

# SECRET RESERVE ACCOUNTING: FROM THE PERSPECTIVE OF MANAGEMENT, SHAREHOLDERS AND EMPLOYEES

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**Abstract** *Secret reserves accounting have been described as one of the most celebrated aspects of accounting practices (Arnold, 1997, p. 162). However, while secret reserve accounting may have played a role in promoting public confidence in the banking system, it conflicted with increasing demands from financial report users and regulatory agencies for comprehensive and accurate disclosures of a bank's financial position and performance. Secret reserve accounting may have been a well-intentioned deceit, but it was still a deceit. In this paper I tried to present the beneficial yet conflicting nature of such hidden reserve. The paper begins with an introduction of secret reserve followed by its background which involves its sources, advantages and disadvantages. Next it focuses on how secret reserve created conflicts between different groups like managers, employees, and shareholders. Finally I end the discussion by explaining the position of secret reserve from legal perspective followed by a concluding remark.*

**Keyword:** *Secret Reserve, Tax, Profit, Final Account, Inflation*

## INTRODUCTION

In financial accounting the term reserve is generally used to describe any part of shareholders' equity, with the exception of basic share capital. According to Tulsian (2006, p.49), reserve usually refers to the profit retained in the business not having any of the attributes of a provision. However, if the provision exceeds the amounts needed to meet the loss or liabilities then the excess is to be treated as reserve. In other words, reserve can be treated as accumulated or undistributed profit. It is generally created to strengthen the financial position, provide funds for the modernisation or expansion of the business, comply with legal requirements, and equalise dividends during the period of inadequate profits or to meet unforeseen or abnormal losses. According to International Accounting Standard Board (IASB) Framework (IASB 1989, p.66), "The creation of reserve is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effect of loss" (Stolowy, Lebas, & Ding, 2006, p.416). The major types of reserves are legal reserve, statutory reserve, regulated reserve, revaluation reserve, reserve for own shares, optional (or voluntary) reserve, profit/loss brought forward etc. Reserves can be open or hidden (secret). Open reserves may be defined as reserves which appear in the balance sheet of the company which every stakeholder may be aware of. These types of reserves provide full information to shareholders regarding which amount has gone to reserves or why they are not getting all

amount of dividend. On the contrary, secret reserves may be defined as that type of reserves which is not shown in published financial reports of company. In other words, it is neither shown in profit and loss account nor in balance sheet. The purpose behind the creation of such reserve was to reduce the volatility of income.

This paper explores the manipulation of published financial reports in order to counter the potentially unfavourable situations through the creation of secret reserve and its effect from the perspective of management, shareholders and employees. During the twentieth century, there was a pervasive attitude among investors, that accounting income for a period measured the proper amount of resources to be distributed as dividends for that period. As a result, corporate directors and management used to feel the pressure to make such distributions of dividends (Johnson & Meade, 1906; Yamey, 1960, Batiz-Lazo & Billings, 2009). Creating a reserve fund by charging "Earned Surplus" (appropriated or restricted retained earnings) was one way that management used to adopt earlier to reduce the pressure for dividend distributions. However these reserves were evident to the readers of a balance sheet, which led the management to create secret reserves in order to avoid distributing firm assets as dividends (Batiz-Lazo & Billings, 2009). According to Joplin (1914, p.409) the primary reason "for secret reserves is to provide, out of excessive profits of prosperous years, a fund which can be drawn upon to increase the profits of less prosperous ones the idea being to prevent fluctuation in the affairs or standing of the company, and to obtain as nearly

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as possible a uniform status of conditions.” Mostly during the era prior to the emergence of more comprehensive regulation, the upholding of secret reserves was often viewed as a way of self-regulation that helped ensure the stability of the company (Buckmaster, 1992). For instance, secret reserves were viewed as a form of income smoothing that helped to promote and maintain public confidence. Without such confidence economic turmoil could have been aroused. However, despite promoting public confidence in the reporting system, secret reserve accounting was blamed for being conflicted with increasing demands from financial report users and regulatory agencies for comprehensive and accurate disclosures of a company’s financial position and performance. On one hand, secret reserve accounting was justified as being in the public interest, on the basis that it would contribute to promoting stability (Brähler & Schmidt, 2014). On the other hand, the desertion of secret reserve accounting was also defensible as being in the public interest, on the basis that more accurate and comprehensive disclosures would meet the legitimate needs of financial reports users and in return promote greater economic efficiency (Brähler & Schmidt, 2014).

The remainder of this paper is organised as follows: the next section reviews previous literature. After that the background of secret reserve has been discussed. The section outlines the objectives of creating secret reserve, its’ sources and the positive & negative effect of such reserve. The next section discusses the conflicts create by secret reserve with examples. Then the issue has been discussed from the legal perspective in the next section. Finally conclusions are stated in the last section.

## LITERATURE REVIEW

As far as secret reserves are concerned, not many investigations exist. Nonetheless, most of the existing studies regarding secret reserve accounting have been conducted in two directions. First, there is an impressive body of evidence documenting reasons behind the creation of secret reserve and ways to create those reserves. For example, in their studies Guttentag and Herring (1986) stated that the purpose of secret reserves was to minimise the danger of damaging the reputation of the company by allowing the suppression of bad news. They have identified secret reserve as an income smoothing device which emphasized “conservatism” by anticipating in advance any losses that might arise on loan assets and the possible diminution in value of other assets (Moore, 1961). According to Dicksee (1903, p. 49), secret reserve is created when a reserve is deliberately accumulated in excess of the estimated loss that is likely to occur under that particular heading (Buckmaster, 1992). On the other hand, Buckmaster (1992), discussed how companies used to create secret reserve by crediting a contra asset account, a

liability, or by failing to record assets and/or writing them off as expenses or directly to surplus (retained earnings). In his study, Matheson (1893, p. 44) revealed how companies used to record unusually large amount of depreciation in good years as a way to create secret reserves at that time. He observes, “while in average or normal years of working a moderate rate of depreciation may suffice for mere physical deterioration, advantage should be taken of prosperous years to write down liberally (through depreciation charges) the book value of the plant.” This observation was later supported by the studies conducted by Dicksee (1903), Knight (1908), Joplin (1914), and Nash (1930). They have also identified write-downs of assets as a method of creating secret reserves. Two additional papers, by Crunder and Belcher (1930); Polak (1930) presented at the 1929 International Congress also recognised the ability of depreciation to create secret reserve. Besides, goodwill amortisation had also been identified as a device of creating secret reserve by some researchers. Matheson (1893, p. 27) identified goodwill as a legitimate object to which the surplus profits of a prosperous year can be applied, whereas, Joplin (1914) expressed in his study that firms can also create secret reserves by making excessive provision for bad debts and by valuing inventories at below cost.

On the other hand, the other direction in which some studies regarding secret reserves have been conducted is related to the conflict that this reserve can give rise to. According to Johnson and Meade (1906), Guttentag and Herring (1986), Arnold (1997), Capie and Billings (2001a, 2001b), and Billings and Capie (2007, 2009), even though secret reserve accounting was always a common and permissible practice and can be justified to avoid the demands of stockholders for dividends, this practice is indignant because the primary incentive for such practice is to manipulate securities prices. In this regard, Joplin (1914, p. 409) discussed the auditors’ responsibility with respect to secret reserves in his article. According to him, even though such practices were necessary to avoid excessive dividend payments, the auditors should disclose the existence of such reserves in the financial reports. In the absence of such disclosures, stock might get undervalued and stockholders will be deprived of their due return as well (Joplin, 1914; Buckmaster, 1992). Arguments over the disclosure of secret reserves are evident in the tension between the Securities and Exchange Commission (SEC) and other regulatory agencies in the USA (Brähler & Schmidt, 2014). The SEC was generally against the use of secret reserves on the ground that “if it is important to an investor it should be disclosed” (Guttentag & Herring, 1986, pp. 95-96). Nevertheless, this argument was countered by the fears that fuller disclosure of data may have a damaging impact on the soundness of the company (Guttentag and Herring, 1986, p. 76).

In recent time few studies have been conducted regarding secret reserve accounting such as Günther & Ott (2008), Hill

(2011), Rodríguez-Pérez, Slof, Solà, Torrent and Vilardell (2011), and Brähler and Schmidt (2014). However, in this study, I have tried to explore the issue of secret reserve from the perspective of management, shareholders, and employees.

## SECRET RESERVE ACCOUNTS AND ITS BACKGROUND

The use of secret reserve in order to conceal the financial position and performance of companies from shareholders and other users of accounts appears to have been widespread in Britain before the second world wars (Tsuji & Garner, 1995, p.135). According to Basu (2007, p.186), reserve has a specific implication in technical accounting jargon which states that it is an amount set aside from profit after tax and will appear in the balance sheet as a component of owner's equity. However secret reserves are deductions from the measured profit which do not distinctly appear in the income statement when charged and are not visible in the balance sheet. Secret reserves are also known as hidden reserve, internal reserve, inner reserve, silent reserve, or quiet reserve. It is called 'hidden reserve' because the reserve is not present on the face of the balance sheet. In 'Dictionary for Accountants', Eric L. Kohler defines a secret reserve as *"The amount by which the net worth has been deliberately understated-a hidden reserve. Such a condition exists where the assets are omitted or undervalued or liabilities are overstated. The term does not represent any actual account bearing the name"* (Kumar & Sharma, 2005, p.470). Due to the presence of secret reserve the financial position of the company is much sounder than what it reflected in the balance sheet.

### Objectives of Creating Secret Reserve

Secret reserve is generally created to serve the following purposes:

- Secret reserves strengthen the financial position of a company. Losses can be handled properly without disclosing their occurrence to the shareholders and others. This helps the company to remain financially strong in spite of a period of adversity.
- It may be best utilised for equalisation of dividends, thereby maintaining the financial stability of the company.
- The profits which would have been utilised for the payment of dividend remain in the business and increase the working capital of the company.
- Secret reserve is created to withhold information of the progress of the company from trade competitors. If the true earning position of the company is shown it is

possible that more rival companies may come into the field and compete with it, thus bringing down its profits. So secret reserve avoids unnecessary competition.

- This type of reserve can be created to manipulate share price for some concealed motives.
- Secret reserve can provide for contingencies or unforeseen emergencies.
- Finally it helps to evade income tax and wealth tax by disclosing lesser amount of profits.

### Sources of Secret Reserve

Secret reserve can be created by the following methods:

- By under-valuation of assets much below their cost or market value, such as investment, stock in trade, etc.
- By not writing up the value of an asset, the price of which has permanently gone up.
- By creating excessive reserve for bad and doubtful debts or discount on sundry debtors.
- By providing, excessive depreciation on fixed assets.
- By making an excessive provision for contingencies or by continuing to carry forward with provisions when they are not required.
- By writing down goodwill to a nominal value.
- By omitting some of the assets altogether from balance sheet.
- By changing capital expenditure to revenue account and thus showing the value of assets to be less than their actual value.
- By overvaluing the liabilities.
- By showing contingent liabilities as actual liabilities.
- Showing imaginary liabilities as real liabilities.
- By inflating purchases.
- By the suppression of sales.

### Positive Effects of Creating Secret Reserve

According to 'Companies Act 1956', creation of secret reserve is prohibited and only banking, insurance, and financial companies are allowed to create secret reserve but that also must be within a reasonable limit (Kumar & Sharma, 2005, p.471). However secret reserve has the following advantages:

- They make the financial position stronger and enable the company to develop and survive without any help from outside.
- Secret reserve helps to show the business situation as less favourable than what it is actually in reality. This

enables the company to avoid competition from its rivals.

- Lack of fluctuations in the dividend rate leads to stability in the share values.
- A company can also meet the contingencies or exceptional losses from the secret reserve without the knowledge of the shareholders.

### Negative Effects of Creating Secret Reserve

- Balance sheet does not exhibit true and fair view of the financial affairs of the company if secret reserve is created and maintained. At the same time, the profit and loss account also does not give the exact results since excessive provision for depreciation or reserve may be made for its creation.
- Shareholders who are the actual owners are deprived of getting a true picture of the financial states of the affair of the company.
- Secret reserves may be utilised by the management to conceal their weakness in the term of mismanagement. It may conceal losses arising out of bad or careless management or even careless speculation.
- If fixed assets are undervalued for the purpose of creating hidden reserve, and at the same time if there is a fire, the company will not be able to claim the full value of the assets because the insurance company will pay according to the book value of the asset destroyed or damaged and hence causing a loss to the company. .
- By creating secret reserves, and therefore lowering the dividend, the directors may indulge in speculation in the shares of the company. The market value of the shares will be adversely affected and will tend to decline.
- When a secret reserve is created by omitting any asset, then the asset can be misappropriated by the directors or management of the company.
- The existence of secret reserve or the use of secret reserve is specially known only to the directors or management personnel at the highest level. In such a situation directors or top management personnel make some illegitimate gains through sales or purchase of shares without the knowledge of the shareholders of the company.

### CONFLICTS CREATED BY SECRET RESERVE

From the definition of secret reserve it can be said that the existence of secret reserve is known only by the management and not by the real owners or shareholders and other employees as a result, the creation of secret reserve can lead

to huge conflict between the management of the company and the shareholders & employees.

### Management vs. Shareholders

Busse von Colbe (1992, p. 30) refers to the conflict between management and investors over question of creation and manipulation of 'hidden reserves'. Secret reserves can be created by adopting accounting policies very cautiously. For instance, assets may be depreciated at too high a rate, or excessively large provisions may be made against doubtful debts. The benefit that management get from secret reserve is that they can that level out the reported profits. According to Leuz, Pfaff, & Hopwood (2004, p.217), even though secret reserves are said to provide a buffer against reactions to short-term swings in company's performance, it actually serves the interests of the insiders, not investors, by reducing the volatility of the pay-outs to the managers and protecting them from immediate consequences of bad decisions.

First of all as the owner of the company, shareholders have the right to know the actual worth of their company and their investment in the company. Moreover the function correct information regarding income is highly essential for the shareholders and for this reason secret reserve is highly undesirable (Roberts, Weetman, & Gordon, 2008, p.217). Secret reserve makes the information present in the financial statements false and inaccurate. Due to the presence of secret reserve, shareholders get deprived of their right of knowing the actual financial position of the company which they held as the owner. As a result shareholders may lose their confidence in the management of the company which in turn can lead to conflicts between the owners and the managers.

The creation of hidden reserve results in the reduction of dividend payment to the shareholders. As a dividend payment is the primary incentive for any shareholder they always want to see higher profits as more dividends can be yield from it. Whilst by creating secret reserve and showing lower profits and in turn lower dividends managers tends to create dissatisfaction among stockholders. This will results in a fall in the goodwill of the company and also a fall in the share price of the company in the market. In addition, this will make shareholders doubtful about manager's performance and company's profitability. Sometimes this adverse effect on profit, dividends payments, goodwill and share price, forced investors to sell their shares by misleading them about the actual worth of the company.

If the secret reserve is created by omitting any asset from the financial statements then it can be wrongly utilised by the managers or directors of the company. The concerned company may suffer from such misappropriation of assets which will definitely affect interest of the shareholders. Such

attitude of managers results in a conflict between stockholders and managers or directors.

The existence of secret reserve increases accounting and financial scams. This type of reserve provide managers an opportunity for fraudulent behaviour by deceiving the owners of the company. Secret reserve can be proved as a blessing for a company if the management do their job honestly. Nonetheless if the managers and directors are dishonest it can be proved as a curse for the company and may even lead to bankruptcy. As the existence of secret reserve is only known to the directors or management personnel, they can easily utilize this funds kept as secret to fulfil their personal needs without the knowledge of shareholders. That means the portion of profits which rightfully belong to the shareholders; managers take that away by deceiving them. This might leads to a huge conflict between the managers and the owners of the company.

Managers can use such hidden reserve to cover their weakness or mismanagement. One of the purposes of creating secrets reserve is to cover-up the loss in times of adversity without disclosing anything to the shareholders or other stakeholders. By giving managers an accounting tool for disguising losses, secret reserves might well allow managers to delay taking painful decisions about their loss-making strategies and investments, in the vain hope that they will return to profitability or the consequences of their decisions will be passed on to the future managers (Leuz, Pfaff, & Hopwood, 2004, p.133). As a result shareholders will be unaware of the actual situation of the company in the market and in turn they may take wrong decision regarding their investments. This mismanagement is another potential source of conflicts between shareholders and managers. On the other hand by showing profits and paying dividends in the adverse period from the secret reserve amounts, managers may create an impression of financially stable company in the market. Thus it may attract more new shareholders to the company by misleading them about company's actual value. This may lead to a huge conflict between shareholders and the managers in the future.

Finally, as the silent reserve is closely known by the managers or directors only, they can use it to make illegitimate gains through the purchase or sales of shares without knowledge of the stockholders. This may also result in a conflict between shareholders and the top management of the company.

Gallhofer and Haslam (1991) investigated the use of hidden reserves or secret reserves by German companies during the First World War. As a result of the First World War, many German companies, especially armaments companies, profited substantially. The state became concerned that workers and soldiers would be provoked by the disclosure of high profits. As a consequence, the use of hidden reserve was encouraged. Some observers at the time noted that industry and state effectively conspired in hiding profits. Nonetheless,

shareholders eventually became aware of the presence of secret reserves and forced companies to pay higher dividends. Management argued that reserves were needed to be built up to provide for adjustment at the end of the War. There was a clash between managers and shareholders.

## Management vs. Employees

Another victim of secret reserve can be the employees of the company along with the shareholders. The creation of hidden reserve can directly affect the interest of the company's employees and therefore provide a source of conflicts between managers and the employees.

The presence of secret reserves lowers the net profit of the company. This lower reported profits (resulting from over prudent accounting policies) will assist management in wage negotiations with unions. As a result employees who receive remunerations as a percentage of profits suffer from lower remuneration. In addition by giving the excuse of lower profits management can deprive employees from any types of bonus, incentives or increments which otherwise they could have earned. They deprive employees from profit sharing. This may create dissatisfaction among the employees. Sometimes it can lead to a dangerous conflict between the employees group and top management which may result in labour tension and threats from labour union. Moreover, this type of deceiving attitude of management can draws unnecessary labour strike in the company for a salary rise or incentives.

As mentioned earlier, secret reserve helps management to hide their wrong decision or weakness in managing the company which in turn keep the employees of the company in dark. As during the adverse time management uses the fund they keep secretly as reserve to run the company and provide the employees with their basic payment, they would not be aware of the company's actual situation. The company may end up being bankrupt without giving any prior hints to its employees, because by using the secret reserve they cannot run for long. If this happens employees will be jobless and their future will be insecure. As a result, if secret reserve gets exposed, it may create a huge conflict between the top management and directors.

Secret reserve lowers the net worth of the company in the market. As we know that, in order to create secret reserve, management needs to show lower profit than what it actually is which reduces their dividend payment and which in turn decreases the share price and the goodwill of the company in the market. This may attract unnecessary take-over of the company by larger one. If such take-over happens employees may lose their job. On the contrary, managers or directors might involve in fraud and take the reserves amount kept

as secret for their personal use. This may provide another source of conflict between them.

Finally we can say that the creation of secret reserve may result in rift between the managers and the employees which will make the company suffer and eventually will provide a path to a conflict between shareholders and management.

## Examples

Lord Kysant was the chairman of the Royal Mail Steam Packet Company. The company which he ran owned one of the largest shipping lines in England, which during the First World War had made large profits, many of which had been secretly transferred to reserves. After the First World War the company had expanded its operations during a time of over-supply in the market and falling prices for both shipping and freight. In latter 1920s, the company was unable to repay a loan of £10m which was guaranteed by the Treasury. Following a government enquiry into the financial affairs, Lord Kysant was charged in 1931 with publishing a false and fraudulent balance sheet. Kysant argued in his defence that, during the downward cycle it was important to retain the shareholder's confidence by paying dividends; hence the need to create profits. Moreover, profitability was also exaggerated during the time of loss based on secret reserve. Ultimately even though Kysant was acquitted of the charge on the basis of company's benefits the company had technically been insolvent for some years. This was followed by a big clash between the shareholders, employees, and the top management. In the following reconstruction of the company that occurred, many shareholders lost their investment.

Secret reserves were an especially common feature of bank accounting and typically comprised some combination of undisclosed earnings, understated assets, and overstated liabilities. However, while secret reserve may have played a role in promoting public confidence in the banking system it conflicted with increasing demands from financial report users and regulatory agencies for comprehensive and accurate disclosures of a bank's financial position and performance (Hui, n.d, p.2). The creation of hidden reserves was widely regarded as a form of "non-disclosure" which served the interests of bank and other stakeholders (for example, shareholders and depositors) as well as the banking system as a whole. The HSBC bank used to practice secret reserve accounting for better financial stability. Even though shareholders and other stakeholders (for example employees or government) had a rough idea regarding this hidden reserve but they were unaware of the actual amount. Investors had no real opportunity to detect the magnitude of secret reserves or transfers to or from those reserves. The genuine financial figures were only disclosed to the directors of a bank and not to other stakeholders. The then Chairman,

G.M. Sayer, argued that the interest of shareholders was best served by retaining inner reserves (King, 1991). He insisted that while disclosure might be useful to determine whether shareholders had been receiving appropriate returns, the system of secret reserves protected depositors who could be assured of additional protection beyond that declared in the balance sheet. Even though, he invited comments from shareholders about the idea of sustaining secret reserves but remarks were received from the audience. However, eventually shareholders and other employees imposed pressure on HSBC for greater transparency. They argued that secret reserve accounting would mislead financial reports users and precipitate economic efficiencies which were not in the common interest.

## SECRET RESERVE FROM LEGAL PERSPECTIVE

The purpose of preparing financial statements is primarily to represent the true financial position of the company in front of all its stakeholders. There are some accounting concepts and conventions that are generally used as guidelines in preparing financial statements for sound accounting practices. These conventions are known as "Generally Accepted Accounting Principle" (GAAP) which includes consistency, full disclosure, conservatism, and materiality. Disclosure can be refers as the process and methodology of providing the information and making policy decisions known through timely dissemination and openness (Greuning & Koen, 2001, p.1). According to this principle all accounting statements should be prepared honestly and to that end full disclosure of all significant information should be made. This principle of preparing financial statements contradict the purpose of creating secret reserve as this type of reserve is created by managers and is meant to be hidden from shareholders, employees and all other stakeholders. On the contrary, the conservatism principle states that accountants must use their judgment to record transactions that require estimation. If the principle of conservatism is stretched without reservations, it results in the creation of secret reserve which is indirect conflict with the principle of full disclosure (Patankar, 2008, p.17).

According to Basu (2006, p.193), "before Companies Act, 1956 came into force; there were no restrictions on the creation of secret reserve except that whenever secret reserve was brought back into accounts, it was necessary to disclose the amount adjusted out of such reserve". Once the Companies Act was introduced it was not possible for the companies to create secret reserve. There are three reasons behind the prohibition of the creation of secret reserve-

- Balance sheet should provide a "true and fair" value of the company's financial position according to Company Act 1956, whereas, secret reserve either underestimate

assets or overestimates liabilities obstructs the reflection of true value of financial position.

- Part (i) of Schedule (vi) to the Companies Act requires that, the Balance Sheet should ensure full disclosure for reserves and provisions and
- Part (iii) of Schedule (vi) to the Companies Act requires that, a provision for depreciation, renewal and diminution in the value of assets, and that in respect of a known liability, which in the opinion of directors, is in excess of the amount which is reasonably necessary for the purpose, should be credited to reserve account. Thus, it should not be possible for any company to create secret reserve.

However the creation of secret reserve is not fully prohibited in the case of banking, insurance, electricity producing, and shipping companies. Whenever a secret reserve exists an auditor should make sure that the intention of creating such reserve is honest and it is for the best interest of the company. The auditors also need to ensure that the amount of the reserve is reasonable and is being utilised properly.

## CONCLUSION

The purpose of this paper was to investigate the issue of secret reserve and its impact from the perspective of management, shareholders, and employees. Besides, examining how these reserves can affect the comparability and faithfulness of financial statements was also another objective of this study.

One of the most controversial areas in UK financial reporting was the issue of “secret” or “hidden” reserves. Such reserves arose when companies deliberately understated profits via the creation of excessive provisions - e.g. for depreciation, tax liabilities or doubtful debts. The existence of such hidden reserve would provide a secret source of future profits and financial stability. However, because of secret reserve financial statements lost its neutrality and the quality of reliability. Even though secret reserve may work very well in many cases which undoubtedly it does, it may be the subject of almost intolerable abuse. Even though secret reserve accounting may have been a well-intentioned deceit, but it was still a deceit. It provides a way to ignore negligence, irregularities and mostly breaches of faith. Secret reserve accounting can be justified as being in the common interest, on the grounds that it would contribute to promoting stability. However, the prohibition of secret reserve accounting is also justified as being in the common interest, on the grounds that more accurate and comprehensive disclosures by companies would meet the legitimate needs of financial reports users and thereby promote greater economic efficiency. When secret reserves are not considered distortions arises in financial statements, which might affect the comparability

and reliability of financial statements.

However, further research is needed to specify and explain these findings in a more detailed way. Clarifying these issues would then give all the stakeholders like employees, management, and shareholders much better basis for understanding under what circumstances secret reserves exist and to which level they affect comparability and how they can be included in financial statement analysis.

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