

## Provisions and Reserves

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### 1. Introduction

Certain accounting concepts, principles and conventions are followed while recording business transactions in the books of accounts and preparing final accounts. Going concern is a basic assumption among these accounting concepts, principles and conventions. As per this assumption, it is assumed that the existence of firm will be continued for a considerable long period and the firm will not be dissolved within near future or business transactions will not be curtailed considerably. To continue the existence of the firm it is quite essential that financial position of the firm must be very sound. For this purpose, some amount from profit is appropriated and transferred to reserve, so that the firm can exist even in adverse situation and can grow also. To fulfill this objective, the principle of prudence is also followed in accounts. As per this principle a part of the profit of business is kept a side and transferred to provision in advance to protect the business from future probable expenses or losses. Thus reserves and provisions enhance long term financial soundness of the business and protects the business against contingencies. In this chapter we will study reserves and provisions in detail.

### 2. Meaning, Characteristics and Importance of Provision

**(1) Meaning of provision :** Provision means an amount appropriated from profit to honor probable liabilities which can be identified but the amount of which can not ascertained accurately. e.g. Provision for depreciation, provision for bad debt, provision for repairs and renewals, provision for taxation, provident fund, pension fund, workers profit sharing fund, provision for voluntary retirement scheme etc.

Thus, provision is different from liability. Amount of liability is fixed and it is sure to pay. While provision is an amount appropriated from profit for probable expenses or losses for which the amount can not be ascertained accurately.

Following accounting entry is passed for provision :

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Profit and Loss A/c <span style="float: right;">Dr</span>			
	To bad debts reserve A/c			
	To provision for depreciation A/c			
	To provision for taxation A/c			

- (2) **Characteristics of Provision** : Characteristics of provision are as under :
- (i) Provision is an amount appropriated from profit or income for specific purpose.
  - (ii) Provision is an amount appropriated from profit for probable expenses or losses or liabilities for which the amount can not be determined accurately.
  - (iii) Provision is appropriated out of profit and loss account.
- (3) **Importance of Provision** : Importance of provision is as under :
- (i) Provision is made for probable expense, loss and liability of respective year and therefore it is appropriated out of the revenue of the same year and hence true profit or loss of the business can be ascertained.
  - (ii) Provision is made to prevent impact of transactions made during the year on the financial performance in future.
  - (iii) Known liability of future can be spread evenly over certain years by making provision.
  - (iv) Assumption of going concern and principle of prudence can be followed by making provision.
  - (v) If provision is not made against decrease in the value of assets in future the capital of the business may be wiped off. Such risk can be avoided by making provision.
  - (vi) Required funds can be managed by making provision of a certain amount every year out of the profit. On the expiry of the useful life of an asset, the managed funds can be used to purchase new assets.

### 3. Meaning, Characteristics and Importance of Reserve

(1) **Meaning of Reserve** : An amount appropriated out of profit to increase financial soundness of the business or to meet with contingent loss or liability in future is called as Reserve. Reserve is an appropriation and it is created out of profit and loss appropriation account. Reserve may be for a specific purpose or for solvency of the business also. e.g. General reserve, dividend equalization fund, workers accident compensation fund, debenture redemption fund, investment fluctuation reserve, capital redemption reserve etc.

- (2) **Characteristics of Reserve** : Characteristics of reserve are as under :
- (i) Reserve is created for financial soundness of the business, for growth of the business or to meet with contingent requirements of business.
  - (ii) Reserve is created out of profit and loss appropriation account.
  - (iii) Certain reserves are created to meet with statutory requirements.
- (3) **Importance of Reserve** : Importance of creating reserve is as under :
- (i) Required funds for expansion of the business is available from profit of the business only and hence there is no need to borrow funds from outside or proprietor does not require to contribute more capital for growth and expansion of business.
  - (ii) Financial solvency of the firm increases by transferring some amount out of profit to reserves.
  - (iii) Uncertain or contingent expenses or losses can be met if there is sufficient reserve in the business.
  - (iv) Reserves can be used to honor long term liabilities.
  - (v) Company can maintain dividend year after year by using reserves.
  - (vi) Reserves are created to fulfill some of the statutory requirements.

#### 4. Types of Reserves

Main types of reserves are as under :

##### Reserve

##### Revenue Reserve

- (a) General Reserve
- (b) Specific Reserve
- (c) Secret Reserve

##### Capital Reserve

(1) **Revenue Reserve** : Profit generated out of purchase and sale of goods and other regular activities of business is called as revenue profit. The reserve created out of such revenue profit is called as **revenue reserve**. Revenue reserve is very useful to increase financial soundness of business. Moreover revenue reserves can also be used to pay contingent expenses or losses of the business. Revenue reserve can be classified into three categories like General reserve, Specific reserve and Secret reserve.

(a) **General Reserve** : The purpose of creating general reserve is to increase financial soundness of the business. Its purpose is not specific. Therefore it can be used to meet with contingent expenses or losses, distribution of dividend, issue of bonus shares and for future growth of the business. Thus general reserve is a helping hand for business in contingencies. General reserve is created out of profit and loss appropriation account, for which following accounting entry is passed.

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Profit and loss appropriation A/c Dr To general reserve A/c			

(b) **Specific Reserve** : When a revenue reserve is created out of profit and loss appropriation account for specified purpose is known as **Specific Reserve**. The purpose of such reserve may be to distribute dividend of shareholders or for redeeming debentures on maturity or to compensate loss against probable decrease in the value of investment or to pay compensation at the time of accident to workers. Thus such reserve is used for the same purpose for which it is created. The most important point about this reserve is that the balance of specific reserve after serving its purpose is transferred to general reserve.

Following accounting entry is passed while creating specific reserve.

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Profit and loss appropriation A/c Dr To dividend equalization fund A/c To debenture redemption fund A/c To investment fluctuation fund A/c To workers accident compensation fund A/c			

Examples of specific reserves are as under :

- (i) **Dividend equalization fund** : The purpose of creating this reserve is to distribute dividend to shareholders in the year in which the profit is not sufficient or even to maintain dividend in the year of loss.
- (ii) **Debenture redemption reserve or debenture redemption fund** : Debenture is a long term debt for the company, which is to be repaid on expiry of its period. For the purpose of redeeming debentures out of profit, a specific amount is appropriated from profit every year and transferred to debenture redemption fund (reserve), and the balance of debenture redemption fund, is transferred to general reserve after redeeming debentures.
- (iii) **Investment fluctuation fund** : When market value of investments is already reduced or there is possibility of reduction in the market price, some amount is transferred to investment fluctuation fund out of profit. After sale of investments, a loss amount on this investment deducted from this reserve and balance amount of investment fluctuation fund, is transferred to general reserve.
- (iv) **Workers accident compensation reserve or workers accident compensation fund** : This reserve is created to compensate workers or employees when they meet with an accident during working hours.
- (v) **Sinking fund** : The reserve which is created out of profit for the purpose of the payment of long term debt or regular payment of interest or purchase of fixed assets is called as sinking fund. e.g. Depreciation fund for purchase of fixed asset, debenture redemption reserve for redeeming debentures.

**Effect in Balance Sheet** : General reserve and specific reserves are shown in the balance sheet under the heading of Reserves and Surplus on liabilities side.

(c) **Secret Reserve** : The reserve created without showing in profit and loss account for the purpose of strengthening financial position of the business is known as Secret Reserve. This is the reserve, of which the existence and amount is not shown in balance sheet and profit and loss appropriation account. Secret reserve is also known as internal reserve. Secret reserve can be created as follows :

- (i) By making more provisions for depreciation
- (ii) By undervaluing closing stock
- (iii) By making more provision for bad debt and contingencies than required.
- (iv) By recording capital expenditure in profit and loss account.
- (v) By showing contingent liability as actual liability.
- (vi) By showing more expenses than actual.

Generally secret reserve can not be created except certain exceptions.

(2) **Capital Reserve** : The reserve which is created out of capital profit and can not be used for distribution of dividend is known as capital reserve.

Following are the sources of capital reserve :

- (i) Profit on sale of fixed assets and investments.
- (ii) Profit on revaluation of fixed assets.
- (iii) Premium received by the company on issue of shares or debentures.
- (iv) Balance of share for forfeiture account after reissue of shares forfeited by the company.



- (v) Profit prior to incorporation of the company.
- (vi) Capital redemption reserve for redeeming preference shares.
- (vii) Profit on redemption of debentures at discount.

#### **Use of Capital Reserve :**

Capital reserve can be used for the following purposes :

- (i) To write off loss on sale of fixed assets.
- (ii) To write off intangible assets like goodwill and fictitious assets like preliminary expenses, discount on issue of debentures, etc.
- (iii) For distribution of bonus shares, if there is provision in Articles of Association of the company.

### **5. Reserve Fund**

Generally the amount of general reserve remains in the business as working capital but if the amount of this reserve is invested outside the business, it is known as reserve fund. Such investments are made in securities which can be easily converted into cash. The company makes investment of reserve outside the business in securities only under following circumstances.

- (i) When it is not possible to employ funds in the business profitably.
- (ii) When there is need of a specific amount on some specific future date.

### **6. Difference Between General Reserve and Provision**

The difference between general reserve and provision is as follows :

<b>Point of difference</b>	<b>General Reserve</b>	<b>Provision</b>
<b>Purpose</b>	The purpose of creating general reserve is to increase financial soundness of the business or to meet with contingent expenses.	Provision is made for special purpose of meeting with known probable liability or losses. e.g. Provision for depreciation, provision for bad debts.
<b>From which account it is appropriated</b>	General reserve is created out of profit and loss appropriation account.	Provision is created out of profit and loss account.
<b>Voluntary or Mandatory</b>	An amount is appropriated to general reserve only if there is profit at the end of an accounting year and it is voluntary.	Provision is made even if there is loss at the end of an accounting year.
<b>Use</b>	General reserve can be used for any purpose.	Provision can be used only for the purpose for which it is created.
<b>Investment</b>	General reserve can be invested in the business or outside the business.	Provision can not be invested in the business or outside the business.

Point of difference	General Reserve	Provisions
<b>Dividend</b>	General reserve can be used for distribution of dividend.	Provision can not be used for the distribution of dividend.
<b>Presentation in accounts</b>	General reserve is shown in balance sheet on liabilities side under the heading of 'Reserves and Surplus'.	Provision is shown in balance sheet on liabilities side. Provision against an asset is shown by deducting from respective asset on assets side.

## 7. Difference Between General Reserve and Capital Reserve

The difference between general reserve and capital reserve is as under :

Point of difference	General Reserve	Capital Reserve
<b>From which account it is appropriated</b>	General reserve is appropriated out of profit and loss appropriation account.	Capital reserve arises out of capital profit. The amount of capital profit is transferred to capital reserve.
<b>Use</b>	General reserve can be used for any purpose like for the growth of the business or for distribution of dividend or to meet with contingent requirements.	Capital reserve can be used to write off loss on sale or revaluation of fixed assets or to write off intangible and fictitious assets like goodwill, preliminary expenses, discount on issue of debentures.
<b>Dividend</b>	General reserve can be used for distribution of dividend.	Generally, capital reserve can not be used for distribution of dividend. Dividend can be paid out of capital reserve only under specific circumstances subject to certain conditions.
<b>Bonus Shares</b>	General reserve can be used for distribution of bonus shares to share holders.	Generally capital reserve can not be used for distribution of bonus shares. It can be used only if there is provision in Articles of Association of the company and that too subject to certain conditions.

### Exercise

#### 1. Select appropriate alternative for each question :

- (1) General reserve is created by debiting ..... account.
  - (a) Profit and loss account
  - (b) Profit and loss appropriation account
  - (c) Trading account
  - (d) Capital account
- (2) Provision is created out of ..... account.
  - (a) Profit and loss account
  - (b) Profit and loss appropriation account
  - (c) Trading account
  - (d) Capital account

- (3) ..... account shows that reserves are invested outside the business.
- |                     |                     |
|---------------------|---------------------|
| (a) General reserve | (b) Provision       |
| (c) Reserve fund    | (d) Capital reserve |
- (4) ..... balance is generally not used for distribution of dividend.
- |                     |                     |
|---------------------|---------------------|
| (a) General reserve | (b) Provision       |
| (c) Reserve fund    | (d) Capital reserve |
- (5) ..... is not advisable to create for business.
- |                     |                     |
|---------------------|---------------------|
| (a) General reserve | (b) Provision       |
| (c) Secret reserve  | (d) Capital reserve |

**2. Answer the following questions in one line :**

- (1) State types of reserves.
- (2) What is reserve fund ?
- (3) What is secret reserve ?
- (4) Which reserve is used to write off loss on sale of fixed assets ?
- (5) Give four illustrations of capital reserve.
- (6) Give four illustrations of provision.

**3. Balances mentioned below are appropriated from profit. State whether it is reserve or provision :**

- |                                 |  |
|---------------------------------|--|
| (1) Bad debts reserve           | (2) Debenture redemption fund          |
| (3) Depreciation fund           | (4) Workers accident compensation fund |
| (5) Discount reserve on debtors | (6) Dividend equalization fund         |
| (7) Capital reserve             | (8) Workers profit sharing fund        |
| (9) General reserve             | (10) Capital redemption reserve        |

**4. Answer the following questions in two or three lines :**

- (1) What is provision ?
- (2) State the characteristics of provision.
- (3) What is the importance of provision ?
- (4) Give the meaning of reserve.
- (5) What is the importance of reserve in business ?

**5. Answer the following questions :**

- (1) Clarify the importance of provision.
- (2) Why a reserve is created in business ?
- (3) What is specific reserve ? State its types.
- (4) How the secret reserve is created ?
- (5) What is capital reserve ? State its uses.

**6. Distinguish between :**

- (1) General reserve and Provision
- (2) General reserve and Capital reserve

