CHAPTER-17
PROVISIONS AND RESERVES

Meaning:

According to the Companies Act the term 'Provision' refers to any of the following amounts -

(a) The amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets; or

(b) The amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

It should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it must be classified as an outright liability and not a provision. Also if any excess provision is made knowingly or intentionally, the amount in excess of the actual need will be treated as 'reserve'.

Examples of Provisions:

Provisions are created for the fulfilment of various objectives :

1. Provision for Depreciation of Assets.
2. Provision for Taxation.
3. Provision for Bad and Doubtful Debts.
4. Provision for Discount on Debtors.
5. Provision for Repairs and Renewals of assets.

Characteristics or Features of Provisions :

(1) Provision is made to meet a known liability.

(2) The liability is known but the amount of such liability cannot be determined with reasonable accuracy. For example, it is almost certain that some debts will prove irrecoverable but the exact amount of bad-debts cannot be predicted with certainty.

(3) Provision is a charge against profits and as such reduces the profits of the year in which it is created. The loss when actually occurs will be written off against such provision and thus the profit of the year in which such loss occurs will not be affected.

Purpose or Importance of Provisions:

(1) **To ascertain the true net profit of the business**

(2) **To ascertain the true financial position of the**

(3) **To provide for known losses in the future**

(4) **For the equitable distribution of expenses**

RESERVES

Meaning-Reserves mean amount set aside out of profits and other surpluses to meet future uncertainties. In other words, a reserve is meant for meeting any unknown liability or loss in the future. According to William Pickles, "Reserves mean the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of the Balance Sheet".

Examples of reserves are:

(1) General Reserve.

(2) Capital Reserve

(3) Dividend Equalisation Reserve

(4) Investment Fluctuation Fund

(5) Workmen Compensation Fund

(6) Reserve for Redemption of Debentures.

It should be clearly understood that the amount of reserve does not represent any expense or loss and as such it is not debited to Profit & Loss Account. Creation of reserve does not reduce the net profits but only reduces the divisible profits. It is an appropriation of profits and hence after ascertaining the net profits it is debited to Profit & Loss Appropriation Account.

Characteristics or features of "Reserves':

(1) It is created out of net profits or divisible profits. As such the reserves are also termed as 'Retained Earnings' or 'Undistributed Profits'.

(2) Creation of reserves is not a legal necessity. It is created voluntarily for strengthening the general financial position of the business and for meeting an unanticipated situation in the future.

(3) Normally, it is not created to meet any known liability or depreciation in the value of assets but for meeting an unknown liability or loss in the future.

(4) Reserves represent accumulated or undistributed profits and as such they belong to the proprietors just as capital does. They are available for distribution as dividends among shareholders and just as the capital is shown on the liabilities side of the Balance Sheet, they are also shown on the liabilities side.

(5) When the amount of reserve is invested in outside securities it is known as 'reserve fund'.

Purpose or Importance of Reserves :

(1) **Helpful in meeting the unforeseen liability or loss**.

(2) **Helpful in strengthening the financial position of the business**

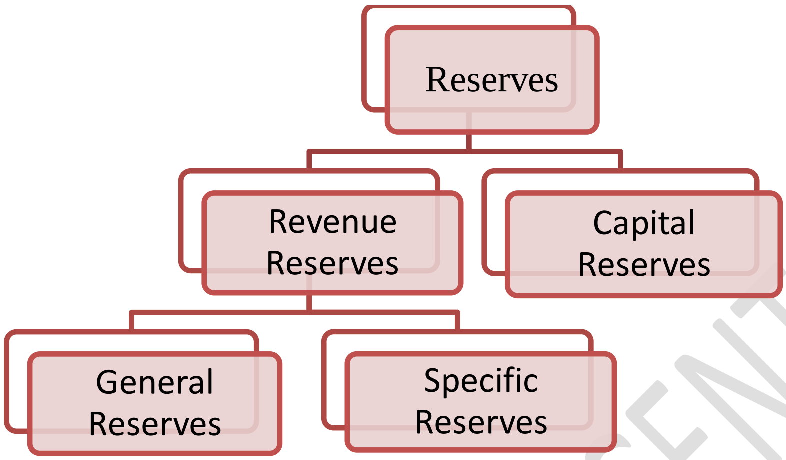
(3) **Equalisation of dividends over the years**

(4) **To provide funds for meeting a specific liability**

Difference between Provision and Reserve

Basis of Difference	Provision	Reserve
1. Meaning	It is created to meet a known liability	It is created to meet an an unknown liability
2. Necessity (Charge or Appropriation)	Creation of Provision is a legal necessity. Provision have to be provided for even if there are no profits. Thus provision is a charge against profits.	Creation of reserve is discretionary. It can be create only if adequate profits have been earned. Thus, reserve in Appropriation of profit.
3. Object	The Object is to provide for depreciation doubtful debts and other specific liabilities.	The Object of reserve is to strengthen the financial position of the business.
4. Mode of Creation	It is created by debiting to P&L A/c. Hence, net profit cannot be calculated unless all provision have been debited to P&L A/c.	It is created not by debiting to P&L A/c but through P&L appropriation A/c. As such, it is created after the calculation of net profit.
5. Investment outside the business.	Provisions are never invested outside the business.	Reserves may be invested outside the business.
6. Presentation in Balance Sheet.	It is either shown on the assets side by way of deduction from the asset for which it is created or as distinct item on the liabilities side.	It is shown on the liabilities side under the head 'Reserve and Surplus'.
7. Utilisation for dividends.	It cannot be utilised for distribution as dividends among shareholders.	It can be utilised for distribution as dividends among shareholders.
8. Utilisation for other purpose	It is created to provide for a specific loss and hence can only be used for meeting that loss.	It is not created to provide for a specific loss and hence can be used for any purpose.

Types of Reserves



Revenue Reserves: These reserves come into existence out of profits which have been warned in the course of day-to-day business operations. Therefore, the revenue reserves represent undistributed profits and as such are available for the distribution of dividends.

Kohler has defined revenue reserves as, that portion, or any detail thereof, of the net worth or total equity of an enterprise representing retained earnings available for withdrawal by proprietors."

Revenue reserves may be of the following two types:

(A) **General Reserve:**- Usually, the businessmen do not withdraw the entire profits from the business but retain a part of it in the business to meet unforeseen future uncertainties. Profit so retained in the business for a rainy day' are known as 'General Reserve'. Similarly, Companies also do not distribute the entire profits as dividends but keep aside a part of it in the form of General Reserve. Such reserves are also termed as 'Contingency Reserves' or 'Free Reserves' because these are not created for any specific purpose and can be freely used for any purpose.

Objectives: - General Reserves may be created or utilised for any of the following purposes:

1. For meeting unforeseen losses.
2. For the strengthening of financial position of business.
3. For expansion of business through internal resources or ploughing back of profits.
4. For equalisation of dividends over years, in case of Companies.

It is not compulsory and binding upon the business enterprises to maintain general reserves. Such reserves may be created in the year in which the profits are sufficient and the management thinks it advisable to do so. General Reserves are shown on the liabilities side of the Balance Sheet under the head 'Owner's Equity'.

(B) **Specific Reserve**:- Such a reserve is created for a specific purpose and can be utilised only for that purpose. Examples of specific reserves are:-

I. **Dividend Equalisation Reserve**:- Such a reserve is created to maintain steady rate of dividend. In the years in which the profits are sufficient, a part of the profit is transferred to such reserve and it is utilised to keep the dividend up in the year in which the profits are insufficient.

II. **Reserve for Replacement of Asset**:- Such a reserve is created to provide finances for the replacement of an asset at the end of its serviceable life. The amount of annual depreciation charged on assets is only capable of providing the original cost of the asset but the replacement of the asset will require a large sum of money due to the inflationary trend of prices. As such, a 'reserve for replacement of asset' is created to provide for the extra amount required for the purchase of the new asset.

Investment Fluctuation Fund: It is created to provide value of investments due to market fluctuations.

Workmen Compensation Fund - It is created to meet compensation payable to workers in case of unexpected or unknown event of an accident.

Debenture Redemption Reserve:-It is created to provide funds for theredemption i.e., repayment of debentures.

Capital Reserves:- In addition to the normal profits, capital profits are also earned in the business from many sources. The reserves created out of such capital profits are known as Capital Reserves. Such reserves generally, are not available for distribution as cash dividend among the shareholders of a Company. Profits received from the following sources are termed as capital profits:

1. Profits on the sale of fixed assets.

2. Profits on the revaluation of fixed assets and liabilities.

3. Premiums received on issue of Shares or Debentures.

4. Profit on the purchase of a running business.

5. Profit prior to the incorporation of a Company.

6. Profit from the reissue of forfeited shares.

7. Profit on redemption of debentures.

All the Capital profits mentioned above should be treated as Capital Reserves.

Distinction between Revenue Reserves and Capital Reserves

Basis of Distinction		Revenue Reserves	Capital Reserves
1.	Source of Creation	These reserves are created out of revenue profits which arise from the normal operating activities of the business and are otherwise available for distribution of dividends.	These reserves are created out of capital profits, which do not arise from the normal operating activities of the business and are not available for distribution of dividends.
2.	Usage	A specific reserve can be utilised only for the earmarked purpose while a general reserve can be utilised for any purpose including distribution of dividends to shareholders without any pre-conditions.	Normally, these reserves cannot be utilised for distribution of dividends to shareholders. However, some capital reserves can be utilised to distribute dividends subject to fulfilment of certain conditions laid down by companies Act.
3.	Purpose	These reserves are created for meeting unforeseen the financial position of business.	These reserve are created to meet Capital losses or may be used for purposes laid down by Companies Act.

Secret Reserves:

A secret reserve is one which is not disclosed by the Balance Sheet. These reserves are created by showing profit at figure much lower than actual and by showing the assets at lower figure and liabilities at a higher figure. When secret reserves exist, the actual position of the firm is much better than what is disclosed by the Balance Sheet. Secret reserves may be created in the following ways:

(i) Writing off excessive depreciation;
(ii) Charging Capital expenditure (such as addition to assets) to Profit& Loss Account;
(iii) Treating a revenue receipt as a capital receipt (such as rent received credited to Building Account);
(iv) Undervaluation of assets (such as undervaluation of closing stock),
(v) Showing an actual asset as a contingent asset;
(vi) Showing a contingent liability as an actual liability
(vii) Suppressing the sales;

Creating excessive or unnecessary provision for doubtful debts and other contingencies

Advantages of Secret Reserves

i. **Financial Stability:**Creationof secret reserves strengthens the financialposition of the enterprise without disclosing this fact to the shareholders or the public.

ii. **Helpful in Absorbing Unforeseen Losses:** The presences of secret reserves enable such concerns to absorb any unexpected losses without any publicdiscomfiture.

iii. **Regularity of Dividends:** Such reserves help the enterprise in maintaining the rate of dividend during adverse trading conditions without disclosing this fact to shareholders or the public.

iv. **Avoidance of Competition:** Because of concealment of actual profitabilityof the enterprise, the entry of the competing firms in the particular line of business is avoided.

Disadvantages of Secret Reserves:

i. **Unfair Presentation of Financial Statements**: Statement of Profit & Loss fails to disclose true profit and the Balance Sheet fails to disclose a true and fair view of the financial position of the enterprise.

ii. **Loss to Shareholders:** Shareholders who wish to sell their shares may not getactual price of their shares because of understatement of profits and financialposition of the enterprise.

iii. **Misuse by Management:** Fraudulent managements may take undue advantage by creating secret reserves. Profits may be suppressed to enable them to buy the shares of the Company at a lower price and then the profitsmay be enhanced by eliminating the secret reserves to enable them to sell the shares at a higher price.

iv. **Cover for Misdeeds of Management:** Secret reserves may be utilised by management to cover their mistakes or misdeeds.

VERY SHORT ANSWER QUESTIONS

1. What are provisions?
2. Give two examples of provisions
3. What are Reserves?
4. Give two example of reserves.
5. Give two differences between provisions and reserves.
6. Differentiate between reserve and provisions on the basis of charges or appropriation.

Ans. Reserve is an appropriation of profits whereas provisions is charge against profit.

7. Give one example of each of ‘provision’ and ‘reserve’.
8. What is dividend equalisation reserve?
9. What is workmen Compensation Fund?
10. Give two example of Specific Reserves.

Ans. (i) Dividend Equalisation Reserve and (ii) Workmen Compensation Fund.

11. What are Capital Reserve?
12. Give one difference between General Reserve and Specific Reserve.
13. Name the reserve can be used in distribution of dividend.
Ans. Revenue Reserve.
14. Where will you transfer profit on sale of a fixed asset?
Ans. Profit on sale of a fixed asset is a capital profit and, therefore it will be transferred to capital Reserve.

OBJECTIVE TYPE QUESTIONS

(A) State whether the following statements are True and False:

(i) 'Provision' is a charged against profits.
(ii) provision is made to meet an unknown liability.
(iii) Creation of reserve reduces taxable profits of the business.
(iv) Creation of reserve is discretionary.
(v) Dividend equalisation reserve is an example of general reserve.
(vi) General reserve can be used only for some specific purposes.
(vii) Capital reserve are normally created out of free or distributable profits.
(viii) Making excessive provision for doubtful debts build up the secret reserves in the business.
(ix) Reserve created for maintaining a stable rate of dividend is treated as secret reserve.
(x) Usually capital reserve are not available for distribution as cash dividends.

[Ans. True :(i), (I if the v), (viii), (x)]

(B) Choose the best Alternate:

1. If the amount of any knows liability cannot be determined accurately.
(a) Provisions should be created
(b) Definite liability should be created
(c) Reserve should be created
(d) should be shown as a contingent liability

2. Which of the following is a corrected difference between a provisions and reserve?
(a) A provision is created out of a legal necessity whereas a reserve is created as a matter of prudence.
(b) A provision is invested whereas reserve is not invested
(c) A provision is an appropriation of profit whereas a reserve is a charge against profit
(d) A provision can be used for distribution of dividend whereas a reserve cannot be allowed to be used for distribution of dividend.

3. Which of the following is a correct distinction between a Revenue reserve and a Capital reserve?
(a) A revenue reserve is created out of capital profits whereas a capital reserve is created out of business profits.
(b) A revenue reserve can be used for distribution of dividend with certain preconditions whereas a capital reserve can be used for distribution of dividend without any preconditions
(c) A revenue reserve is created for strengthening the financial position whereas capital reserve is created for meeting capital losses or to be used for purpose specified by the Companies Act.
(d) There is no distinction between revenue reserve and capital reserve

4. Which of the following statements are correct about a "Provision"?
(i) Provisions are a charge against the profits of an enterprise
(ii) Provisions are created out of divisible profits
(iii) Creation of provisions are not necessary for a business
(iv) Provisions are created to meet a known liability
(a) (i), (ii) and (iii)
(b) (ii) and (iv) only
(c) (i), (iii) and (iv)
(d) (i) and (iv) only

5. Which of the following statements is not appropriate in relation to "provision"?
(a) Provision is a charge against profit
(b) Provision is created for known liability
(c) Provision is created for strengthening the financial position of the business.
(d) creation of provision satisfies the principle of conservatism.

[Ans. 1.(a) 2. (a) 3. (c) 4. (d) 5. (c)]

(C) Fill in the blanks with respect to reserve that complete the sentences.
(i) …………………… are created in business for rainy day.
(ii)………………… are created for specific purpose.
(iii)………………… are created out of capital gains.
[Ans.(i) General Reserve; (ii) Specific Reserve; (iii) Capital Reserve.

HIGHER ORDER THINKING SKILLS QUESTIONS

1.Eicher Ltd. Intentionally made excess provision for doubtful debts. What term will be have used for excess provision?
2. Is reserve a charge against profit or an appropriation of profit?
3. Why 'Dividend Equalisation Reserve' is termed as Reserve and not a provision?

ANSWERS:

1. Reserve.
2. It is created not by debiting to P/L A/c but through P& L Appropriation A/c.
As such, it is appropriation of profit because it is created after the calculation of net profit.
3. Dividend Equalisation Reserve is not debited to Profit and Loss Account. Its creation does not reduce the net profits. It is appropriation of profit and is debited to Profit and Loss Appropriation Account.