VIDYA BHAWAN BALIKA VIDYA PITH

शक्तिउत्थानआश्रमलखीसरायबिहार

Class 11 commerce Sub. ACT Date 14.02.2021 Teacher name – Ajay Kumar Sharma

Depreciation, Provisions and Reserves

SECTION - II

Provisions and Reserve

7.11 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 realisation 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 provisions are:

- Provision for depreciation;
- Provision for bad and doubtful debts;
- Provision for taxation:
- · Provision for discount on debtors; and
- 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 alongwith current liabilities, for example provision for taxes and provision for repairs and renewals.

7.11.1 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 likely to 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 at the 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 bad debts. 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 A/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, 2014 is given below:

Date	Account title	L.F.	Debit Amount Rs.	Credit Amount Rs.
	Sundry Debtors		68,000	

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:

Journal

Date	Particulars		L. F.	Amount Rs.	Amount Rs.
2014 Mar. 31	Bad debts A/c To Sundry debtors A/c (Bad debts written off)	Dr.		8,000	8,000
Mar. 31	Profit & Loss A/c To Bad debts A/c (Bad debts debited to profit and loss account)	Dr.		8,000	8,000
Mar. 31	Profit and Loss A/c To Provision for doubtful deb (For creating provision for doubtful			6,0001	6,0001

Working Notes

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

Rs. 68,000 - Rs. 8000 = Rs. 60,000

Rs.
$$6000 \times \frac{10}{100} = \text{Rs. } 6000^{\circ}$$