1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 01 (Class XI, Semester - 1)
Module Name/Title	Provisions and Reserve – Part 2
Module Id	keac_10502
Pre-requisites	Basic knowledge of Depreciation, Provisions & Reserves Process and its accounting terms
Objectives	After going through this lesson, the learners will be able to understand the following: • Significance of creating Provisions and Researves • Implications of Secret Reserve
Keywords	Provion and Reserves, Accounting Treament, Creating Reserves

2. Development Team

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Provisions and Reserve

Provisions

There are certain expenses/losses which are related to the current accounting period but amount of which is not known with certainty because they are not yet incurred. It is necessary to make provision for such items for ascertaining true net profit. For example, a trader who sells on credit basis knows that some of the debtors of the current period would default and would not pay or would pay only partially. It is necessary to take into account such an expected loss while calculating true and fair profit/loss according to the principle of

Prudence or Conservatism. Therefore, the trader creates a *Provision for Doubtful Debts* to take care of expected loss at the time of realisationrealization from debtors. In a similar way, Provision for repairs and renewals may also be created to provide for expected repair and renewal of the fixed assets. Examples of provisionsareprovisions are:

i. Provision for depreciation;
ii. Provision for bad and doubtful debts;
iii. Provision for taxation;
iv. Provision for discount on debtors; and
v. Provision for repairs and renewals.

It must be noted that the amount of provision for expense and loss is a charge against the revenue of the current period. Creation of provision ensures proper matching of revenue and expenses and hence the calculation of true profits. Provisions are created by debiting the profit and loss account. In the balance sheet, the amount of provision may be shown either:

- By way of deduction from the concerned asset on the assets side. For example, provision for doubtful debts is shown as deduction from the amount of sundry debtors and provision for depreciation as a deduction from the concerned fixed assets;

- On the liabilities side of the balance sheet alongwithalong with current liabilities, for example provision for taxes and provision for repairs and renewals.

Accounting Treatment for Provisions

The accounting treatment of all types of provisions is almost similar. Therefore, the accounting treatment is explained here taking up the case of provision for doubtful debts.

As already stated that when business transaction takes place on credit basis, debtors account is created and its balance is shown on the asset-side of the balance sheet. These debtors may be of three types:

Good Debtors are those from where collection of debt is certain.

• *Bad Debts* are those debtors from where collection of money is not possible and the amount of credit given is a certain loss.

• *Doubtful Debts* are those debtors who may pay but business firm is not sure about the collection of full amount from them. In fact, as a matter of business experience, some percentage of such debtors are not likelyto pay, hence treated as doubtful debts. To consider this possible loss on account of non-payment by some debtors, it is a common practice (and necessary also) to make a suitable provision for doubtful debts atthe time of ascertaining true profit or loss. The provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after deducting/writing-off all known baddebts. Provision for doubtful debts is also called 'Provision for bad and doubtful debts'. It is created by debiting the amount of required provision to the profit and loss account and crediting it to provision for doubtful debts account.

For creating a provision for doubtful debts the following journal entry is recorded:

Profit and Loss aA/c Dr. (with the amount of provision)

To Provision for doubtful debts A/c

This is explained with the help of the following example Observe an extract of the trial balance from the books of Trehan Traders on March 31, 2005 2017 is given below:

Books of M/s Trehan Traders

Balance Sheet as at March 31, 2017 *

Date	Account titleParticulars	L.F.	Dr. Rs.Debit Amount Rs.	Dr. Amount	RsCredit

		Rs.
Sundry Debtors	68,000	

*Relevant item only

Additional Information

• Bad debts proved bad but not recorded amounted to Rs. 8,000

• Provision is to be maintained at 10% of debtors.

In order to create the provision for doubtful debts, the following journal entries will be recorded:

Date	Particulars		L.F	Amount Rs.	Amount Rs.
2017 2005	Bad debts A/ac	Dr.		8,000	
March. 31	To Sundry Debtors Ac/cC				8,000
	(Bad debts written off)				
March. 31	Profit & Loss Ac/c	Dr.		8,000	
	To Bad debts Aa/c				8,000
	(Bad debts debited to profit and loss account)				
March. 31	Profit and Loss A/c	Dr.		6,000	
	To Provision for doubtful debts A/c				6,000
	(For creating pProvision for doubtful debts created)				

Working Notes

Provision for doubtful debts @10% of sundry debtors i.e.

(Rs. 68,000 – 8000) = Rs. 60, 000

$$= \text{Rs. } 60{,}000 \times \frac{10}{100}$$

$$= \text{Rs. } 6{,}000$$

Reserves

A part of the profit may be set aside and retained in the business to provide for certain future needs like growth and expansion or to meet future contingencies such as workmen compensation. Unlike provisions, reserves are the appropriations of profit to strengthen the financial position of the business. Reserve is not a charge against profit as it is not meant to cover any known liability or expected loss in future. However, retention of profits in the form of reserves reduces the amount of profits available for distribution among the owners of the business. It is shown under the head Reserves and Surpluses on the liabilities side of the balance sheet after capital. Examples of reserves are:

General reserve;
Workmen compensation fund;
Investment fluctuation fund;
Capital reserve;
Dividend equalisation reserve;
Reserve for redemption of debenture.

Difference between Reserve and Provisions and Reserves

The points of difference between reserve and provision are explained below:

1. Basic nature : A provision is a charge against profit whereas reserve is an appropriation of profit. Hence, net profit cannot be calculated unless all provisions have been debited to profit and loss account, while a reserve is
created after the calculation of net profit.

2. Purpose : Provision is made for a known liability or expense pertaining to current accounting period, the amount of which is not certain. On the other hand reserve is created for strengthening the financial position ofthe business. Some reserves are also mandatory under the law.

3. Presentation in balance sheet: Provision is shown either (i) by way of deduction from the item on the asset side for which it is created, or (ii) on the liabilities side along with current liabilities. On the other hand, reserve is shown on the liabilities side after capital.

4. Effect on taxable profits : Provision is deducted before calculating taxable profits. Hence, it reduces taxable profits. A reserve is created from profit after tax and therefore it has no effect on taxable profit.

5. Element of compulsion : Creation of provision is necessary to ascertain true and fair profit or loss in compliance with ‘Prudence’ or ‘Conservatism’ concept. It has to be made even if there are no profits. Whereas creation of a reserve is generally at the discretion of the management. However, in

certain cases law has stipulated for the creation of specific reserves such as Debenture Redemption Reserve. Reserve cannot be created unless there are profits.

6. Use for the payment of dividend : Provision cannot be used for distribution as dividends while general reserve can be used for dividend distribution.

Basis of Difference	**Provision**	**Provision**
1. Basic nature	Charge against profit.	Appropriation of profit.
2. Purpose	It is created for a known liability or expense pertaining to current accounting period, the amount of which is not certain.	It is made for strengthening the financial position of the business. Some reserves are also mandatory under law.
3. Effect on taxable profits	It reduces taxable profits	It has no effect on taxable profit.
4. Presentations in Balance sheet	It is shown either (i) by way of deduction from the item on the asset side for which it is created, or (ii) In the liabilities side along with current liabilities.	It is shown on the liabilities side after capital amount.
5. Element of compulsion	Creation of provision is necessary to ascertain true and fair profit or loss in compliance ‘ Prudence’ or ‘Conservatism’ concept. It must be made even if there are no profits.	Generally, creation of a Reserve is at the discretion of the management. Reserve cannot be created unless there are profits. However, in certain cases law has stipulated for the creation of specific reserves such as ‘Debenture’ ‘Redemption’ reserve.
6. Use for the payment of dividend	It can not be used for dividend distribution	It can be used for dividend distribution.

Types of Reserves

A reserve is created by retention of profit of the business can be for either a general or a specific purpose.

1. *General Rreserve* : When the purpose for which reserve is created is not specified, it is called General Reserve . It is also termed as free reserve because the management can freely utilise it for any purpose. General
reserve strengthens the financial position of the business.

2. *Specific Rreserve* : Specific reserve is the reserve, which is created for some specific purpose and can be utilised only for that purpose. Examples of specific reserves are given below :

  i. (i) Dividend Eequalisation Rreserve: This reserve is created to stabilise or maintain dividend rate. In the year of high profit, amount is transferred to Dividend Equalisation reserve. In the year of low profit, this reserve amount is used to maintain the rate of dividend.
  ii. (ii) Workmen Ccompensation Ffund: It is created to provide for claims of the workers due to accident, etc.
  iii. (iii) Investment Ffluctuation Ffund: It is created to make for decline in the value of investment due to market fluctuations.
  iv. (iv) Debenture Rredemption Rreserve: It is created to provide funds for redemption of debentures.

Reserves are also classified as revenue and capital reserves according to the nature of the profit out of which they are created.

1. (a) Revenue Rreserves : Revenue reserves are created from revenue profits which arise out of the normal operating activities of the business and are otherwise freely available for distribution as dividend. Examples of revenue reserves are:

• General Rreserve;

• Workmen Ccompensation Ffund;

• Investment Ffluctuation Ffund;

• Dividend equalisationEqualization Rreserve;

• Debenture Rredemption Rreserve;

2. (b) Capital reserves: Capital reserves are created out of capital profits which do not arise from the normal operating activities. Such reserves are not available for distribution as dividend. These reserves can be used for

Writing off capital losses or issue of bonus shares in case of a company. Examples of capital profits, which are treated as capital reserves, whether transferred as such or not, are :

i. • Premium on issue of shares or debenture.
ii. • Profit on sale of fixed assets.
iii. • Profit on redemption of debentures.
iv. • Profit on revaluation of fixed asset & liabilities.
v. • Profits prior to incorporation.
vi. • Profit on reissue of forfeited shares

Difference between Revenue and Capital Reserve

Revenue reserves and capital reserves are differentiated on the following grounds:

1. Source of creation : Revenue reserve is created out of revenue profits, which arise out of the normal operating activities of the business and are otherwise available for dividend distribution. On the other hand capital reserve is created primarily out of capital profit, which do not arise from the normal operating activities of the business and are not available for distribution as dividend. But revenue profits may also be used for creation of capital reserves.

2. Purpose : Revenue reserve is created to strengthen the financial position, to meet unforeseen contingencies or for some specific purposes. Whereas capital reserve is created for compliance of legal requirements or accounting practices.

3. Usage : A specific revenue reserve can be utilised only for the earmarked purpose while a general reserve can be utilised for any purpose including distribution of dividend. Whereas a capital reserve can be utilised for specific purposes as provided in the law in force, e.g. to write off capital losses or issue of bonus shares.

Basic of Difference	**Revenue Reserve**	**Capital Reserve**
1. Source of creation	It is created out of revenue profits which arise out of normal operating activities of the business and are otherwise available for dividend distribution.	It is created primarily out of capital profit which do not arise out of the normal operating activities for dividend distribution. But revenue profits may also be used for this purpose.
2. Purpose	It is created to strengthen the financial position, to meet unforeseen contingencies or	It is created for compliance of legal requirements or accounting practices

	for some specific purposes.	
3. Usage	A specific revenue reserve can be utilized only for the earmarked purpose while a general reserve can be utilised for any purpose including distribution of dividend.	It can be utilised for specific purposes as provided in the law in force e.g. to write off capital losses or issue of bonus shares.

Importance of Reserves

A business firm may consider it proper to set up some mechanism to protect itself from the consequences of unknown expenses and losses, it may be required to bear in future. It may also regard it as more appropriate in certain cases to reduce the amount that can be drawn by the proprietors as profit in order to conserve business resource to meet certain significant demands in future. An example of such a demand is the much needed expansion in the scale of business operations. This is presented as the justification for reserves in business activities and in accounting. The amount so set aside may be meant for the purpose of :

• Meeting a future contingency

• Strengthening the general financial position of the business;

• Redeeming a long-term liability like debentures, etc.

Secret Reserve

Secret reserve is a reserve which does not appear in the balance sheet. It may also help to reduce the disclosed profits and also the tax liability . The secret reserve can be merged with the profits during the lean periods to show improved profits. Management may resort to creation of secret reserve by charging higher depreciation than required. It is termed as ‘Secret Reserve’, as it is not known to outside stakeholders. Secret reserve can also be created by way of :

i. • Undervaluation of inventories/stock
ii. • Charging capital expenditure to profit and loss account
iii. • Making excessive provision for doubtful debts
iv. • Showing contingent liabilities as actual liabilities

Creation of secret reserves within reasonable limits is justifiable on grounds of expediency, prudence and preventing competition from other firms.

Summary

A reserve is an appropriation of profits for a specific purpose. Reserves are created by management that simply makes note of its future cash needs, and budgets for them appropriately. By setting aside a reserve, the board of directors is segregating funds from the general operating usage of a company. Capital reserve are funds set for aside to purchase fixed assets.

A provision is the amount of an expense or reduction in the value of an asset that an entity recognize now in its accounting system, before it has precise information about the exact amount of the expense or asset reduction. For example, an entity routinely records provisions for bad debts, sales allowances, and inventory obsolescence. Less common provisions are for severance payments, asset impairments, and reorganization costs.

In short, a reserve is an appropriation of profit for a specific purpose, while a provision is a charge for an estimated expense.