Provisions and Reserves

Provisions & Reserves - Meaning and Accounting Treatment

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Meaning of Provision
  - Meaning of Reserves
  - Distinction between Provisions and Reserves

Provision
Every business organisation is exposed to some common known expenses or losses the exact amount of which in the future period is unknown such as depreciation on fixed assets, payment of tax liability, default in payment by customers, etc. For the purpose of meeting such expenses or losses a business may keep aside a certain amount every year.
The amount that is kept aside from the profits of an enterprise to meet the future 'known' liabilities is known as *provision*. It is created only for those liabilities, the amount of which cannot be ascertained precisely and accurately beforehand.

Therefore, if a provision is created for a liability whose amount is already known cannot be considered as a provision rather, it would be considered as a liability for the business. From this it is clear that there lies a difference between a provision and a liability as the former is to provide for a future known liability whose amount is difficult to be determined while the latter is in itself a future known liability whose amount is already known. *For example*, provision created for a tax liability of Rs 10,000 to be paid in the month of December is a liability and not a provision. This is because, here, the amount of liability is already known, therefore provision cannot be created for this liability.

This creation of provision is truly based on the intuitions and past experiences of a business. In other words, it is created on an estimated basis based on the past performances. The unascertained liabilities in the form of provisions are kept aside which helps a business to sustain from the future unexpected losses. Provision is considered as an expense of a business which is charged from the profits by debiting it to the Profit and Loss Account.

The underlying principle behind creation of provision is accounting principle of Conservatism which state that '*provide for all anticipated expenses or losses but do not provide for anticipated incomes or gains*'. It should be noted that creation of provision is compulsory even if the business does not have profits. The main rationale for making provisions is to provide cushion to the future business performance against the uncertain and unforeseen losses that may arise from the past transactions. The creation of provision helps in determining the true profits or losses during an accounting period.

As per Penguin Dictionary of Commerce '*A provision is the amount written off or retained by way of providing depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy*'.

The following are few examples of provisions.

1. Provision for Doubtful Debts
   ii. Provision for Discount on Debtors
   iii. Provision for Taxation
   iv. Provision for Depreciation
   v. Provision for Repairs and Renewals

Accounting Treatment
The amount of provisions is charged against profits by debiting it to the Profit and Loss Account. It is charged in the accounting period in which such provision is created. We know that provision is compulsorily to be create therefore, it has to be created by the business even in case of losses. The following is the Journal entry for creating provision.

Profit and Loss A/c	Dr.
To Provision for….A/c	
(Provision made for…)	

Disclosure of Provision in the Balance Sheet

The amount of provision in the Balance Sheet can be shown in any of the following ways-

1. It can be shown either on the Assets Side of the Balance Sheet as a*deduction*from the concerned asset. *For example*, Provision for Depreciation is shown as a *deduction* from the concerned fixed asset,
2. Or it can be shown on the Liabilities Side of the Balance Sheet.*For example*, Provision for Taxation.

Features of Provisions

The given below are some features of provision that can be derived from its above explanation.

1. It is created to meet the future known liability the exact amount of which cannot be determined.
2. It is an estimation based on the past experiences and performances.

iii. It is compulsory to create irrespective of the fact whether there are profits or losses.

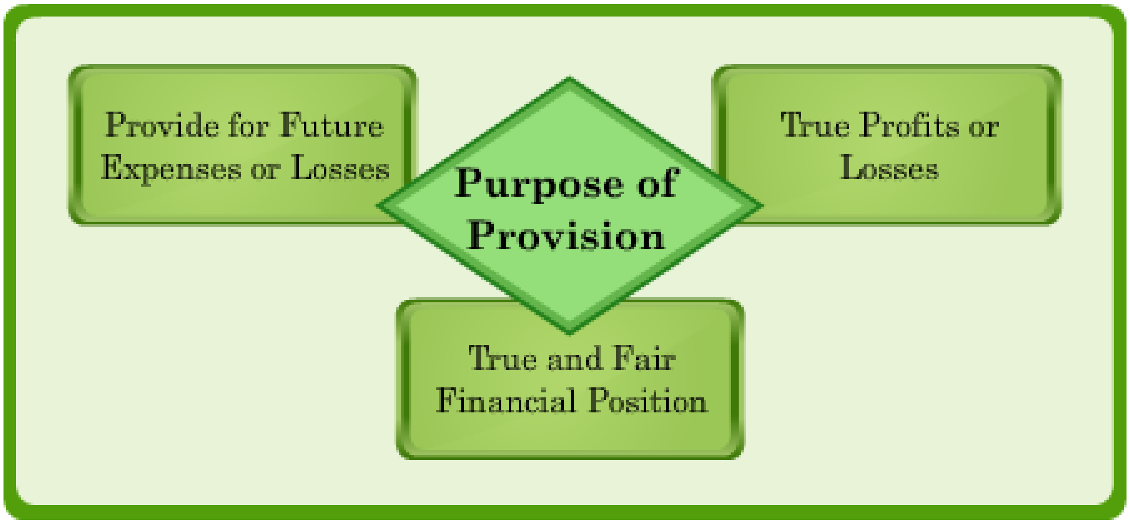
1. It is a charge against profits and not an appropriation of profits.

Importance of Provisions

The following are the various purposes served by creating provisions.

1. ***Provide for Future Expenses or Losses*-**Provision is the amount kept aside out of profits to meet the future expected liabilities and losses. Therefore, it helps the business in meeting the expenses or losses that are expected to take place in the near future.
2. ***True Profits or Losses*-**The true profit or loss of a firm can be determined only when all the expenses or losses (whether they are paid/incurred or not are provided) i.e. debited to Profit and Loss Account. Provision is a charge against revenues or profits of a firm and therefore it helps in ascertaining the true profit or loss during an accounting period.

iii. *True and Fair Financial Position*- By creating the provisions for anticipated expenses and losses the true financial position of an organisation can be assessed at the end of an accounting period.



Reserves

The amount that is kept out of the profits of an enterprise to meet the future 'unknown' or 'unexpected' liabilities is known as reserve. The creation of reserves helps in meeting the unforeseen expenses or losses that may occur in the near future. It should be noted that creation of reserve is not compulsory. Its creation completely depends upon the will of an enterprise. It is an appropriation of profits which is created out of the undistributed profits of the business. It helps in strengthening the financial position of the business. Besides this, the amount of reserves can also be utilised for distribution of profits among its shareholders.

As creation of reserve is an appropriation of profit so, it does not reduce the profits of the firm. Therefore, the reserves are not debited to the Profit and Loss Account. Rather, it is debited to the Profit and Loss Appropriation Account. Also, the reserves created are shown on the Liabilities Side of the Balance Sheet under the head Reserves and Surplus.

Sometimes, a business may opt to invest the amount of reserve so created outside its operations. Such investment of reserve is known as ***Reserve Fund***.

In the words of William Pickles, '*Reserves means the amount set aside out of the profits and other surpluses, which are not earmarked in a way to meet any particular liability, known to exist on the date of Balance Sheet*'.

As per American Institute of Accounting views- '*The use of term reserves be limited to indicate that an undivided part of asset is being held or retained for general or specific reserve*'.

The given below are some examples of reserves.

1. General Reserve
   ii. Dividend Equalisation Fund
   iii. Capital Reserve
   iv. Debenture Redemption Reserve

v. Workmen Compensation Fund
vi. Investment Fluctuation Fund, etc.

Features of Reserves

The following are the various features of reserves that can be derived from the above explanation.

1. It is created to meet the future uncertainties.
2. Its creation is not compulsory.

iii. It is an appropriation of profits and not a charge against profits.

1. It can be distributed as dividends.

Importance of Reserves

The given below are some purposes served by the creation of reserves.

1. ***Provide for Future Unexpected Liabilities-***The amount of reserves can be utilised to meet the unexpected future losses or expenses of the business.
2. ***Improved Financial Position-***Reserves are basically the retention of certain portion of undistributed profits of the business. Therefore, for the purpose of expanding the business the reserves can be used as an internal source of finance.

iii. *Improve Goodwill-* The reputation of a business depends on the uniformity in the payment of dividends. The reserves can be utilised for the distribution as dividends to its shareholders which gives them a sense of surety and security of their investment in the business. This in turn, enhances the goodwill of the business.

1. ***Repayment of Long-term Liabilities-***The specific reserve can be created for the repayment of long-term liabilities. For example, for the purpose of redeeming the debentures, a business may create Debenture Redemption Reserve for making payment to its debenture-holders.
2. ***Meeting Legal Requirements-***Sometimes the reserves may be created just to fulfill the legal requirements. For example, creation of Investment Fluctuation Fund is legally required by the Income Tax Law.

Distinction between Provisions and Reserves
Although both provisions and reserves are created to meet the future liabilities of the business, but following are some of points of dissimilarities between the two.

Point of Distinction	**Provisions**	**Reserves**
Objective	Created to meet the future known liability the amount of which cannot be determined precisely.	Created to meet the future unknown liabilities.
Appropriation v/s Charge	It is a charge against profit	It is an appropriation of profits
Aim	Created to meet the specific liability of the business in the near future	Created for strengthening the financial position of the business
Recording	Recorded on the debit side of the Profit and Loss Account	Recorded on the debit side of the Profit and Loss

		Appropriation Account.
Effect on Profit	The available profits of the business reduces as it is a charge against profits	It does not reduces the profit of the business as it is an appropriation of profits
Utilisation	Cannot be utilised for the purpose of distribution as profits.	Can be utilised for the purpose of distribution as profits.
Creation	It is compulsory to create even if there are no profits	It is not compulsory to create. Therefore, in cases of inadequate profits it is not created
Investment of Amount	It can never be invested outside the business	It can be invested outside the business
Disclosure in Balance Sheet	It is shown either on the Assets Side as a deduction from the concerned asset or can be shown on the Liabilities Side	It is shown on the Liabilities Side of the Balance Sheet under the head Reserves and Surplus

Reserves- Meaning and Types

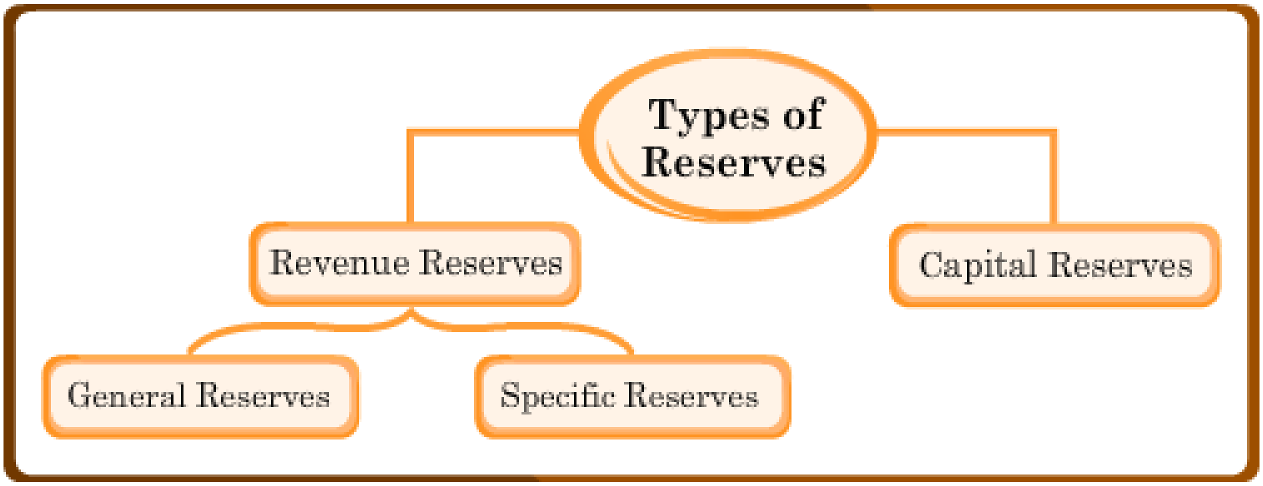
Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Types of Reserves
  - Distinction between Revenue Reserves and Capital Reserves
  - Distinction between General Reserves and Specific Reserves
  - Concept of Secret Reserves

Types of Reserves
We know that reserves are the portion of undistributed profits of a business that is kept aside to meet the future uncertainties. The reserves can be broadly bifurcated as revenue reserves and capital reserves. The revenue reserves can

be further classified as general reserve and specific reserve. A clear picture of the classification of the reserves is depicted in the given below diagram.



1. Revenue Reserves

The reserves that are created out of those profits which are earned from carrying out the normal activities of a business are known as *Revenue reserves*. In other words, revenue reserves are created out of revenue profits of the firm. These reserves are created to meet the unexpected expenses or losses of the business. It helps to strengthen the financial soundness of the business. These can be utilised for distribution of dividends among the shareholders. In the words of Kohler, '*Reserves are that portion, or any thereof, of the net worth or total equity of an enterprise representing retained earnings available for withdrawal by proprietors*'. Some of the examples of Revenue reserves are Debenture Redemption Reserve, Investment Fluctuation Reserve, General Reserve, etc. The Revenue reserves can be further classified as General Reserve and Specific Reserve.

- ***General Reserves*-**These are the reserves that are created out of revenue profits without any specific purposes. In other words, these reserves are maintained to meet the future unforeseen liabilities of the business. The purposes of utilising such reserves are not specified and thus it can also be used to enhance or improve the financial position of the business. These reserves are used as per the discretion of the management for the general purposes. The given below are some purposes for which the general reserve can be utilised.

1. To strengthen the financial position of the business.
2. To meet unexpected expenses or losses.

iii. To provide a channel for expanding the business.

- ***Specific Reserves-***These are the reserves that are created out of revenue profits for fulfilling the specific purposes of the business. These reserves cannot be utilised for the purposes other than specified purposes for which it has been created. For example, Debenture Redemption Reserve is a specific reserve that can be utilised for redeeming the debentures of the company. Some of the examples of specific reserves are Investment Fluctuation Fund, Workmen Compensation Fund, Dividend Equalisation Fund, Sinking Fund, Development Rebate Reserve, etc.

2. **Capital Reserves**

The reserves that are created out of the capital profits of a business are known as Capital reserves. Capital profits are the profits that are not earned in the normal business activities. These reserves are created out of the transactions which are capital in nature. Therefore, all the capital profits arising from the specific capital nature transactions can be termed as C*apital reserves*. The following are the some examples of capital reserves.

1. Profit on sale of fixed assets.
   ii. Profit on re-issue of forfeited shares.
   iii. Profit on revaluation of assets and liabilities.
   iv. Premium received on issue of shares and debentures.
   v. Profit on redemption of debentures.
   vi. Profit prior to incorporation.

These reserves are utilised by the business for writing-off the capital losses and cannot be utilised for distribution of dividends among the shareholders.

Distinction between General Reserves and Specific Reserves

The given below are some points of distinction between general reserves and specific reserves.

Point of Distinction	**General Reserves**	**Specific Reserve**
Meaning	These are the reserves that are created without any specific purposes	These are the reserves that are created for some specific purposes
Purpose	It can be utilised for any purpose as per the discretion of the management	It is utilised only for the specified purposes for which it has been created
Examples	Reserve fund, Contingency Reserve, Retained Earnings,	Investment Fluctuation Fund, Debenture Redemption Reserve,

	etc.	Dividend Equalisation Fund, etc.

Distinction between Revenue Reserves and Capital Reserves

The given below are some points of difference between Revenue reserves and Capital reserves.

Point of Distinction	Revenue Reserves	Capital Reserves
Creation	Created out of revenue profits that are earned in the normal business activities.	Created out of capital profits that are not earned in the normal business activities.
Distribution as Dividend	It can be utilised for distribution as dividends.	It cannot be utilised for distribution as dividends.
Aim	Created to meet the future uncertainties and enhancing the financial soundness of the business.	Created to write-off the capital losses or to meet the purpose laid down in the Companies Act.
Examples	General Reserve, Debenture Redemption Reserve, Retained Earnings, etc.	Profit on sale of fixed assets, Premium on issue of shares, Profit prior to incorporation, etc.

Meaning of Secret Reserves
Secret reserves are those reserves which exist in the business to strengthen its financial position but are not disclosed in the Balance Sheet. As these reserves are not apparent on the Balance Sheet, therefore, it is also known as Hidden Reserve or Inner Reserves. These reserves are created by showing the profit at much lower figure or by understating the assets and overstating the liabilities of the business. The presence of such reserves in the business restrains the Balance Sheet to reveal its true financial position. Due to the existence of these reserves the actual position of the business is much better than what is actually depicted by the Balance Sheet. The creation of secret reserves is not permitted by the Companies Act, 1956 except in the cases of Banking Companies and Insurance Companies.

Ways of Creating Secret Reserves
The following are the various ways through which the secret reserves may be created.

1. By undervaluation of assets.
   ii. By overvaluation of liabilities and provisions.
   iii. By creating excessive provision for doubtful debts.
   iv. By charging excessive depreciation on the fixed assets.
   v. By treating capital expenditure as revenue expenditure.
   vi. By ignoring the prepaid expenses.
   vii. By ignoring outstanding incomes.
   viii. By treating contingent liability as an actual liability.
   ix. By understating the goodwill.
   x. By suppressing the sales.

Benefits of Secret Reserves
The given below are some benefits of creating secret reserves.

1. ***Financial Soundness***- Secret reserves helps in enhancing and improving the financial soundness of the business without intimating it to the shareholders and outsiders.
2. ***Reduced Competition***- The secret reserves are created by revealing the actual profits of the business at much lower figures. This helps the management to avoid the competition in the market.

iii. ***Writing-off Unexpected Losses***- Secret reserves helps in writing-off the huge unexpected losses of the business without bringing it to the notice of the public and also without affecting the regular profits of the business.

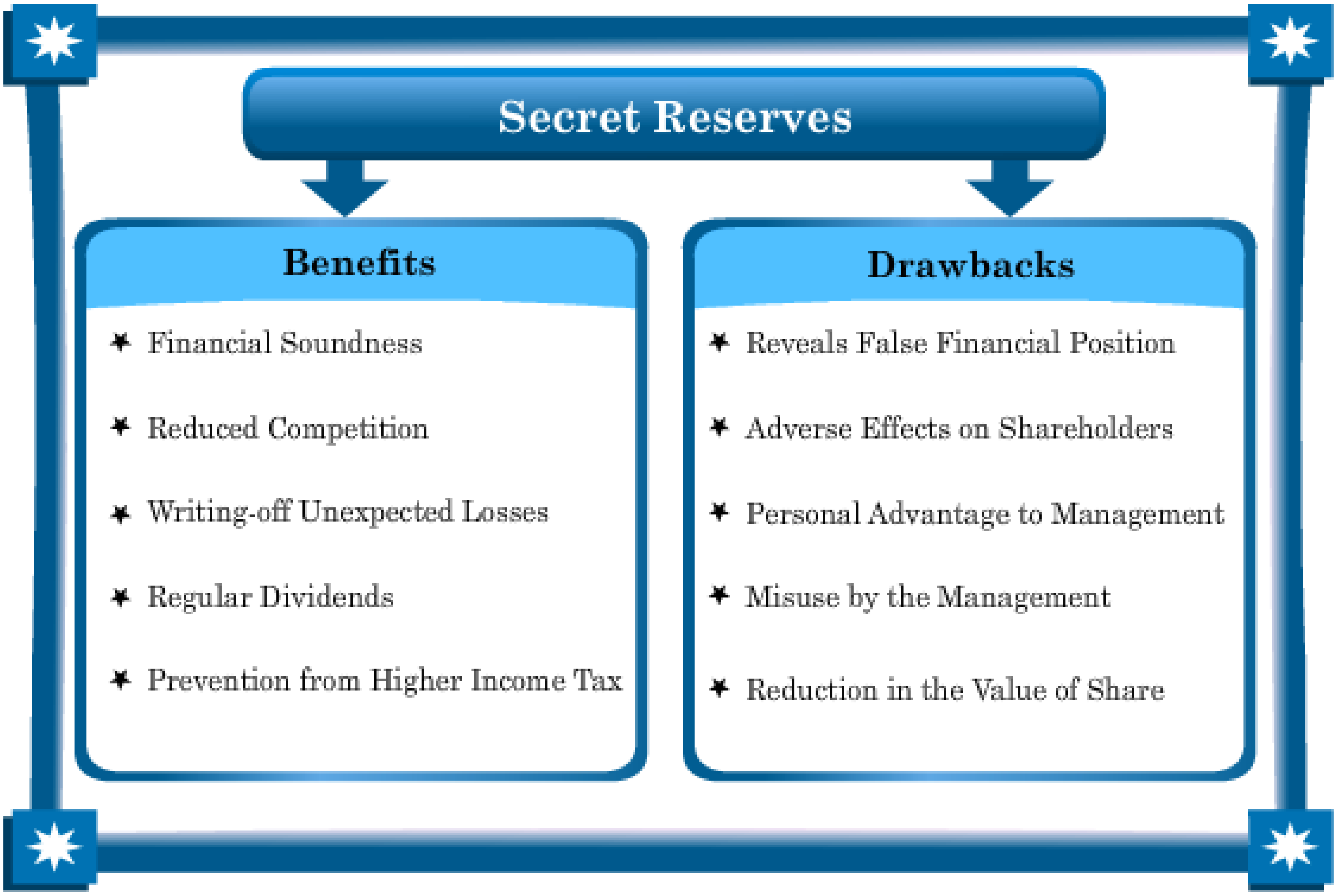
1. ***Regular Dividends***- In the adverse conditions of the business, when there are low profits, the secret reserves can be utilised to maintain the uniformity in the payment of dividends to its shareholders.
2. ***Prevention from Higher Income Tax***- The disclosure of reduced profits in the books leads to the reduction in the income tax liabilities.

Drawbacks of Secret Reserves
Besides various benefits of secret reserves there also exist some drawbacks. These are as follows.

1. ***Reveals False Financial Position***- Secret reserves restrain the Profit and Loss Account from revealing the true profits and Balance Sheet from disclosing the true and fair financial position of the business.
2. ***Adverse Effects on Shareholders***- These reserves lead to the losses to the shareholders due to the concealment of actual profits in the books. Therefore, they are not able to get their due share of actual profits.

iii. ***Personal Advantage***- The management or directors can take the undue advantages of such reserves for their personal purposes.

1. ***Misuse by the Management***- These reserves can be utilised by the management for hiding their mistakes and fraudulent activities.
2. ***Reduction in the Value of Share***- Creation of secret reserves leads to a decline in the price of share in market.



Distinction between Provisions and Reserves

Basis of Distinction	**Provisions**	**Reserves**
1) Charge Vs. Appropriation	Charge Against Profit	Appropriation of Profit.
2) When created?	To be created whether profit is made or not.	To be created only when there is a profit.
3) Motive	To meet a known liability	To act as a buffer in case

	or contingency even if its amount cannot be determined.	of an unknown liability.
4) Disclosure	Can be either shown on the Liability side under the head 'Other Liabilities' or deducted from the assets.	Shown on the liabilities side of the Balance Sheet under the head 'Reserves and Surplus.'
5) Disbursement	Cannot be paid as dividend and reduces net profit.	Unutilised portion can be distributed as dividend.
6) Compulsion	A must as per the GAAP.	Created out of prudence and not mandatory.
7) Examples	Provision for Depreciation, Provision for Bad Debts, etc.	General Reserve, Investment Fluctuation Reserve, etc.