VIDYA BHAWAN BALIKA VIDYA PITH

शक्तिउत्थानआश्रमलखीसरायबिहार

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Teacher name – Ajay Kumar Sharma

Depreciation, Provisions and Reserves

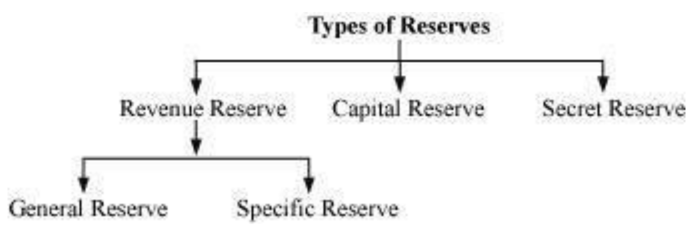
Question 5:

Name and explain different types of reserves in details.

ANSWER:

Reserves− Reserves are created for strengthening the financial positions and future growth. It is created out of profit earned by business.

The broad classification of reserve is diagrammatically presented below.



1. **Revenue Reserve−** It is created out of revenue profit, i.e., revenue earned from normal activities of the business. It can be used for either general purpose or specific purpose. It is of two types:

a. General Reserve− When the reserve is created **without** any specified purpose, then the reserve is called general reserve. It is a free reserve and so can be used for any purpose. It can also be used for future growth and expansion. For example, reserve funds, retained earnings, contingencies reserves, etc.

b. Specific Reserve− When reserve is created for some specific purpose, then the reserve is called specific reserve.

Examples of specific reserve are given below.

i. Debenture Redemption Reserve

ii. Investment Fluctuation Reserve

iii. Dividend Equalisation Reserve

iv. Workmen Compensation Fund

2. **Capital Reserve−** It is created out of capital profit, i.e., gain from other than normal activities of business operations, such as sale of fixed asset, etc. It is created to meet the capital loss. It **cannot** be distributed as dividend. The example of capital reserves are given below.

i. Premium on issue of shares

ii. Premium on issue of debentures

iii. Profit on redemption of debentures

iv. Profit on sale of fixed assets

v. Profit on reissue of forfeited shares

vi. Profit prior to incorporation

3. **Secret Reserves−** Reserves that are created by overstating liabilities or understating assets are known as secret reserves. They are **not** shown in the Balance Sheet. These reduce tax liabilities, as the liabilities are overstated. It is created by management to avoid competition by reducing profit. Creation of secret reserve is **not** allowed by Companies Act, 1956, which requires full disclosure of all materials facts and accounting policies, while preparing final statements.

Question 6:

What are provisions? How are they created? Give accounting treatment in case of provision for doubtful Debts.

ANSWER:

Provisions are the amount that is created against profit to meet the known liability; however, the amount of liability is uncertain. It is created for specific liability. Creation of provision is compulsory even if, there is **no** profit. The underlying principle behind creation of provision is *conservatism*, *viz*., to prepare for future loss. The main rationale for making provisions is to provide cushion to the future business performance against the uncertain and unforeseen losses that may arise from the past transactions. A few examples of provisions are given below.

1. Provision for bad and doubtful debts
2. Provision for depreciation
3. Provision for taxation
4. Provision for discount on debtors

Provisions are made by debiting the Profit and Loss Account on estimate basis. The provisions are created on the basis of past experiences. Every year, a business may experience common losses, such as depreciation of fixed assets, taxation, etc., which are although known; however, their exact amount of future period is unknown. Thus, business creates provision of certain percentage every year, which is truly based on the intuitions and past experiences. These unascertained liabilities in form of provisions are kept aside, which help future business activities, undisturbed from the future losses.

Accounting treatment for provision for doubtful debts is:

Profit and Loss A/c Dr.

To Provision for Doubtful Debts

(Provision for doubtful debt made)