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Terminology Department

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CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The committee on terminology presents in this issue of *THE JOURNAL OF ACCOUNTANCY* definitions of:

Accrue
Allowance
Provision
Requirement
Reserve
Surplus

Accrue:

This word conveys the following meanings:

- (a) To accumulate, as an accrual of interest.
- (b) To come as a natural result or increment, as by growth.
- (c) To come into existence, as a right or the like.
- (d) To arise, as an addition, accession or advantage.
- (e) To become vested (legal usage), indicating a present and enforceable right or demand.
- (f) To increase (rare usage.)

The meaning most commonly met in accounting practice is that of accumulation [(a) above] based upon lapse of time, e.g., in the case of interest it signifies an accumulation to a stated date of an item receivable or payable at a later date but covering a period commencing prior to the stated date.

Allowance:

This word conveys the idea of that which is approved, permitted, awarded, conceded, yielded or assigned.

As used in accounting it indicates—

1. A recognition of modifying circumstances or a margin for deviations from standard; specifically
 - (a) A deduction from the purchase or selling price of commodities on account of short weight, inferior quality, damaged goods, delayed delivery, breach of contract, etc. Such deductions should be made directly from the accounts which they affect.
 - (b) A deduction from the amount charged for personal services rendered, for work performed or for service furnished (heat, light, telephone, transportation, etc.), either receivable or payable, on account of dissatisfaction, breach of contract, etc.
 - (c) A deduction of a lump sum from an amount receivable or payable for prompt payment, as distinct from a percentage discount.

The above allowances are deductible from the accounts containing the items upon which the allowances are made, whether such accounts be nominal or real.

2. An amount granted for a specific purpose, e. g., an allowance for office rent; an allowance in lieu of actual expenses.

In law the word is used to denote an extra sum awarded, in addition to regular costs, to the successful party in a difficult case.

In minting the word is used to denote a permissible deviation in the fineness and weight of coins, owing to the difficulty in securing exact conformity to standard prescribed by law.

Note: The word "allowance" is occasionally used synonymously with "reserve," e. g., allowance for depreciation or allowance for bad debts, but this usage should be discouraged.

Provision:

This word is used as a substitute for "reserve" but should only provide:

- (a) For *liabilities known to exist*, the exact amount of which will not be known until a later date, e. g., income taxes, overlapping accounts payable (bills or invoices not received or not audited and not entered on books), dividends declared but the amount of which is not known because of outstanding convertibles.
- (b) For *disputed liabilities* arising out of or due to past operations or activities, e. g., judgments payable on appeal, additional income taxes levied but disputed and under review by the taxing authorities or being adjudicated in the courts. Obligations contingent upon the future action or non-action of other parties should be reserved for and not provided for, e. g., reserve for notes discounted.

In its legal sense the word (usually in the plural) means a distinct stipulation, the part of an agreement, arrangement or rule referring to one specific thing, e. g., the provisions of a bill.

Requirement:

This word conveys the idea of something that is needed by virtue of the attendant circumstances or the nature of things; a necessity or requisite; something that must be provided for in a financial way.

In its legal sense, the word indicates a condition that must be met or a rule that must be observed.

Reserve:

The correct use of this word, as applied to an account, will be facilitated by reference to its derivation, *re*, back, and *servare*, to keep, i. e., a keeping back or withholding.

A reserve account indicates a segregation of and withholding for a specific purpose of past or current profits, revenue or income from any source. It is invariably a credit account and may be provided to cover:

1. An estimated loss in value of physical property which has theoretically occurred in the past or is due to or arises from past operations or activities; e. g., reserve for wear and tear.
2. An estimated or actual loss in value of choses in action, e. g., reserve for bad and doubtful debts, reserve for depreciation or

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fluctuation of securities (to cover repudiation, bankruptcy, insolvency or merely a temporary fluctuation.)

3. A discounting or proration of future estimated or actual loss of exclusive use or possession of intangible capital such as patents, copyrights, franchises, leaseholds, rights of way, water rights or special terminable privileges or rights of any kind which have been capitalized. A *reserve for amortization* should be used in this case where lapse of time is the governing factor.
4. An estimated loss in value of physical property which may (problematical as to occurrence) or will (problematical as to extent) occur in the future, e. g., a self-insurance reserve to cover loss by fire, accident, casualty or action of the elements.
5. An estimated future expenditure for compensation to employees or other necessitated by reason of the foregoing contingencies, e. g., reserve for workmen's compensation or reserve for accident liability.
6. An estimated future expenditure or loss occasioned by guaranties or endorsements, contingent upon the future action or non-action of other parties to the transactions; e. g., a reserve for notes discounted or a reserve for accommodation endorsements; or an estimated future expenditure or loss contingent upon breach of warranty, or upon non-fulfillment of contractual conditions, e. g., reserve for tire mileage.
7. An estimated future expenditure for capital outlay, the reserve being created to conserve the available cash balance by reducing the amount of unappropriated surplus, e. g., reserve for capital additions. From the standpoint of accounting terminology, this is an unfortunate use of the word "reserve." "Appropriated surplus" is a preferable designation.
8. An actual or estimated loss in value of tangible property of any kind which has occurred in the past, partly or wholly recoverable by insurance and in process of amicable adjustment with or disputed by insurers; e. g., reserve for fire loss.

A loss of possession of tangible property of any kind due to burglary, larceny, embezzlement or defalcation, not covered by insurance, should, upon discovery, be written off to an appropriate nominal account. A reserve should not be created for such loss. The property value should be reinstated in the assets and the nominal account should be credited, if and when recovery ensues. If, however, the exact amount of the loss may not be determined for some time, an appropriate reserve account may be set up in the books as a temporary expedient, subject to clearance and adjustment when the facts are known.

A reserve account which is created to cover losses in the past or an amortization reserve for future loss of use or possession is, in effect, abatement of the corresponding assets, whereas reserve accounts created to cover losses and attendant expenses which may or will occur in the future or to cover future capital outlays or other future expenditures are

mere segregations of surplus and as such are part of the true net worth of a business.

Some eminent accountants have used the word reserve as descriptive of a "reserve fund," but this practice, which is an excellent example of the confusion existing in accounting terminology, is falling into disuse.

Reserve is also used in a descriptive sense to denote something stored up for future use or in excess of current needs, e. g., a reserve stock of materials, or to denote something set apart for a particular purpose, e. g., a reserve of land, but in neither case is it customary to give effect to the designation in the books of account.

In still another sense reserve is used to denote the minimum ratio of cash and choses in action to the amount due depositors which banks are required by law to maintain at all times.

Note: A reserve for loss on containers or on other property delivered to vendees and to be returned by them has fallen into disuse in most industries as such loss is now usually obviated by a tentative charge or actual deposit.

Surplus:

This word is a contraction of two Latin words, *super*, meaning above, and *plus*, meaning more: an overplus; something left over after certain requirements are fulfilled.

As applied to corporations or similar forms of legal entity organized and conducted for profit, surplus, in its broadest significance, measures the excess of assets over liabilities and capital. When used without qualification, or designated as "unappropriated," "free" and the like, and in absence of legal restriction, it indicates the maximum amount of undistributed profits which, if available in liquid form, may be distributed to stockholders or other legal participants in the discretion of directors or others charged with such distribution, as stated below. When designated as "manufacturing," "operating," and the like, it indicates the accrued profits pertaining to a certain phase of a business. When designated as "appropriated," "reserved," and the like, it indicates the amount of undistributed profits withheld for some specific purpose.

Surplus (a) may be accumulated through the normal operations of a business, (b) it may be paid in upon incorporation or as part of later financing, (c) it may result from a reappraisal of assets, reflecting thereby either a correction or adjustment of former account classification or an unearned increment, (d) it may be acquired through the purchase of a company's own stock or obligations, or in other ways. However, surplus is surplus by whatever legal means acquired and is distributable as such, subject to the facts, legal aspects and moral restrictions applicable to each case.

In some corporations "profit and loss," "undivided profits," or "loss and gain" is used in place of "surplus," and in other cases two accounts are kept, the former to reflect the results of current operations, while "surplus" is the account to which the former is closed at the end of a fiscal period.

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In partnership accounts, the account corresponding to "surplus" is usually designated as "profit and loss" or as "undistributed profits" and is distributable in accordance with the partnership agreement, whether written or oral.

The surplus of a government (federal, state or city) or of a corporation or other form of legal entity not organized or conducted for profit (e. g., an educational, eleemosynary or religious organization) indicates the excess of available resources over obligations and commitments, which may be applied to or used for future activities.

Communications should be addressed to any one of the undersigned.

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Flack & Flack of Melbourne, Sydney, Brisbane and Perth (Australia) announce the opening of an office at Steamship buildings, Currie street, Adelaide, South Australia.

Naramore & Miles announce the opening of a branch office at 305 Proctor building, Troy, New York.