Chapter 8 RESERVES AND PROVISIONS

JKUIG7

Learning Objectives

- To understand the meaning, definition, classification and auditors duties with regard to reserves and provisions.
- To identify the differences between reserves and provisions.

POINTS TO RECALL RECAP

In the previous Chapter, we have studied the meaning and definition of depreciation, causes of depreciation, objectives and different methods of calculating depreciation, auditors duties with regard to verify depreciation.

8.1 Reserves

8.1.1 Meaning

Reserve is a part of the profits which are set aside for any known or unknown contingency, liability or diminution in the value of an asset etc. It is that portion of the current profits or of accumulated profits which is not distributed as dividend, but is kept separate for the purpose of meeting some known or unknown liabilities which might arise in the future.

8.1.2 Definition

- **Companies Act** defines Reserve as, "shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability".
- **The American Institute of Accountant** defines a reserve as, "the use of the term be limited to indicate that an undivided portion of the assets is being held or retained for general or specific purpose."

8.1.3 Classification of Reserves

1. GENERAL RESERVE

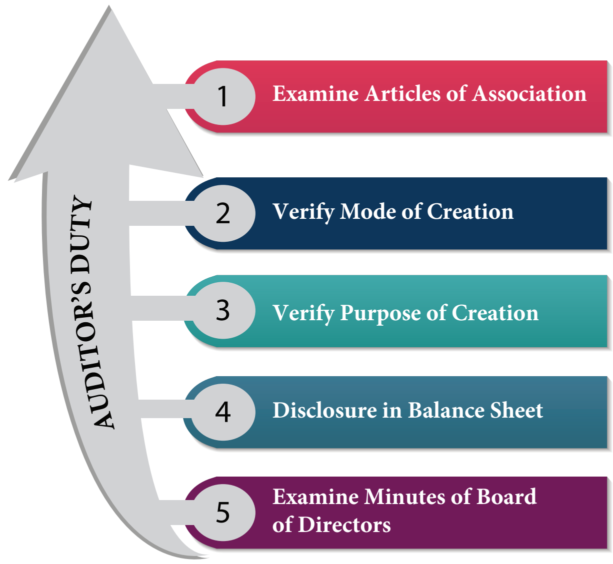
A reserve which is created out of the profits or surplus of a business for meeting any unknown liability is called as 'General Reserve' or 'Free Reserve' or 'Revenue Reserve.' It is an appropriation of profit. According to Companies Act, creation of general reserve is not compulsory, it is to be created only when the company has sufficient profit. However, if the Articles of Association of the company state that a specific amount is to be set aside out of profit before distribution of dividend, then the amount should be transferred to General Reserve account.

Objects of creating General Reserve

It is created with an object to

- Provide additional working capital,
- Strengthen the liquid resources of the business,
- Meet any unknown contingency or liability,
- Equalize dividend in the years in which profits are inadequate and
- Expand business etc.

AUDITOR'S DUTY



1. **Examine Articles of Association:** The auditor should examine the Articles of Association to see whether provision regarding creation of general reserve has been complied with.
2. **Verify Mode of Creation:** It is the duty of the auditor to ensure that reserve is created only out of profits of the company.
3. **Verify Purpose of Creation:** Auditor should ensure that general reserve is created for the best interest of the company.
4. **Disclosure in Balance Sheet:** He should examine that reserve amount is properly shown in the Balance Sheet. When reserve amount is invested in securities, he should verify that investments are shown on the assets side of the Balance Sheet.

5. **Examine Minutes of Board of Directors:** Auditor should examine Minutes of the Board of Directors meeting to verify directors approval for utilizing the reserve amount.

2. SPECIFIC RESERVE

A reserve which is created for the purpose of providing for losses and contingencies which are known or expected to occur at a future date is called as a Specific Reserve. In simple words, it is a reserve created out of profit or loss of a company for a specific purpose. For example, Dividend Equalization Reserve, Investment Fluctuation Reserve, Reserve for redemption of Debentures, Plant Replacement Reserve etc.

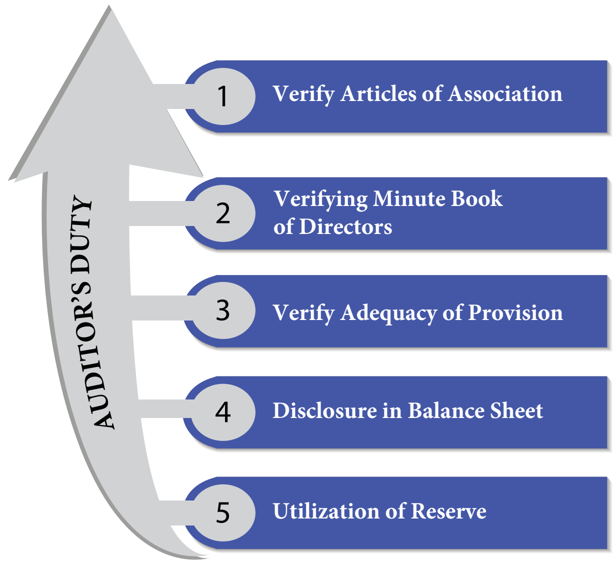
Specific Reserve is not represented by any asset and therefore it is not available for distribution amongst the shareholders. The reserve must be created irrespective of profit or loss involved in the business.

Objects of creating Specific Reserve

The reserve is created with a definite object to:

- Meet a known loss, such as depreciation, heavy repairs and renewals etc.
- Meet an expected contingency such as, doubtful debts, discount on debtors, liability for a disputed claim, contingency under Workmen's Compensation Act, etc.
- Meet an outstanding liability for expenses already incurred such as, salaries and wages, commission, income tax and other outstanding expenses.

AUDITOR'S DUTY



1. **Verify Articles of Association:** It is the duty of the auditor to verify the Articles of Association to check whether the amount appropriated from profit to specific reserve is duly complied.
2. **Verifying Minute Book of Board meeting:** The auditor should ensure that profits are appropriated according to the board of directors decision by verifying the Minutes book of the Board meeting.
3. **Verify Adequacy of Provision:** Auditor should ensure that adequate provision has been created. In case, the amount created is not adequate, he should insist the management to increase the provision. Otherwise, he should disclose the same in the audit report.
4. **Disclosure in Balance Sheet:** The auditor should see whether provisions are properly shown on the liabilities side of the Balance Sheet.

5. **Utilization of Reserve:** Lastly, the auditor has to ensure that reserve is utilized for the special purpose for which they are created.

3. CAPITAL RESERVE

A reserve which is created out of capital profits of a company is called as a Capital Reserve. It is defined in Part III of Schedule VI of the Companies Act as, "any reserve which cannot legally be distributed amongst the shareholders". Capital profit refers to the following:

- Profits on sale of fixed assets
- Profits on revaluation of fixed assets and liabilities
- Profits earned prior to incorporation of a company
- Profits made in purchasing a business
- Profits on redemption of debentures at a discount
- Premium received on issue of shares or debentures
- Profits earned from forfeited shares and re-issue of forfeited shares
- Exceptional profits not earned during regular course of business.

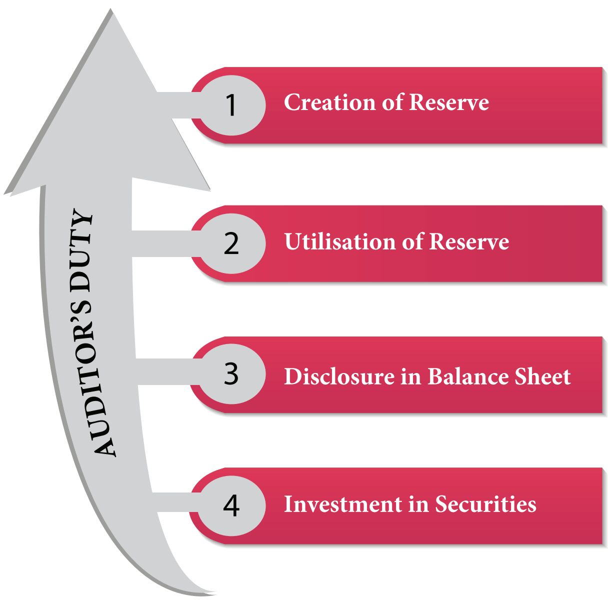
Capital profits should not be utilized in distributing dividend to the shareholders but should be kept aside to strengthen the financial position of the company and to meet capital or abnormal revenue losses.

Objects of creating Capital Reserve

Capital Reserves are utilised for the following purposes:

1. To issue bonus shares to the shareholders subject to the Articles of Association of the company.
2. To write off intangible assets of the company like goodwill, preliminary expenses etc.
3. To provide for premium payable on the redemption of debentures or redeemable preference shares.
4. To write off discount allowed, commission paid or expenses incurred on the issue of shares and debentures of the company.

AUDITOR'S DUTY



1. **Creation of Reserve:** The auditor should ensure that the reserve is created only out of the capital profits of the company.
2. **Utilisation of Reserve:** He should verify that the reserve is utilized according to the provisions of the Companies Act and the Articles of Association of the company.
3. **Disclosure in Balance Sheet:** Auditor should examine whether capital reserve has been shown separately from the revenue reserve in the Balance Sheet.

Any addition or deduction from the previous year balance sheet should be clearly shown.

4. **Investment in Securities:** The auditor should check whether capital reserve is invested in easily realizable securities or may be invested in the business itself.

4. SECRET RESERVE

It is a reserve, the existence of which is not apparent on the face of the Balance Sheet. It is also called as "Hidden Reserve" or "Internal Reserve" or "Inner Reserve". The reserve represents the surplus of assets over liabilities and capital. Secret Reserves are usually created by banking companies, insurance companies and electricity supply companies. When secret reserve exist, the financial position of the company is better than what it would appear from the balance sheet. However, the existence of such a reserve is found only by a close and intelligent scrutiny of the account of the company.

Objects of creating Secret Reserve

Secret Reserve is created for the following purpose:

1. To meet any extraordinary loss without disclosing the fact to the shareholders or outsiders.
2. To increase the working capital and to strengthen the financial position of the company.
3. To withhold information of the progress of the company from trade competitors.
4. To equalize the payment of dividend during the period of loss.
5. To meet unexpected financial losses in future.

Methods of Creating Secret Reserve

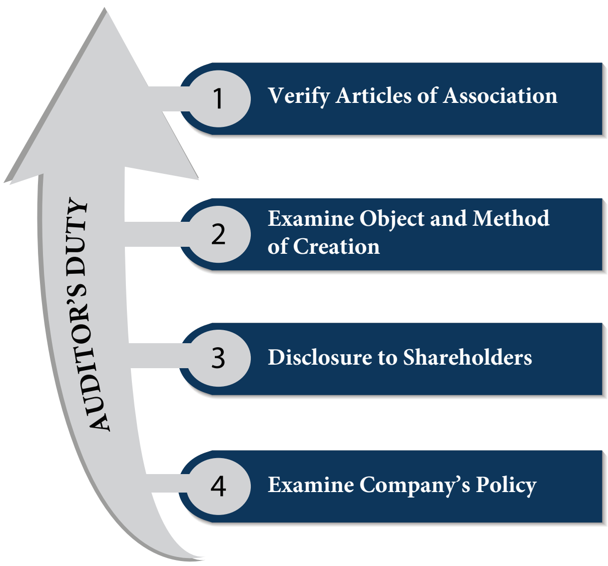
- Undervaluing the assets below cost or market value.
- Not recording the appreciated value of an asset.
- Providing excess reserve for bad and doubtful debts or discount on debtors.
- Providing excess depreciation on fixed assets.
- Writing down goodwill to a nominal value
- Omitting some of the assets in the Balance Sheet.
- Undervaluing the assets by charging capital expenditure to revenue account.
- Overvaluing the liabilities.
- Inclusion of fictitious liabilities
- Showing contingent liabilities as real liabilities.
- Grouping dissimilar items on the liabilities side of the Balance Sheet.

AUDITOR'S DUTIES

1. **Verify Articles of Association:** The auditor should study the Articles of Association of the company to ascertain the legal implications of creating the reserve.
2. **Examine Object and Method of Creation:** Auditor should examine carefully the

object and method of creating a secret reserve if he is fully satisfied, he should disclose the facts in his report.

3. **Disclosure to Shareholders:** It is the duty of the auditor to disclose the fact to the shareholders that secret reserve has been created. If he fails to do so, he will certify a false statement which will not exhibit a true and fair view of the state of affairs of the company.
4. **Examine Company's Policy:** When secret reserve is created by undervaluing the assets or overvaluing the liabilities, the auditor should make a detailed enquiry with the directors and examine the company's policy.

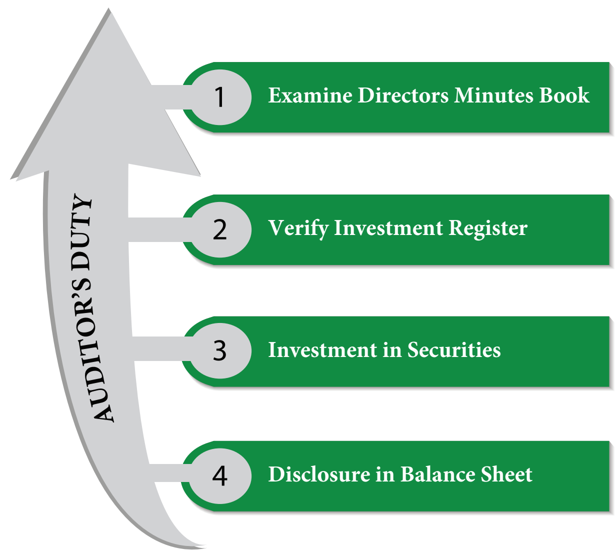


5. RESERVE FUND

It is a reserve created out of the surplus of the company and is invested in outside securities. It is similar to general reserve, which is created out of surplus but is retained in the business. In other words, reserve fund is appropriations of profits which is invested in safe securities and are easily realizable.

AUDITOR'S DUTY

1. **Examine Directors meeting Minutes Book:** Auditor should examine the Minutes of Board of Directors meeting to verify that all investments are made with the consent of the Board.
2. **Verify Investment Register:** The auditor should physically verify the securities with the Investment Register.
3. **Investment in Securities:** The auditor should ensure that the reserve fund is invested in easily realizable securities.
4. **Disclosure in Balance Sheet:** He should verify that the reserve fund is shown distinctly on the liabilities side of the Balance Sheet.



6. SINKING FUND

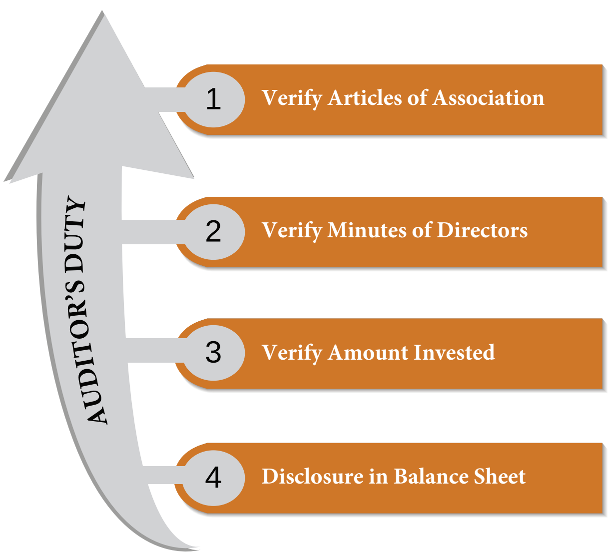
The fund which is created to have a certain sum of money accumulated for a future date by setting aside a certain sum of money every year is called as Sinking Fund. It is defined as, "a form of specific reserve set aside for redemption of a long debt or replacement of a wasting or a depreciable asset".

Objects of Creating Sinking Fund

The objects of creating Sinking Fund are as follows:

- To reduce a liability for example, redemption of debentures or repayment of a loan.
- To replace a wasting asset.
- To replace a depreciating asset.
- To renew a lease.

AUDITOR'S DUTY



1. **Verify Articles of Association:** Auditor should verify Articles of Association and examine the creation and utilisation of the fund.
2. **Verify Minutes of Directors:** He should verify the Minutes of the Board of Directors to ensure the correctness of the amount transferred to Sinking Fund.
3. **Verify amount Invested:** He should ensure that the amount set aside is invested in guilt-edged securities known as Sinking Fund Investment which earns a reasonable rate of return.
4. **Disclosure in Balance Sheet:** The auditor should verify that sinking fund and Sinking Fund Investment is separately and properly disclosed in the Balance Sheet.

8.2 Provisions

8.2.1 Meaning

Provision is an amount which is set aside as a charge against earnings to meet a loss which may arise on the sale or realization of certain asset or diminution in the value of an asset or to meet heavy depreciation, repairs and renewals or to meet a known liability. Provisions are created for a specific known liability or contingency and they can be used to meet only the specific liability for which they are created.

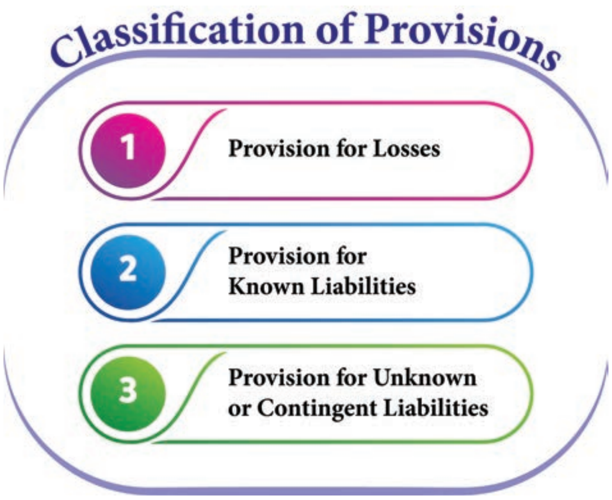
Examples of Provisions: (1) Provision for Depreciation (2) Provision for Taxation (3) Provision for Doubtful Debts (4) Provision for discount on Debtors (5) Provision for Repairs and Renewals.

8.2.2 Definition

- **Companies Act** defines the term Provision as, "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retain by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

8.2.3 Classification of Provisions

Provisions can be broadly classified as follows:



1. **Provision for Losses:** An amount which is set aside out of the earnings of the company to meet losses, for example, (1) loss on account of depreciation on fixed assets (2) loss on account of repairs and renewals etc.
2. **Provision for Known Liabilities:** Provision which is created for known liabilities or expenses which arise in future, for example, (1) Provision for Income Tax, (2) Provision for Dividend, (3) Provision for discount on Debtors and Creditors, (4) Provision for outstanding expenses such as outstanding salaries and wages, payment on retirement such as pension, provident fund, gratuity etc.
3. **Provision for Unknown or Contingent Liabilities**

   Provision created for unknown or contingent liabilities, for example, (1) Provision for bad and doubtful debts, (2) Provision against disputed claims, (3) Provision against guarantee, (4) Provision against compensation, (5) Provision against payment of arrears of dividend.

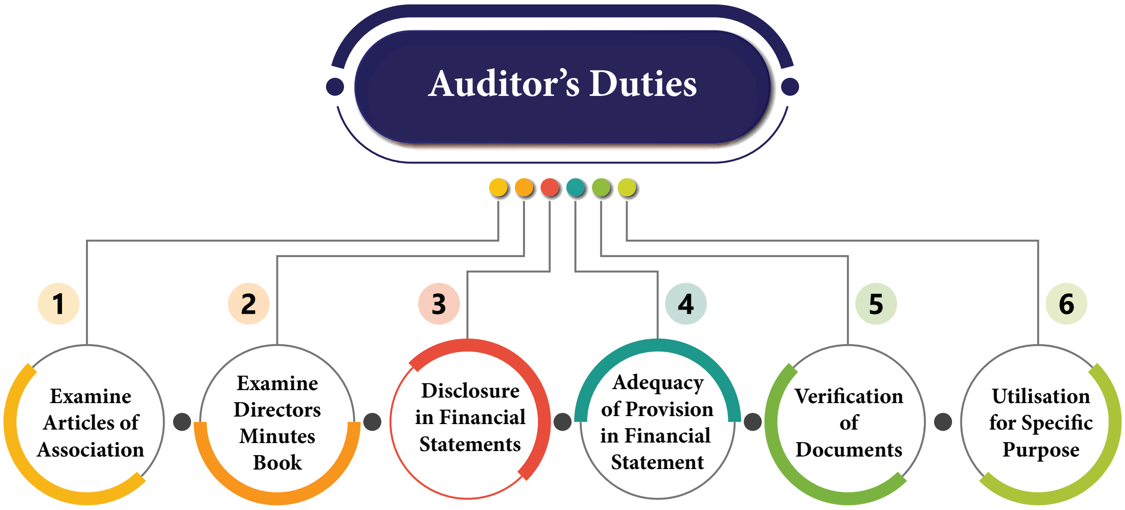
Provision for Repairs and Renewals: Provision created to equalize the charge of repairs and renewals over the life of the asset.
Provision for discount on debtors and creditors: Provision is created when a debtor makes payment within the prescribed period or when a certain amount of discount is allowed. Similarly, a business concern earns discount on making payment to suppliers.
Provision for Bad and Doubtful Debts: Provision for bad debts is created when a debtor fails to pay the whole or a part of the debt owing by them. The expected loss on account of bad debts should be charged to current year's profit.

8.2.4 Auditor's Duties

1. **Examine Articles of Association:** The auditor should examine the provisions of the Articles of Association to confirm the appropriations created for a specific purpose.
2. **Examine Directors Meeting Minute Books:** Auditor should examine the Minute Book of the Board of Directors to verify the provisions to be made.
3. **Disclosure in Financial Statements:** He should ensure that all provisions are properly disclosed in the Profit and Loss Account and Balance Sheet.
4. **Adequacy of Provision in Financial Statement:** He should ensure that adequate provision has been shown in the financial statement. If in case, the provision created is not adequate, the auditor should mention the fact in the report.

5. **Verification of Documents:** The auditor should examine all the documents and ensure that the amount to be created as provision is adequate and sufficient to meet the loss or liability.

6. **Utilisation for Specific Purpose:** He has to ensure that the provisions created are utilized for the specific purpose for which they are created.



8.3 Differences Between Reserves and Provisions

Generally the term 'Reserves' and 'Provisions' are used together, giving an impression that both are one and the same thing. However, it is desirable to understand the differences between the two terms.

S.No.	Basis	Reserves	Provision
1.	Meaning	Reserve is that portion of current or accumulated profits which is kept aside for meeting some known or unknown liabilities. It is an appropriation of profit.	Provision is a charge against the profit to meet known or unknown liabilities or losses.
2.	Creation	A Reserve is created by debiting Profit and Loss Appropriation Account.	A Provision is debited to Profit and Loss Account.
3.	Nature	A reserve is created for unknown liabilities.	A provision is made for a known liabilities.
4.	Purpose	The main object of creation of reserve is a matter of financial policy of a business concern. It is created without taking into account the actual amount required except in the case of redemption of debentures.	Provision is created as a legal necessity.

S.No.	Basis	Reserves	Provision
5.	Disclosure	It is shown on the liabilities side of the Balance Sheet.	It is shown on the assets side of the Balance Sheet by way of deduction from the concerned asset. For example Reserve for bad and doubtful debts is deducted from the balance of Sundry Debtors.
5.	Charge Against Profit	Reserves depend upon the profit position of the company, when a company suffers a loss no reserve is created.	Provisions do not depend upon the profit position of the company, hence they are created even when company suffers a loss.
6.	Payment to Shareholders	Reserves represent undistributed profit, hence it can be distributed amongst shareholders as dividend.	Provisions are not distributed to shareholders as dividend.
7.	Auditors Duty	An auditor need not interfere on creation of reserve except when Articles of Association specifically provide for creation of a reserve.	The auditor should carefully examine whether adequate provision has been created to meet the loss or liability.

STUDENTS ACTIVITY

1. Visit a industry and discuss with its owner's about the reserves they made.
2. Estimate total income of your parents. Discuss about creating reserves for unforeseen expenses of your family.
3. Discuss with your parents for making provision for meeting expected losses.
4. How would you create reserve funds from your students consumer club for meeting any emergency for your students.

SUMMARY

Reserve is that portion of current or accumulated profits which is kept aside for meeting some known or unknown liabilities or contingencies which might arise in future. It is classified as, (1) General Reserve, (2) Specific Reserve, (3) Capital Reserve, (5) Secret Reserve, (6) Reserve Fund, and (7) Sinking Fund.

Provision is a charge against profit created for a specific known or unknown liability or contingencies. It is classified as, (1) Provision for losses, (2) Provision for known liabilities, and (3) Provision for unknown liabilities. It is the duty of an auditor to carefully examine whether adequate provision has been created to meet the loss or liability.

KEY TERMS

- **Reserve** – It is an amount which has been set aside for future use or for emergency.
- **General Reserve** – It is a reserve creatd to provide additional working capital created from profit.
- **Sinking Fund** – It is a form of specific reserve set aside for the redemption of a long term debt.
- **Capital Reserve** – It is created out of profits of a capital nature.
- **Secret Reserve** – Any reserve which is not apparent on the face of the balance sheet.
- **Provisions** – It is an amount set aside as a charge against earnings created for a specific known liability.

EVALUATION

I. Multiple Choice Questions:

1. Reserve means ____________
   a) Use for future emergency
   b) Meet contingency
   c) Meet Liability
   d) All the above

2. __________ is to provide additional working capital.
   a) General Reserve
   b) Specific Reserve
   c) Sinking Fund
   d) Secret Reserve

3. The reserve which is a charge against reserve for the purpose of providing for losses and contingencies which may result in losses and which are known or expected is known as __________

a) Specific Reserve

b) General Reserve

c) Provision

d) Sinking Fund

4. ______________________ fund is a form of specific reserve set aside for the redemption of a long term debt or the replacement of a wasting or a depreciating asset.

a) General

b) Special

c) Redemption

d) Sinking

5. ______________________ cannot be utilized for payment of dividend as a reserve can be, because it has been created for a specific purpose.

a) Development Fund

b) Special Fund

c) General Fund

d) Sinking Fund

6. ________________________ is created out of profits of a capital nature.

a) Capital Reserve

b) General Reserve

c) Specific Reserve

d) None of the above

7. Any reserve which is not apparent on the face of the balance sheet is known as ________________

a) Secret Reserve

b) General Reserve

c) Specific Reserve

d) Sinking Reserve

8. Secret reserve is created for the purpose of ______________________

a) To avoid competition

b) To regulate dividend

c) To meet unforeseen emergencies

d) All the above

9. It is created as a charge on profits for some specific purposes in order to meet specific losses and certain but un-estimated liabilities ______________________

a) General Reserve

b) Specific Reserve

c) Capital Reserve

d) Reserve Fund

10. In which side of the balance sheet, the reserve fund and sinking fund are to be shown?

a) Assets

b) Liabilities

c) Both

d) None of these

Answers: 1.(d), 2.(a), 3.(a), 4.(b), 5.(a), 6.(a), 7.(a), 8.(d), 9.(b), 10.(b)

II. Very Short Answer Question:

1. What is Reserve?
2. Define a "Reserve".
3. What are the types of Reserves?
4. What is capital reserve?
5. What is secret reserve?
6. Write a note on sinking fund.
7. What is meant by provision?
8. Define a Provision.

III. Short Answer Questions:

1. What is general reserve? How it is created?
2. Differentiate reserves and provisions.
3. How can capital reserve be created?
4. How secret reserve is created?
5. Explain the duties of an auditor with capital reserve.
6. What are the duties of an auditor with regard to sinking fund?
7. What are the duties of an auditor with regard to secret reserves?
8. Briefly explain various types of provisions.

IV. Essay Type Questions:

1. Discuss the classifications of reserves.
2. What are the dangers of creating secret reserve?
3. Explain the auditor's duty with regard to provisions
4. Discuss the auditor's duty with regard to reserves.
5. Differentiate Reserves and Provisions.

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