Unit- 3 Reserves – Meaning, Objectives and Types

A reserve is a part of the profit set aside to meet future contingencies and losses. Usually, the whole amount of profit earned by the business is not distributed to the owners or shareholders. A part of the profit is retained in the business either for meeting its unexpected future liabilities and losses or for strengthening financial position. It can be created for redeeming liabilities or replacing depreciable assets or declaring uniform rate of dividend over years. It is created out of the profit only. If there is no profit in a particular year, no reserve can be created in that year. It is created by debiting the profit and loss appropriation account. It does not reduce the figure of net profit because it is created after determining profit. The reserve, therefore, reduces only the figure of divisible profit. It belongs to the owners and shareholders. It can be distributed to the shareholders if its existence is no longer required.

Objectives of Reserve

The main objectives of maintaining reserve are as follows:

- To meet unexpected future losses, liabilities and contingencies.
- To strengthen the financial position of the business.
- To redeem debentures, preference shares and other loans and liabilities.
- To replace wasting or depreciating assets.
- To declare and distribute the uniform rate of dividend over years.
- To meet the need of fund from internal sources.
- To provide additional working capital and to improve the working capacity of the business.

Types of Reserve

The following are the mainly three types of reserves;

1. Capital Reserve
2. Revenue Reserve
3. Secret Reserve

1. Capital Reserve

A reserve which is created out of the capital profit is known as capital reserve. It is not created out of the profit earned in normal course of the business. Capital reserve is created out of the profit earned from some specific transactions of capital nature. Capital reserve is not available for the distribution to the shareholders. The examples of capital profit from which capital reserve is created are as follows:

- Profit on sale of fixed assets

- Profit on sale of investment
- Profit on revaluation of assets and liabilities
- Premium on issue of shares and debentures
- Profit on re-issue of forfeited shares
- Discount on redemption of debentures
- Profit on purchase of an existing business

The following are the objectives and advantages of capital reserves;

1. Capital reserve helps in making the organization financially strong.
2. Capital reserve helps in writing off the capital losses arising from the sale of fixed assets, shares and debentures.
3. Capital reserve helps in the issue of fully paid bonus shares to the existing shareholders.

The following are the disadvantages of capital reserve;

1. Capital reserve is not available for the distribution to shareholders.
2. Capital reserve does not give any indication of operating efficiency of the business.
3. Capital reserve does not help in making the management responsible to sale old assets at satisfactory price.

2. Revenue Reserve

A reserve which is created out of the revenue profit is called revenue reserve. Revenue profit is earned in the normal course of the business. Revenue reserve refers to the undistributed revenue profit. It is created for strengthening the financial position, replacing depreciallble assets, redeeming liabilities, declaring uniform rate of dividend and conducting research and development functions. If the reserve is not needed in the future, it can be distributed as dividend to the shareholders.

There are two types of revenue reserve:

1. **General Reserve:** A reserve which is created out of the profit not for a specific purpose is known as general reserve.General reserve is used for general purpose as per the discretion of the management. Usually, general reserve is used for strengthening the financial position and meeting future contingencies and losses.
2. **Specific Reserve:** A reserve which is created out of the profit for a particular purpose is known as specific reserve. Such reserve can not be utilized for any purpose other than specified. Specific reserve is created by debiting the profit and loss appropriation account. It can be invested in outside securities. It serves for a specific purpose as to equalize dividend or to redeem a fixed liability or to replace a fixed assets or to conduct a research and development work. The important types of specific reserve are, Dividend equalization fund, Sinking fund and Research and development fund.

3. Secret Reserve

A reserve which maintained to strengthen the financial position of the business without disclosing it in the book is known as secret reserve. Secret reserve is hidden reserve which is not disclosed by the balance sheet. Secret reserve is also known as internal reserve. It is created by showing the figure of net profit less than actual. Its existence makes the financial position of the business better than what the balance sheet is disclosing. Generally, it is maintained by bank, Insurance and other financial institutions.

A secret reserve is created in any of the following ways:

- By depreciating the fixed assets at excessively high rates.
- By undervaluing the current assets.
- By eliminating the assets altogether from the books.
- By over-valuing the liabilities.
- By showing contingent liabilities as real assets.
- By creating excessive amount of reserve for future contingencies.
- By treating capital expenditure as revenue reserve.
- By ignoring accrued income or treating income as liability.

The following are the objectives and advantages of secret reserve;

1. Secret reserve helps in strengthening the financial position of the business.
2. Secret reserve gives the sense of financial stability to the shareholders and creditors by equalizing the rate of dividend.
3. Secret reserve helps in eliminating unhealthy competition by not showing true profit to the competitors.
4. Secret reserve provides additional working capital.

The following are the disadvantages of secret reserve;

1. The existence of secret reserve is known to the management only and not to the real owners or shareholders.
2. Secret reserve makes the information of financial statements false and inaccurate.
3. Secret reserve may be the strong cause of loosing trust and confidence of the shareholders and outsiders.
4. Secret reserve may cover up the inefficiency and fraud committed by the managers and directors.