

7-1935

## Reserve for Contingencies

A. S. Fedde

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

---

### Recommended Citation

Fedde, A. S. (1935) "Reserve for Contingencies," *Journal of Accountancy*. Vol. 60 : Iss. 1 , Article 3.  
Available at: <https://egrove.olemiss.edu/jofa/vol60/iss1/3>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact [egrove@olemiss.edu](mailto:egrove@olemiss.edu).

## Reserve for Contingencies

BY A. S. FEDDE

Admittedly, one of the most important functions of accounts is that of indicating the differentiation between capital and income in the segregation and apportionment of charges and credits, so that income and accumulated balance of income may be correctly determined and stated. There appears to be room for more preciseness in the titles of reserves carried in the balance-sheet in order that their classification may be correctly interpreted.

Absence of exactness may occasionally arise by reason of the naming of reserve accounts in directors' resolutions, possibly without very definite understanding of the implications contained in the titles used. Statements, obviously, should be at least clear enough that a stockholder may have an opportunity to recognize the difference between equity or proprietorship accounts; those reserves which effect a reduction of stated asset values; and those providing for liabilities (again distinguished as between expected capital outlay and possible or expected outlay normally chargeable against income).

The reserve account, which in many instances leaves the stockholder absolutely in the dark as to its nature, is the frequently used "reserve for contingencies." This title has been used upon occasion for a valuation reserve against book values to provide for the difference between cost and market of securities carried as investments; the title has been given to credits set up to provide for expense contingencies which appeared as possible charges, though not yet ascertained; and it has been used as a surplus reserve, thinly veiled under this caption apparently so that stockholders should not view the amount as available undistributed surplus.

In a report of a special committee on terminology published under the auspices of the American Institute of Accountants the following tentative definitions appear:

- "Contingent reserve: An account with a credit balance set up by a charge to profit-and-loss or to surplus, representing a provision out of profits for an uncertain future loss or expense."
- "Reserve for contingencies: An amount set up out of apparent net worth to provide against any unforeseen loss or requirement. It is sometimes doubtful whether reserves set up for contin-

gencies should be treated as liabilities or as part of the surplus. If there are no definite reasons for expecting losses the reserve would seem to be part of the surplus."

The dictionary definition of "contingent" is: likely or liable but not certain to occur; fortuitous; possible, probable. "Contingency" means a possibility of happening.

No investor nor even an accountant can tell from published accounts containing the term "reserve for contingencies", without explanatory notes, how to classify the reserves; and where the provision is made by a charge to income account he may be utterly misled. Here is a commonly used accounting term which, in its daily use, can not be distinguished as to what it means. It is neither fish, flesh nor good red herring, though sometimes reminiscent of a mackerel.

There seems to be a shadowy distinction between something that is contingent and a contingency. The latter seems, perhaps, a trifle more remote. Such a distinction, which may be purely imagination on my part, does not seem excusable in accounting terminology.

It would seem reasonable that contingencies to be reserved for should have some connection with the business and be susceptible of some estimate. Such might be payments of damages in the event of adverse decisions in suits, alleged tax deficiencies or imminent losses from failure of customers or others to fulfill contracts. But, as it is most frequently used, the reserve for contingencies has no connection with any contingent expense and is in most cases a segregation of a portion of surplus.

However, the title has an easy, mouth-filling, unctuous sound and is not likely to be discontinued, so it will probably avail us nothing to disapprove of it. We can nevertheless lay hold of it and say it shall be one thing or another, according to good accounting practice. I would, therefore, suggest that it should not be used as a valuation reserve, nor as a reserve for known expense possibilities, but solely as a reserve for unknown contingencies—that is, purely as a surplus reserve. And being for unknown contingencies, future ascertained costs or losses should not find therein an unmarked grave but be charged, if no specific provision therefor has been made, to current income account or in exceptional cases to accumulated income, i. e., to earned surplus. The creation of the reserve should not be permitted to confuse the amount of current earnings but should be a transfer out of sur-

plus; and, when no longer desired or needed, either in whole or in part, it should be returned to surplus account.

The question remains as to what shall be done to provide for costs or losses which are not yet determined but are a genuine possibility. That problem is easily met by the entry of a charge to current income and a credit to a reserve properly captioned to identify it with the specific purpose and related in amount to a reasonable estimate of the cost which, without such provision, would become properly chargeable to income account. If in such case the term "contingencies" is desired, perhaps as a matter of policy in order not to disclose the nature of the possible loss or costs to be provided for, let the account be designated "reserve for specific contingencies."