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Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets*

Foreword

The accounting treatment of reserve created on revaluation of fixed assets has been widely debated in the accounting circles in the past. Of late, the matter has assumed considerable importance in view of the fact that many companies have resorted to major revaluation of fixed assets as a partial accounting response to inflation.

Considering the practical importance of the subject, the Research Committee made an in-depth study of the various issues involved and issued an exposure draft on the subject in August, 1981 for public comments. The encouraging response received by the Committee from members in the form of comments on the exposure draft itself gave an indication of the need for guidance on this subject. Based on these comments and after discussions on the subject with an eminent counsel, the Committee has now finalised this Guidance Note, which I trust will be useful to the members both in industry and in practice.

I also trust that the conclusions arrived at after detailed consideration of various aspects would go a long way in bringing about the desired level of uniformity in the accounting treatment of reserve created on revaluation of fixed assets.

New Delhi
April 30, 1982

A. C. Chakrabortti
Chairman
Research Committee

* For accounting treatment of revaluation reserves in amalgamations, see Accounting Standard (AS) 14, 'Accounting for Amalgamations'.

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1. In the preparation of the financial statements of a company, various fixed assets are stated on the basis of their historical cost. Sometimes, in order to bring into the Balance Sheet their replacement cost, a company revalues its fixed assets on the basis of a valuation made by competent valuers. When the value of fixed assets in written up in the books of account of a company on revaluation, a corresponding credit is given to the Revaluation Reserve. Such reserve represents the difference between the estimated present market values and the book values of the fixed assets. When such reserve is created, a question arises about its nature and the manner in which it can be utilised. This guidance note deals with accounting treatment of the reserve created on revaluation of fixed assets (herein referred to as "Revaluation Reserve").

2. Part I of Schedule VI to the Companies Act, 1956 provide that every company shall classify its fixed assets under convenient heads and show under each head the original cost, additions/deductions and the total depreciation provided upto the end of each accounting period. When a company revalues its fixed assets, it is necessary for the company to show separately the date of revaluation and, for a period of five years thereafter, the amount of increase made.

3. When a company revalues its fixed assets, depreciation should be provided on the basis of the revalued figures.

4. A view has been expressed in some quarters that, for measurement of profits, revenue is deemed to have arisen when it is actually collected or when a justifiable claim to collect it arises (e.g. credit sale) or when there is knowledge and evidence that it is capable of being collected if a sale were to be made (i.e. prevailing market price). According to this view, this principle will apply equally to current and fixed assets and, therefore, when fixed assets are written up to their present value, the corresponding Revaluation Reserve cannot be considered as an unrealised reserve. It is, therefore, argued that past accumulated losses as well as depreciation for the year or

arrears of depreciation for earlier years which are required to be provided under Section 205 of the Companies Act can be written off or adjusted against such Revaluation Reserve.

5. There is a contrary view that such Revaluation Reserve is created as a result of a book adjustment only and, therefore, such a reserve is an unrealised reserve which is not available for distribution as dividends. When accounts are prepared on the basis of historical cost, measurement of profits can be made by comparing the cost of the assets at the beginning and at the end of the accounting period. As such there is no justification for taking credit for unrealised gains because the increase in market value may be due to various extraneous factors such as fall in the purchasing power of currency or other factors not related to the operations of the company. So far as fixed assets are concerned, these are held for the use in the business and not for sale in the normal course of business. In the circumstance, the difference between the market value and the book value does not represent realised gain and cannot be treated as such in the books of account.

6. Section 205 of the Companies Act provides that a company can declare or pay dividend only out of its profits. The profits for this purpose are to be arrived at after providing for depreciation. If dividend is to be declared out of the profits of any earlier year or years, it is necessary that such profits should be arrived at after providing for depreciation for the respective years.

7. Proviso (a) to Section 205 (1) of the Companies Act reads as under:

> "(a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960, it shall before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years."

This proviso makes it clear that it is necessary to provide for arrears of depreciation of earlier years, if any dividend is to be declared out of profits of any subsequent year. For this purpose depreciation (or arrears of depreciation) is to be provided out of the profits of the company. Indeed, a reference to Part II of Schedule VI to the Companies Act indicates that the Profit and Loss Account is to be so made as clearly to disclose the result of working of the company during the period covered by the account.

8. When accumulated losses and depreciation (including arrears of depreciation) are adjusted against Revaluation Reserve it will amount to setting off actual losses against unrealised gains. If dividend is declared out of the current profits after adjusting accumulated losses or arrears of depreciation against the Revaluation Reserve, it will mean that dividend is declared out of profits which should, in fact, have been utilised in setting off past losses and arrears of depreciation. In effect, the company will be declaring dividend out of profits which are not available for distribution. By adopting this method, the company will be declaring dividend out of unrealised gains appearing in the accounts in the form of Revaluation Reserve. Accordingly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve.

9. A question may arise, as to whether the additional depreciation provision required in consequence of revaluation can be adjusted against "Revaluation Reserve". As stated earlier, depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the account after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against "Revaluation Reserve" by transfer to Profit and Loss Account. In other words, as per the requirements of Part II of Schedule VI to the Companies Act, the company will have to provide the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the Profit and Loss Account of the relevant period, and thereafter the company can transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable. Such a disclosure would appear to be in consonance with the requirement of Part I of Schedule VI to the Companies Act, prescribing disclosure of write-up in the value of fixed asset for the first five years after revaluation.

10. If a company has transferred the difference between the revalued figure and the book value of fixed assets to the "Revaluation Reserve" and has charged the additional depreciation related thereto to its Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to the Profit and Loss

Account or to the General Reserve as the circumstances may permit, provided suitable disclosure is made in the accounts as recommended in this guidance note.

11. The Revaluation Reserve is not available for payment of dividends. This view is also supported by the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Similarly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve. However, the revaluation reserve can be utilised for adjustment of the additional depreciation on the increased amount due to revaluation from year to year or on the retirement of the relevant fixed assets (as discussed in paras 9 and 10 above respectively).

12. The revaluation of fixed assets is normally done in order to bring into books the replacement cost of such assets. This is a healthy trend as it recognises the importance of retaining sufficient funds through additional depreciation in the business for replacement of fixed assets. As such, it will be prudent not to charge the additional depreciation against revaluation reserve, though this may result in reduction of distributable profits. This practice would also give a more realistic appraisal of the company's operations in an inflationary situation.