

University of Mississippi

eGrove

American Institute of Accountants

Deloitte Collection

1948

Recommendation of Committee on Terminology: Use of term "reserve"; Accounting Research Bulletin, no. 34

American Institute of Certified Public Accountants. Committee on Accounting Procedure

Follow this and additional works at: https://egrove.olemiss.edu/dl_aia



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants. Committee on Accounting Procedure, "Recommendation of Committee on Terminology: Use of term "reserve"; Accounting Research Bulletin, no. 34" (1948). *American Institute of Accountants*. 325.
https://egrove.olemiss.edu/dl_aia/325

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in American Institute of Accountants by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Accounting Research BULLETINS

★

Issued by the
Committee on Accounting Procedure,
American Institute of Accountants
13 East 41st Street, New York 17, N. Y.
Copyright 1948 by American Institute of Accountants

October, 1948

No. 34

Recommendation of Committee on Terminology Use of Term "Reserve"

FOREWORD

The members of the committee on accounting procedure have approved as an objective the recommendation of the committee on terminology made herein with respect to the use of the term "reserve" in accounting, and have authorized its publication. The statements herein contained, however, are not to be regarded as formal pronouncements of the committee on accounting procedure.

USE OF THE TERM "RESERVE"

The term *reserve* is used in accounting in a variety of different and somewhat conflicting senses. As a result clarity of thought and accuracy of expression are impaired and an adequate understanding of financial statements on the part of users is made more difficult than is necessary. In addition the variations in balance-sheet classification and presentation of the so-called reserves contribute to the confusion and make comparisons difficult. It is suggested that the current uses of the term may be reviewed and that recommendations may be made as to acceptable definition and to limitations on usage which will serve to make the financial statements more readily understood.

In dealing with financial matters the term *reserve* is commonly used to describe specific assets which are held or retained for a specific purpose. This is the sense in which the term is employed, for instance, in our banking system, which derives its name from the fact that member banks are required to maintain deposits with the central or *reserve* banks. The term is also used to indicate such assets as oil and gas properties which are held for future development. These usages present no problem in accounting where the assets in question are described according to their nature or referred to as *funds* or *deposits* for specific purposes.

Accounting Research Bulletins

In current accounting practice the term *reserve* is used in four senses, as follows:

1. The term is used to describe (a) a deduction which is made from the face amount of an asset in order to arrive at the amount which it is expected will be realized, as in the case of a reserve for uncollectible accounts, or (b) a deduction which is made from the cost or carrying value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense reserves are customarily referred to as valuation reserves, and are usually deducted in the *asset* section of the balance-sheet.

2. The term is used to indicate (a) an estimate of an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) an approximation of the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) an estimate of a liability or loss which is sufficiently likely to occur to require recognition, as in the case of a reserve for self-insurance. These reserves are included in the *liability* section of the balance-sheet, in a section immediately below the ordinary liabilities, or in the *proprietary* section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is required to meet future payments under policies.

3. The term is sometimes used, although not in accordance with the best practice as generally recognized, to indicate a variety of charges set forth in the income statement, including estimated losses as a result of uncollectible accounts and other causes, depreciation, depletion, amortization, probable losses, specific contingencies, and similar items. It is to be noted here that the term refers to the charge by means of which a reserve (in the credit sense) is created.

4. The term is used to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense a reserve is frequently referred to as an appropriation of retained earnings.

The dictionaries define the term *reserve* generally and in substance in its etymological sense, as something held or retained for a purpose, frequently for emergencies. It is apparent therefore that

Use of Term "Reserve"

the broad usage referred to, in the second paragraph of this memorandum, is one which clearly reflects the general understanding of the term, i.e., specific assets held or retained for some purpose. It is also apparent, however, that the occasions for usage in this sense are distinctly limited, and that where specified assets are segregated and held for some purpose they may be described for accounting purposes by the use of such terms as *fund*, *deposit*, *temporary investments*, etc. While the general characterization of these items as reserves is acceptable usage, it is not involved in the problem of definition within the field of accounting.

The first accounting usage of the term set forth above seems clearly contrary to the commonly accepted meaning of the term. A so-called reserve for bad debts or for depreciation does not in itself involve a retention or holding of assets, identified or otherwise, for any purpose. Its function is rather to indicate a diminution or decrease in an asset due to a specified cause; the use of the so-called reserve in this area is essentially a part of a process of measurement. In the recent amendment of the British Companies Act the British accountants appear to have been troubled by the various uses of the term *reserve* and as a result of their recommendations it is now provided that the so-called reserve of this type shall be described as a *provision*. It may well be doubted whether this is an improvement, because any provision must of necessity and in the final analysis be made by the allocation or segregation of assets. While it seems clearly advisable to drop the term *reserve* in this area, it should be replaced by terms which indicate the measurement process, i.e., such terms as "less estimated uncollectibles," "less estimated losses in collection," "less amortization to date," etc.

The second of the four accounting usages set forth above is also contrary to the generally accepted meaning of the term. It may be argued, of course, that the statement of any liability in the balance-sheet is an indication that a portion of the assets will be required for its discharge. In this sense the statement may be regarded as a provision or reserve. It is clearly preferable, however, to regard the statement as indicating the obligation itself which is a deduction necessary to arrive at proprietary investment or net assets. The items in this area described as reserves might better be designated in some such way as "estimated liabilities" or "liabilities of estimated amount."

The third of the four usages set forth above involves different considerations since it is a matter of the income statement rather than the balance-sheet. In a sense a charge of this nature in the income statement, e.g., a charge for depreciation, is a "reserve" in so far as it indicates that cash or other assets received by way of reve-

Accounting Research Bulletins

nues is, to the extent indicated, to be used or devoted to a special purpose. It seems clear, however, that the basic purpose in the making of these charges is one of income measurement and that the designation of such charges as costs, expenses or losses, i.e., elements in the measurement of income, is clearly more understandable than the designation of *reserves*. The description of these charges as *reserves* or *provisions* suggests not only that the function of depreciation accounting is one of replacement, but in addition leads to the suggestion that the provision be based upon estimated future cost. It seems desirable accordingly that the use of the term *reserve* in the income statement be discontinued.

The generally accepted meaning of the term *reserve* corresponds fairly closely to the last of the four usages set forth above, i.e., the indication of an amount of unidentified or unsegregated assets held or retained for a specific purpose. While retention of assets for a variety of purposes is an important phase of corporate management and finance, the retention does not ordinarily involve a segregation. It is suggested that this meaning may well be adopted as the primary significance of the term in accounting and that other uses of the term be discontinued. It is interesting to note that in the 1947 revision of the British Companies Act, the British accountants succeeded in securing a limitation of the term to this area.

To summarize, it is recommended that the use of the term *reserve* in accounting be limited to the last of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes and that the use of the term in the balance-sheet, in describing deductions from assets or provisions for particular liabilities and in the income statement be discontinued.

COMMITTEE ON TERMINOLOGY

JAMES L. DOHR, *Chairman*

WILLIAM H. BELL

ALVIN R. JENNINGS