

Reserves and Provisions

Meaning of Reserves

Reserves are part of profits or gain that has been allotted for a specific purpose. Reserves are usually set up to buy fixed assets, pay bonuses, pay an expected legal settlement, pay for repairs & maintenance and pay off debt.

What are Reserves in Accounting?

When an enterprise earns a profit during the end of a year, a certain part of it is retained in the trading concern to meet future exigencies, growth outlooks etc., The amount of money that is kept aside is known as Reserves in Accounting.

They assist in securing the financial situation of an enterprise and can be utilised for different purposes such as stable dividend repayments, expansion, meeting contingencies, legal requirements, investments, improving the financial situation, etc., It is also termed as retained earnings.

For instance – Reserve for Dividends Equalisation, General reserve, Reserve for Increased Cost of Replacement, Reserve for Expansion, etc.,

Inside Financial Statements

It is shown on the liability side of a balance sheet (B/S) below the heading ‘Reserves and Surplus’ with capital if an enterprise suffers losses, then it is not created.

Types of Reserves

- Capital Reserve
- Revenue Reserve

What is Capital Reserve?

The capital reserve is established out of capital profits and are normally not allocated as dividends to the shareholders. It cannot be established out of profits acquired from core operations of an enterprise.

Examples

- Profit earned before an enterprise's embodiment
- Premium acquired on the issue of debentures and shares
- Gain on re-issuance (redistribution) of forfeited shares
- Profit kept aside for redemption of debentures or preference shares
- Gain on sale of fixed assets
- The surfeit on revaluation of liabilities and assets
- Capital redemption reserve

What is Revenue Reserve?

Revenue reserves are established out of gains acquired from operations of an enterprise. Reserves are shown under Reserves and Surplus section on the liabilities side of a balance sheet. It can be utilised for the following:

- Dividend to shareholders
- Expansion of trading concern
- Balance the dividend rate

What is the Definition of Provision?

In the field of financial accounting, under the International Financial Reporting Standards, a provision is an account that records the present liability of an entity. This liability is recorded in the balance sheet of the concern to match its related expenses. According to the principle of GAAP, a provision is an entity's expense, while according to IFRS provision is a liability.

A provision can be described as a liability of uncertain timing or an amount. A liability, in turn, is a present obligation of the entity which arises from past events. The settle of this liability is expected from the outflow of resources which embodies economic benefits.

What is Provision in Accounting?

Provisions in Accounting are to be described as an amount that is set aside to cover an expense in the future which may occur in all probability. This means this is the reduction in the value of an asset.

This is the fund that is to be put aside by a company to cover the anticipated losses in the future. Provision is a liability that responds to an uncertain expense. Provisions are listed on a firm's balance sheet.

These provision amounts are to be estimated. While conducting a financial report, these provisions are recorded as the current liability on the balance sheet, and then it is matched to the appropriate expense account on the income statement.

Why Are Provisions Created?

Provisions are created for a specific purpose, creation of these provisions are important because they account for certain company expenses, which is to be paid in the same year. The creation of the provision is important as it also makes the company's financial statements more accurate.

These provisions are not a form of savings, as the expenses are 'probable', the amount which is set aside and is expected to be spent.

Is a Provision a Reserve?

The direct answer to this question is, no provision is not considered as a reserve.

A reserve or the reserve fund is such a fund that is formed by allocating the money from the profit made by the company for a specific purpose, while a provision is a fund that is allocated

for a specific expense. A reserve is a fund that is typically liquid, these funds can be analysed immediately, like for example, from the savings account.

An example of an entity that is using a reserve fund would be an Owners' Association. The company may also have a reserve fund for the unscheduled repairs. They exactly do not know what these repairs will be for, or precisely with what the costs are associated, they only know that the repairs will be required at some point in time.

An example of a provision could be an automobile company, which sets aside its own money for the warranty repairs for the last year.

Example of Provision

The examples of provisions are listed as below:

- Accruals
- Asset impairments
- Bad debts
- Depreciation
- Doubtful debts
- Guarantees (product warranties)
- Income taxes
- Inventory obsolescence
- Pension
- Restructuring Liabilities
- Sales allowances

What Are Tax Provisions?

Tax provisions are the amount that is set aside specifically for paying a company's income taxes. This is done to calculate the tax amount which the business owes a business. This provision is required to adjust its gross income by the number of tax deductions that it is claiming.

Tax deductions, meals, interest expenses, depreciation allowances, holiday parties, etc may also be included. After the calculations are done, the total tax amount which the company determines it owes can be allocated on its books in a term of provision, which is known as a "tax provision".

Differences between Reserve and Provision in the table below:

Reserve	Provision
Definition	
The portion of profit kept aside for unforeseen obligations of a business	A portion of money from the business set aside for meeting known liabilities or expenses
Method of Creation	
Created by debiting Profit and Loss appropriation account	Created by debiting Profit and Loss Account
Purpose	
It provides capital for running the business and safeguards against expenses from unforeseen contingencies	It secures business from expenses arising from known liabilities
Allocation	
Presence of profit is required for allocation of reserve.	Presence of profit not necessary for allocation
Dividend Payment	
Paid from reserves	Cannot be paid
Impact on Profit	
Reduces net profit of the organisation	Reduces profits for dividend distribution
Appears in	
Always shown on the liability side	Appears as a deduction from the concerned asset, in case of an asset, in case of liabilities, it is shown in the liabilities side
Utilisation	
Can be used for any given purpose	Needs to be used for the specific purpose it is allocated for

Differences between Capital Reserve and Revenue Reserve

Basis for Comparison	Revenue Reserve	Capital Reserve
Inherent meaning	Created from the trading activities of a business;	Created from non-trading activities of a business;
Application	Acts as a reinvesting source for the business.	Acts as a provision for future contingencies like inflation, instability, etc.
Distribution	Depending on the discretion of the company, a company may distribute as a dividend to shareholders.	Is never distributed;
Term	It is useful for short and mid-term purposes.	It is useful for long term purposes.
Monetary value	Always received in monetary value;	Not always received in monetary value;
Other purposes	The company always reinvests back a portion or distributes as a dividend.	Also used for legal purposes;
Examples	Retained earnings.	Reserve created out of profit on sales of fixed assets.

Practical Problems:

Illustration 20

Trial Balance as on 31st December, 2013 of Mr. S. Saha contains the following items :

Provision for Doubtful Debts	₹ 15,000
Bad Debts	10,000
Sundry Debtors	1,40,000

On enquiry it was ascertained that Debtors include :

- ₹ 15,000 due from Mr. B. Sen and Creditors include ₹ 20,000 due to Mr. B. Sen.
- ₹ 10,000 due on account of sale of Furniture.
- Bad Debts ₹ 7,500.

Prepare Provision for Doubtful Debts Account and Bad Debts Account.

Provision for Doubtful Debts is to be created at 5% on Trade Debtors.

[C.U.B.Com. (General) — 2014]

Solution

In the books of Mr. S. Saha

Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31.12.2013	To Balance b/d	10,000	31.12.2013	By Provision for Doubtful Debts A/c	15,000
	To Debtors A/c	7,500	"	By Profit and Loss A/c	2,500
		17,500			17,500

Provision for Doubtful Debts Account					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31.12.2013	To Bad Debts A/c	15,000	1.1.2013	By Balance b/d	15,000
"	To Balance c/d (Note 1)	5,375	31.12.2013	By Profit and Loss A/c	5,375
		20,375			20,375

Working Note : (1) Calculation of Provision for Doubtful Debts

Sundry Debtors	₹ 1,40,000
Less: Mutual Set-off (Mr. B. Sen)	15,000
Less: Due on account of Sale of Furniture	10,000
Less: Further Bad Debts	7,500
	1,07,500
Less: Provision for Doubtful Debts @ 5%	5,375
	<u>1,02,125</u>

Illustration 19

On 01.01.2014, B Sen had the following balances :

Sundry Debtors ₹ 1,20,000 and Provision for Doubtful Debts ₹ 6,000.

During the year ending 31.12.2014, B Sen sold goods on credit amounting to ₹ 15,00,000. During the year customers returned goods of ₹ 5,000, while the firm collected in cash from debtors ₹ 12,00,000, allowed discounts of ₹ 2,000 and received acceptance (B/R) amounting to ₹ 2,00,000. The firm could not collect ₹ 5,000 from Debtors and had to write off the amount. It was decided to maintain provision for doubtful debts @ 5% on Debtors as on 31.12.2014.

You are required to show Sundry Debtors and Provision for Doubtful Debts Accounts.

[C.U.B.Com. (General) — 2015]

Solution

Dr.			Sundry Debtors Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
1.1.2014	To Balance b/d	1,20,000	?	By Sales Return A/c	5,000			
?	To Sales A/c (Credit)	15,00,000	?	By Cash A/c	12,00,000			
			?	By Discount Allowed A/c	2,000			
			?	By Bills Receivable A/c	2,00,000			
			?	By Bad Debts A/c	5,000			
			31.12.2014	By Balance c/d	2,08,000			
		16,20,000			16,20,000			

Dr.		Provision for Doubtful Debts Account				Cr.
Date	Particulars	₹	Date	Particulars	₹	
31.12.2014	To Bad Debts A/c	5,000	1.1.2014	By Balance b/d	6,000	
	To Balance c/d (₹ 2,08,000 x 5%)	10,400	31.12.2014	By Profit and Loss A/c (Balancing figure)	9,400	
		15,400			15,400	

Illustration 23

On 31st December, 2013 sundry debtors and provision for bad debts stood at ₹ 90,000 and ₹ 6,750 respectively. During the year 2014 Bad Debts amounting to ₹ 4,560 were written off. On 30th June, 2014 an amount of ₹ 580 was received on account of a debt written off as bad debt last year. The Debtors list on 31st December, 2014 was verified and it was found that amongst Sundry Debtors amounting to ₹ 65,940 an amount of ₹ 940 was to be written off as bad. It was decided to maintain the provision for bad debts at the same percentage as it was on 31st December, 2013.

Prepare Bad Debts Account and Provision for Bad Debts Account. Also show how the relevant items would appear in the Profit and loss Account and Balance Sheet as on 31.12.2014. [C.U.B.Com. (Hons.) — 2015]

Solution

Dr.			Bad Debts Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
?	To Debtors A/c	4,560	31.12.2014	By Provision for Bad Debts A/c	5,500			
31.12.2014	To Debtors A/c (Further Bad Debts)	940						
		5,500						5,500

Dr.			Provision for Bad Debts Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
31.12.2014	To Bad Debts A/c	5,500	1.1.2014	By Balance c/d	6,750			
	To Balance c/d (Note 2)	4,875	31.12.2014	By Profit and Loss A/c (Balancing figure)	3,625			
		10,375			10,375			

Dr.			Profit and Loss Account for the year ended 31st December, 2014 (Includes)			Cr.		
Particulars	₹		Particulars	₹				
To Provision for Bad Debts A/c	3,625		By Bad Debts Recovery	580				

Balance Sheet as at 31st December, 2014 (Includes)			
Liabilities	₹	Assets	₹
		Debtors	65,940
		Less: Bad Debts	940
			65,000
		Less: Provision for Bad Debts A/c @ 7.5%	4,875
			60,125

Working Notes :

(1) Percentage of Provision for Bad Debts in 2013 = $\frac{6,750}{90,000} \times 100 = 7.5\%$

(2) Calculation of Provision for Bad Debts

Debtors balances as on 31.12.2014

Less: Further Bad Debts

Less : Provision for Bad Debts @ 7.5%

₹
65,940
940
65,000
4,875
60,125

Illustration 24

The following is the extract from the Trial Balance of Mr A Banerjee as on 31st December, 2012 :

Particulars	Dr. (₹)	Cr. (₹)
Bad Debts	8,000	—
Sundry Debtors	3,00,000	—
Provision for Bad and Doubtful Debts	—	12,000

It is desired to maintain a provision of 5% for bad and doubtful debts.

Prepare the Bad Debts Account and Provision for Bad and Doubtful Debts Account. Also show how the relevant items would appear in the Profit and Loss Account and Balance Sheet. [C.U.B.Com. (Hons.) — 2013]

Solution

In the books of Mr A Banerjee

Dr. Bad Debts Account				Cr.	
Date	Particulars	₹	Date	Particulars	₹
31.12.12	To Balance b/d	8,000	31.12.12	By Provision for Bad Debts A/c	8,000
		8,000			8,000

Dr. Provision for Bad Debts Account				Cr.	
Date	Particulars	₹	Date	Particulars	₹
31.12.12	To Bad Debts A/c	8,000	31.12.12	By Balance b/d	12,000
	To Balance c/d	15,000		By Profit and Loss A/c (Balancing figure)	11,000
		23,000			23,000

Dr. Profit and Loss Account for the year ended on 31st December, 2012				Cr.	
Date	Particulars	₹	Date	Particulars	₹
31.12.12	To Provision for Bad Debts A/c	11,000			

Balance Sheet of A Banerjee as at 31st December, 2012

Liabilities	₹	₹	Assets	₹	₹
			Sundry Debtors	3,00,000	
			Less: Provision for Bad Debts A/c	15,000	2,85,000

Illustration 27

On January 1, 2016 the Provision for Bad and Doubtful Debts Account of a concern showed a balance of ₹ 60,000 and the Debtors amounted to ₹ 15,00,000. Out of these, during 2016, Debtors amounting to ₹ 10,75,000 paid in full, but the following debts proved bad or doubtful: A (₹ 20,000)—bad to the full extent; B (₹ 40,000)—insolvent, estate expected to pay 50 paise in the rupee; C (₹ 12,000)—realised 33.1/3 % in full settlement.

The remaining debts were considered somewhat doubtful on December 31. The following further debts became due during 2016 but outstanding on December 31:

D (₹ 20,000)—expected to prove totally bad; E (₹ 80,000)—expected to prove 5% bad; F (₹ 6,40,000)—expected to prove 4% bad; G (₹ 4,00,000)—expected to prove bad to some extent; H (₹ 12,60,000)—expected to prove wholly good.

It was decided to write off actual debts and to make reserve of 5% on debts of unknown doubtful nature. Draw up the Provision for Bad and Doubtful Debts Account and show the balance of the account as at December, 31, 2016.

Solution

Calculation of Actual Bad Debts		Creation of Provision		Calculation of Other Debtors*	
Amount due from A (fully bad)	₹ 20,000	50% amount due from B	20,000	Debtor at the beginning	15,00,000
Amount due from C (2/3 bad)	8,000	Full amount due from D	20,000	Less: Paid during the year	10,75,000
	28,000	5% amount due from E	4,000		4,25,000
		4% amount due from F	25,600	Less: Amount due from A, B and C	72,000
		5% amount due from others*	37,650		3,53,000
			1,07,250	Add: Amount due from G	4,00,000
					7,53,000

Dr. Provision for Bad and Doubtful Debts Account				Cr.	
Date	Particulars	₹	Date	Particulars	₹
2016 Dec.31	To Bad Debt A/c	28,000	2016 Jan.1	To Balance b/f	60,000
	To Balance c/d	1,07,250	2016 Dec.31	To P & L A/c (balancing figure)	75,250
		1,35,250			1,35,250
			2017 Jan.1	By Balance b/f	1,07,250