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CBSE

CLASS-11th

THE CENTRAL BOARD OF SECONDARY EDUCATION

Accountancy - II

SIERRA INNOVATIONS

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Accountancy - II

Chapter 8 Provisions and Reserves

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● 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 take into account such an expected loss while calculating true and fair profit/loss according to the principle of **Prudence or Conservatism.**

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.

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**.

Profit and Loss A/c Dr. (with the amount of provision)

To Provision for doubtful debts A/c

In the balance sheet, the amount of provision may be shown either:

a. By way of deduction from the concerned asset on the assets side.

OR

b. On the liabilities side of the balance sheet under current liabilities.

● Reserves

Basis	Provisions	Reserves
Nature	Charge against profit	Appropriation of profit
Purpose	It is created for a known liability or expense pertaining to the current accounting year, the amount of which is not known	It is made for strengthening the financial position of the business
Effect on taxable profit	Reduces the profit	No effect on taxable profit
Presentation in Balance sheet	It is shown- a. By way of deduction from the concerned asset on the assets side. **OR** b. On the liabilities side of the balance sheet under current liabilities.	It is shown on the liabilities side under current liabilities.
Element of Compulsion	Creation of Provisions is necessary to ascertain true and fair profit or loss in compliance with Prudence/Conservatism concept.	Creating a Reserve is optional but cannot be made unless there are profits. However, some reserves like Debentures Redemption Reserve are mandated by law.
Use for payment of dividend	It cannot be used for dividend distribution.	It can be used for dividend distribution.

A part of the profit may be set aside and **retained in the business** to provide for certain future needs like growth and expansion or to meet future contingencies such as workmen compensation.

Unlike provisions, reserves are the **appropriations of profit** to strengthen the financial position of the business. Reserve is **NOT a charge against profit** as it is not meant to cover any known liability or expected loss in future. However, retention of profits in the form of reserves reduces the amount of profits available for distribution among the owners of the business.

It is shown under the head **Reserves and Surpluses on the liabilities side of the balance sheet** after capital.

Examples of reserves are: General reserve, Workmen compensation fund, Investment fluctuation fund, Capital reserve, Dividend equalisation reserve, Reserve for redemption of debenture.

Difference between Provisions and Reserves

Types of Reserves

1) **General reserve**: When the purpose for which reserve is created is not specified, it is called General Reserve. **It is also termed as free reserve** because the management can freely utilise it for any purpose. General reserve strengthens the financial position of the business.
2) **Specific reserve**: Specific reserve is the reserve, which is created for some **specific purpose and can be utilised only for that purpose**. Examples of specific reserves are given below:

(i) Dividend equalisation reserve: This reserve is created to **stabilise**

or

maintain dividend rate. In the year of high profit, amount is transferred to Dividend Equalisation reserve. In the year of low profit, this reserve amount is used to maintain the rate of dividend.

(ii) Workmen compensation fund: It is created to provide for claims of the workers due to accident, etc.

(iii) Investment fluctuation fund: It is created to make for decline in the

value of investment due to market fluctuations.

(iv) Debenture redemption reserve: It is created to provide funds for

redemption of debentures.

Reserves are also classified as revenue and capital reserves according to the **nature of the profit out of which they are created.**

1) **Revenue reserves**: Revenue reserves are created from **revenue profits which arise out of the normal operating activities** of the business and are otherwise freely available for distribution as dividend.

Examples of revenue reserves are: General reserve and Workmen compensation fund

2) **Capital reserves:** Capital reserves are created out of **capital profits which do not arise from the normal operating activities**. Such reserves are not available for distribution as dividend. These reserves **can be used for writing off capital losses or issue of bonus shares in case of a company**.

Examples of capital profits which are treated as capital reserves are: Premium on issue of shares or debenture, Profit on sale of fixed assets, Profit on redemption of debentures, Profit on revaluation of fixed asset & liabilities.

Basis	Revenue Reserves	Capital Reserves
Source of creation	Created out of revenue profits arising out of normal operating activities of the business.	Created out of capital profits which do not arise out of normal operating activities of the business.
Purpose	It is created to strengthen the financial position of the company, to meet unforeseen contingencies or for some specific purpose	It is created for compliance of legal requirements or accounting practices.
Usage	A specific revenue reserve can only be utilised to meet its special requirements whereas a general reserve can be utilised for any purpose.	It can be utilised for specific purposes as provided in the law in force e.g., to write off capital losses or issue of bonus shares.

Secret Reserve

Secret reserve is a reserve which **does not appear in the balance sheet.** It may also help to reduce the disclosed profits and also the tax liability. The secret reserve can be merged with the profits during the lean periods to show improved profits.

Management may resort to creation of secret reserve by charging higher depreciation than required. It is termed as 'Secret Reserve', as it **is not known to outside stakeholders**. Secret reserve can also be created by way of:

- Undervaluation of inventories/stock
- Charging capital expenditure to profit and loss account
- Making excessive provision for doubtful debts

• Showing contingent liabilities as actual liabilities

Creation of secret reserves within **reasonable limits is justifiable on grounds of expediency, prudence and preventing competition from other firms.**

Points to remember

- Provisions are created to be able to meet certain expenses/losses which are related to the current accounting period but are not incurred yet.
- Reserves are appropriations of profit made to strengthen the financial position of the company by retaining profits.
- There are two types of Reserves- General and Specific Reserves.
- Reserves are also classified on the basis of the nature of the profits that they are created out of- Capital and Revenue Reserves.
- Revenue reserves (General) can be used for dividend distribution. However, capital reserves cannot be used for the same.
- Secret reserves are reserves that are not shown in the balance sheet.

Questions

Q1. Explain the concept of secret reserve. (1 mark)

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.

Q2. Distinguish between general reserve and specific reserve on the basis of usage. (1 mark)

General Reserve can be used for any purpose whereas specific reserve cannot be used for any other purpose than the specified purpose for which it is created.

Q3. Name and explain different types of reserves briefly. (1 mark)

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.
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.

Q4. What are provisions? (1 mark)

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.

Q5. **An extract of Trial balance from the books of Tahiliani and Sons Enterprises on Marc 31 2017 is given below: (4-5 marks)**

Name of the Account	Debit Amount Rs	Credit Amount Rs
Sundry debtors	50,000	
Bad debts	6,000	
Provision for doubtful debts		4,000

Additional Information:

- **Bad Debts proved bad; however, not recorded amounted to Rs 2,000.**
- **Provision is to be maintained at 8% of debtors**

Give necessary accounting entries for writing off the bad debts and creating the provision for doubtful debts account. Also, show the necessary accounts.

Date	Particulars	L.F.	Debit Amount Rs	Credit Amount Rs
	Bad Debt A/c Dr.		2,000	

	To Debtors A/c (Further bad debt charged from Debtors Account)			2,000
	Provision for Doubtful Debt A/c Dr. To Bad Debt A/c (Amount of bad debt transferred to Provision for Doubtful Debt Account)		8,000	8,000
	Profit and Loss A/c Dr. To Provision for Doubtful Debt A/c (Amount of Provision for Doubtful Debt transferred to Profit and Loss Account)		7,840	7,840

Bad Debt Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
2017				2017			
Mar.31	Balance b/d		6,000	Mar.31	Provision for Doubtful Debt		8,000
Mar.31	Debtors		2,000				
			8,000				8,000

Debtors Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
2017				2017			

Mar.31	Balance b/d		50,000	Mar.31	Bad Debt		2,000
				Mar.31	Balance c/d		48,000
			50,000				50,000

Provision for Doubtful Debts Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
2017				2017			
31 Mar.	Bad Debt (6,000 + 2,000)		8,000	Apr.01	Balance b/d		4,000
31 Mar.	Balance c/d		3,840	Mar.31	Profit and Loss		7,840
			11,840				11,840

Q6. The following information is extracted from the Trial Balance of M/s Nisha Traders on 31 March 2017. (4-5 marks)

Sundry Debtors	**80,500**
Bad Debts	**1,000**
Provision for Bad Debts	**5,000**

Additional Information

Bad Debts Rs 500

Provision is to be maintained at 2% of Debtors

Prepare bad debts account, Provision for bad debts account and profit and loss account.

Bad Debt Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

			Rs				**Rs**
2017				2017			
Mar.31	Balance b/d		1,000	Mar.31	Provision for Bad Debts		1,500
Mar.31	Debtors		500				
			1,500				1,500

Provision for Bad debt Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
2017				2017			
Mar.31	Bad Debt		1,500	Mar.31	Balance b/d		5,000
Mar.31	Profit and Loss		1,900				
Mar.31	Balance c/d		1,600				
			5,000				5,000

Profit and Loss Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
				2017			

				Mar. 31	Provision for Bad Debts		1,900

Class 11th

Chapter 9 Bills of exchange

Contents-

Bills of exchange, Promissory note- Meaning and difference

When goods are sold/bought on credit the payment is deferred to a future date. In such a situation, normally the firm relies on the party to make payment on the due date. But in some cases, to avoid any possibility of delay or default, an instrument of credit is used through which the buyer assures the seller that the payment shall be made according to the agreed conditions.

These instruments of credit are called bills of exchange or promissory notes. The bill of exchange contains an **unconditional order to pay a certain amount on an agreed date** while the promissory note contains an **unconditional promise to pay a certain sum of money on a certain date.**

● Bills of exchange

A bill of exchange is defined as an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument.

The following features of a bill of exchange emerge out of this definition-

- A bill of exchange must be **in writing**.
- It is **an order** to make payment.
- The order to make payment is **unconditional.**
- The maker of the bill of exchange must **sign** it.
- The **payment to be made must be certain**.
- The **date** on which payment is made must also be certain.
- The bill of exchange **must be payable** to a certain person.

- The amount mentioned in the bill of exchange is **payable either on demand or on the expiry of a fixed period of time**.
- It **must be stamped** as per the requirement of law.
- A bill of exchange is generally **drawn by the creditor upon his debtor.**
- It is **just a draft till its acceptance** is made.

There are **three parties** to a bill of exchange:

1. **Drawer is the maker of the bill** of exchange. A seller/creditor who is entitled to receive money from the debtor can draw a bill of exchange upon the buyer/debtor. The drawer after writing the bill of exchange has to sign it as maker of the bill of exchange.
2. **Drawee is the person upon whom the bill of exchange is drawn.** Drawee is the purchaser or debtor of the goods upon whom the bill of exchange is drawn.
3. **Payee is the person to whom the payment is to be made**. The drawer of the bill himself will be the payee if he keeps the bill with him till the date of its payment. **The payee may change** in the following situations:

a) In case the **drawer has got the bill discounted**, the **person who has discounted the bill will become the payee**

b) In case the **bill is endorsed in favour of a creditor of the drawer, the creditor will become the payee.**

Normally, the drawer and the payee are the same person. Similarly, the drawee and the acceptor are normally the same person.

- **Promissory note**

  A promissory note is defined as an instrument in writing containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument.

  Following features emerge out of the above definition:

- It must be **in writing**
- It must contain an **unconditional promise to pay**.
- The **sum payable must be certain.**
- It must be **signed by the maker**.
- It **must be payable** to a certain person.
- It should be **properly stamped**.
- A promissory note **does not require any acceptance** because the maker of the promissory note himself promises to make the payment.

There are **two parties** to a promissory note-

1. **Maker or Drawer is the person who makes or draws the promissory note** to pay a certain amount as specified in the promissory note. He is **also called the promisor**.
2. **Drawee or Payee is the person in whose favour** the promissory note is drawn. He is **called the promisee**.

Generally, the drawee is also the payee, unless, it is otherwise mentioned in the promissory note.

Difference between Bills of exchange and Promissory note

Basis	**Bills of exchange**	**Promissory note**
Drawer	It is drawn by the creditor	It is drawn by the debtor
Order/Promise and Parties	It contains an order to make payment. There can be three parties i.e. the drawer, drawee and payee.	It contains a promise to make payment. There can be two parties i.e. drawer and drawee
Acceptance	It requires acceptance by the drawee or someone on his behalf	It does not require any acceptance
Payee	Drawer and Payee can be the same person	Drawer cannot be the payee of it
Notice	In case of its dishonour, due notice of its dishonour is to be given by the holder to the drawer.	No notice needs to be given in case of its dishonour.

Advantages of Bills of Exchange

1. **Framework for relationships**: A bill of exchange represents a device, which provides **a framework for enabling the credit transaction** between the seller/creditor and buyer/debtor on an agreed basis.

2. **Certainty of terms and conditions**: The creditor knows the time when he would receive the money so also debtor is fully aware of the date by which he has to pay the money. This is due to the fact that **terms and conditions** of the relationships between

debtor and creditor such as amount required to be paid; date of payment; interest to be paid, if any, place of payment **are clearly mentioned in the bill of exchange.**

3. **Convenient means of credit**: A bill of exchange enables the buyer to buy the goods on credit and pay after the period of credit. However, the seller of goods even after extension of credit can get payment immediately either by discounting the bill with the bank or by endorsing it in favour of a third party.

4. **Conclusive proof:** The bill of exchange is **a legal evidence of a credit transaction** implying thereby that during the course of trade buyer has obtained credit from the seller of the goods, therefore, he is **liable to pay** to the seller. In the event of refusal of making the payment, the law requires the creditor to obtain a certificate from the Notary to make it a conclusive evidence of the happening

5. **Easy transferability**: A debt can be settled by **transferring a bill of exchange through endorsement and delivery.**

Basic Terms

- **Maturity of Bill:** The term maturity **refers the date on which a bill of exchange or a promissory note becomes due for payment**. In arriving at the maturity date **three days, known as days of grace, must be added to the date** on which the period of credit expires instrument is payable. However, where the date of maturity is a public holiday, the instrument will become due on the preceding business day.
  But when an emergent holiday is declared under the Negotiable Instruments Act 1881, by the Government of India which may happen to be the date of maturity of a bill of exchange, then the date of maturity will be the next working day immediately after the holiday.
- **Discounting of Bill:** If the holder of the bill needs funds, he can **approach the bank for encashment of the bill before the due date.** The bank shall make the payment of the bill **after deducting some interest (called discount in this case).** This process of encashing the bill with the bank is called discounting the bill. **The bank gets the amount from the drawee on the due date.**
- **Endorsement of Bill:** Any holder may transfer a bill unless its transfer is restricted, i.e., the bill has been negotiated containing words prohibiting its transfer. The bill can be initially endorsed by the drawer by putting his signatures at the back of the bill along with the **name of the party to whom it is being transferred**. The act of signing and transferring the bill is called endorsement.

Recording related transactions

For the person who draws the bill of exchange and gets it back after its due acceptance, it is a bill receivable. For the person who accepts the bill, it is a bill payable.

Bills receivables are assets and Bills payable are liabilities. Bills and Notes are used interchangeably.

I. In the Books of Drawer/Promissor

A bill receivable can be treated in the following **four ways** by its receiver-

a) He can **retain it till the date of maturity**, and
   i. get it collected on date of maturity directly, or
   ii. get it collected through the banker.
b) He can get the **bill discounted from the bank.**
c) He can **endorse the bill** in favour of his Creditor.

Entries-

a) When the bill of exchange is retained by the receiver with him till date of its maturity:

i. On receiving the bill

Bills Receivable A/c Dr.

To Debtors A/c

On maturity of the bill

Cash/Bank A/c Dr.

To Bills Receivable A/c

ii. On sending the bill for collection

Bills Sent for Collection A/c Dr.

To Bills Receivable A/c

On receiving the advice from the bank that the bill has been collected-

Bank A/c Dr.

To Bills Sent for Collection A/c

b) When the receiver gets the bill discounted from the bank: