PROBLEMS IN RELATION TO HIDDEN RESERVES, A CANADIAN VIEW

by J. G. Arthur, B.A., F.C.A.

In his article on "Auditing Problems in Relation to Hidden Reserves, a British View" which appeared in this journal in June 1962, Sir Thomas Robson stated that hidden or secret reserves may be divided into two kinds, which he described as follows:

> "The first is confined to undisclosed applications of profits to reduce by an amount materially greater than is necessary the amounts at which assets are stated in the books of an undertaking, to provide amounts materially greater than are required to meet liabilities, losses and commitments, and to write off capital expenditure on additions to plant, buildings and other assets as if it were an ordinary working expense of the year."

The second kind arises

> "... where, unless accompanied by supplemental information, the use of the historical cost basis of accounting ... would result in failure to reflect and disclose material appreciation in the value of assets or other facts of a character highly relevant to an adequate understanding of the significance of the accounts and the state of the company's affairs."

A secret reserve is defined in "Accounting Terminology", a publication of the Canadian Institute of Chartered Accountants, as

> "A hidden or inner reserve, which is not disclosed in the financial statement, and may or may not be a matter of formal record. A secret reserve is an understatement or omission of assets, or an overstatement of liabilities."

Although the meaning of the term "secret reserve" is expressed in somewhat different language in the foregoing definitions, it is apparent that the general understanding of the term is much the same in Canada as in Britain.

Canadian law, for the most part, has its roots in British law and in particular much of Canadian commercial law and commercial practice is derived from British sources. Likewise, the accounting profession in Canada has been greatly influenced by British precedent. British accountants, who had settled in Canada, played considerable part in founding the first Canadian professional accounting bodies in the latter part of the nineteenth century. It is not surprising therefore, that Canadian accounting practices have many points in common with British practices. In particular, the Canadian position relating to secret reserves closely parallels the British position as described in Sir Thomas Robson's article and, accordingly, I shall not attempt to duplicate in this article what he has done so well, other than to comment on some aspects of the problems which are relevant in Canada.

Accounting Developments and the Profession

There have been marked changes in accounting and auditing practices and principles in the years since the first professional accounting bodies were organized in Canada. Before the turn of the century, Canada's economy was largely based on agriculture and forest products. The business community was relatively small and was comprised, in large part, of sole proprietors or small companies and the owners of such companies were usually closely connected with the day-to-day operations. Public accountants devoted much of their time to bookkeeping duties or acting as trustees and liquidators in bankruptcy and, although some auditing was done, their influence on accounting thought was not particularly great. Because many business enterprises were closely held, accounts were not widely circulated. Such accounts as were published were often prepared on an excessively conservative basis and the use of secret reserves was widely accepted.

Business activity and the accounting profession both grew relatively slowly until the outbreak of World War I in 1914. During the war years, however business and the profession both expanded rapidly. In 1917 the Canadian Parliament introduced, for the first time, income tax laws which taxed business and personal incomes. One of the results of this was to bring about a greater measure of uniformity in the methods used in the determination of business income. Although, in the early years after the introduction of the income tax, wide differences continued to exist, mainly because of administrative inexperience. While the use of secret reserves continued in that period, the taxation authorities gradually developed regulations which had a part in discouraging the practice.

Concurrent with the growth of the economy during the first war, there was an increase in the number of widely held public companies, in which management and ownership had become separated. The public accountant devoted a larger part of his time to acting as shareholders' auditor of public companies and he was able to exercise a growing influence on matters relating to financial disclosure. The professional accounting bodies began to develop, or to adopt mainly from British or American sources, certain generally accepted accounting standards which, amongst other things, also tended to discourage the use of secret reserves in the determination of business income.

Present Position

Business activity continued to expand after the first war and following another period of rapid growth during the second world war and thereafter, Canada has become a highly industrialized country. The professional accounting bodies have kept pace with this growth. They occupy a position of importance in the business life of the country and they provide leadership in the development of current accounting thought.

With the exception of the Canadian chartered banks and certain other financial institutions, such as trust companies, it can be said that the use of secret reserves in the sense of writing down the value of assets or overstating liabilities, has all but disappeared in Canada. In the case of corporations, which may be organized under either the federal Companies Act or any one of the companies acts of each of the ten provinces, there is no statutory authority for the use of secret reserves.

In the case of chartered banks, which are subject to the federal Bank Act, there is statutory recognition of so-called contingency reserves, which are, in effect, secret reserves. The position is taken that it is in the public interest to permit the chartered banks to create secret reserves out of income for the purpose of providing for contingencies, which will enable them to withstand periods of economic stress without unduly disturbing public confidence. The Bank Act is revised every ten years and the next revision is expected to be made in 1964. A Royal Commission is, at present, considering certain aspects of the banking laws in Canada and the opinion has occasionally been expressed that use of secret reserves in the accounts of banks should be discontinued.

Trust companies sometimes carry their investments in securities at less than cost and the market value thereof is not always indicated other than, in some cases, by a statement to the effect that the carrying value of securities is not in excess of their market value. In such cases, a secret reserve has been created, to the extent that the carrying value of securities is less than original cost. The non-disclosure of the excess of market value over original cost represents a further secret reserve, in the second sense of the term, as used in Sir Thomas Robson's article.

One of the most important influences on accounting practices in Canada, apart from statutory requirements, is the series of accounting and auditing practices bulletins issued by the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants. The Canadian Institute is comprised of the members of the ten provincial institutes of Chartered Accountants and it represents, by far, the largest group of public accountants in Canada. Those bulletins set out the Committee's views on certain accepted accounting and auditing practices and the members of the various provincial institutes are expected to take cognizance of the bulletins in carrying out their duties as auditors.

The Uses of Reserves

In bulletin No. 9, issued in January, 1953, the Committee set out its views on the use of the term reserve and accounting for reserves. The Committee commented on the practice, which was widely followed at that time, of using the term reserve in circumstances such as the following:

(a) Reserve for doubtful accounts when used to describe a deduction from accounts receivable to reduce them to the amount expected to be realized.
(b) Reserve for depreciation to describe a deduction made from the stated value of fixed assets (such as buildings or machinery) to indicate that portion of the cost that has been charged to expenses in the profit and loss account.
(c) Reserves to describe certain liabilities where the amount could not of necessity, be precisely computed, such as liability for taxes.
(d) Reserves for services to be provided in the future.

The Committee recommended that the term „reserve" should not be used in the foregoing senses for the purpose of designating amounts provided in respect of actual liabilities, deferred income or dimunitions in the value of assets.

It was suggested that the following terminology be used to replace the inappropriate use of the term „reserve" in the examples cited in items (a) to (d) above:

(a) Allowance for doubtful accounts
(b) Accumulated allowance for depreciation
(c) Income taxes payable (estimated)
(d) Services paid for in advance

It was also recommended that the term „reserve" be used in future only to designate amounts which have been appropriated from net profits or other surplus:
(a) At the discretion of management, e.g. reserves for general contingencies, reserves for future decline in inventory values, reserves for plant extension or

(b) Pursuant to the requirements of a statute, the instrument of incorporation or by-laws of a company or a trust indenture or other agreement, e.g. sinking fund reserves, general reserves, preferred stock redemption reserves.

In accounting for reserves, it was recommended that charges should not be made against reserves which would relieve the profit and loss account of charges that should be properly taken into account in determining net profit or loss for the year. Reserves can only be regarded as discretionary appropriations from earned surplus and should be reduced by transfers to earned surplus account.

The Committee expressed the opinion that since reserves are segregations of earned surplus it is desirable that they be shown on financial statements as constituting part of the shareholders' equity. It was also recommended that changes in reserves during the year should be disclosed.

The Ontario Corporations Act, which was enacted in 1953, contains provisions relating to the use of „reserves" which are very similar to the recommendations contained in bulletin No. 9. With respect to the federal Companies Act and the various companies acts of the other nine provinces, there is a draft uniform companies act under consideration which, if enacted in its present form, would also contain similar provisions relating to „reserves".

Standards of Disclosure

The Committee has also published a bulletin on standards of disclosure in financial statements (Bulletin No. 14 issued in August 1957). The standards set out in that bulletin go considerably beyond the minimum statutory requirements laid down in most of the various companies' acts, mentioned earlier in this article. The bulletin contains specific recommendations as to the disclosure of basis of valuation of assets. In the case of such assets as cash and accounts receivable it is assumed that they are carried at their realizable values and in the case of other assets such as investments, inventories (stock in trade), fixed assets and intangibles, the basis of valuation should be specifically stated.

The recommendations as to reserves and standards of disclosure are applicable to commercial and industrial companies generally. As indicated previously, special circumstances obtain in the case of banks and certain other financial institutions such as trust companies. There are also exceptions in the case of insurance companies, railway companies and public utilities which are subject to special requirements under various statutes and it is not proposed to deal with these here.

The recommended form of auditors' report, as set out in the Committee's Bulletin No. 17 issued in October 1959, requires the auditor, amongst other things, to state whether or not the financial statements, on which he is reporting, present fairly the financial position of a company at a given date and the results of its operations for the financial period ended on that date, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Apart from the Committee's recommendations, the various companies' acts require that the shareholders' auditors shall specifically report on the correctness or fairness of a company's financial statements. It will be apparent therefore, that a member of the Canadian Institute when reporting on the accounts of a commercial or industrial enterprise in Canada has a responsibility to see that there is a plain disclosure, on the basis of historical cost accounting, of the financial position of the enterprise. The creation of secret reserves, in the sense of abritrarily writing down the value of assets or overstating liabilities, is not compatible with the Committee's recommendations and in practice the use of secret reserves in that sense receives little or no support from responsible accountants.

Historical Cost Basis of Accounting

As indicated in the opening paragraph of this article, Sir Thomas Robson stated that the use of the historical cost basis of accounting, unless accompanied by supplementary information, would result in failure to reflect and disclose material appreciation in the value of assets or other facts of a character higly relevant to an adequate understanding of the significance of the accounts and the state of a company's affairs.

Historical cost is the underlying basis, used in Canada, for the purpose of recording most accounting transactions. However, where it is anticipated that certain assets such as accounts receivable, inventories and investments will be realized at less than their carrying values (normally cost), it is the practice to adjust the carrying values of such assets to their estimated realizable values. It follows that it is not normal practice to record, in the accounts, the excess of realizable value over cost. It is appreciated that this practice may not meet the problem of disclosure of material appreciation in the value of certain assets. There are, perhaps, four principal classes of assets where this problem could arise, which are:

(a) Investments
(b) Inventories (stock in trade)
(c) Fixed assets
(d) Intangibles

With regard to investments in marketable securities, the recommended practice calls for disclosure of market values by way of supplementary information to the financial statements and, in the case of securities of subsidiaries held, information is to be given relating to the underlying value as shown by the accounts of unconsolidated subsidiaries. When securities, other than those of subsidiary companies, are held for which there are no public quotations, these are generally shown separately in the financial statements. On occasion, supplementary information is given in the financial statements relating to unquoted securities. However, there are undoubtedly instances where unquoted securities have an underlying value materially in excess of cost which is not disclosed.

The general view on inventories is that they represent costs incurred in the current accounting period which are applicable to a succeeding accounting period and in accordance with the concept of matching costs against income, the excess of realizable value over cost should not be taken up in the accounts until the goods haven been sold. Hence, no recognition is given to the enhancement in value over cost until a sale is effected. However, where the current replacement cost or the estimated realizable value of inventories is less than cost, the carrying value of an inventory of goods is appropriately reduced.

Although cost is the most generally accepted basis of recording the value of fixed assets, appraised values may be recorded in the accounts on occasion. In such circumstances the name of the appraiser and the date of the appraisal are required to be shown as supplementary information to the accounts. There has been considerable discussion in recent years among accountants generally, having regard to the effects of inflation, on the merits of reflecting current values in the accounts in respect of property, plant and equipment and increasing the annual depreciation charge accordingly. This matter has also aroused interest in Canada, however, with the exception of the occasional situation where appraisal values are recorded, which would not be an annual occurrence, the general practice continues to be to carry property, plant and equipment at cost less accumulated depreciation. Generally no attempt is made to disclose current values by way of supplementary information. The position is taken that, over their useful lives, such assets, when used in a business, produce income, after deducting therefrom the annual depreciation charge, and the enhanced value of such assets, if any, assuming an economic price structure, will be reflected in increased earnings. If capital requires to be retained in the business to replace plant at inflated prices, then retained earnings should be kept at an appropriately higher level.

Intangibles are generally understood to include such items as patents, franchise and other rights and goodwill. Here again, the normal practice in Canada is to record intangibles at cost and where they are considered to have a limited life, the cost is amortized over such life, as an expense. Intangibles, by their nature, do not readily lend themselves to a valuation on a current basis and, in any event, the writing up of intangibles with a view to reflecting current values is discouraged.

Conclusion

In summary it can be said that, in Canada, except for certain financial institutions such as banks, there is no statutory recognition of secret reserves and in practice the use of secret reserves, in the sense of abritrarily writing down assets or overstating liabilities, has all but disappeared. It is recognized that by the use of the historical cost method of accounting, secret reserves can exist to the extent that the undisclosed current value exceeds the cost of an asset. However, with the growing trend towards fuller disclosure in the presentation of financial statements, undoubtedly the accounting profession in Canada will be giving increasing thought to this matter.