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## PROVISIONS AND RESERVES

You know that businessmen prepare their accounts on the basis of going concern concept assuming that their business will continue for an indefinite period. Hence, in order to ascertain the net profit for each year, businessmen need to take into account not only the current contingencies but future contingencies also. In fact, provisions and reserves are such considerations which actually relate to the future needs for which a part of the current earnings has to be set aside.



### OBJECTIVES

*After studying this lesson you will be able to*

- understand the meaning and need of provision;
- understand the meaning and objectives of reserves;
- explain types of reserves and
- know the difference between provisions and reserves.

### 15.1 PROVISION : MEANING AND NEED

As you know in our daily routine life we make various arrangements for the future expected needs. For example, if your father wants to give you higher education such as Engineering, Doctorate, or any other professional course, he will need a lot of money. Now question arises how would your father be able to arrange such an amount? Yes, you are thinking right, he will start saving money from today and every year he will do the same. The events which are about to happen in the future are planned in the present with the help of available resources. In the same way these things are followed in a business also. When there are certain expected losses/ expenses, these are planned to



## Notes

be managed in advance from the current year's profits/ surplus. The amount which is kept separately to meet such expected losses/expenses is called a Provision.

If an amount is payable in the future and the amount is certain, it is a liability. For example, October month's rent, totalling ₹ 2,000. is payable on 31<sup>st</sup> October. The enterprise will debit Rent Account and Credit Rent Outstanding Account as it is a definite liability. However, if the amount in respect of a liability or expected loss is not certain, an estimated amount is set aside by debiting the Profit and Loss Account. The amount so set aside is known as a Provision. Thus, 'Provision' means an estimated amount to meet an uncertain loss or expense in future. Some of the examples of Provisions are: Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation.

**Needs of Provision**

Provisions are provided for:

- i) Depreciation, renewal or reduction in the value of assets.
- ii) A known liability, the amount of which cannot be determined with substantial accuracy.
- iii) A disputed claim.
- iv) Specific loss on realization of an asset or on payment of taxes.
- v) Redeeming the liability.
- vi) Writing off bad-debts/doubtful debts.
- vii) Contingent liabilities.

**General rules in creation of Provisions:**

- i) It is created by debiting the profit and loss account.
- ii) It is created to meet a known liability or a specific contingency, e.g. 'Provision for bad and doubtful debts' and 'provision for depreciation' etc.
- iii) A provision is created irrespective of whether there is profit or loss in the business.
- iv) It is not available for distribution as dividend among shareholders.
- v) A provision is made for a definite amount and, therefore, a definite sum is set aside every year to meet the known contingency.
- vi) Making of a provision is must to meet known liability or contingency.
- vii) The provision is generally shown on the liability side of the balance sheet.

**INTEXT QUESTIONS 15.1**

*Fill in the blanks with suitable words:*

- i. Provision means an estimated amount to meet an uncertain \_\_\_\_\_ or \_\_\_\_\_ in future.
- ii. A provision may be provided for a \_\_\_\_\_ claim.
- iii. A provision is created by debiting \_\_\_\_\_ account.
- iv. A provision is not available for distributions as dividend among \_\_\_\_\_.
- v. A provision is generally shown on \_\_\_\_\_ side of the balance sheet.



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**15.2 MEANING OF RESERVE**

Our future is uncertain. There are a lot of contingencies, various needs and requirements in the future. Sometime we estimate for some unexpected losses/ expenses we may have to bear in the future. For this, we save some money from our current earning. If the unexpected event happens, we can use this saved money. Suppose your father earns ₹ 20,000 in a month and he does not set some money aside for any type of unexpected happening. In the mid of the month you get ill then how will your father manage for the various medical expenses for your treatment. Definitely, he will have to ask for money from friends, relatives etc. If they do not help your father, then think what will happen?

If your father had kept some money for these kinds of unexpected happenings, he would not have to face such types of troubles. Thus, an amount which is kept aside from our current income to meet the unexpected happening in the future is the reserve.

Future is uncertain, in the business there are a lot of happenings which may happen unexpectedly. For this arrangement of funds in a well planned manner is necessary. Some amount of total earned fund in a year is needed to set aside as a reserve.

Reserves are the amounts set aside out of profits. It is an appropriation of profits or accumulated profits to strengthen the financial position of the business. It is not a charge against profits. Reserves are not meant to cover any liability or depreciation in the value of assets. Examples are General Reserves, Reserves for Expansion, Reserve for Equalization of Dividends, Reserve for Increased Costs of Replacement, etc.

## 15.3 TYPES OF RESERVES



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Sometimes business, likely or certainly, has to anticipate some known or unknown future contingencies/emergencies. To meet this, business set aside a part of the profits and other surpluses which is called a reserve. Reserve is an appropriation of the profits and not a charge to it because it is not supposed to meet any known liability or diminution in the value of an asset. It is that part of profits that is kept aside to meet an unknown liability or for future emergency. It is created by debiting the P&L Appropriation A/c. It can be created only when there is profit in the business. It is usually shown on the liability side of the balance sheet. Reserves can be categorized into:

- |                     |                     |                     |
|---------------------|---------------------|---------------------|
| i. General Reserve  | ii. Capital Reserve | iii. Secret Reserve |
| iv. Revenue Reserve | v. Specific Reserve | vi. Reserve Fund    |
| vii. Sinking Fund   |                     |                     |

**i) General reserve:** As the name suggests, the general reserve is not tied down to any specific purpose. It can be utilised to meet any future contingency or unknown liability. It is not legally mandatory to create a general reserve. It is created only when there is sufficient profit. It is shown on the debit side of P&L Appropriation A/c.

- It is created not for any specific purpose but for meeting future contingencies.
- It can be utilized for meeting any future loss.
- It is created only when there are sufficient profits.
- It is shown on the debit side of profit and loss appropriation account.
- Only distributable profits are reduced because of it.

This reserve is created by setting aside revenue profits. The object is to strengthen the general financial position of the business. It is not for a specific purpose. It is a free reserve. It acts as a safety cushion against all unforeseen contingencies in the future. It is immediately available for distribution as dividend profit.

General Reserves are retained profits. They are part of the surplus. They are the amount kept aside from profits. There can be no reserves if there are no profits. Reserves are undistributed profits. They are appropriations of profits. While provisions are a pre-profit matter, reserves are a post-profit matter. One cannot talk of creating reserves, without first finding out profits. It is a good business policy to create reserves. Reserve strengthen the financial position of the business. Reserves are created for different purposes. They may be for expansion of business; they may be for equalization of dividends or they may be for redemption of debentures

or loans. Again, reserves may be created out of capital profits or out of revenue profits. The reserves created out of capital profits are called capital reserves, whereas, others are called revenue reserves.

- ii) Capital Reserve :** A capital reserve is generally created out of profits which are of capital nature only, such as capital gains, premium on issue of shares and debentures, profits prior to incorporation, profits on revaluation of assets and liabilities etc. It should not be distributed as dividend among the shareholders. It is used to strengthen the financial position of business, to write off capital losses or losses of abnormal nature.

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Thus, the Capital Reserves

- Are appropriations from profits which cannot be distributed by way of cash dividends.
- Arise mainly from (i) equity transactions between the enterprise and its shareholders; (ii) from adjustments arising in accounting for business combinations; (iii) from differences arising on transactions of foreign currency operations; (iv) from surpluses arising from asset revaluation; (iv) any unrealized gain which has not been included in income.
- Examples of capital reserves includes: security premium, capital redemption reserves, capital reserves arising on merger and acquisition of a business, statutory reserves, asset revaluation reserve and exchange fluctuation reserves.

Capital reserves are created out of capital profits. Capital profits are not regular trading profits. They are profits on rare transactions. Capital reserves are generally not available for distribution as dividend. They are set aside to strengthen the financial position of the business or to meet capital losses. The following are the examples of capital profits :

- a) Profit on sale of fixed' assets.
- b) Profit prior to incorporation.
- c) Profit on redemption of debentures.
- d) Premium on issue of shares or debentures.
- e) Profit on forfeiture of shares.
- f) Profit on acquisition of business.
- g) Profit which have not been earned in the regular course of business.



Notes

*Capital reserves can be utilized in the following ways:*

- a) Issue of bonus shares.
- b) Writing off goodwill.
- c) Writing off preliminary expenses.
- d) Writing off shares/debentures issue expenses.
- e) Writing off losses prior to incorporation.

**iii) Secret Reserve :** Sometimes, a firm creates a reserve which is not shown in the balance sheet; it is known as secret reserve or hidden reserve or internal reserve. The existence of this reserve is not disclosed in the financial statements. It strengthens the financial position of the business, promotes confidence and stability. It is not created by joint stock companies except banking, insurance and financing companies.

**iv) Revenue Reserves :** Revenue Reserves are appropriation from revenue profits which can be distributed by way of cash dividends although some may be set aside for other purposes.

**v) Specific Reserve :** As the name suggests, the Specific Reserve is created for a specific purpose. It is utilised for only that purpose for which it has been created and not for purpose other than that. Whether a firm earns profit or suffers losses, it is obligatory for it to create specific reserve. It is shown on the debit side of P&LA/c. Examples of such reserves are- dividend equalization reserves, investment fluctuation reserves, plant replacement reserves and reserves for redemptions of debentures.

- a) It is created for a specific purpose.
- b) It is utilized for that specific purpose, for which it was created.
- c) Whether profit or no profits, it must be created.
- d) It is necessary to create in order to ascertain profit.
- e) It is shown on the debit side of profit and loss account.
- f) Net profits are reduced because of it.

This too is created by setting aside revenue profits. But it is for a specific purpose. This is not immediately available for distribution. For example, reserve created for redemption of debentures. During the period of liability, this reserve is not available for distribution. It becomes a general reserve on the redemption of debentures. Similarly, a reserve may be created for equalization of dividend.

**vi) Reserve Fund :** When a part of the profit set aside and used in the business, it is a reserve. But when a part of profits and other surplus is set aside and invested outside the business then it is known as reserve fund. In this case, the retained amount is invested in safe securities which are readily and easily realisable. Investments are not being carried for definite period. The purpose is to strengthen the financial position of the business house. Thus, the use of the term 'fund' indicates investment of reserve outside the business. Reserve fund Investments are not made for definite period. It is created always out of divisible profits. Interest received on investments representing reserve fund may not be re-invested.



Notes

Profit set aside and used in the business is a reserve. But profit set aside and invested outside the business is a reserve fund.

- a) Investments are not for definite period.
- b) It is created always out of divisible profits.
- c) Interest received on investments representing reserve fund may not be re-invested.

**vii) Sinking Fund :** A sinking fund is established for the future redemption of the long-term debts or liabilities or for replacement of assets or to renew a lease. A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities. Thus, a sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits.

Reserves are appropriations of profit namely when profits have been ascertained after deducting all expenses which includes provision and others. Reserves are residual earnings after all expenses and taxation which belongs to the owners namely the shareholders.

- a) Sinking fund Investments are for a definite period.
- b) It is not always out of divisible profit e.g. sinking fund for replacement of asset is provision for depreciation, it must be created even if there are no profits.
- c) In case of sinking fund, interest is always re-invested.

A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities.



*Notes*

A sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits. A sinking fund represents amount invested outside the business.

**General rules in creation of Reserves**

- i) It is created by debiting the profit and loss appropriation account.
- ii) It is created to meet an unknown liability, or to strengthen the financial position of the company or for equalization of dividends etc.
- iii) A reserve is created only when there is profit in the business.
- iv) It can be distributed among shareholders as dividend.
- v) The reserve debentures is created without taking into consideration the actual amount required except in the case of redemption of when a definite sum is set aside.
- vi) Creation of reserve depends upon the financial policy of the business and discretion of its management.
- vii) It is usually shown on the liability side of the balance sheet as it is not a specific reserve.



**INTEXT QUESTIONS 15.2**

*Fill in the blanks with suitable words :*

- i. An amount kept aside from current income to meet unexpected happening in future is called \_\_\_\_\_.
- ii. It is not legally mandatory to create a \_\_\_\_\_.
- iii. \_\_\_\_\_ reserve is created out of \_\_\_\_\_ profit.
- iv. Profit on sale of fixed assets is \_\_\_\_\_ profit.
- v. \_\_\_\_\_ reserve is not shown in the financial statement.
- vi. Profit set aside and used in business is called a \_\_\_\_\_.
- vii. Profit set aside and invested outside the business is called \_\_\_\_\_.
- viii. Sinking Fund Investments are for a \_\_\_\_\_ period.

## 15.4 DIFFERENCES BETWEEN PROVISION AND RESERVE

S. No.	Provisions	Reserves
1.	It is created by debiting the Profit & Loss A/c.	It is created by debiting the Profit & Loss Appropriation A/c.
2.	It is a charge against the profits without which true profit or loss of the business can't be ascertained.	It is an appropriation of profits and doesn't require to be created to ascertain true profit or loss.
3.	It has to be provided even if there is loss or no profit in the business. It is created irrespective of whether there is profit or loss in the business.	It can be created only when there is profit in the business.
4.	It can't be available to be distributed as dividend among the shareholders.	It can be distributed as dividend among the shareholders.
5.	It is a sum for known liability or for specific contingency e.g. provision for bad and doubtful debts, or provision for depreciation etc.	It is a sum to meet an unknown future liability or contingency or to strengthen the financial position of the business or for equalization of dividends etc.
6.	Making of a provision is a legal necessity for the management.	It is not legally obligatory to create a reserve. It depends upon the financial policy of the business and discretion of its management.
7.	Amount can't be utilized for purposes other than that for which they are created.	Amount can be utilized for any purpose because they represent undistributed profits.



Notes



## INTEXT QUESTIONS 15.3

## I. State whether the following statements are True or False :

- i. Provisions are the charges against profits for all apprehended losses.
- ii. All reserves appear on the liability side of the balance sheet.
- iii. Capital reserves are freely distributed as profits.



*Notes*

- iv. The purpose of reserve is generally to strength the financial position of a business enterprise.
- v. A provision is made for a definite amount and therefore, a definite sum is set aside every year to meet the known contingency.

### **II. Multiple Choice Questions:**

- i. Out of the following which is not a provision:
  - a) Provision for bad debts.
  - b) Provision for discount on debtors.
  - c) Dividend Equalization Reserve.
  - d) Provision for Depreciation.
- ii. Out of the following which is not a reserve:
  - a) Reserve for Expansion.
  - b) Dividend Equalization Reserve
  - c) Secret Reserve
  - d) Provision for bad debts.
- iii. Out of the following name the reserve which is created not for any specific purpose but for meeting future contingencies:
  - a) General Reserve                      b) Capital Reserve
  - c) Specific Reserve                      d) Secret Reserve
- iv. Out of the following name the reserve which can be utilised for issue of bonus shares:
  - a) General Reserve                      b) Capital Reserve
  - c) Secret Reserve                      d) Sinking Fund
- v. Out of the following identify the item which is created by debiting the profit and loss appropriations Account:
  - a) Provision for bad debts
  - b) Provision for discount on debtors
  - c) Provision for Income tax
  - d) General Reserve



### WHAT YOU HAVE LEARNT

- Provision is an estimated amount to meet an uncertain loss or expense of future e.g., Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation, etc. Provisions are created out of profits and are generally shown on the liability side of the balance sheet. Making a provision is must to meet a known liability in future.
- An amount which is kept aside from current income to meet the unexpected happening in the future is called a reserve e.g. General Reserve, reserve for expansion, reserve for equalization of dividend etc. General Reserve is undistributed or retained profits. No reserve can be created if there is no profit. Reserves strengthen the financial positions of the business. Capital reserves are created out of capital profits eg. Capital gains, premiums on issue of shares and debentures, profits prior to incorporation etc. These reserves are not available for distribution of dividend. Secret reserve is not shown in the balance sheet. Revenue reserves are appropriations of profits which can be distributed as dividends. Specific reserve is created for a specific purpose e.g. dividend equalization reserve, investment reserve, investment fluctuation reserve etc. When a part of the profit is set aside and invested outside the business then it is known as a reserve fund. A Sinking fund is established for the future redemption of long term debts or liability or replacement of assets etc.



*Notes*



### TERMINAL EXERCISE

1. What is meant by Reserve Fund?
2. What is meant by a provision?
3. Give the meaning of reserves.
4. State the purposes for which provision are created?
5. Why an organisation creates reserves? Explain briefly.
6. State the purposes for which capital reserves can be utilized.
7. Distinguish between provision and reserve (any four points).
8. Describe briefly the following:
 

i. Secret Reserves	ii. Revenue Reserves
iii. Specific Reserves	iv. Sinking Fund



**ANSWERS TO INTEXT QUESTIONS**

- 15.1** i) Loss/expense      ii) Disputed      iii) Profit and Loss Account  
 iv) Shareholders      v) Liability
- 15.2** i) Reserve      ii) General Reserve      iii) Capital, Capital      iv) Capital  
 v) Secret      vi) Reserve      vii) Reserve Fund      viii) Definite
- 15.3** I.      i) True      ii) True      iii) False      iv) True      v) True  
 II.      i) c      ii) d      iii) a      iv) b      v) d



*Notes*



**ACTIVITY**

- Your parents from their regular income make some savings for the known or unknown expenses/liability to meet out in future. Prepare a list of past three months savings with reasons and differentiate them in reserves or provisions keeping in view the principles of the same, so that you may be clear about the term reserve & provisions.