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Reserves

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The reserve account is a jack-of-all-trades and badly overworked. It has to do duty in too many capacities and to serve in too many liveries. It is, like Pooh Bah in *The Mikado,* Lord High Everything. This fact is well stated by Mr. Montgomery, as follows:

> "The status of the reserve account is unsatisfactory from the point of view of the professional auditor, chiefly because the term 'reserve' is indiscriminately applied to items which are essentially different."†

This essential difference in the nature of various reserves may be shown by three pairs of contrasted illustrations:

The first pair: when depreciation has reduced the value of a fixed asset, we set up a reserve for depreciation. And when market conditions have increased the realizable value of the same fixed asset, we may set up another reserve for the unrealized profit. Thus one reserve measures the estimated increase in the value of an asset.

The second pair: a company has capital invested in a mine or other wasting asset. At the close of each period the reserve for depletion is credited with the estimated value of the deposit extracted during the period. This reserve measures a decrease in asset values which has actually taken place in the past and a decrease which is chargeable to the operations of the past. But suppose that a corporation, after providing for all known losses, sets up a reserve for contingencies. This reserve represents a vague and problematical loss; one which has not yet been suffered, which may in fact never be suffered and should certainly not be a charge against the operations of the past

The third pair: taxes are accrued at the end of the period, and a reserve for taxes is set up. This reserve represents a liability, and the offsetting debit records an expense. Contrast this with a reserve for sinking fund, which is not a liability but a part of the surplus. The entry setting up this reserve does not record an expense; it merely records the fact that, because of a

* A paper read at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 19, 1922.

† R. H. Montgomery, *Auditing Theory and Practice,* 1922, vol. I, page 267.

contract with the bondholders, a portion of the surplus is temporarily not available for dividends.

From these illustrations it appears that some reserves are set up because actual expenses or losses have occurred in the past; others are set up because contigent losses may possibly occur in the future; others indicate that profits could be realized by the sale of fixed assets; while others represent neither a profit nor a loss, but a temporary earmarking of a portion of the surplus.

Some reserves are a part of the surplus; some represent real liabilities; some represent contingent liabilities; some are related to assets, and these asset reserves may show that the property has already decreased in value, or that it may possibly decrease in value at some time in the future, or that it has actually increased in value. Some reserves are set up by charges to profit and loss, some by charges to surplus, and some by charges to asset accounts.

This multiplicity of reserves, meaning so many things, set up in so many ways, and appearing in so many places in the balance-sheet, is bound to result in confusion. This confusion ought to be avoided. Any term appearing in the balance-sheet should, if possible, be self-explanatory, and the term "reserve" can scarcely be self-explanatory when it may mean a deduction, already suffered, in the value of an asset, or a possible future deduction in the value of an asset, or an unrealized profit, or a real liability, or a contingent liability, or a mere segregation of a portion of the surplus.

If the term "reserve" is not self-explanatory, and if the danger of confusion is real, it would seem desirable to limit the use of the term to a few accounts, all of a similar nature; and this would in turn require the development of a larger, richer and more precise vocabulary, supplying terms by which to designate accounts which are now called reserves, but to which that title would no longer be applied.

Any alteration or attempted standardization of accounting terminology can be expected to have cogency only to the extent that it is sanctioned by the American Institute of Accountants. It is proper, also, to expect that the institute, in considering suggestions of this nature, should act through its committee on accounting terminology. As this committee has asked for suggestions and co-operation from the membership of the institute, the proposals as to terminology offered in this paper may be considered an open letter addressed to the committee.

Classification of Reserves.

Before discussing various reserves and offering suggestions as to terminology, I wish to submit a classification of the accounts to which the term "reserve" has been applied. Various classifications have appeared in texts. One writer classifies them as real and nominal; another as operating and non-operating; another as necessary and voluntary; another as valuation reserves and proprietorship reserves; another as reserves out of income and reserves out of surplus. It seems to me that there should be three main groups, with subdivisions, as follows:

I. Profit-and-loss reserves, set up by debits to profit and loss, because some expense, properly chargeable to current operations, has resulted in
   - (a) A decrease in the value of an asset; or
   - (b) The creation of a liability.

   (For the sake of emphasis I may say that later in this paper I shall suggest that the term "reserve" be restricted to accounts of this class, and that other terms be applied to accounts belonging in other classes.)

II. Surplus reserves, representing
   - (a) Conservative provisions for possible future losses, not already incurred; and
   - (b) Appropriations of surplus, ear-marked as unavailable for dividends because of
     - (1) Contracts with bondholders, other creditors, or preferred stockholders, in relation to sinking funds.
     - (2) Action by stockholders or directors intended to limit the payment of dividends for various financial reasons.

III. Reserves for unrealized profits.

This three-fold classification recognizes that some reserves are set up because expenses and losses have decreased the net profits; reserves of the second class represent, not deductions from net profit or total surplus, but merely a division of the surplus into two parts: surplus which is available for dividends and surplus which, for the time being at least, is not available for dividends; while reserves of the third class represent unrealized profits which, if put on the books at all, should be kept out of surplus.

Distinction Between Profit-and-Loss Reserves and Surplus Reserves.

Before discussing profit-and-loss reserves I want to make as clear a distinction as I can between profit-and-loss reserves and surplus reserves. Profit-and-loss reserves are set up by charges to nominal accounts or some section of the profit-and-loss account, and are necessitated by the fact that some expense has reduced the net profit for the period. Mr. Dickinson calls them "necessary" reserves. The term "necessary," as applied to these reserves, does not seem sufficiently restrictive, because some appropriations of surplus which do not in any sense represent expenses or losses are necessary. For instance, a reserve for sinking fund is necessary if the contract with the bondholders requires it. However, Mr. Dickinson's meaning is clear: the reserve is necessary in order to determine the true net profit.

To be a true profit-and-loss reserve, the account must represent a provision for an expense or a loss which has already been incurred and is properly chargeable to current income. It is not necessary that its amount be definitely ascertainable, but there must be a certainty, or at least a high degree of probability, that the loss has actually been incurred as a result of past operations.

To show the difference between a profit-and-loss reserve and a surplus reserve, let us assume that a company owns valuable machinery which it uses in manufacturing a peculiar type of product and it could not use in the manufacture of any other product. A reserve for depreciation will be necessary because of the certainty that depreciation is continually taking place. Since depreciation is a proper charge against current operations, the reserve for depreciation is a profit-and-loss reserve.

But there is also a possibility that the product manufactured by this machine may be superseded by some other article, or that a new machine may be invented which will render the machine now owned obsolete. It may therefore be desirable to set up a reserve for supersession or obsolescence. This will not be a profit-and-loss reserve because the loss has not yet occurred, there is no certainty that it will ever occur, and even if it does occur it will not be a result of the company's operations. If a provision is made for this possible loss—and it would be conservative to make such a provision—it should be made out of surplus, and the account representing the provision should be recognized as a part of the surplus and so be shown on the balance-sheet.

Having made this distinction between profit-and-loss reserves and surplus reserves, I wish to make two suggestions as to terminology before proceeding to a further discussion of profit-and-loss reserves. These suggestions are:

First, that the term "reserve" be applied only to accounts set up because of operating expenses or losses, and that accounts set up out of surplus to provide for contingent future losses shall be given some title other than "reserve".

Second, that if the amount of the operating expense or loss can be definitely computed it should be booked in some manner other than by crediting a reserve.

If these suggestions should be adopted, the reader of a balance-sheet could be sure that all reserve accounts appearing therein represent provisions for operating expenses actually incurred and not merely contingent, but impossible of exact computation at the present time. And if self-explanatory titles can be found for the other accounts now appearing as reserves, much of the cause for confusion will be avoided.

Profit-and-Loss Reserves.

Profit-and-loss reserves, set up because of current operating expenses, may be divided into two sub-classes: reserves representing deductions from the value of assets and reserves representing liabilities.

Let us consider the first sub-class: reserves representing deductions from the value of assets. I have suggested that the term "reserve" be used only in case the amount of the expense or loss, and consequently the amount of the decrease in asset value, can not be definitely computed. This is the case with the reserve for depreciation, the reserve for depletion and the reserve for bad debts. These titles should be retained. The layman is already fairly familiar with them; the deduction of the reserve from the related asset account makes the nature of the reserve self-evident; and the layman can be relied upon to realize that an exact computation of the deduction is impossible and that the reserve is only an estimate.

But reserves have often been set up to record decreases in asset values which are exactly measurable. As an illustration, let us assume that a company leases property for a period of ten years and proceeds to make leasehold improvements which will revert to the owner of the real estate at the expiration of the lease. The asset of leasehold improvements decreases in value by exactly one-tenth of the cost. Some accountants might set up a reserve for leasehold improvements; but since the amount of the annual reduction in value is definitely known, it would seem preferable to write down the asset.

Turning now to the second sub-class of profit-and-loss reserves, those representing liabilities for expenses already incurred, we find that the amount of the liability may be only an estimate or it may be definitely known. If the amount of the liability is only an estimate, as in the case of accrued taxes, there can be no objection to the use of the reserve title, although I am inclined to believe that greater clearness would be obtained by using a self-defining title such as "estimated liability for taxes".

But when the amount of the liability can be accurately computed, it seems preferable to record the liability in some account other than a reserve. Mr. Kester has stated this point clearly and emphatically, as follows:

> "Why unpaid expenses of any kind should be called reserves for expenses when the amount of them is definitely known has never been satisfactorily explained; yet the practice is sometimes met. There is some excuse in the case of expense items the amount of which cannot be definitely determined either from the nature of the item itself or other condition over which the concern has no control. Thus, 'reserve for wages' is usually a misnomer, the title 'wages accrued' showing the item correctly; but 'reserve for taxes', while just as true a liability as the other item, may be justified on the ground that the latter is only an estimate subject to correction when the exact amount is known, whereas the former is already definitely known."*

Before proceeding to a consideration of surplus reserves and reserves for unrealized profit, I should like to summarize what

* Roy B. Kester, *Accounting Theory and Practice,* vol. 2, page 415.

has been said about proft-and-loss reserves. I have suggested that the term "reserve" be used only in case the account is set up because an actual operating expense or loss of unascertainable amount is known to have occurred. If the loss is contingent and problematical it may be provided for out of surplus, but the provision should not be called a reserve. If the loss is certain in amount it should be recorded otherwise than by a reserve.

Thus, estimated deductions from assets on account of depreciation, depletion and bad debts and estimated liabilities for expenses such as taxes would be recorded in reserves. Exactly measurable deductions from assets would be recorded by writing down the asset accounts; exactly measurable liabilities for expenses would be recorded in liability accounts. Contingent deductions from assets and contingent liabilities on account of expenses or losses which may or may not occur in the future would be provided for as conservative appropriations of surplus.

Surplus Reserves.

This brings us to the second main class of reserves, namely surplus reserves. These may be divided into two sub-classes, as follows:

(a) Conservative provisions for possible or contingent future losses; and

(b) Appropriations of surplus for financial purposes, such as the sinking-fund reserve or the reserve for extension of plant.

Both these classes of surplus reserves have this distinctive and very important feature in common: they are a part of the surplus and should be shown as such on the balance-sheet.

Dealing with the first sub-class, conservative provisions for contingent losses, we find that it may be further subdivided, for if the contingency becomes a reality the loss may result in decreasing the value of an asset or in creating a liability. To illustrate a contingent reserve for loss on an asset, let us assume that the books are closed using the market value of the inventory at December 31st, which is lower than cost; but there is danger that the market may still further decline, causing additional loss. Consequently a reserve is set up by charging surplus and crediting a reserve for market fluctuations in inventory. This reserve provides for a contingent loss on an asset.

To illustrate a contingent loss which may result in a liability, let us assume that this concern employs men to work in its factory, and that there is a possibility that workmen may be injured and liabilities for damages incurred thereby. A reserve may be set up to provide for this contingent loss and contingent liability.

Concerning surplus reserves for contingent losses, I wish to express an opinion on four points:

First, when a reserve is set up to provide for a loss, the profit-and-loss account should be charged only in case the loss has already been incurred. If the loss is contingent, the charge should be made against surplus. Thus, in closing the books at the end of 1921, a reserve for possible losses in inventories due to any market declines which may take place in 1922 should not be charged against current profits of 1921, because the loss has not yet occurred, it may never occur, and if it does occur it will be a loss of 1922. If a reserve for accidents is being set up at the end of 1921 because future accidents may result in liabilities, this reserve should be a charge against surplus.

I am willing to go so far as to say that a reserve for fire loss, in case of self-insurance, should be created out of surplus and not out of current income. It may sound radical to say that profit and loss should not be charged when the reserve for insurance is credited, and I am not sure that I would have the temerity to make the assertion if I were not supported by the good authority of Mr. Dickinson, who places the "provision for insurance against future possible losses from fire and other insurable risks" among the "mere allocations of surplus."* Moreover, it seems to be a position which can be logically defended. Profit and loss ought not to be charged unless a loss has already occurred. The amount may not be ascertainable, but it must have occurred before profit and loss can properly be charged, and it must have been the result of past operations. Now a loss can not occur without reducing the value of an asset or creating a liability, and conversely if the assets have not been reduced in value and if a liability has not been created there can have been no loss. This seems to be the case when a reserve for fire loss is set up. Until the fire occurs, the assets are still in existence; the net worth has not diminished; there has been no loss which is properly chargeable against operations (even assuming that

* A. Lowes Dickinson, *Accounting Practice and Procedure,* pages 149 and 150.

a fire loss is an operating expense), and the reserve is a part of the surplus. It may be argued that where available experience figures are adequate to furnish a trustworthy estimate of the future loss, a periodical charge should be made to operations to equalize this loss in order to maintain uniformity. The answer to that argument seems to be that an appearance of uniformity is not desirable when there is no real uniformity.

The second thing I wish to say in regard to surplus reserves for future contingencies is that if a loss does occur it should be charged against the reserve only in case it is an extraneous loss, and that if it is an operating loss it should be charged to profit and loss regardless of the existence of the reserve.

To illustrate, assume that a reserve is set up at the end of 1921 for possible losses on inventories from market declines which may take place in 1922. If the loss occurs it should be dealt with as other operating expenses are dealt with and should be reflected in the profit-and-loss account for 1922. Unless the reserve is needed for other possible losses, it should be returned intact to surplus. But if a reserve has been set up for fire losses, the reserve may properly be charged in the event of a fire. A fire loss is extraneous to operations; it is a proper charge to surplus, and the reserve for fire loss is merely a portion of the surplus set apart and retained for the purpose of absorbing such losses.

The third thing I wish to say is that, since such reserves are in reality surplus, they should be called surplus, although the title of the account should indicate that it represents surplus reserved or withheld from dividends in order to avoid a deficit in the event of some specified loss. I suggest such titles as "surplus reserved for contingent fire loss," "surplus reserved for contingent accident loss" and "surplus reserved for contingent inventory loss."

The fourth thing is that these accounts should appear in the balance-sheet as a part of the surplus. Thus in the balance-sheet we might have:

Surplus:		
Reserved for contingent fire loss	$25,000.00	
Reserved for contingent inventory loss	10,000.00	
Total surplus not available for dividends	35,000.00	
Free and available for dividends	60,000.00	
Total surplus		$95,000.00

We now come to the second sub-class of surplus reserves: those which are appropriations of surplus, not intended as provisions for contingent losses but designated as not available for dividends because of a contract with bondholders or stockholders or because of some financial policy of the management. In this class we find the reserve for sinking fund, the reserve for working capital and the reserve for extension of plant.

In discussing this class of reserves, I have six things to say.

First, it would be advisable to discontinue the use of the term "reserve" and use in its place the term appropriated surplus —thus, "surplus appropriated for sinking fund," "surplus appropriated for working capital" and "surplus appropriated for extension of plant."

Second, these accounts should be shown on the balance-sheet as part of the surplus, thus:

Surplus:

Reserved for contingent fire loss	$25,000.00	
Appropriated for sinking fund	10,000.00	
Total surplus not available for dividends	35,000.00	
Free and available for dividends	60,000.00	
Total surplus		$95,000.00

Third, in the case of so-called sinking-fund reserves, the appropriated surplus should be the amount which ought to be in the fund if the corporation were exactly meeting its obligations in the matter of contributions and if interest were being accumulated at the theoretical rate used in determining the amount of the annual contributions. Thus the fund account will show what is actually in the fund, while the reserve will show what ought to be in the fund.

Fourth, these accounts should not be set up by charges to profit-and-loss, and their existence should in no way affect the profit-and-loss account. There was a time when the credit to the sinking-fund reserve was offset by a debit to profit-and-loss. This is no longer done, but many accountants still charge sinking-fund expenses against the reserve and credit sinking-fund income to the reserve instead of passing them both through the revenue account. Thus the existence of the reserve does improperly affect the profit-and-loss account. It is wrong to charge profit-and-loss and credit the reserve when the cash contributions are made to the fund, because current income is thereby understated; and it seems equally incorrect to understate current income by crediting sinking-fund earnings direct to the reserve instead of passing them through the revenue account.

Fifth, these reserves may be required by contract or they may be optional. The trust indenture of a bond issue may specifically require the segregation of surplus as well as the creation of a fund; or the requirement may be implied by the provision that the sinking fund shall be provided "out of profits." The same may be said if the sinking fund is to be used for the retirement of preferred stock.

It is often contended that an appropriation of surplus for a sinking fund for bonds or for preferred stock is expedient even though it is not obligatory. The argument in support of this contention runs somewhat as follows: The bonds or preferred stocks were issued because additional fixed assets were required and the funds for their construction could not be spared from the working capital. And since it is impossible to make sinking-fund contributions and also to pay dividends to the full amount of the profits without an eventual impairment of the working capital it is advisable to set up a sinking-fund reserve or appropriation of surplus to prevent the payment of dividends to the full extent of the profits.

While it is true that the payment of annual dividends equal to the annual profits would in many cases result in an impairment of the working capital, it does not seem to follow that the creation of an appropriated-surplus account is essential. It is not essential if the directors can be relied upon to give due consideration to financial requirements when determining the amount of dividends to be paid. Corporate directors as a class can scarcely be charged with having sacrificed the financial stability of the corporations under their control by unwise dividend policies, and it is doubtful whether they need the self-imposed restriction of an appropriated-surplus account. It is sometimes said that the reserve is desirable to prevent stockholders from clamoring for dividends equal to the balance of the surplus account. If this reasoning is sound, the logical conclusion would be that the directors should transfer from ordinary surplus to permanent surplus all of the balance of the former account except the amount which can safely be paid in dividends. This surely is not necessary as the very purpose of the surplus account is to carry the profits not to be distributed as dividends.

Sixth, if the sinking-fund reserve or appropriated-surplus account is required by contract, it should not be returned to surplus until the last bondholder or preferred stockholder has been paid off through the sinking fund. This question rarely arises in regard to a sinking fund for bonds, but it does arise in regard to a so-called sinking fund for preferred stock, because of the difference in the methods of operating the two types of funds. When a sinking fund is created for bonds, the bonds purchased for the fund are held alive: thus the fund and the reserve steadily increase in amount until the maturity of the issue. But the sinking fund for preferred stock is increased by contributions and forthwith decreased by the purchase and cancellation of stock. The fund rises and falls; it does not steadily accumulate. Then why accumulate the appropriated surplus? Because the appropriation of surplus is made in order to safeguard the working capital, to avoid the jeopardizing of future earnings and to maintain the company in an income-producing condition that will enable it to meet future sinking-fund requirements for the retirement of the remaining stock. The last preferred stockholder to be paid off through the sinking fund has the right to this protection.

Unrealized-profit Reserves

Finally, we come to the third main class of reserves: accounts which are set up because fixed assets have increased in market value and because the write-up ought not to be carried into surplus. For these accounts I suggest the title "unrealized increment." For instance, "unrealized increment in land value" or "unrealized increment in plant value." Thus we would get away from one more use of the term "reserve," and the term "unrealized profit" is self-contradictory. If the increase in value is unrealized it can not be a profit.

Some might say, Credit capital surplus. In my opinion the word "surplus" should not appear in the title of an account unless that account contains real surplus, either appropriated for some reason or free for dividends. Let the surplus account contain operating profits, and let the capital-surplus account contain extraneous additions to surplus which, though not arising from operations, are nevertheless realized and legally available for dividends.

Others may say, Keep the increase in market value off the books. This has often been said, but it seems to me that it is not necessary. It is only necessary to make sure that the corporation does not credit the increase to surplus and incur the risks of using this credit for dividends. If the credit is passed to an unrealized increment account, clearly understood to be unavailable for dividends, and so shown on the balance-sheet, I see no objection to allowing the corporation to show the present value of its fixed property.

Summary.

To summarize, so far as terminology is concerned, I suggest that the term "reserve" be used only when some expense, properly chargeable to profit-and-loss, has decreased the value of an asset by an indeterminable amount or created a liability which can not be accurately computed. Thus the appearance of a reserve on the balance-sheet would always mean that profit-and-loss had been charged for an estimated operating expense.

If the amount of the decrease in the value of the asset is exactly measurable, credit the asset account; if the amount of the liability is exactly measurable, credit a liability account.

If the loss has not yet occurred, but is contingent upon some future and uncertain event, any provision for the loss should be made out of surplus; the account should be called "surplus reserved" for this or that contingency; and it should appear on the balance-sheet as a part of the net worth.

Mere appropriations of surplus, for sinking funds, working capital, extensions, equalization of dividends, etc., should be called "surplus appropriated" for such and such a purpose; and so-called unrealized profits should be credited to unrealized-increment accounts.