctions were drawn between 'fixed capital' and 'circulating capital'. The appreciation of fixed capital did not need to be included in the profit and loss account but that relating to circulating capital did. The capital account and the revenue account were, for the purpose of ascertaining the profit available for dividend, treated separately so that it was possible for dividends to be declared from current profits before capital losses were refunded (*Bond v. Barrow Haematite Steel Co.*, 1902, 1 Ch. 353, 366; *Verner v. General and Commercial Investment Trust*, 1894, 2 Ch. 239, 266, 267; *Lee v. Neuchatel Asphalte Co.*, 1889, 41 Ch. D. 1, 22, 23, 24). Until the introduction of section 56 of the Companies Act, 1948, dividends could even properly be paid out of assets representing share premiums (*Drown v. Gaumont British Picture Corpn.*, 1937, Ch. 402, 1937, 2 All E.R. 609).

All but one of the companies, Vickers, had a capital reserve at some time over the period reviewed and the remainder described six types of reserve as capital reserves, as shown in Table 3.2.

Table 3.2 Percentage of companies disclosing different types of reserves

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Title of reserve	%	%	%	%	%	%	%	%	%	%	%	%	%
Capital Reserve	29	29	29	29	33	33	38	38	48	48	62	67	75
Share Premium	5	10	10	10	14	14	14	14	38	48	71	71	75
EPT Post War Refund									29	38	52	48	40
Asset Replacement								10	10	14	19	24	29
Preference Stock Reserve	5	5	5	5	5	5	5	5	5	5	5	5	5
Investment Reserve	5	5	5	5	5	5	5	5	5	5	5	5	5

Capital reserve

By 1950, seventy-five per cent of the sample companies were reporting a general 'capital reserve' account, almost three times the level in 1938. Once established, capital reserve accounts were generally retained and tended to grow through the inclusion of both surpluses on the sale of assets and of asset revaluations. To a lesser extent, general capital reserve accounts were also used to write off charges and losses of a capital nature.

Share premium

There was no statutory guidance on the treatment of premiums on the issue of shares until the Companies Act 1947 (s.72) required companies to transfer premiums to a share premium account. Prior to that, there

was no statutory bar to the distribution of share premiums as dividends (Buckley, 1949). Only one of the companies, Patons & Baldwins, showed a share premium account in 1938 but several others started to use the category during the period to reflect past issues of shares at a premium as part of a process of regrouping reserves under the headings of 'capital reserves' or 'revenue reserves'.

Excess Profits Tax post-war refund

The Finance Act (No. 2), 1945 (s. 43) offered a refund of part of the EPT paid up to 31 December 1945, provided the refund was used to 'develop and re-equip' the business (s.40). There were considerable uncertainties involved, both in determining the amount of EPT payable and in deciding whether expenditures from the refund met the necessary criteria. By definition, the reserve only affected companies in the period 1946-50¹ and was subject to fluctuation.

Asset replacement

The continued rise in prices after the end of the Second World War prompted a lively debate in the financial press on the proper response to the recognition of replacement costs. The wisdom, under these circumstances, of ploughing back profits in order to increase the capital retained in the business, seemed to be generally accepted, but the question of whether these extra retentions were necessary charges against profits (provisions) or voluntary uses of those profits (transfers to reserve) was widely discussed.

The debate was in large part characterised as a disagreement between economists and accountants. The former was keen to charge the increased capital required for the replacement of assets against earnings, whereas the latter (notably the ICAEW) generally seeing this as a matter of financial prudence that could only be dealt with by voluntary transfers to reserves, particularly given the difficulties of estimating the amounts

involved with any real degree of accuracy. There are clear indications, however, in the accounting literature of the time of an awareness of the enormous size of the amounts needed to cover the 'back liability' (known as 'back-log depreciation' in more recent times) and it is possible that the objections to classifying amounts set aside as 'provisions' were influenced by issues of size as much as principle (see editorial 'Quo Vadis' in *The Accountant*, 27 March 1948 and Byrd, 1948).

During the period 1945-50, six of the sample companies recognised the inadequacy of current depreciation rates as a means of setting aside sufficient funds to replace assets, and set aside considerable amounts from profits to capital reserve to alleviate the situation. This was consistent with the recommendations of the ICAEW's Recommendation N.9, which stated that this was a matter of financial prudence that should be dealt with through reserves. This, of course, met a political need to recognise the problem, but without requiring any reduction in reported profits.

In some cases the transfers provided a highly approximated, round-sum recognition of the problem of ensuring that sufficient funds were retained to meet the costs of expansion and rising asset prices. In 1945, Fisons noted that, in the past, surpluses on the disposal of fixed assets had been used to write down the net book value of fixed assets and that these profits had now been reclassified. In 1947, the directors of Lever Bros. set aside amounts intended to represent 'the difference between applying normal depreciation rates to original cost (or valuation) and applying them to current replacement cost' (Directors Report, 31 December 1947).

An alternative, if less satisfactory, approach to the problem was merely to amend the rate of depreciation without creating a capital reserve (in contradiction of Recommendation N.9). Thus GKN in 1949 stated that they had changed from providing depreciation equal to Inland Revenue annual allowances, to providing depreciation that was substantially higher than this (Directors Report, 31 March 1949). The

importance of standardising the approach to the issue was recognised by Recommendation N.12, which recommended that amounts allocated to finance the replacement of fixed and current assets should be classified as a capital, not revenue, reserve.

Preference stock reserve

One company, Anglo-Iranian maintained a preference stock reserve, to set aside funds to assist in the redemption of its preference shares, that grew from £1.5 million to £8 million (3.5% of total assets) during the period; the balance was never specifically described as a 'capital reserve' but was shown under share capital, separately from 'revenue reserves and undistributed profits'.

Investment reserve

Daily Mail, an investment company, maintained an investment reserve, to set aside amounts against possible falls in the value of its investments against which surpluses or deficits on investments sold or redeemed were credited or debited. In the first accounts under the Companies Act 1948, the account was re-titled 'capital (investment) reserve'.

Revenue reserves

The following section reviews the items treated as revenue reserves by sample companies during the period 1938-50. These have been listed in Table 3.3, with the frequency of their occurrence expressed as a percentage of the sample.

Table 3.3 Percentage of companies with the following categories of revenue reserve

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Title of reserve	%	%	%	%	%	%	%	%	%	%	%	%	%
Profit & loss balance	100	100	100	100	100	100	100	100	100	100	100	100	100
General	90	86	86	86	86	86	86	86	86	86	81	81	80
Contingencies	19	24	29	38	43	43	43	43	10	10	24	24	25
Taxation		10	10	10	14	19	38	52	57	62	86	86	90
Other reserves	43	48	48	48	52	57	57	57	52	67	57	48	45

Profit and loss account

Each company in each of the years under review retained a profit and loss account balance, variously described as ‘undistributed profits’, ‘unappropriated profits’, ‘surplus’ or ‘profit and loss account balance’.

General reserve

The general reserve, also referred to as the ‘reserve’, ‘reserve fund’ or ‘free reserve’, which functioned as the repository for the prudent setting aside of undistributed profits against unforeseen eventualities, was used in 1938 by 90% of the sample companies, but not by the Daily Mail or Ford.

Contingencies

Closely related to, but less widely used than, the description ‘general reserve’, was the ‘reserve for contingencies’. The title suggests that, instead of merely retaining funds as an act of prudence, the directors had identified possible future events which might give rise to calls on

retained profits, although those who used the published accounts could not have found it easy to distinguish between the reserve and provision components. Recommendation N.6 sought to clarify the position, suggesting that a distinction be made between 'reserves to meet unknown contingencies' and 'provisions for known contingencies' (s.39). The sudden decline in the use of reserves for contingencies from 43% of sample set companies in 1942-45 to only 10% in 1946-47 (see Table 3.3), seems to reflect this advice, although it may also indicate the extent to which the end of the war removed uncertainty. After the passing of the legislation of 1947-48, three companies (Lyons, Patons & Baldwins and Spillers) which had not had contingency accounts during the war period then created such reserves.

The exact title of the reserve rarely gave any real indication of the nature of the contingency, although Anglo Iranian, Boots, ICI and Patons & Baldwins used 'war contingency' reserves, Lever Bros. used a 'special contingencies reserve' and ICI carried a 'metal stocks contingency' from 1948-50, while several other companies combined their contingency reserve with other specific (non-general) reserves, including GKN, which used successively a reserve for 'taxation, workers compensation and contingencies' (1938-42), 'taxation and contingencies' (1943-44) and 'contingencies and deferred repairs' (1945).

Taxation

During the early years of the period under review, where information was provided on the liability for taxation, the term 'tax reserve' and 'tax provision' were often used interchangeably. Thus, Fisons (1938-43) placed a 'reserve for taxation' under the heading 'creditors' on the balance sheet before designating it as a provision and Vickers showed its 'provision for contingencies, creditors and taxation' under the heading 'creditors and provisions' (1939-44).

These instances almost certainly relate to the current tax liability payable in the following accounting period, although two other areas gave

rise to potential future tax liabilities, future taxation and deferred taxation that were frequently presented in the accounts of sample companies as revenue reserves and which have accordingly been included as 'taxation reserves' in Table 3.3.

Future taxation

The first reason for creating a revenue reserve against future tax arose when, as was normal, a company's liability for income tax during the period was assessed on the preceding year basis and apportioned according to the period covered by the accounts under review. Recommendation N.3, issued in 1943, advised that merely providing for income tax due for the year on a 'flow through' basis would ignore the liability arising from using the current year's profits as a basis for calculating the tax liability for a subsequent year. To avoid undesirable distortions in the trend in profits after taxation from the use of this strict liability approach, N.3 recommended that companies instead disclose any provision for the estimated future liability to income tax in respect of fiscal years subsequent to the balance sheet date. Table 3.4 details the date of disclosure and the treatment of future taxation in the accounts of the sample companies.²

Table 3.4 Disclosure and treatment of future taxation

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Classification	%	%	%	%	%	%	%	%	%	%	%	%	%
Reserve		10	10	10	10	10	24	29	24	29	57	47	45
Provision						5	10	10	10	10	10	10	15
Deferred liability					5	5	10	14	24	19	19	29	26
Current liability								5	5	5			
Total		10	10	10	15	20	44	58	63	63	86	86	86

There were considerable increases in the disclosure level of amounts set aside for future taxation in 1944, after the publication of ICAEW Recommendation N.3, which recommended either grouping future tax with reserves or showing it as a deferred liability, and in 1948, when the Companies Acts came into force. Companies that allowed for the potential liability could show this in four ways, as a: current liability; deferred liability (either under that heading or separately between 'share capital and reserves' and 'current liabilities'); provision; or reserve. It is apparent that disclosure levels lagged behind the recognition of future taxation; thus Anglo Iranian noted in their 1942 accounts that their 'reserve for taxation' was based on that year's profits, although not assessable until 1943-44 and that previously, similar amounts had been included in creditors.

It is interesting to note that practice appeared to be little affected by the amended recommendations of the ICAEW (N.3, addenda May 1948), based on counsel's opinion that any allocation of profit to meet future income tax was not a liability, that any amount set aside should not be described as a provision, nor treated as a deferred liability, but must be grouped with reserves (see also Companies Act 1947, Part IV, Schedule 1, para. 1(1) (a)). Despite this, three companies in 1949-50 (AEI, Boots and Dunlop) used the term 'provision', three others continued to show the amount separately after share capital and reserves and, in direct contravention of the advice given, two companies (Morgan Crucible and Patons & Baldwins) moved the balance from reserves to deferred liability. The consideration given by directors to the accounting treatment of future taxation is well illustrated by Morgan Crucible, that classified the balance as a separately disclosed provision within the current liability for taxation (1943-44), then as a separate current liability (1945-47), then as a reserve (1948) and finally as a deferred liability (1949-50).

Tax deferral (or equalisation)

The second reason for creating a revenue reserve for future taxation was deferred taxation. The Finance Act (No. 2) 1945 (s. 18) introduced initial allowances as from 6 April 1946 (10% for buildings and 20% for plant and machinery) which were available in the year of acquisition as well as the ongoing wear and tear allowances.

Companies, such as GKN, that provided a tax deferral reserve provided clear explanations of their reasoning, perhaps because of its unfamiliarity:

...the increased amount of Depreciation so charged in the 1949 Accounts is less than the total Inland Revenue Allowances deductible in computing the tax chargeable on the Profits of the year, because of the effect of the higher Initial Allowances. Initial Allowances confer only a temporary benefit by deferring the liability to tax. Therefore, a further charge against profits for Taxation Equalisation has been made of an amount equal to the tax on the difference between the total Inland Revenue Allowances and the Depreciation charged in the Accounts. This further charge has been included in Deferred Liabilities (GKN, Annual accounts 1949).

The recognition of tax deferral increased rapidly without legislation or professional recommendation, from no companies in 1947, the first year in which it could reasonably have been included, to nine in 1950, 45% of the sample, although its treatment varied between companies, as shown in Table 3.5. In each case, however, the classification used by the company concerned mirrored that accorded to future taxation. Three other companies quantified the value of the tax saving in their profit and loss account and as Spillers explained:

The liability to taxation arising on profits of the year is affected by the operation of Initial Allowances on expenditure on certain fixed

assets during the year. The effect of this system is broadly to increase the allowance for wear and tear in the first year of the life of the asset and to reduce the allowance therefore in subsequent years.

There is no increase in the total allowance obtained over the effective life of the asset. Consequently any reduction in the taxation liability in the first year is, in effect, offset by a greater liability in subsequent years. In these circumstances it has been deemed advisable to include in the taxation provision in the Profit and Loss Account the benefit represented by the Initial Allowance applicable to this year (£110,000) and carry this forward to be utilised against the liability to taxation arising in future years. (Spillers, Annual accounts 1949, note 5 (ii)).

Table 3.5 Disclosure and treatment of tax deferral

19XX	47	48	49	50	Comments
Classification	%	%	%	%	
Reserve		10	20	20	English Electric, Dunlop, Fisons, Lever Bros
Provision			5	10	AEI and Boots
Deferred liability			10	15	GKN, ICI, Morgan Crucible
Total	0	10	35	45	

Other

There was a very wide range of other revenue reserves, as listed by number of companies in Table 3.6, presumably to inform shareholders of the reasons for the retention of profits. The number of reserves was at its peak in the period 1942-45. Reserves such as the war personnel reserve (ICI), fuel crisis reserve (AEI) and the prudent 'dividend equalisation' reserves (AEI and Dunlop) were driven directly by the circumstances of the war and its immediate aftermath.

Several of the titles used, 'insurance', 'depreciation' (Staveley) and 'bad debts' (Spillers) seem indicative of the lack of precision in the use of the terms 'reserves' and 'provisions' which led the ICAEW to publish Recommendation N.6 in 1943, although it is possible that these were genuine reserves, as funds retained against unknown or unlikely contingencies.

Lever Bros. used a stock reserve from 1947, explaining that profits had risen on the turnover of stocks purchased at prices considerably below replacement cost and, having regard to the high commodity prices of the immediate post-war period, considered it prudent to establish a reserve to set against these stock values.

Table 3.6 Titles of 'other reserves'

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Type of Reserve	No.	No.	No.	No.	No.	No.	No.	No.	No.	No.	No.	No.	No.
Redemption of shares and debentures	2	4	4	4	4	4	4	4	4	4	3	2	2
Dividend equalisation	2	2	2	2	2	2	2	2	1				
Development	2	2	2	2	2	2	2	2	1	2	2	2	2
Merger/reorganisation		1	1	1	1	1	1						
Extra depreciation	1	1	1	1	1	1	1	1	2	1			
Stocks (inc. fall in commodity prices)	1	1	1	1	1	1	1	2	1	2	4	2	3
War personnel					1	1	1						
Bad debt	1	1	1	1	1	1	1	1	1	1			
Insurance	2	2	2	2	2	2	2	2	2	2	2	2	1
Fuel crisis									1				
Unspecified 'other'	1	1	1	1	1	1	1	2	1	1	2	2	2
Total	12	15	15	15	16	16	16	16	14	13	13	10	10

Provisions

The ICAEW saw the almost interchangeable use of the terms 'reserve' and 'provision' as a major problem for those who used financial statements and they published two Accounting Recommendations in 1943-44 N.6 and N.8 to regularise practice in this area.

Specific commitments and contingencies

All but three of the companies in the sample (Daily Mail, Lever Bros. and Shell) had separate provision balances for one or more years during the period. Table 3.7 shows the increase in the disclosure level of provisions for specific liabilities contingencies or commitments, with marked rises in 1946-47 and after the Companies Act came into force in 1948. The recommendations in N.6 and N.8 (ICAEW, 1944-57) did not appear to have had any significant immediate impact.

Table 3.7 The disclosure of provision balances

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
No. of provisions separately identified	%	%	%	%	%	%	%	%	%	%	%	%	%
Three								5	14	5	5	5	
Two						5	5				14	18	20
One	24	24	24	24	19	19	24	24	33	42	52	48	50
None	76	76	76	76	81	76	71	71	53	53	29	29	30

The most common specific commitments were deferred repairs (ten companies) and pensions (five companies) but seven companies referred only to 'provisions', 'other provisions' or 'sundry provisions'. A further six referred to 'contingencies' in the provision title, including such catch-all

descriptions as ‘specific liabilities and contingencies including taxation and deferred repairs’ (ICI, Annual accounts 1945-1950).

The increased disclosures were part of a process of separating out ‘creditor and ...’ titles, which amalgamated several items and poorly distinguished between provisions and reserves. Thus, English Electric reported ‘trade and other creditors, bills payable, contingency and taxation reserves’ (1938-41), ICI reported ‘sundry creditors and provisions for taxation and contingencies’ (1938-44) and Morgan Crucible showed ‘sundry creditors and reserves for taxes and contingent liabilities’ (1938-39). Table 3.8 accordingly analyses the extent to which provisions and so-called ‘reserves’ were reported within omnibus ‘creditor and ...’ titles.

Table 3.8 Provisions and reserves reported within creditors

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Described as:	%	%	%	%	%	%	%	%	%	%	%	%	%
Provision	24	24	24	20	24	28	28	38	30	24	10	5	
Reserve	29	29	24	28	24	20	20	20	14	20			
Total	53	53	48	48	48	48	48	58	44	44	10	5	0

It is clear that the major improvement in disclosure, with the separation of reserves, provisions and creditors, did not take place immediately after the publication of the relevant professional recommendations, but instead had to await the introduction of legislation in 1948.

Current taxation

In 1938, information on current taxation levels was either not disclosed or else included in a general heading for creditors, but by 1950 it was usually shown as a separate current liability. These changes were the result of a number of influences. ICAEW Recommendation N.3 recommended disclosure of the provision for current taxation, a

position reinforced by the definition of 'provision' in N.6 and N.8. Not everything was quite so harmonious however; the definition of 'provision' in the Companies Act 1948 (Schedule VIII, s. 27 (1)) as:

any amount ... retained by way of providing for any known liability of which the amount cannot be established with substantive accuracy

prompted the ICAEW to issue an Addenda to N.3 in May 1948. This stated that the word 'provision' should cease to be used to denote amounts set aside to meet specific requirements the amounts whereof can be estimated closely; such amounts should be grouped with creditors as they represent liabilities or accruals.

Table 3.9 shows the proportion of sample companies disclosing a current taxation liability, and how it was described, in each year in the period 1938-50. The major break in the inclusion of current taxation within creditors occurred in 1945, when it started to be shown as a separate statement, either as a liability for taxation or as a provision. This continued until 1948, when the combination of the Companies Act 1947 and the Addenda to N.3 led the majority of companies in the sample to classify taxation payable more openly as a current liability.

Table 3.9 Disclosure of liability for taxation

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Classification	%	%	%	%	%	%	%	%	%	%	%	%	%
Included in creditors	48	48	48	48	48	48	52	29	24	24	19	19	20
Provision	19	19	19	19	19	24	24	38	43	33	19	19	15
Current liability – tax charge						5	5	10	10	20	48	48	55
Not shown	33	33	33	33	33	23	19	23	23	23	14	14	10

Proposed dividends

The sample companies varied in their approach to profit appropriations; some reported proposed appropriations, including dividends, within the financial statements, whereas others merely mentioned them in the directors' report, so that they were not reflected in the financial statements until the following year.

Recommendation N.5 addressed this problem and recommended that proposed profit allocations, despite technically needing confirmation by the shareholders, should be provided for in the current year's accounts. This was to make inter-year comparisons easier. N.5 and N.8 also recommended that the provision for dividends should be shown separately from other current liabilities on the balance sheet.

Table 3.10 Inclusion of proposed appropriations in current year's accounts

19XX	38	39	40	41	42	43	44	45	46	47	48-50
Percentage	%	%	%	%	%	%	%	%	%	%	%
Compliance with N.5	33	38	48	52	71	76	86	90	95	95	100

The information set out in Table 3.10 shows when companies in the sample adopted this practice and suggests that the recommendations in N.5, when published in March 1943, largely reflected what was already majority practice (see also comments in *The Accountant*, 28 August 1943).

Depreciation

The information provided in the financial statements of a company's investment in fixed assets, and the extent to which these had been written off as depreciation, was very sketchy for much of the period 1938-50.

This is despite comments in *The Accountant* in 1943 that it was already 'modern practice' to show depreciation:

in the form of an accumulated reserve account deducted from total fixed assets, the provision for the year being recorded in the profit and loss account (28 August 1943).

ICAEW was less convinced and issued three recommendations to address the situation:

- N.6 recommended that the balance sheet should show fixed assets at cost with deductions for provisions for depreciation and diminution in value shown separately;
- N.8 extended this by recommending that fixed assets be shown under appropriate headings and disclosed at cost, with the aggregate provisions for depreciation up to that date given as a deduction therefrom; and
- N.9 held that provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases and any additional provisions separately disclosed.

These themes were duly incorporated into the Companies Act 1948, which required the disclosure of the net amount of fixed assets, with details of their cost or valuation and the aggregate amount provided or written off since they were acquired or valued to allow for their depreciation or diminution in value (Schedule VIII, s. 5 (1)).

The call by N.8 for the reporting of fixed assets 'under appropriate headings' received a mixed reception; distinguishing investments in subsidiaries and associated companies from physical assets and other intangibles was widespread, although the allocation of physical fixed assets to alternative categories was not common.

In the early part of the period, even such major companies as Crompton Parkinson, AEI, GKN and Patons & Baldwins were making

available their annual depreciation charges but hiding their fixed asset costs and accumulated depreciation figures, typically presenting merely the net book value brought forward, less that year's depreciation charge. Some companies that showed accumulated depreciation in the earlier part of the period, such as Staveley, gave full information on their accounting for fixed assets but others were less forthcoming. Ford, for example, followed a conservative depreciation policy under which 'full provision was made for depreciation and obsolescence' and showed on the capital and liabilities side of the balance sheet (1938-42):

RESERVE FOR DEPRECIATION AND OBSOLESCENCE

Provisions to date

Less: - Applied in writing down assets.

[As the reserve was fully applied, there was a nil balance]

Similarly, Boots treated accumulated depreciation as a reserve (1938-40) and then as a provision (1941-46) on the capital and liabilities side of the balance sheet. ICI also showed depreciation on the liabilities side and initially built this up from profit appropriations (1938-41) before charging the annual amounts against profits.

Table 3.11 shows all too clearly that, despite recommendations from the ICAEW, the disclosure of fixed asset costs and amounts of accumulated depreciation by a significant number of major companies did not happen until the Companies Acts 1947-48. This reflects the limited influence of professional recommendations, compounded by the difficulties some companies faced in extracting the necessary information from their own internal records. When three of the sample companies, Crompton Parkinson, English Electric and Morgan Crucible, complied with legislative requirements in 1948, they were still unable to identify

the cost and accumulated depreciation of their fixed assets and had to start with the net amount, after depreciation, in 1947.

Table 3.11 Disclosure of accumulated depreciation to arrive at net book values³

19XX	38	39	40	41	42	43	44	45	46	47	48	49	50
Percentage	%	%	%	%	%	%	%	%	%	%	%	%	%
Showing accumulated depreciation	11	11	11	11	11	17	17	22	33	44	94	100	100

Articulation between profit and loss and balance sheet

Each of the companies in the sample provided profit and loss account and appropriation account information throughout the period, even though this information was not required under the Companies Act 1929. The information given in the profit and loss account varied but it normally began with a profit brought forward figure, from which was deducted a number of items such as directors' fees, debenture interest, depreciation, repairs and renewals or taxation, leaving a balance for appropriation.

Some companies continued to use the 'omnibus' descriptions of profit that had attracted such notoriety during the inter-war period. Thus Lyons (in 1938) reported that:

The balance of the Trading Account including Dividends from Subsidiary and Associated Companies, Mortgage and Loan Interest and Transfer Fees after deducting Interest on Debenture Stock and Mortgages, Directors' Fees, Salaries, Wages, Rents, Rates, Taxes, Repairs and other Expenses and after providing for Depreciation and reserve for Contingencies (including N.D.C) is ...

and Spillers in 1939 reported a figure for their surplus on trading for the year:

.... (including Dividends from Subsidiary Companies) after making provision for Depreciation and Obsolescence of Buildings, Plant and Machinery, Management Remuneration and Staff Bonus under the Co-partnership Scheme, but exclusive of surplus on the operation of Insurance Current Account and Providing for Taxation.

In the early years of the period, appropriations were as often disclosed in the directors' report as in the financial statements.

Table 3.12 shows that disclosure of the annual charge for taxation and depreciation was quite common before the ICAEW recommended their disclosure in N.3 and N.8 in 1943-44. Several companies heavily involved in the war effort, AEI (1941-44), English Electric (1939-47), Lever Bros. (1941-44) and Vickers (1939-44), that disclosed their tax charges at the commencement of the period, then ceased to report the tax charge for the years indicated, whether because of wartime uncertainties or out of a desire for secrecy.

Table 3.12 Disclosure of annual taxation and depreciation charges

19XX	38	39	40	41	42	43	44	45	46	47	48-50
Percentage	%	%.	%	%	%	%.	%	%	%.	%	%
Taxation charge shown	56	48	57	48	48	48	52	67	71	71	100
Deprec. charge shown	49	55	55	55	61	61	61	67	73	73	100

Note: The depreciation charge proportions are based on a sample set of 18 companies, as Daily Mail, Shell and Vickers, as holding companies, had no fixed assets beyond investments in subsidiaries and associate companies.

All the sample companies reported their transfers to reserves and, in the majority of cases, movements on reserves were traceable, despite their often somewhat incomplete specification. Some companies, such as ICI (1938-41) provided both an appropriations account and a separate statement on reserve accounts:

GENERAL RESERVES:	£	£	£
(a) Capital Reserve:			
As at 31 December, 1937		2,660,000	
Less Amount applied in writing down:			
“Shares and Debentures in & advances to Subsidiary Companies”	231,818		
“Shares and Debentures in Associated Companies”	<u>53,182</u>		
		<u>285,000</u>	
			<u>2,375,000</u>
(b) Free Reserve:			
As at 31 December, 1937		8,500,000	
Appropriation out of 1938 income		<u>1,125,000</u>	
			<u>9,625,000</u>

The absence of any clear distinction between provisions and reserves, especially in the early part of the period, led to a number of anomalies. Thus, Boots (1944-50) treated transfers to their pension fund as an appropriation, not as a charge against profits and Vickers (1938-44) made appropriations to a contingencies fund that was held in creditors. There were also appropriations that were not shown on the balance sheet, such as GKN's ‘investment reserve’, while amounts set aside to meet future tax were often not treated in a manner consistent with their official status as a reserve (e.g. at Charringtons 1948-50).

Table 3.12 also suggests that the publication of N.3 and N.8 had little effect on disclosures in this area and that it took the Companies Acts 1947-1948 to force those reluctant to disclose this information to do so.

ENDNOTES:

1. Some companies merely noted the existence of the position, without attempting to quantify the amounts involved. In some cases, the liability was still not determined in 1953.
2. Daily Mail and Vickers were holding companies whose income comprised mainly dividends and interest from subsidiary companies. As this income was paid under the deduction of income tax and the profits from which dividends were paid had been subject to income tax and excess profits tax, no further taxation was payable by the companies and therefore the companies did not incur any future tax liabilities.
3. Daily Mail, Shell and Vickers as holding companies had no fixed assets beyond investments in subsidiaries and associate companies.

CHAPTER FOUR

THE CONTENT OF RESERVE AND PROVISION ACCOUNTING, 1938-50

The previous chapter focused primarily on changes in the way that information relating to reserve and provision accounting was presented in the public accounting statements of sample companies across the period 1938-50. This chapter concentrates on the more quantifiable changes in reserve and provision accounting and analyses the information contained in the various balance sheets, profit and loss accounts and supporting notes, by using a consistent, standardised format or template across the period. The implicit assumption in so doing is that users, particularly the more influential or sophisticated, would have been informed primarily by the substance of the information contained in the financial statements and not unduly distracted by variations over time in the way that it was presented.

The consistent composition of the sample enables the numerical content of the various balance sheets and profit and loss accounts to be aggregated and averaged each year. Appendix three accordingly sets out the mean profit and loss accounts and balance sheets of the sample set of companies in each year in the period 1938-50, paying particular attention to items that impact directly on reserve and provision accounting practices. Appendix four identifies the components of the reserve and provision headings of the same companies.

Reserves

During the period 1938-50 there was a dramatic increase in the importance of reserves, which represented 15.5% of total assets in 1938, 23.7% in 1945 and 42.7% in 1950 (see Appendix three). Average total assets themselves rose from £23.1m in 1938 to £55.8m in 1950, although much of this can be attributed to the impact of general inflation. The relative increase in reserves across the war years is perhaps surprising, given the substantial increases in wartime taxation but was underpinned by dividend restraint (in 1938 average dividends were £1.5m but fell back to £1.1m across the period 1939 to 1945) and uncertainty (including the calculation of tax liabilities under the more complex war-time rules), taken in conjunction with the high demand for manufactured goods and sustained inflation.¹

The accelerated post-war rise in reserve levels can in turn be largely attributed to improved profitability (at least in monetary terms; average profits after taxation rose from £1.7m in 1945 to £3.1m in 1948 and £4.0m in 1950), inflation and the continued effects of dividend restraint (not until 1950 did dividends return to their 1938 levels), which were often commented upon in company financial statements. The Chairman of AEI, for example, in 1947 noted that, although their record profits would clearly justify a higher dividend, this would be against 'the clearly expressed wish of His Majesty's Government in regard to the limitation of dividends', so that allocations to reserve would necessarily rise (Chairman's statement).

Several of the ICAEW Recommendations might also have had an effect on the level of reserves, through the reclassification of balances previously treated as creditors or provisions as reserves and through the movement of balances set aside as a deferred liability for future taxation to reserves. Similarly, the new Companies Acts caused amounts previously carried as secret reserves in creditors (or as deductions from asset categories) to be transferred to reserves.

There were of course contrary factors, including the high tax levels that persisted in the post-war period. The data that Appendix three yields (tax charges and profits before tax) suggest that the effective tax rate on company profits from 1948 onwards, when there was full disclosure of the tax charge, was 47% in 1948, 48% in 1949 and 52% in 1950. The rates of tax imposed by the post-war Labour government were much complained of in the financial statements, with the Chairman of Dunlop, for example, reminding his shareholders that the percentage of group net profits deducted in taxes had risen from 34% in 1938 to 54% in 1947 (Chairman's Statement, 1947) although this was not all that surprising, given the impact of the war effort.

The growth in reserves was common to both capital and revenue reserves; capital reserves rose from 2.7% of total assets in 1938 to 5.4% in 1945 and to 19% in 1950, while revenue reserves represented 12.7% of total assets in 1938, 18.3% in 1945 and 23.7% in 1950 (see Appendices three and four).

The composition of this growing volume of reserves also changed markedly across the period 1938-50. The information in Appendix four shows that the level of undistributed profit held in the profit and loss account remained very close to 10% of total reserves across the period 1938 to 1949, although general reserves fell from 61% of total reserves to 34% across the period 1938 to 1950, suggesting that there was both a greater use of, and an increasing specification of, other reserve categories. Specified revenue reserves (i.e. those other than retained profits and general reserves) thus increased from 11.6% of total reserves in 1938 to 34.7% in 1945, but then fell back sharply to 16.0% in 1950. The initial growth in these reserves can be seen (from Appendix four) to be almost entirely due to the recognition of future taxation (0 to 8.6%), contingencies (3.4 to 11.3%) and additional depreciation (5.7 to 11.0%), while the substantial decline after 1945 resulted from the running down of contingency reserves (11.3 to 2.3%) and from the abandonment of voluntary appropriations to revenue reserve for additional depreciation

(11.0 to 0%). Specified revenue reserves did not, however, decline to pre-war levels because future tax reserves increased slightly, particularly if one includes tax deferral in this category, rather than fell.

Capital reserves also played an important part in the shift within reserves (representing 17.5% of total reserves in 1938, 22.6% in 1945 and 44.6% in 1950) although, in large measure, this reflected the transformation in the legal position regarding share premiums; capital reserves other than share premium accounts rose more gradually from 16.9% of total reserves in 1938 to 29.4% in 1950.

Provisions

In the years 1939-44, provisions other than tax and depreciation represented an almost negligible percentage of total assets (maximum 0.2%; see Appendix three and Tables 3.7 and 3.8), with pensions the most recurrent item. Even after the publication of N.6 and N.8, the Cohen Committee Report and the Companies Acts 1947-48, provisions remained below 5% of total assets until 1950.

Provisions for taxation, in absolute terms, rose gradually across the period, although the data is not as meaningful as it might be, because of changing perspectives on how best to account for both current and future taxation. By far the largest provision was depreciation although, only after the legislation of 1947-48, did sufficient companies publish the relevant information for the data to be properly analysable (see also Table 3.11). In 1948-49, accumulated provisions for depreciation accounted for approximately one third of the cost (or valuation) of fixed assets, before falling sharply to 22.0% in 1950, in the face of the high levels of capital expenditure in that year.

This chapter has shown that changes in reserve accounting were far more important than variations in provision levels across the period 1938-50. The substantial growth in amounts carried as reserves were partly caused by increased transfers from profit and loss but also to

changes in the way that the balance sheet was classified. The major change in this respect was the requirement in the Companies Acts 1947-48 that abolished the carrying of secret reserves by most companies, a subject examined in detail in the next chapter.

ENDNOTE:

1. The poor disclosure of taxation charges in the war years does not permit any meaningful calculation of average tax rates (see Table 3.12).

CHAPTER FIVE

SECRET RESERVE ACCOUNTING

In 1945, the Cohen Committee (Report, s.101) concluded that undisclosed, secret or inner reserves were the 'chief matter which had raised controversy' in the area of financial reporting at that time. In the first half of the inter-war period, the professional and financial institutions had been relatively supportive of the practice, but the climate seemed to change as secret reserves were increasingly drawn upon, rather than created, especially after the public revelations of the Royal Mail case (Rex v Kysant and another, 1931).

The Cohen Committee stood fully behind this revised perspective, concluding that, although undisclosed reserves could be used to prevent undue fluctuations in profits or dividends, the overstatement of liabilities or understatement of asset values, together with the consequent impact on the profit and loss account, distorted the view of the company given in the accounts and had the 'unfortunate result that shareholders and investors and their advisors have not the information to enable them to estimate the real value of the shares' (Report, s. 101). The Companies Acts 1947-48 responded to these concerns by effectively prohibiting companies (other than those in the banking, insurance and shipping industries) from carrying secret reserves (1948 Act, VIII, s. 6, 7, 12, 23 and 27).

This legislative change provided a unique opportunity to observe the levels of secret reserve accounting that had been established during the highly uncertain, but relatively profitable, commercial conditions of the war years, to obtain information on the mechanisms that had been used to keep profits hidden and to determine whether any accounting 'devices' were utilised in making them public.

The extent of secret reserve creation

The full financial statements of all 21 companies were examined carefully and evidence was found of secret reserve accounting at 14 companies. Secret reserves have been defined as the undisclosed retention of profits in a way that could be readily reversed as part of a process of smoothing company profits over a period of time. This distinguishes their establishment from more normal commercial prudence or caution, whereby the financial position of the company is protected (from supposedly excessive dividends or wage claims) by the use of conservative asset valuations (including large depreciation write-offs) and/or by making relatively generous (but still plausible) provision for future liabilities whose amount could not, at that point in time, be estimated accurately.

The reclassification of secret reserves as reported reserves took place in the period 1945-48. Most of these re-classification were made before the provisions of the new Companies Acts were in place, with four companies carrying out their re-classification in 1945, four in 1946 and six in 1948. This may seem at first sight surprising, even if the prohibition of secret reserves had been 'trailed' for some time before the legislation was introduced, it was likely that early disclosures of secret reserves would receive less publicity than those made in 1948, when they might be portrayed as part of the justification for the new legislation.

Although the ability to transfer amounts into and out of secret reserves materially reduces the level of trust that can be placed in published financial statements and threatens to distort the pattern of profitability over time, the amounts involved have not always been as large as the subject's notoriety would suggest. Companies can, in effect, only hide profits that are in excess of those that their investors would expect them to make and, although the levels of trade during the Second World War were high (mainly because of governmental, war-related demand), above-average net profits were restrained by the high levels of the new profits taxes. The amounts of secret reserves reclassified in the period 1945-48 represented 9.8% of the total reserves of the companies studied, although

the variation across individual companies ranged from nothing (at seven companies) to nearly 60% (at AEI in 1945).

Table 5.1 shows the level of secret reserve disclosure by each individual company, as a percentage of total reserves in the last year in which they were carried. There is some suggestion that early 'adjusters' might have had larger secret reserves, three of the four adjusters in 1945 had secret reserves in excess of 30% of their total reserves, but there are too many exceptions for any real pattern to be discernable.

The level of incidence, with two-thirds of companies using some level of secret reserve accounting, half of whom had secret reserves of more than 30% of their total reserves, is highly consistent with Arnold's (1996) findings for the earlier period 1900-24. Arnold (1996) found that two-thirds of companies in a sample of thirty companies practiced some degree of secret reserve accounting, a third of whom used secret reserves extensively.

Table 5.1 Secret reserve disclosures as a percentage of total reserves

Secret reserves to total reserves (%)	No.	Company (Year)
1-10	2	Fisons (1945), ICI (1946)
11-20	4	Boots (1948), Charrington (1948), Dunlop (1946/47), Patons & Baldwins (1946)
21-30	1	Spillers (1948)
31-40	5	Crompton Parkinson (1948), English Electric (1948), GKN (1946), Lyons (1948), Shell (1945)
Over 40%	2	AEI (1945), Vickers (1945)
Total	14	

Note Calculated as the sum of total reserves in the year of disclosure (with Dunlop this time treated as a '1947 company', in order to capture the cumulative effect of its transfers to secret reserve in successive years), plus the total reserves in 1948 (as the year in which disclosure was first required) of companies that did not indicate any use of secret reserves. It is not possible to comment on the size of secret reserves relative to reported profits as no information was provided by the companies concerned on the years in which the secret reserves were established.

Accounting mechanisms used to keep reserves secret

The Cohen Committee (1945, s.101) indicated that the two main ways of creating secret reserves were to over-provide for contingencies or to excessively write down fixed or current assets.

Table 5.2 shows the mechanisms used by the 14 companies in the sample that made public their secret reserves in the period 1945-48. The inclusion of secret reserves within creditors ('In creditors') was more frequently used as a mechanism than unrevealed deductions from assets ('Asset deduct') and was also considerably more significant in value terms, accounting for 64.1% of the total secret reserves identified.

Table 5.2 Secret reserves at sample companies

Company	Secret reserves (a) £	In creditors	Asset deduct	Total reserves (year) (b)	a/b %
1 Anglo Iranian	0			£52,730,000 (1948)	0
2 AEI	3,747,000	Yes		£6,383,000 (1945)	58.7
3 Beechams	0			£2,058,000 (1948)	0
4 Boots	494,485		Yes	£4,192,082 (1948)	11.8
5 Charrington	838,138	Yes		£4,892,002 (1948)	17.1
6 Crompton Parkinson	1,288,476	Yes		£3,667,280 (1948)	35.1
7 Daily Mail	0			£1,959,000 (1948)	0
8 Dunlop Rubber	1,000,000	Yes		(1946)	
	750,000	Yes		£12,593,000 (1947)	13.9*
9 English Electric	1,025,000	Yes		£3,195,000 (1948)	32.1
10 Fisons	73,846	Yes	Yes	£879,040 (1945)	8.4
11 Ford	0			£13,026,000 (1948)	0
12 GKN	2,666,393		Yes	£8,544,798 (1946)	31.2

* Dunlop revealed secret reserves in both its 1946 and 1947 published accounts and has been treated as a '1946' disclosing company. The cumulative transfer from secret reserves is therefore compared to total reserves in 1947.

Table 5.2 Secret reserves at sample companies (Continued)

Company	Secret reserves (a)	In creditors	Asset deduct	Total reserves (year) (b)	a/b %
13 ICI	502,580		Yes	£46,153,262 (1946)	1.1
14 Lever Bros	0			£35,437,000 (1948)	0
15 J Lyons & Co	1,437,000	Yes		£4,123,000 (1948)	34.9
16 Morgan Crucible	0			£2,007,000 (1948)	0
17 Patons & Baldwins	450,000		Yes	£3,640,945 (1946)	12.4
18 Shell	3,524,370	Yes	Yes	£10,242,570 (1945)	34.4
19 Spillers	1,221,869	Yes	Yes	£5,410,326 (1948)	22.6
20 Staveley Coal & Iron	0			£3,940,000 (1948)	0
21 Vickers	3,849,901	Yes		£8,524,414 (1945)	45.2
Total	22,869,058			£233,597,690	9.8

Whether accounting ‘devices’ were used in making secret reserves public

The Cohen Committee’s description of secret reserves as involving either the excessive writing down of fixed or current assets or over-provision for contingencies indicates that the distinction between normal commercial prudence and secret reserve accounting can sometimes seem unclear, particularly for those not involved in internal discussions.

Although the fourteen companies which made their previously secret reserves public in the period 1945-48 (see Tables 5.1 and 5.2) did not draw particular attention to the matter, most gave the necessary information regarding the transfers from earlier provisions with reasonable clarity.

In four cases, the new reserves came to be shown as a result of the straightforward disaggregation of composite items included in current liabilities the year before. At English Electric, the previous year's item, 'trade and other creditors, bills payable, contingency and other reserves and reserve for taxation' was subdivided in 1948, producing three new reserves; a capital reserve of £250,000 (being 'past profits considered to be of a capital nature') a depreciation equalisation reserve of £350,000 (the accounts stated that both amounts 'in previous years were included under creditors') and a 'reserve for estimated future liability for income tax on profits of the year' of £425,000. Lyons, in March 1947 described its profits as 'after providing for depreciation, reserves and contingencies reserve' and one of the current liabilities as 'trade and other creditors, provisions for taxation and accrued preference dividend, reserves and contingencies reserves'. A year later the latter had been subdivided into 'sundry creditors, taxation and other accrued liabilities' and four additional reserves, general £564,000, share premium £229,000, contingencies £267,000 and future income tax £377,000. Similarly, the previous year's current liability caption 'provision for contingencies, creditors and taxation' was disaggregated by Vickers in 1945, with a new contingencies reserve shown under reserves. The comparative figures indicated that the amount included under current liabilities the year before for this item had been £3,849,901. AEI, in December 1945, moved to fuller disclosures 'in accordance with more modern practice'. The current liability caption of the year before was narrowed and two new items appeared, £1,950,000 of unspecified 'other' reserves and £1,797,000 set aside for future taxes.

At ICI, a new reserve of £503,000 clearly identified in December 1946 as a 'metal stocks contingency reserve' had been covertly deducted from stock ('at or under cost') the previous year. Fisons produced a new 'reserve for special depreciation and obsolescence' of £73,846, from both its current liabilities (£25,000) and fixed asset (£48,846) categories the

previous year, as part of a general restatement of reserves. The company attributed the balance sheet's new format to a desire to:

give slightly more detailed information and follow generally the principles laid down in the Cohen Report on the Amendment of Company Law (Fisons, 1945 Accounts).

Shell modified the layout of its balance sheets in 1945, disaggregating creditors so as to reveal a new reserve for future taxation (£80,028) and also reversing earlier, unrevealed write-offs of fixed assets of £3,444,342, in order to establish a share premium account. Until 1947 Spillers had shown only a single net figure for its operational fixed assets but, the following year, fixed assets were shown at cost less accumulated depreciation, with the increased net book value balanced by the recognition of a new 'reserve for the obsolescence and replacement of fixed assets' of £612,019. Also in 1948, a narrowing of the previous year's current liability caption led to the recognition of a new contingencies reserve for £609,850.

In 1946, Dunlop Rubber's reserves were reorganised, with the company crediting £1,000,000 to profit and loss (and £750,000 in 1947) as 'amounts receivable on account of claims for refund of Excess Profits tax in respect of companies previously in enemy or enemy occupied companies'. These round-sum amounts could have been the result of a genuine change in estimates of future tax liabilities but it seems most unlikely that these sums would have lain outside the remit of the Excess Profits Tax post-war refund suspense account that they maintained and they have accordingly been viewed as the release of secret reserves. The disaggregation by Crompton Parkinson of one of its current liabilities in September 1948 gave rise to a new reserve for future taxation of £468,107, a 'specific reserve' of £223,417 and the release of 'provisions no longer required and profits relating to previous periods' of £596,952 to profit and loss.

In the four remaining cases, the treatments adopted were more deceptive. On Charringtons December 1948 balance sheet, an apparently clear explanation that part of a new heading of 'capital reserves' was a 'transfer from internal reserves' of £88,138 in fact covered little more than 10% of the real amounts involved. A careful comparison of successive balance sheets indicated that two further amounts in the reserves (general reserve £500,000 and reserve for future taxation £250,000) could only have come from the disaggregation of the previous year's current liability caption 'trade creditors and other outstandings including beer duty, War Damage contributions and provisions for deferred repairs and taxation'.

In 1948, Boots showed a 'reserve against falls in the value of stock' on its balance sheet of £600,000, with a comparative figure of £494,485 but no further explanations. No such figure or item had, in fact, appeared on the 1947 balance sheet and an examination of the comparatives indicated that the reserve had previously been an unrevealed deduction from stock.

The approach adopted by GKN and Patons & Baldwins was more unusual. In 1948 GKN identified:

certain reserves built up in previous years against specific assets [that had] become free on the transfer of those assets to the newly formed subsidiaries (GKN 1948 Accounts, Directors Report).

Compliance with the Companies Acts involved merely a change of the positioning of the reserves, as they had been clearly shown as deductions from the assets concerned on the previous year's balance sheet and were, in no sense, 'secret'. Two years previously, however, as the direction of the future legislation was becoming clearer, more substantive changes had taken place. In 1946, reserves were deducted from fixed assets (a 'general depreciation and obsolescence reserve' of £727,219), shareholdings in subsidiary companies (£1,059,076), investments (£350,098) and stock (£530,000) without explanation or comment. A comparison with the

balance sheet for 1945 showed that all four reserves had in that year been covertly deducted from the assets concerned. In both years the shareholdings in subsidiary companies were described as 'at or under cost', which indeed they were.

The approach used by Patons & Baldwins was strikingly similar. In 1948, it reclassified its reserves, in order to comply with the new legislation, moving reserves openly deducted from stock and investments a year before into general reserve. Once again the real changes had taken place two years previously. In 1945, the value placed on the stock in trade had been 'as certified by the officials of the company', although the comparative figures to the 1946 accounts show a reserve against possible falls in the price of stock of £425,000 as a deduction therefrom. A reserve of £25,000 was also deducted from investments in the comparatives to the 1946 accounts. Neither reserve had been identified on the balance sheet for 1945.

CHAPTER SIX

DISCUSSION AND CONCLUSIONS

There was a considerable increase in the importance of both capital and revenue reserves across the period 1938-50, which rose from 2.7% and 12.7% of total assets respectively in 1938 to 19% and 23.7% in 1950, at a time when the monetary value of total assets was also rising rapidly. The composition of the growing volume of reserves also changed markedly, with a rapid growth in share premium accounts, following the requirement in the Companies Act 1947 (s.72) that premiums on the issue of shares be transferred thereto, and in the use of specified (i.e. non-general) revenue reserves.

The period also saw a significant evolution in the means of accounting for reserves and provisions. The position in 1938 was that:

- reserves were only grouped in a minority of balance sheets;
- there was no distinction in the balance sheet between capital and revenue reserves;
- there was no distinction between reserves and provisions, with the terms often being used interchangeably;
- provisions for contingencies, taxation and others matters were usually included in the figure for creditors; and
- few companies disclosed the cost of, or accumulated depreciation on, their fixed assets, although a significant proportion of companies did identify the year's depreciation charge.

By the end of the period the position had altered significantly, so that:

- reserves were uniformly grouped on balance sheets, along with information on share capital, so as to give the amount of shareholders funds;
- the distinction between non-distributable capital reserves and distributable revenue reserves was made apparent;
- Recommendation N.6 (ICAEW (1944-57) and the Companies Acts 1947-48 had established a distinction between reserves and provisions that was generally followed in the presentation of financial statements;
- the separate disclosure of a number of provisions under the current liabilities heading was the norm;
- secret reserves had been effectively abolished, except for companies in the banking, insurance and shipping industries; and
- the cost, accumulated depreciation and net book value of classes of fixed assets were uniformly shown on company balance sheets.

Capital reserves

Companies in the sample generally took a prudent and conservative approach to the need to retain funds in their businesses. Realised profits on fixed asset sales and other non-trading items and sometimes even post-war refunds of Excess Profits Tax, although legally distributable, were frequently credited to a capital reserve account.

The disclosure of capital reserves under a separate heading, although advocated by Recommendation N.6 (ICAEW, 1944-57), was not widely adopted until the coming into force of the Companies Acts 1947-48. This suggests that companies preferred to retain distinctive features in their reporting of reserves, possibly to avoid the implications for future

dividends that might arise from classifying a proportion of reserves as non-distributable.

In addition to the reclassification of reserves, the growth in capital reserves, other than share premium accounts, from 3.2% of total assets in 1945 to 12.5% in 1950 was materially contributed to by the creation of capital reserves against the increasing cost of replacing fixed assets. This approach, which was consistent with the legal distinction between 'fixed capital' and 'circulating capital' (Buckley 1949), arose from the significant inflationary pressures in the post-war period, allied to the advice of Recommendation N.12 (ICAEW, 1944-57).

Revenue reserves

Revenue reserves grew more evenly, from 12.7% of total assets in 1938 to 18.3% in 1945 and then to 23.7% in 1950, with their composition also changing. General reserves, the general reserve and the profit and loss account, declined as a proportion of total reserves across the war years (from 70.9% in 1938 to 42.7% in 1945). While specified revenue reserves increased sharply across the same period but then fell back in relative terms during the post-war years as contingency arrangements became less necessary and voluntary appropriations to revenue reserve for additional depreciation were abandoned.

As far as the accounting treatment of revenue reserves was concerned, there was greater consistency in the distinctions drawn between reserves and provisions from 1945 onwards. This was in response to the recommendations in N.6 (ICAEW, 1944-57) and the Report of the Cohen Committee (Board of Trade, 1945) and to the requirements of the Companies Acts 1947-48, with the abandonment of 'reserves' whose titles (e.g. investment reserve, bad debt reserve, stocks or fuel crisis) suggested that they must have really been provisions.

Within this general pattern of increased conformity, there were significant variations in the treatment of potential taxation liabilities

arising from the use of the prior year basis for the assessment of business income tax. An increasing number of companies set aside funds to meet the eventual liability from 1943 onwards, either in order to comply with the advice in Recommendation N.3 (ICAEW, 1944-47) or as a means of absorbing profits that would otherwise, given dividend restrictions, have increased the level of retained profits, although it was not until the Companies Acts 1947-48 came into force that provisioning (whether as reserve, provision or deferred liability) became the norm. Following the introduction of initial allowances on the acquisition of various classes of fixed assets from April 1946, the area of controversy over accounting for taxes was widened to include tax deferral or equalisation accounting. By 1950, 43% of companies in the sample provided for timing differences in a deferred tax account, generally as a reserve but otherwise as a provision or deferred liability.

These differences in approach, and the variations in the titling of revenue reserves, suggest that professional recommendations had only modest effects upon the standardisation of reserve accounting practices.

Provisions

Towards the end of the period 1938-50 there were major changes in the way that provisions were accounted for on company balance sheets. Previously, provisions were as likely to be called 'reserves' as 'provisions'. Thus, in both 1938 and 1944 approximately equal numbers of companies used each term to refer to amounts set aside within creditors and it was not until the Companies Acts 1947-48 that this practice ceased. It was also a minority practice, until the passing of the legislation, for companies to disclose provisions as separate balance sheet items, with most companies including their provisions within 'omnibus' current liability items.

The presentation of profit allocations also changed markedly. In 1944, after the publication of Recommendation N.5 (ICAEW, 1944-57), 86% of sample companies showed the impact of proposed profit allocations on their balance sheets, even though they still awaited the formal approval of their shareholders, compared with only a third of companies in 1938.

In terms of volume, however, provisions other than tax and depreciation were never more than of modest significance and only amounted to as much as 5% of total assets in 1950. Provisions for taxation tended to grow across the period, particularly in the war years, although this is difficult to quantify because of limited disclosures and because of changing perspectives on how best to account for both current and future taxation.

By far the most important provision was depreciation. At the start of the period under review, all companies distinguished their investments from other fixed assets. Almost half of the sample companies showed the depreciation charge and split their physical fixed assets into different classes, but only two companies disclosed their accumulated depreciation provisions. The level of information provided on depreciation gradually increased, although less than half the sample companies disclosed the cost of their fixed assets, or the accumulated depreciation provisions until the legislation of 1947-48. Thereafter, accumulated provisions for depreciation accounted for a third of the cost (or valuation) of fixed assets of the sample companies until they fell to 22% in 1950 following increased expenditure on fixed assets.

Secret reserves

The reclassification of secret reserves as reported reserves took place in the period 1945-48, with more of the re-classification being made before, rather than after the provisions of the new Companies Acts were in place.

However, the amounts involved were not always as large as the subject's notoriety would suggest. The amounts of secret reserves reclassified in the period 1945-48 represented just under 10% of the total reserves of companies studied, although the differential effect was much greater. Two-thirds of companies used some level of secret reserve accounting, half of whom had secret reserves of more than 30% of their total reserves. The results suggest that the desire of many companies to manage profit levels across a period of considerable commercial uncertainty proved stronger than any criticisms evoked by the Royal Mail case of 1931 or expressed as part of the subsequent debate within the profession.

It is clear that secret reserves were more often included within creditors than deducted from assets and that the amounts involved in the former practice were twice as large as the latter. The release of secret reserves accordingly involved the disaggregation of 'omnibus' items within current liabilities rather than breaking down previously provided asset figures. Companies that made public their formerly secret reserves in the period 1945-48 did not draw attention to the matter but most gave the necessary information with reasonable clarity. Where this was not the case, the restatement of comparative figures was the most common accounting device used to mask the accounting re-classification concerned.

Further evolution of reserve and provision accounting

Recommendation N.6 (ICAEW, 1942-1957) and the related definitions of reserves and provisions in the Companies Acts 1947-48, responded to the lack of distinction between reserves and provisions and prevented reserves being used to set aside amounts from profits or other surpluses in order to meet specific requirements or commitments.

The debate subsequently moved to the need to distinguish between a contingency and a provision. SSAP 18 (Accounting Standards Board, 1980) saw provisions as appropriate where the major difficulty was estimating the liability and contingent liabilities as appropriate where

there was further uncertainty as to whether the outcome that would give rise to the liability would occur.

The matter was further clarified in FRS 12 (Accounting Standards Board, 1999b), whose objectives were to ensure that a provision, defined as a liability of uncertain timing or amount, was recognised only when it actually existed at the balance sheet date and that provisions were recognised and measured on a consistent basis with sufficient disclosure in the notes as to enable users to understand their nature, timing and amount. Based on the Accounting Standards Board's definition of a liability (Accounting Standards Board, 1999a), a provision should be recognised only when an entity has a present legal or constructive obligation, which can be estimated reliably, as a result of a past event; it is also probable that a transfer of economic benefits will be required to settle the obligation. Although the position is not dissimilar to N.6 and the Companies Acts 1947-48, FRS 12 makes it much more difficult for companies to justify the creation of a provision by requiring the demonstration of a legal or constructive obligation.

Following the European Union's decision to mandate Standards issued by the International Accounting Standards Board for listed companies, current generally accepted accounting principles are based on IAS 37 (International Accounting Standards Board 1999). Because FRS12 and IAS 37 were developed as a joint project, the position as regards the distinction between provisions and contingencies is similar. However, IAS 37 (s.7) explicitly states that the term 'provision' does not include adjustments to asset values as with, for example, depreciation, which was included in the definition of provision in N.6 and the Companies Acts 1947-48, and only implicitly excluded in SSAP 18 and FRS 12.

Recommendation N.5 (ICAEW, 1943-57) required proposed dividends to be provided for in the financial statements whereas IAS 10 (International Accounting Standards Board, 2004, s.12) effectively reversed this, stating that dividends declared at balance sheet date should not be shown as a liability in the balance sheet because they do

not conform to the criteria for a liability under IAS 37, until they are approved by shareholders after the year end. This principle is now in place in the UK following the publication of FRS 21 (ASB 2004) which has the effect of implementing IAS 10 in the UK.

The legal position of reserves since 1950 has, however, changed far less. The definition of reserves and provisions in the Companies Act 1985 was unchanged from the Companies Acts 1947-48, although the Companies Act 1985 (Schedule 4, s.89) did provide further clarification by stating that:

References to provisions for liabilities and charges are to any amount retained as reasonably necessary for the purposes of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or to date

a position consistent with FRS 12 and IAS 37.¹

Finally, the results provide an opportunity to contrast voluntary compliance under self-regulation through Recommendations on Accounting Principles (ICAEW, 1942-1957) with statutory direction under the Companies Acts 1947-48. Although the issue of the first series of Recommendations was hailed as 'a very definite milestone in accounting history' and N.6 as a 'very notable landmark in accounting history', Zeff (1972) argued instead that the Recommendations should have been 'firmer and more positive and less patient with alternative practice'.

The results also provide the 'hard evidence' that Zeff (1972) thought was lacking, to test the position of an informed observer, the former senior partner of a large firm and one-time Chair of the Parliamentary and Law Committee, who claimed that the Recommendations had 'met a remarkable degree of acceptance'. The evidence in this paper suggests instead that, while Recommendations that were relatively easy

to implement, like N.5 (Inclusion in the accounts of proposed profit allocations) were adopted fairly quickly and widely, others that required more investment to obtain the information, like N.9 (Depreciation of fixed assets), or revealed sensitive information, such as N.3 (Treatment of taxation) and N.6 (Reserves and provisions), had a far more limited impact on accounting practice.

Indeed, in the latter examples it was not until the Companies Acts 1947-48 provided legal support for the Recommendations, that there was widespread compliance. The results thus suggest that, while voluntary self-regulation can bring about some improvement in practice, a mandatory approach to the specification of generally accepted accounting principles may be necessary for their consistent adoption.

ENDNOTE:

1. See Companies Act 1947 (Schedule VIII, Part IV, s. 27 (1)), Companies Act 1967 (Schedule 2, Part IV, s.27 (1)), the Companies Act 1985 (Schedule 9, Part V, s.32 (1)) and FRS 12 (App. V, s.5).

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APPENDIX ONE

COMPOSITION OF SAMPLE COMPANIES

Industry sector	Description	No.	Not England & Wales	Net population	Not found	Identified	In sample	Company No.
			(a)			(b)	(c)	(d)
20	Food & kindred product	24	3	21	11	10	3	5; 15; 19;
21	Tobacco manufacturers	4	1	3		3		
22	Textile mill products	8	1	7	6	1	1	17;
23	Apparel & other textile products	1		1	1			
26	Paper & allied products	4	1	3	3			
27	Printing & publishing	4		4	2	2	1	7;
28	Chemicals and allied products	10		10	4	6	5	3; 4; 10; 13; 14
29	Petroleum & coal products	3	1	2		2	2	1; 18;
30	Rubber & misc. plastic products	1		1		1	1	8;
31	Leather & leather products	1		1	1			
32	Stone, clay & glass products	5		5	1	4	1	16;
33	Primary metal industries	14	1	13	13		1	20;
34	Fabricated metal products	3		3	2	1	1	12;
35	Manufacturing except electrical	2		2	2			
36	Electric & electronic equipment	5		5		5	3	2; 6; 9;
37	Transportation equipment	9		9	6	3	2	11; 21
39	Misc. manufacturing industries	2		2	2			
		100	8	92	54	38	21	

- (a) Companies at Companies House in Scotland or Northern Ireland
- (b) Companies whose detailed files could be traced through the Companies House database
- (c) Companies for which a complete set of published accounts were held
- (d) Company reference number used in this study

APPENDIX TWO

SAMPLE OF COMPANIES

		Industrial sector	Company size
1	Anglo-Iranian Oil Co Ltd	29	2
2	Associated Electrical Industries Ltd	36	18
3	Beecham Group Ltd	28	34
4	Boots Pure Drug Co Ltd	28	29
5	Charrington & Co Ltd	20	47
6	Crompton Parkinson Ltd	36	79
7	Daily Mail & General Trust Ltd	27	50
8	Dunlop Holdings Ltd	30	10
9	English Electric Co Ltd	36	57
10	Fisons Ltd	28	75
11	Ford Motor Co Ltd	37	31
12	Guest Keen & Nettlefolds Ltd	34	13
13	Imperial Chemical Industries Ltd	28	3
14	Lever Bros & Unilever Ltd	28	4
15	J Lyons and Co Ltd	20	19
16	Morgan Crucible Co Ltd	32	81
17	Patons & Baldwins Ltd	22	68
18	Shell Transport & Trading Co Ltd	29	5
19	Spillers Ltd	20	52
20	Staveley Coal & Iron Co Ltd	33	48
21	Vickers Ltd	37	12

Notes:

Industrial sectors are as defined in Appendix one.

Ranking of company size is as defined by the market value of their shares (see Chandler, 1990, appendices B1-B3).

APPENDIX THREE

SAMPLE SET COMPANY BALANCE SHEETS AND PROFIT & LOSS ACCOUNTS, 1938-50 (£000)

Accounting year end in:	1938		1939		1940		1941		1942		1943		1944		1945		1946		1947		1948		1949		1950			
	21 mean	%	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	21 mean	20 mean	%	
Balance sheets																												
Number of Companies	14989		15213	15773	15772	15238	15840	15291	15356																			
Share Capital	3573	15.5	3808	4156	4346	4979	5451	5879	6911	23.7	8420	13019	14945	23841	42.7	24034	26692	29879	32638	42455								
Reserves (see Appendix 4)	18562		19021	19929	20118	20217	21291	21170	22267																			
Total shares and reserves	1013		1001	1017	1002	803	871	814	715																			
Debentures																												
Current Liabilities																												
Current tax (See Appendix 4)	61		96	179	224	344	371	225	356																			
Dividends	915		580	581	572	520	551	549	608																			
Subsidiaries	961		968	872	1004	1195	1266	512	407																			
Creditors	169	0.7	203	234	323	412	492	474	1063	3.6	1403	1680	1948	1936	2038	3.7	2857	2828	3226	4096	2975	5.3	655					
Other	1363	5.9	1761	2400	2648	2975	3374	4489	3023	10.4	87	256	509	627	655													
Overdrafts	61		25	46	160	148	167	119	243																			
Provisions (not tax or depreciation) – See Appendix 4	17	0.1	15	14	12	9	57	53	513	1.8	903	993	1249	3199	5.7													
Fixed assets at cost or valuation	23122	100.0	23670	25272	26063	26623	28440	28405	29195	100.0	31732	34970	39537	42972	55796	100.0	16968	18872	24126	5263								
Less depreciation (see Appendix 4)																												
Fixed assets nbv	5629		5814	5554	5413	5272	5262	6306	7525																			
Investments	13228		13046	14160	14291	13634	13952	11440	10553																			
Current assets	4265		4810	5558	6359	7717	9226	10659	11117																			
Total assets	23122		23670	25272	26063	26623	28440	28405	29195																			

Note: too few companies disclosed the cost and aggregate depreciation of fixed assets in 1938-47 for the figures to be representative

SAMPLE SET COMPANY BALANCE SHEETS AND PROFIT & LOSS ACCOUNTS, 1938-50 (£000)

Accounting year end in:	1938		1939		1940		1941		1942		1943		1944		1945		1946		1947		1948		1949		1950			
	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%	21	%		
Profit & Loss Accounts																												
Number of Companies :	21		21		21		21		21		21		21		21		21		21		21		21		21		21	
Provisions shown																												
Depreciation	105		112		118		110		210		219		209		136		239		258		1213		1652		2026		2026	
Taxation	149		279		549		496		808		668		558		794		953		1764		2733		2549		4326		4326	
EPT refunds																	-59		-39				36					
Other	9		9		12		74		7		6		8		21		12		19		-4		14		34		34	
Profit after tax	1802		1516		1402		1253		1613		1471		1470		1679		1986		2807		3137		2792		4045		4045	
Profits brought forward	312		344		396		483		445		481		531		582		660		826		943		1265		1201		1201	
Profits available for appropriation	<u>2114</u>		<u>1860</u>		<u>1798</u>		<u>1736</u>		<u>2058</u>		<u>1952</u>		<u>2001</u>		<u>2261</u>		<u>2646</u>		<u>3633</u>		<u>4080</u>		<u>4057</u>		<u>5246</u>		<u>5246</u>	
Dividends	1462		1102		1029		1027		1151		1157		1137		1175		1151		1201		1208		1243		1506		1506	
less transfers to reserves																												
General reserve	126	5.9	61	3.4	22	1.2	15	0.8	17	0.8	50	2.5	62	2.8	88	4.0	199	9.7	971	47.1	1189	57.1	925	43.8	1619	77.0	1619	77.0
Other	182	8.6	301	16.2	264	14.7	249	13.8	409	21.4	214	10.8	220	10.5	338	15.4	470	22.4	518	24.5	418	19.5	429	19.8	882	41.2	882	41.2
Retained Earnings	344	16.3	396	21.0	483	25.8	445	24.2	481	25.2	531	25.8	582	27.8	660	30.2	826	39.1	943	44.5	1265	59.5	1460	68.4	1239	58.3	1239	58.3
	<u>2114</u>	100.0	<u>1860</u>	100.0	<u>1798</u>	100.0	<u>1736</u>	100.0	<u>2058</u>	100.0	<u>1952</u>	100.0	<u>2001</u>	100.0	<u>2261</u>	100.0	<u>2646</u>	100.0	<u>3633</u>	100.0	<u>4080</u>	100.0	<u>4057</u>	100.0	<u>5246</u>	100.0	<u>5246</u>	100.0

APPENDIX FOUR

COMPOSITION OF RESERVES AND PROVISIONS ON SAMPLE SET BALANCE SHEETS, 1938-50 (£000)

Accounting year end in:	1938		1939		1940		1941		1942		1943		1944		1945		1946		1947		1948		1949		1950			
	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%	mean	%		
Number of companies:	21		21		20		20		21		20		21		21		21		21		21		21		21		20	
Reserves																												
Capital reserves	23	0.6	68	72	72	72	72	72	320	320	336	336	320	320	617	617	837	837	902	902	2471	2471	3285	3285	3619	3619	15.2	
Share premium	347	9.7	303	258	258	258	258	258	406	406	341	341	409	409	412	412	601	601	547	547	646	646	881	881	3996	3996	16.8	
Capital reserve																												
Revaluation surplus	8	0.2	10	10	10	10	10	10	0	0	43	43	61	61	110	110	102	102	190	190	272	272	273	273	149	149	0.6	
EPT post-war refund																												
Asset replacement	71	2.0	71	75	75	75	75	75	95	95	125	125	143	143	167	167	190	190	238	238	286	286	333	333	400	400	1.7	
Preference stock reserves	178	5.0	164	212	215	215	215	215	228	228	242	242	254	254	256	256	3.7	3.7	92	92	185	185	86	86	95	95	0.4	
Investment reserve	627	17.5	616	627	630	630	630	630	1049	1049	1087	1087	1187	1187	1562	1562	2075	2075	2321	2321	3883	3883	5006	5006	10618	10618	44.6	
Total capital reserves																												
Revenue reserves	2187	61.2	2209	2272	2239	2239	2239	2239	1908	1908	2129	2129	2124	2124	2290	2290	2954	2954	4011	4011	5374	5374	6150	6150	8162	8162	34.2	
General reserve	344	9.7	396	501	459	459	459	459	485	485	548	548	582	582	660	660	826	826	930	930	1265	1265	1460	1460	1230	1230	5.2	
P&L account	120	3.4	194	292	470	470	470	470	649	649	780	780	821	821	781	781	11.3	11.3	487	477	410	410	437	437	545	545	2.3	
Contingencies																												
Future taxation			52	67	76	76	76	76	332	332	261	261	388	388	593	593	704	704	1343	1343	1456	1456	1082	1082	2130	2130	8.9	
Tax deferral																					17	17	140	140	475	475	2.0	
Other revenue reserves	21	0.6	26	33	38	38	38	38	36	36	38	38	36	36	36	36	0.5	0.5	24	24								
Dividend equalisation																												
Development	5	0.1	9	13	16	16	16	16	19	19	24	24	27	27	31	31	35	35	39	39	42	42	42	42	49	49	0.2	
Share & deb redemption																												
Merger & reorganisation			6	5	4	4	4	4	3	3	2	2	1	1														
Extra depreciation	205	5.7	240	304	373	373	373	373	420	420	517	517	612	612	761	761	1008	1008	1291	1291	14	14	127	127	5	5	0.0	
Stocks (inc fall in commod prices)																												
War personnel	7	0.2	7	7	7	7	7	7	7	7	10	10	10	10	10	10	0.1	0.1	10	10	10	10	10	10	10	10	0.0	
Bad debt																												
Insurance	44	1.2	40	27	29	29	29	29	48	48	27	27	51	51	47	47	49	49	48	48	35	35	36	36	25	25	0.1	
Fuel crisis																												
Unspecified/other/special/specific	13	0.4	13	15	12	12	12	12	13	13	28	28	33	33	133	133	166	166	180	180	220	220	217	217	142	142	0.6	
Total revenue reserves	<u>2946</u>	<u>82.5</u>	<u>3192</u>	<u>3529</u>	<u>3716</u>	<u>3716</u>	<u>3716</u>	<u>3716</u>	<u>3930</u>	<u>3930</u>	<u>4364</u>	<u>4364</u>	<u>4692</u>	<u>4692</u>	<u>5349</u>	<u>5349</u>	<u>77.4</u>	<u>77.4</u>	<u>6345</u>	<u>6345</u>	<u>8553</u>	<u>8553</u>	<u>9136</u>	<u>9136</u>	<u>13223</u>	<u>13223</u>	<u>55.4</u>	
Total reserves	<u>3573</u>	<u>100.0</u>	<u>3808</u>	<u>4156</u>	<u>4346</u>	<u>4346</u>	<u>4346</u>	<u>4346</u>	<u>4979</u>	<u>4979</u>	<u>5451</u>	<u>5451</u>	<u>5879</u>	<u>5879</u>	<u>6911</u>	<u>6911</u>	<u>100.0</u>	<u>100.0</u>	<u>10874</u>	<u>10874</u>	<u>13019</u>	<u>13019</u>	<u>14945</u>	<u>14945</u>	<u>23841</u>	<u>23841</u>	<u>100.0</u>	

The Evolution of Reserve and Provision Accounting in the UK, 1938-50

Reserve and provision accounting has traditionally been seen as a method of smoothing results. This report considers the evolution of reserve and provision accounting across the period 1938-50. There were major changes in accounting during this period, including the abolition of secret reserves. Many of these developments are still evident in today's financial statements.

The study focuses on the accounting practices of 21 of the largest industrial companies in Great Britain in 1948. The report considers the regulatory and other influences that affected accounting during the period, before looking at the presentational and quantifiable changes in reserve and provision accounting that took place.

In addition to providing a detailed analysis of changes in accounting, these developments are linked to contemporary developments in reserve and provision accounting. The report also provides an insight into the usefulness and effectiveness of accounting regulation, comparing the success of voluntary self-regulation to a mandatory regulatory approach.

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