UNIT 22 PROVISIONS AND RESERVES

Structure

22.0 OBJECTIVES

After going through this unit, you Should be able to :
- explain the meaning of term 'provision' and 'reserve'
- distinguish between provision and reserve
- prepare provision for repairs and renewals account
- describe the nature of different types of reserves.

22.1 INTRODUCTION

Business firms maintain their accounts as going concerns on the assumption that the business will continue to exist indefinitely, Hence, at the end of each accounting year, they must also take into account the future contingencies and the requirements of funds before determining the amount of net profit available for distribution among the owners. Provisions and reserves actually relate to the future needs for which a part of the current earning has to be set aside. In this unit you will learn about the meaning of provision and reserve, the difference between provision and reserve, and also the various types of reserves which are usually created before distribution of profits.

22.2 WHAT IS A PROVISION?

It is a generally accepted accounting principle that while measuring income for an accounting year, all possible losses and expenses must be taken into account. Hence we usually provide for depreciation on fixed assets and their repairs, renewal etc. Similarly, there may be certain liabilities/losses the amounts of which cannot be ascertained with substantial accuracy such as dispute claims for damages, bad debts, and so on. We must charge their estimated amounts to Profit and Loss Account before working out the net profit. Such charge to the Profit and Loss Account is called 'Provision', The Indian Companies Act has defined it as ***"any amount written off or retained by way of providing for depreciation, renewal 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"***

Thus, provisions are the amounts set aside out of profits and other surpluses to provide for (i) depreciation, renewals, or diminutionin the value of assets, and (ii) any known liability of which the amount cannot be determined with substantial accuracy.

It must be noted that any known liability the amount of which can be determined accurately does not fall within the definition of a provision and should be described as 'accrual' or 'accrued liabilities'. In other words, provision for outstanding salaries, rent, etc., in the strict sense of the term, cannot be called provisions. They will be termed as 'accruals'.

The provisions are usually created by debiting the Profit and Loss Account and are either shown on the liabilities side of the Balance Sheet or deducted from the concerned asset. You learnt about the provision for bad and doubtful debts, provision for discount on debtors and provision for depreciation in Unit 7. Let us now study about the provision for repairs and renewals.

Provision for Repairs and Renewals : Certain assets used for business purposes need repairs and renewals which may not be significant in initial years when any asset is purchased, but it may increase with its constant use and passage of time. To equalise the charge on Profit and Loss Account over the year in respect of repairs and renewals, we make a provision for repairs and renewals by debiting the Profit and Loss Account and crediting the Provision for Repairs and Renewals Account. The actual expenditure incurred on repairs and renewals is charged to the Provision for Repairs and Renewals Account every year. Look at Illustration 1 and see how this account appears in books.

Illustration 1

A business concern decided to provide Rs. 1000/- every year for the repairs and renewals of a machine used in the process of manufacture from the year 1981. In the first five years the amount spent on repairs was Rs. 3001-, Rs. 3251-, Rs. 4801-, Rs. 7001-, Rs. 1,2001-. Prepare a Provision for Repairs and Renewals Account for five years.

Solution :

Provisions for Repairs and Renewals A/c

Dr. Cr.

Date	Particular	Amount	Date	Particulars	Amount
1981		Rs.	1981		Rs.
Dec. 31	To Repair A/c	300	Dec. 31	By P & L A/c	1,000
,, 31	To Balance c/d	700			
		1,000			1,000
1982			1982		
Dec. 31	To Repair A/c	325	Jan. 1	By Balance b/d	700
,, 31	To Balance c/d	1,375	Dec. 31	By P & L A/c	1,000
		1,700			1,700
1983			1983		
Dec. 31	To Repair A/c	480	Jan. 1	By Balance b/d	1,375
,, 31	To Balance cld	1,895	Dec. 31	By P & L A/c	1,000
		2,375			2,375
1984			1984		
Dec. 31	To Repair A/c	700	Jan. 1	By Balance bld	1,895
,, 31	To Balance c/d	2,195	Dec. 31	By P & L A/c	1,000
		2,895			2,895
1985			1985		
Dec. 31	To Repair A/c	1,200	Jan. 1	By Balance b/d	2,195
,, 31	To Balance cld	1,995	Dec. 31	By P & L A/c	1,000
		3,195			3,195

22.3 WHAT IS A RESERVE?

The term reserve refers to the amount set aside out of profits and other surplus which are not designed to meet any liability or diminution in value of assets known to exist at the date of the Balance Sheet. The Indian Companies Act has not given any clear definition of the term 'Reserve'. It states, however, that *"the expression 'reserve' shall not....... include any amount written off or retained by way of providing for depreciation, renewal or diminution in value of an asset, or retained by way of providing for any known liability.* In other words, any amount set aside out of profits to meet unexpected future losses and liabilities is called reserve. Not only that if any amount retained by way of providing for any known liability in excess of the amount actually needed for the purpose, shall also be treated as reserve and not a provision.

The basic purpose of creating a reserve is to provide for unexpected losses in future and also retain profits within business (not distribute them to the owners or shareholders) to provide funds for expansion of the business. Most well managed companies make it a point not to distribute the whole of their profits to the shareholders. They retain good portion of their profit in the form of general reserve (also called contingency reserve). This also enables them to pay dividend even during the year when the profits are low or there are losses.

Reserves are created by debiting their amounts to the Profit and Loss Appropriation Account. But reserve is not a compulsory charge on profits. It is purely voluntary and is regarded as an appropriation of profits. It means that reserve represents an undistributed portion of net profit and not a loss or expense which ought to have been charged before calculating the net profit, as is done in case of the provisions.

Reserve Fund : The term 'reserve fund' is used for the amount of reserve which has been invested in outside securities. The instructions given in the Companies Act for the preparation of Balance Sheet, the word 'fund' in relation to any reserve can be used only when such reserve is specifically represented by earmarked investments. Examples of Reserve fund are employees' welfare fund, pension fund, gratuity fund, debenture redemption fund, etc. If, however, the amount of reserve is being utilized by the business itself and not invested in some outside securities, it cannot be called reserve fund.

22.4 DISTINCTION BETWEEN PROVISION AND RESERVE,

You have learnt the meaning and purpose of creating a provision and also a reserve. Various points of distinction between the two can be summarised as follows :

	Provision		Reserve
1	Provision is made to meet a known liability for depreciation/renewal of assets.	1	Reserve is created to meet unexpected contingencies likely to arise in future.
2	The amount set aside is used only to meet the specific purpose for which provision was made.	2	Amount can be used for any liability or loss.
3	Provision is to be made even if there are no profits.	3	It is created only when there are sufficient profits,
4	It is a charge on profits and must be debited before arriving at the figure of net profit.	4	it is an appropriation of profits and represents undistributed profits.
5	It cannot be used for the payment of dividends.	5	Except in some cases, it can be used for payment of dividends.
6	It cannot be invested outside the business.	6	It can be invested outside the business, when created For a specific purpose.

Check Your Progress A

1 Define Provision.

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2 Which of the following statements are true and which are false.

i) Provision for discount on debtors is a charge on Profit and Loss Account. ......

ii) Creation of reserve may lead to reduction of net profit. ......

iii) Provision made can be distributed among shareholders if the directors so decide. .....

iv) Reserves are always invested outside the business. ......

v) Amount set aside out of profits is known as reserve if it is created for meeting unexpected future contingencies. ......

vi) Reserve is a charge on net profit. ......

3 How is 'Reserve Fund' different from 'Reserve'?

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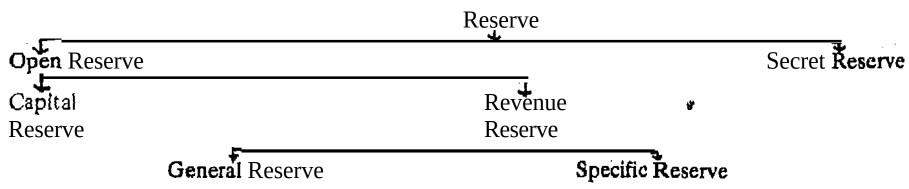
22.5 TYPES OF RESERVES

To have a clear understanding of the nature and purpose of reserves we may classify them into different categories as follows:



22.5.1 Open Reserves

There are two ways of creating reserves: (1) by debiting the amount to Profit and Loss Account and clearly showing it in the Balance Sheet in one form or the other, and (2) by undervaluation of assets or overproviding for losses. The first category of reserves can be easily identified from the financial statements and are termed as open reserves. The second category of reserves cannot be identified by the reader of financial statements. They are known only to the management. Shch reserves are called 'secret reserves'. These will be discussed later in this unit.

Open reserves are further classified as capital reserves and revenue reserves depending on the nature of profit out of which they are created.

Capital Reserve : A reserve created out of capital profits is called 'Capital Reserve'. Capital profits may arise on account of revaluation or sale of fixed assets. In case of companies the following items are also regarded as capital profits.

i) credit balance left in Forefeited Shares Account after the re-issue of such shares,

ii) premium received on issue of shares on debentures,

iii) profit realised on the purchase of company's own debentures from the market, and

iv) profits made prior to incorporation.

Capital profits cannot normally be used for distribution of dividends and therefore are transferred to capital reserve. If at all the company, at some stage, wants to utilize capital reserve for the distribution of dividends, it has to satisfy certain specified conditions.

You should note that ***reserve capital*** is not the same thing as capital reserve. The reserve capital refers to the uncalled amount of share capital which can be called only in the event of liquidation of the company. You will learn about this in a separate course (ECO-04 Accountancy II).

Revenue Reserve : Any reserve other than capital reserve can be called a revenue reserve. Revenue reserves are usually created out of business profits which are available for distribution of dividends. They are meant for specific purposes or general purposes and are accordingly known as ***specific reserves*** or ***a 'general reserve'.*** The specific purposes for which they are usually created are dividend equalisation (known as dividend equalization reserve), redemption of debenture (known as debenture redemption fund), workmen's compensation (known as workman's compensation fund); etc. A general reserve, on the other hand, is meant for meeting the unforseen contingencies and to strengthen the financial position of the business. All these reserves are debited to the Profit and Loss Appropriation Account and shown on the liabilities side under the head 'Reserves and Surplus'. As a matter of fact, ***they reflect the undistributed profits of the business.***

Distinction between Capital Reserve and Revenue Reserve

The capital reserves and revenue reserves differ in many respects. The main points of distinction are as follows :

	Capital Reserve		Revenue Reserve
1	It is created out of capital Profits.	1	It is created out of business profits.
2	It can be used for distribution of dividends only if the company satisfies certain conditions' prescribed by'the Companies Act.	2	It can be used for distribution of dividends without any pre-condition.
3	It is created for meeting capital losses or to be used for purposes specified by Companies Act.	3	It is created for strengthening the financial position, and meeting the unforeseen contingencies or some specific purpose.

Sinking Fund : A sinking fund is a specific reserve created with the object of providing funds for the redemption of long term liabilities like redeemable debenture. It is created by setting aside a fixed sum out of profits every year for a definite period. Such a sum is invested at a compound interest so that at the end of the period, the annual amounts with accumulated interest will be sufficient to discharge the liability. If, for example, a company has to redeem debentures worth Rs. 1,00,000 at the end of ten years, it may set aside certain amount of profits every year and invest it in some securities carrying certain rate of interest. The interest earned every year is also re-invested. At the end of ten years, the total amount of investment (including interest) will be equal to the amount needed for redemption i.e., Rs. 1,00,000. The securities are then sold and the amount so realized is used for the redemption of the debenture. The amount of yearly instalment can be determined by reference to the sinking fund table. The same is debited to Profit and Loss Appropriation Account and credited to the Debenture Redemption Fund.

The term sinking fund is also used for the provision made for the replacement of a fixed asset. In that case, it is called Depreciation Fund which, in fact, is not a reserve in the strict sense of the term. You learnt about the depreciation fund in Unit 21. The ***journal entries for creation of debenture redemption fund are more or less the same as those of depreciationfund.*** (You will study in detail about the accounting treatment of debenture redemption fund in a separate course ECO-04 Accountancy II).

The sinking fund to redeem a'liability (debenture redemption fund) and the sinking fund to replace an asset (depreciation fund), however, differ in various ways. Look at Chart 22.1 and not the main points of difference.

Chart 22.1

Distinction Between Sinking Fund for Redemption of Liability and Sinking Fund for Replacement of an Asset

Sinking Fund for redemption of liability	Sinking Fund for replacement of an asset
1 The purpose is the redemption of a long term liability.	1 The purpose is the replacement of a fixed asset.
2 It is designated as 'Debenture Redemption Fund' or 'Loan Redemption Fund'.	2 It is designated as 'Machinery Replacement Fund' or 'Depreciation Fund'.
3 It is an appropriation of profit and so is debited to the Profit & Loss Appropriation Account.	3 It is a charge on profit and so debited to Profit and Loss Account.
4 At the time of redemption the accumulated fund is transferred to the credit of General Reserve.	4 At the time of replacement the accumulated fund is transferred to the credit of the concerned asset account.

Dividend Equalisation Fund : This fund is created by setting aside a portion of distributable profits during prosperous years as a provision for lean period so that company is able to declare usual dividend even if sufficient profits are not there. The amount representing this fund need not be invested in outside securities. Even if there is no specific dividend equalisation fund, a company can always use its reserves, if any, for the purpose of equalising dividends.

Investment Fluctuation Fund : This is a reserve created to provide for the loss by way of fluctuation in the values of investments made by the company in outside securities. This is generally provided by banks and insurance companies who invest huge funds in government securities.

Workman's Compensation Fund : Under Workmen Compensation Act, the workers are entitled to certain amount of compensation in case of accidents in the factory. When an accident takes place, the amount of compensation involved may be heavy. Hence, in order to avoid such loss being charged to the Profit and Loss Account of the year in which it occurs, the companies set aside a portion of profits every year and create a special fund for this purpose. It is called, 'Workmen's Compensation Fund'. As and when some compensation is paid, the same can be debited to this fund.

22.5.2 Secret Reserves

The term 'Secret Reserve' is applied to a reserve, the existence of which does not appear on the face of the Balance Sheet. When secret reserves exist, the financial position of the business is better than what may appear on the face of the balance sheet.

The main purpose of creating secret reserve is to reduce the disclosed profit so that during bad period this hidden profit, or a portion of it, may be merged into the earnings and thus help in equalising the dividends.

Methods of creating Secret Reserves: Secret Reserves may be created in one of the following ways :

i) Writing off excessible depreciation
ii) Undervaluation of closing stock
iii) Charging capital expenditure to Profit and Loss Account
iv) Making excessive provision for bad and doubtful debts
v) Showing contingent liabilities as actual liabilities
vi) Retaining appreciating assets at cost price

In all the above cases the value of the assets are reduced without disclosing the fact in the financial statements, As such they become 'secret' and are known only to the management.

Merits and Demerits : Creation of secret reserves, within certain limits, is justifiable on the ground of expediency and prudence. Secret Reserves enable the business to meet extra-ordinary losses without the same being disclosed and thus prevent the public confidence being shaken. The concealment of huge profits is also essential in order to prevent competition from other firms.

Despite certain merits, the following objections are raised against the practice of creating secret reserves.

i) Secret Reserves prevent the financial statements from showing the true and fair position of the business. The Profit and Loss Account charged with fictitious amount in respect of excessive depreciation, doubtful debts, or repairs etc, fails to disclose the true profits. Similarly, when the value of certain asset is understated or some liabilities are overstated, the Balance Shet cannot be said to represent the true state of affairs of the business. Thus, the financial statements become unreliable.

ii) The shareholders cannot assess the value of their holding correctly.

iii) Management can conceal its inefficiency by making use of secret reserves.

iv) It permits misuse of secret reserves for personal gain by managers. Sometimes the management, or those close to them, having knowledge of wilful suppression of net profits, inay indulge in certain nialpractices in the stock markets.

Before the enactment of the Companies Act, 1956, there were no restrictions on the creation of secret reserves. But, at present such reserves cannot be created by a company because the auditor has to certify that the Balance Sheet of the company gives a true and fair view of the state of affairs of the company. In case some secret reserves have been created, the auditor cannot give such a report without disclosing the extent of such reserves.

Check Your Progress B

1 Fill in the blanks

i) Open reserves can be of two broad categories................and................

ii) Capital Profits may arise on the sale of......................

iii) If the amount of reserve is invested outside the business it is known as.,..........

iv) Premium received on issue of shares is treated as............reserve.

v) Secret reserve can be created by treating...............expenditure as..........expenditure.

2 Which of the following stateinents are True and which arc False.

i) Dividend equalisation reserve is a type of capital reserve ......

ii) Keserve fund is only that part of reserve which is invested outside the business. ......

iii) Revenue reserves of company can he distributed as profits. ......

iv) A sinking fund may or may not be inve'sted outside the business. ......

v) Secret reserves affect the credibility of financial statements. ......

22.6 LET US SUM UP

Provision means any amount set aside from current earnings for depreciation. repairs and renewals, ctc. or for meeting a known liability the amount of which cannot be determined with substantial accuracy. It is a charge on profits and must for the ascertainment of true profits of the business.

The term 'reserve' refers to the amount set aside out of profits for meeting Cnforeseen contingencies and provide funds for business expansion. Reserves can be classified into two broad categories : (1) open reserves and (ii) secret reserves.

Open reserves are reserves which are clearly shown in the books of account, and may be in the nature of capital reserve or revenue reserve. Capital reserves are those reserves which are created out of capital profits. Such reserves cannot be normally used for the distribution of dividends. Kevenue reserves, on the other hand, are created out of normal business profits and are allowed to be used fur the distribution of dividends. They may be created for general purposes (meet any contingency in future) or for specific purposes. Dividend Equalization Fund, Debenture Redemption Fund (Sinking Fund), Investment Fluctuation Fund, Workmen's Compensation Fund are' some examples of specific reserves.

Secret reserves refer to such reserves that are not disclosed in the Balance Sheet. They are created by providing excessive depreciation undervaluation of closing stock or by charging capital expenditure to Profit and Loss Account. Such rkserves may be justified on grounds of Prudence and discouraging competitors from entering the market. But, they prevent disclosure of true and fair view of the financial position of the business and are likely to be misused by management:

22.7 KEY WORDS

Capital Reserve : Reserve created out of capital profits.
Open Reserves : Reserves which are clearly shown in the financial statements.
Provision : Amount set aside of current earnings of a business for depreciation, repairs or renewals or meeting a known liability the amount of which is uncertain.
Reserve : Amount set aside out of profits or surplus to meet unexpected contingencies or provide funds for growth.
Revenue Reserve : Reserve created out of normal business profits.
Reserve Fund : That part of reserve which is invested outside the business.
Sinking Fund : A fund created out of earnings to repay a long term liability or replace an asset.
Secret Reserves : Reserves, the existence of which is not revealed in the financial statements.

22.8 SOME USEFUL BOOKS

Maheshwari S.N. 1986. *Introduction to Accounting,* Vikas Publishing House : New Delhi. (Chapter 13)

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting,*** R. Chand & Co., New Delhi. (Chapter 4 V)

Shukla, M.C. and T.S. Grewal, 1987. ***Advanced Accounts,*** S. Chand & Co., New Delhi. (Chapter 7)

William Pickles. 1982. ***Accountancy,*** E.L.B.S. and Pitman London. (Chapter 7)

22.9 ANSWERS TO CHECK YOUR PROGRESS

A 2 i) True ii) False iii) False iv) False v) True vi) False
B 1 i) Capital reserve and revenue reserve ii) fixed asset (iii) reserve fund iv) capital v) capital, revenue
2 i) False ii) True iii) True iv) False v) True.

22.10 TERMINAL QUESTIONS/EXERCISES

1 What is a reserve? Examine critically the policy of some concerns in building up huge reserves and others totally ignoring it.

2 Distinguish between :
a) Reserve and Provision
b) Capital Reserve and Revenue Reserve
c) Specific Reserve and General Reserve
d) Sinking fund to repay a liability and sinking fund to replace an asset

3 What is a secret reserve? Enumerate methods employed by a firm to create secret reserves. Critically evaluate the practice from the viewpoint of general investors and shareholders.

4 In a concern where the current expenditure on repairs is comparatively less but where it is known that the expenditure at a subsequent period will be considerable: you find that a Provision for Repairs Account is created and credited every year with Rs. 90,000. What is the object of creating such an account, and how is the amount of Rs. 90,000 ascertained.

If the actual repairs amounted to Rs. 9,000 in the first year, Rs. 21,000 in the second year, and Rs. 33,000 in the third year, what could be the Revenue Charges for the respective years?

Show the Provision for Kepairs Account for the three years.

ECO-02 ACCOUNTANCY-I
Course Components

BLOCK	UNIT NO.	PRINT MATERIAL
1		**Accounting Fundamentals**
	1	Basic Concepts of Accounting
	2	The Accounting Process
	3	Cash Book and Bank Reconciliation
	4	Other Subsidiary Books
	5	Bills of Exchange
2		**Final Accounts**
	6	Concepts Relating to Final Accounts
	7	Final Accounts-I
	8	Final Accounts-II
	9	Errors and their Rectification
3		**Consignments and Joint Ventures**
	10	Consignment Accounts-1
	11	Consignment Accounts-ll
	12	Consignment Accounts-111
	13	Joint Venture Accounts
4		**Accounts from Incomplete Records**
	14	Self Balancing System
	15	Accounting from Incomplete Records-I
	16	Accounting from Incomplete Records-II
	17	Accounting from Incomplete Records-1II
5		**Accounts of Non-trading Concerns, Depreciation, Provisions and Reserves**
	18	Accounts of Non-trading Concerns-1
	19	Accounts of Non-trading Concerns-I1
	30	Depreciation-1
	31	Depreciation-II
	2Z	Provisions and Reserves