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.

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 :—** 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. For example, the provision should be made for doubtful debts, because the amount of such bad-debts cannot be estimated very accurately.

(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 such as provision for taxation, provision for repairs, provision for damages likely to arise from a pending suit and such others.

(4) **For the equitable distribution of expenses :—** For example, if a machine is estimated to run for 10 years and the total amount of repairs expected to be incurred during its entire life span is ₹10,000, a 'provision for repairs a/c' will be created by debiting ₹1,000 to each year's Profit & Loss Account. Actual expenses of repairs incurred each year will be debited to this account. Hence, it will put equal burden on the Profit & Loss Account of each year in respect of expenses of repairs which will be very light in the earlier years but definitely heavy in the later years.

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. 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 :—** 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 undistributed or accumulated profits and technically known as 'ploughing back of profit'. It is 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. Sometimes a reserve known as 'dividend equalisation reserve' is also created for the specific purpose of equalising the rate of dividend.

(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. For example, if we need ₹5 crore for the repayment of debentures after 10 years, a fund is created for this purpose by transferring a fixed amount from the divisible profits each year. The funds so accumulated may also be invested outside the

business in such a way that after 10 years ₹5 crore will become available for the payment of debentures. It will facilitate the payment of such a big sum in one go.

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 unknown liability.
2. **Necessity (Charge or Appropri-ation)**	Creation of provision is a legal necessity. Provisions have to be provided for even if there are no profits. Thus, provision is a **charge against profits.**	Creation of reserves is discretionary. It can be created only if adequate profits have been earned. Thus, reserve is an **Appropriation of Profit.**
3. **Object**	The object is to provide for depreciation, doubtful debts and other specific liabilities.	The object of reserves 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 provisions 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 a distinct item on the liabilities side.	It is shown on the liabilities side under the head 'Reserves 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 purposes.**	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

Reserves
- Revenue Reserves
  - General Reserves
  - Specific Reserves
- Capital Reserves

Revenue Reserves :— These reserves come into existence out of profits which 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 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. For example, if an asset was purchased 10 years ago at a cost of ₹10 Lac and if the depreciation has been provided @ 10% on the original cost, it will provide only a sum of ₹10 Lac. But, suppose, the current price of the asset is ₹40 Lac, an additional sum of ₹30 Lac will be required for purchasing a new asset. Therefore, the reserve is created for providing this additional sum.

'Reserve for Replacement of Asset' is created by annually transferring a certain amount from Surplus of Statement of Profit & Loss. Following entry is passed for this purpose :

Surplus of Statement of Profit & Loss Dr.
To Asset Replacement Reserve A/c
(Amount transferred out of divisible profits)

The amount of replacement reserve is either kept and utilised in the business itself or is invested in outside securities bearing interest at a pre-determined rate. When this reserve is invested in outside securities it is known as 'reserve fund'.

Such a reserve is created out of divisible profits. In other words, instead of declaring higher dividends the amount is transferred to replacement reserve. If such a reserve had not been created, the profit would have been distributed as dividend and the amount would have gone outside the business. The amount thus saved is accumulated from year to year and is utilised for the specific purpose of replacement of the asset. 'Reserve for Replacement of Asset A/c' is closed by transferring it to 'General Reserve A/c' at the end.

(III) **Investment Fluctuation Fund :** It is created to provide for decline in the value of investments due to market fluctuations.

(IV) **Workmen Compensation Fund :—** It is created to meet compensation payable to workers in case of unexpected or unknown event of an accident.

(V) **Debenture Redemption Reserve :—** It is created to provide funds for the redemption 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.

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.

All the same, it would be a prudent policy on the part of the management not to distribute such profits. They should be kept in the business to strengthen its financial position.

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 disribution 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 losses and for strengthening the financial position of business.	These reserves 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 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 :

(*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;

(*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 :

(*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 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. Profits may be suppressed to enable them to buy the shares of the Company at a lower price and then the profits may 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.

The creation of secret reserves is not allowed under the Companies Act, 2013 as it requires a full disclosure of all material facts and significant accounting policies followed in preparing financial statements.

SHORT ANSWER QUESTIONS

1. Define provision. What is the importance of creating a provision? (any three points of importance).
2. Distinguish between Provisions and Reserves. *(KVS 2024)*
3. Distinguish between Provision and Reserve on the following basis :
   (*i*) Basic Nature (*ii*) Purpose
   (*iii*) Effect on Taxable Profits (*iv*) Presentation in Balance Sheet
   (*v*) Element of Compulsion (*vi*) Use for payment of dividend. *(KVS 2018)*
4. Differentiate between Provision and Reserve on the basis of
   (*i*) Appropriation or Charge (*ii*) Financial Position
   (*iii*) Distribution