Journal of Accountancy

Volume 43 | Issue 3 Article 4

3-1927

Confusion of Terms

William Morse Cole

A Confusion of Terms

By William Morse Cole

To the accountant the difficulty which the average business man finds in interpreting financial statements is puzzling. Yet every accountant knows that a vast mass of misunderstanding follows the attempt to interpret accountants' figures, both as found on balance-sheets and on operating statements and income sheets. There is, of course, nothing intrinsically difficult about the meaning of accounting terms, if one knows enough about accounting processes to understand the fundamental relation between debit and credit and the significance of the two sides of a balance-sheet. In spite of this, however, we find constantly not only in the mind of the business man, but in the presentation of arguments before public-utility commissions and the courts, absolutely wrong interpretation of accounting figures, and even in the decisions of courts we find complete misunderstanding of the facts which the accounts show to a person versed in accounting practice. No term, probably, has led to more serious misunderstandings and to more unjust decisions of public-utility commissions and of courts than "reserve for depreciation." In one case* we find the item which appears upon the balance-sheet of a public-utility under the title "Reserve for depreciation" discussed by counsel in the case and even by the court in its decision as a "fund," an amount "invested," "charges," and "losses." It is obvious that this reserve for depreciation can not be all these things at once. The confusion in the minds of those handling the case is unquestionably due to the fact that accountants usually use in this relation a word that is in daily use in other matters than accounting, but use it in a sense which is purely technical and which departs somewhat from its significance in ordinary speech. The purpose of this article is to suggest the desirability, in relation to the term "reserve," of remembering that the word carries to the non-accounting mind a connotation that such a mind finds difficulty in forgetting when the word appears in relation to accounting.

The word "reserve" in ordinary speech implies that something is held back or reserved for a future use or for permanent withholding. This, commonly, the accountant who uses the term in

---

**Michigan Public Utilities Commission* v. *Michigan State Telephone Co.*, Michigan supreme court, Oct. 30, 1924.

relation to depreciation will say is exactly how the word is used in accounting. That is what is now denied. The process of setting up a reserve for depreciation in accounting is, of course, to debit some account which indicates a cost, such as depreciation, or depletion, or obsolescence, and to credit the reserve for depreciation. This credit is made in order to record on the books the fact that some of the assets must be reserved from distribution as profits lest the capital be impaired. The important fact to realize is that this reserve represents neither assets nor the source of assets. It represents nothing but an overvaluation of assets. Of course the logical thing is to write down the asset account as the asset which it represents suffers a shrinkage in valuation. Only because the accountant wishes usually to preserve the original figure of the cost of the asset does he resort to the device of crediting a reserve account instead of the original asset account. Since, then, the reserve for depreciation represents a hole, so to speak, in an asset, it does not represent anything like what in ordinary speech we mean by the term "reserve." It is absurd to talk about reserving a thing that does not exist. The "reserve" as it is commonly used in accounting does not represent a reservation of assets shown on the other side of the balance-sheet, for the assets so shown do not actually exist. The reserve as commonly shown registers the degree in which the assets shown on the other side of the balance-sheet fail to exist—the overvaluation of those assets. Consequently, to the extent of the reserve as shown by the account, it is impossible to reserve the items shown on the other side. One may reply that there are other assets to be reserved, and that this account is meant to suggest the need of reserving other assets in order to make good an overvaluation of the assets for which the reserve was set up. That, however, does not serve the purpose of making clear to the lay mind the fact that assets do not equal the total of the credit side of the balance-sheet, and when the balance-sheet is in balance with the item "reserve" on one side the lay mind assumes that assets must exist in amount equal to the total credit side of the sheet, for it would be absurd to talk of a reserve of a thing which did not exist to be reserved. The whole trouble lies in the fact that the layman assumes that assets listed on the asset side of the balance-sheet exist as assets. Indeed, why should he not?

The practice of subtracting the so-called reserve, in short extension, from the gross value reported on the balance-sheet does not always remove the difficulty, for, since one can not reserve what does not exist, the layman still takes the balance-sheet to indicate the existence of the gross asset as given, and understands a part of that value to be merely reserved for a future purpose. Indeed, why should he not, when that is what in common speech we mean by a thing reserved? All accountants are familiar with stock or store records in which are found some items reserved for particular use. They are actually in existence, but unavailable for uses not previously designated.

Yet, as all persons familiar with accounts know, this same term "reserve" is used now and then by accountants to represent not a hole in the assets, an overvaluation, but an excess of assets over the claims to those assets as shown by the other items on the balance-sheet, that is, profits which for one reason or another the managers desire to reserve from distribution as dividends. These two uses of the word "reserve" are absolutely contradictory. One represents the fact that the assets shown on the balance-sheet do not, to the extent of the reserve, exist in reality, and the other shows that what we may call excess assets do exist and belong to the proprietors of the business, but are reserved from distribution for some purpose usually indicated in the title of the account, as reserve for expansion, reserve for pension funds, or even reserve for extraordinary depreciation, where profits are held back not because the managers believe the property has depreciated to the extent suggested by the reserve account but because they wish to be on the safe side and withhold from distribution as dividend profit believed to have been actually earned, so as to be ready for an emergency which may fall upon any business when extraordinary circumstances happen to bring heavy decline in values.

In the case of *Michigan Public Utilities Commission* v. *Michigan State Telephone Co.*, cited previously in this article, the public-utility commission said that the depreciation reserve of $9,500,000 cost the company nothing, for it was derived from returns paid by users of its service. This implies that the commission thought that the reserve was an asset, in spite of its appearance on the credit side of the balance-sheet. The commission appears never to have realized that the reserve was nothing but a representation of the consumption of assets by the company in rendering service to its patrons—as much a consumption as the consumption of supplies, fuel, and cash in the payment of wages. It is not surprising that the commission took this attitude in view of the fact that the word "reserve" was used in that relation. In Montgomery's *Auditing* we find in the same sentence* the term "reserve" in the sense of an overvaluation of assets and in the sense of surplus appropriated for future use and thus withheld from dividends:

> "Therefore the only way to show the exact or as nearly exact as possible earnings is to carry a reserve for exhaustion account among the liabilities equal to 5 cents per ton, and a reserve for sinking fund account equal to an additional 5 cents per ton as a segregated part of surplus."

Mr. Montgomery on the next page says that it is "settled practice" to use the term "reserve" in both senses. The regrettable thing is that the settled practice of accountants is actually so unsettling to laymen. Doubly unfortunate is it that, as Mr. Montgomery points out, sometimes the accountant uses the word "fund" or "reserve fund" for a reserve which is segregated surplus, whereas in common speech a fund is always an asset. Why should the accountant put to strange uses words that are in common speech when he can perfectly well use common words in common senses?

In a recent book called *Profits, Dividends and the Law,*† we find in the same paragraph these two sentences: "Functional causes of depreciation . . . should not be taken into . . . the annual charge . . . which gives rise to a *valuation reserve* unless the effect of such causes can be intelligently foreseen"; and, "In providing reserves for mere contingencies the charge should be to undivided profits, giving rise to a *true reserve* of a proprietorship nature." [The italics are mine.] Note the effort to make clear the distinction.

In the October number of THE JOURNAL OF ACCOUNTANCY, in an editorial on page 285, are these words:

> Recently the credit men of banks have been thinking a good deal about the meaning of the language in which an accountant expresses his opinion of the condition of a company or other business entity, and there seems to be a rapidly developing demand that the words used shall be so clear, so devoid of ambiguity, that the simplest reader would not be deceived.

Under present accounting practice one can not know whether a reserve represents the ownership of assets or the negation of assets. It is hard to conceive of any better confession that accounting terminology is seriously deficient than the use by an accountant of the same term for two things so contradictory. If it is desirable to distinguish between these two kinds of reserves,

* Montgomery's *Auditing Theory and Practice*, third edition, pages 285–286. Ronald Press Co.
† *Profits, Dividends and the Law*, by Prosper Reiter, Jr., pages 120–121. Ronald Press Co.

question arises as to the method of making that distinction. Some accountants use the term "reserve" for any overvaluation of assets, due to such things as depreciation, and use the term "surplus reserved" for reservations of profits as a means of providing for future needs through actual reservation of existing assets. This is vastly better than the failure to distinguish at all; but unless both terms appear on the balance-sheet at the same time, and possibly even then, the danger of a misunderstanding of the nature of the reserve for depreciation remains; for the man in the street naturally thinks that the total assets equal all the other items on the credit side plus the reserve.

Yet there is a word in ordinary speech which suggests exactly the idea which the accountant has in mind when he sets up a "reserve for depreciation." It is used in business and in other walks of life in exactly the sense that it is used by some accountants, namely, the word "allowance." That word is used universally except in accounting for the correction of exaggerations. We make allowances for exaggerations in peoples' stories, for valuations in the mind of the seller of goods when he must face a buyer's market, for the shrinkage in the value of products due to depreciation, for claims for loss and damage, etc., etc. The following sentences were taken from a newspaper report of a public-utility case and were written presumably by a reporter who was not versed in accounting terminology but was writing the language of the man in the street:

TO SHOW DEPRECIATION

CITY'S EXPERT INSISTS $11,000,000 A YEAR IS AMPLE ALLOWANCE

When the hearing was resumed yesterday by the public-service commission on the applications of the New York Telephone Company for increased rates, Manfred K. Toeppen, a consulting engineer who specializes in valuation problems of public utilities, one of the city's witnesses, was cross-examined by Frankland Briggs of counsel for the company. Last week Mr. Toeppen testified that the annual allowance for depreciation of the company's property in this city should not be more than $11,000,000. He explained that this figure was based on a study of the actual retirement of property from service since the company was organized. The company thinks it should be $15,000,000.

It will be observed that the reporter uses the word "allowance" in exactly the sense that most accountants use the term "reserve" when they are trying to record an overvaluation of property. Presumably, too, the writer of the headline was using the talk of the layman.

It is difficult to believe, if the word "allowance" were always used for the title of accounts intended to show over-valuations, that confusion in the mind of the layman would be so prevalent as today it is, and that any new misconceptions could be created by such adoption. The only reason that any one can desire to use, in accounting, terms of ordinary speech with extraordinary meanings is that he wishes to make accounting more incomprehensible or misleading. No reputable accountant has such a desire. It is easy, of course, to say that tradition or custom demands the use of the word "reserve" in the sense which is here objected to; but, with every fondness for tradition and conservatism, one can not see why a term which actually results in confusion and serious misunderstanding should be kept when a term which falls into ordinary speech and will serve the purpose equally well is so obviously available. Other terms than "allowance" may be just as good, but they do not appear so obvious and presumably would not so readily remove the confusion which now is common.

A third need arises in a similar relation, namely, the need for a term to represent that which neither is an overvaluation of present assets nor a reservation of past profits. The best illustration of this is provision for income taxes to be levied on the income of one period and paid in a subsequent period. Such provision does not represent an overvaluation of assets, for the assets are still intact. It merely represents a claim to those assets on the part of the government. In one sense this provision is properly called a reserve, for it represents income or surplus reserved for the government. From the point of view of the owners of the business, however, it is not surplus but liability. To distinguish it, therefore, a third term is desirable. Again we ought to use a word which falls in with the speech of the layman. We commonly say that we have "provided" for certain things. If we wish on our balance-sheet to show that the government's share of our profits has been provided for, we may very well show on the credit side of the balance-sheet a provision for income taxes. This indicates that of the assets shown on the other side of the balance-sheet (which are in actual existence except for any allowances) a certain value is labeled as assignable to the claim of the government.

A similar use of the word "provision" would naturally cover expected losses or shrinkages of which past periods should bear a share, even though the assets have not yet actually shrunk. If, for instance, the buildings of a business are insured under policies which involve co-insurance, it is obvious that a fire would involve a loss not recoverable through the policies. The years when no fire occurs ought to bear a share of the losses actually incurred in other years, and the cost of insurance is not properly indicated if only the premiums actually paid are charged as operating costs. The setting up of a provision for fire loss is required by proper accounting methods in years when no losses occur. The natural credit for such entries is in an account which may be called "provision for fire loss." This indicates neither present shrinkage in assets nor profits reserved: it represents the fact that a part of present assets will under the law of averages need application in the future to offset losses actually to be suffered in the future, but chargeable to the present, and therefore that the proprietors' effective equity in the property is reduced.

It may, indeed, be desirable to divide such provisions into two classes—one representing an expected future shrinkage in assets in which past periods must bear a share, as provision for fire losses, and the other representing liabilities that will be established in the future on operations of the past, as provision for income or other taxes. The first might be called a "provision," and the other an "estimated liability." The difference between these is not, however, fundamental, for the effect of both is to indicate that some of the assets shown on the balance-sheet, though not overvalued today, will ultimately be absorbed by exigencies originating in the past.

In summary, the argument is that balance-sheets will be much more intelligible if they contain terms in accordance with the practices of ordinary speech. The term "reserve" in common use in accounting confuses three things. These three things ought to be distinguished on a balance-sheet, and the following are recommended: the term "allowance" to indicate overvaluation, either from depreciation or from decline in value due to other causes; the term "surplus reserved" for appropriations of surplus for special purposes; and the term "provision" for a necessary record of the fact that, though assets are now in existence intact, either a claim will be later established against them by someone else or an inescapable shrinkage will be suffered in them (both really chargeable against past periods), and that therefore the value of the owners' equity in the assets is really reduced below what it would appear to be without such record.