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Accounting Research BULLETINS

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Issued by the

Committee on Accounting Procedure,
American Institute of Accountants,

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No. 28

Accounting Treatment of General Purpose Contingency Reserves

INTRODUCTION

1. Accounting for reserves and their presentation in financial statements involve problems that are both numerous and complex. Since complete solution of all the relevant problems has not been considered possible at an early date, the committee has deemed it wise to separate the problems for individual treatment. The first steps were taken when the committee dealt with reserves arising out of the war.¹ As another step, consideration is given in this bulletin to general contingency reserves which may be set up by management but which are not required at the time under generally accepted accounting principles and whose purposes are not specific. The committee has left for future consideration and possible definitive treatment many aspects of reserves including inventory reserves, reserves for specific but undisclosed contingencies, and the general use of the term "reserve" in financial statements. These are now being studied by the committee.

DISCUSSION

2. The purpose of the committee in the issuance of this bulletin is to establish criteria which will promote sound accounting procedures for the treatment of general contingency reserves and lead to greater uniformity in reporting net income. The committee believes the action taken in this bulletin is in accordance with the current trend of accounting thinking and practice. In reaching this conclusion consideration has been given to the declining use of general purpose contingency reserves as charges to income and to the general recognition that their use may either arbitrarily reduce income or be the means of shifting income from one year to another.

3. When a reserve is provided by a charge to income, the amount recorded as net income for the period is correspondingly reduced. If the provision is not properly chargeable to current revenues, net

¹ *Accounting Research Bulletins* Nos. 13 and 26.

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income for the period is understated by the amount of the provision. If such a reserve should then be used to relieve the income of subsequent periods of charges that would otherwise be made thereagainst, the income of such subsequent periods would be thereby overstated. When a reserve is used in this manner, profit for a given period may be significantly increased or decreased by mere whim.² When this practice is followed the integrity of financial statements is impaired and they tend to be misleading and of doubtful value. The committee is therefore of the opinion that general contingency reserves, such as those created :

- (a) for general undetermined contingencies, or
- (b) for a wide variety of indefinite possible future losses, or
- (c) without any specific purpose reasonably related to the operations for the current period, or
- (d) in amounts not determined on the basis of any reasonable estimates of costs or losses,

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

RECOMMENDED PROCEDURES

4. Accordingly it is the recommendation of the committee that, as to general contingency reserves described in paragraph 3:

- (a) Provisions for such reserves should not be included as charges in determining net income.
- (b) When such a reserve is set up it should be created preferably by a segregation or appropriation of surplus; it may be created by an appropriation of net income but this is less desirable.
- (c) If such a reserve is created by an appropriation of net income, the net income should first be determined and so designated, after which the reserve provision should be deducted and clearly captioned as an appropriation of net income and the final figure should be so captioned as to clearly indicate that it is not the entire net income.
- (d) Costs or losses should not be treated as charges to such reserves and no part of such a reserve should be transferred to income or in any way used to affect the determination of net income for any year.³

² "It is not permissible to create reserves for the purpose of equalizing reported income." *Accounting Research Bulletin* No. 13, p. 112.

³ This paragraph also applies to general contingency reserves set up in prior years.

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- (e) When such a reserve or any part thereof is no longer considered necessary it should be restored to surplus, either directly (the preferable treatment) or after the determination of net income, in the income statement, in such a way as to indicate clearly that it is not income.⁴

The statement entitled "Accounting Treatment of General Purpose Contingency Reserves" was unanimously adopted by the twenty-one members of the committee. Messrs. Dohr, Herrick, Stans, and Wellington assented with qualification.

Mr. Dohr does not agree that an appropriation of income is less desirable than a segregation of surplus. He believes that appropriations included at the foot of the income statement are helpful in indicating the disposition made of current income.

Messrs. Herrick, Stans, and Wellington assent to the bulletin, but do not approve the recommendation that there may be included on the income statement after the determination of net income either charges for the creation or increase of general purpose contingency reserves (as permitted in paragraph 4(b)) or credits for the restoration of any part of such a reserve no longer considered necessary (as permitted in paragraph 4(e)). They feel that, even with complete disclosure and clear and unmistakable wording, the inclusion on the income statement of either charges or credits for general contingency reserves will be confusing to the reader and that such charges or credits, if made, should be reported only on the surplus statement.

NOTES

1. *Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)*

⁴This paragraph also applies to general contingency reserves set up in prior years.

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2. *Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)*

COMMITTEE ON ACCOUNTING PROCEDURE (1946-1947)

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