

Chapter 17

Provisions

and

Reserves

In order to strengthen the financial position of the business and with a view to meeting all eventualities both expected and unexpected, it is desirable that the entire profit should not be distributed among their owners. Some portion of the profit should be kept in the business for meeting the known as well as unknown liabilities in future. This is done, by making provisions and creating reserves out of current year's profits at the time of preparation of final accounts.

PROVISIONS

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.

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.
- (3) Provision is a charge against profits and as such reduces the profits of the year in which it is created.

Purpose or Importance of Provisions

- (1) **To ascertain the true net profit of the business:**
In order to ascertain the true profit of a business it is necessary

that all expenses pertaining to that year, whether paid or outstanding, must be debited to Profit and Loss account and a provision should also be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy.

(2) To ascertain the true financial position of the business: The Balance Sheet will depict the true and fair view of the financial position of the business only if adequate provision is made for all the anticipated losses and expenses.

(3) To provide for known losses in the future: Funds will be required to meet the losses and liabilities that are likely to occur in the near future. As such, provisions are made to provide funds for meeting those losses.

RESERVES

Meaning

Reserves mean amounts 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.

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) It is created 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.

(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: If any unforeseen or abnormal loss arises in the future, reserves can be utilised to meet such eventualities.

(2) Helpful in strengthening the financial position of the business: Reserves are a source of internal financing of the expansion of business. In case the reserves had not been maintained the profit would have been distributed as dividend among shareholders.

(3) Equalisation of dividends over the years: Goodwill of a Company depends upon maintaining a uniform rate of dividend from year to year and also to increase the dividend steadily. Reserves help the directors to achieve this objective because in the periods of inadequacy of profits, the amount can be withdrawn from reserves.

(4) To provide funds for meeting a specific liability: Sometimes a reserve is created for a specific purpose such as

'Debenture Redemption Fund' for the payment of debentures. It will facilitate the payment of such a big sum in one go.

Types of Reserves

There are two types of Reserves

- 1. Revenue Reserves**
- 2. Capitals Reserves**

1. Revenue Reserves:

These reserves come in existence out of profits have been earned 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. Profits so retained in the business are known as 'General Reserve.'

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
- (ii) Reserve for Replacement of Asset
- (iii) Investment Fluctuation Fund
- (iv) Workmen Compensation Fund
- (v) Debenture Redemption Reserve

(B) 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. Capital reserves are used to write off Capital losses and for the issue of fully paid bonus shares. Usually, the capital reserves are not available for distribution as cash dividends. Some capital reserves can however be utilised to distribute dividends subject to fulfilment of the following conditions: -

1. Articles of the Company must not prohibit such dividend.

2. Capital profits must have been realised in cash.

3. Such profit remains after a fair revaluation of assets and liabilities.

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 a 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:

(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) Writing off excessive depreciation;

(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;
- (viii) Creating excessive or unnecessary provision for doubtful debts and other contingencies.

Advantages of Secret Reserves:

(i) Financial Stability: Creation of secret reserves strengthens the financial position of the enterprise without disclosing this fact to the shareholders or the public.

(ii) Helpful in Absorbing Unforeseen Losses: The presence of secret reserves enable such concerns to absorb any unexpected losses without any public discomfiture.

(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 profitability of the enterprise, the entry of the competing firms in the particular line of business is avoided.

Disadvantages of Secret Reserves

(1) Unfair Presentation of Financial Statements: Profit & Loss Account 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 get actual price of their shares because of understatement of profits and financial position of the enterprise.

(iii) Misuse by Management: Fraudulent managements may take undue advantage by creating secret reserves.

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

The creation of secret reserves is not allowed under the Companies Act, 1956 as it requires a full disclosure of all material facts and significant accounting policies followed in preparing financial statements.

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