

41.2 An exercise on prudence and probabilities

A firm is sued for damages of £100. According to the best advice, there is a 50% chance that the firm will lose the case and have to pay £100, and a 50% chance that the case will be dismissed and the firm will have nothing to pay.

Should the firm make a provision? If so, for how much?

Response

The alternatives appear to be:

1. Ignore the case and make no provision, because there is a 50% chance that the firm will not have to pay the damages.
2. Make a provision for £100, because there is a fair chance that the firm will have to pay the damages.
3. Make a provision of £50, because that, on a statistical basis, is the expected value of the fine.

There are all sorts of unpleasant eventualities of low probability for which a firm does not and should not make provision, but in this case Option 1, making no provision, seems to be imprudent when the probability of the fine arising is as high as 50%.

Option 3, making a provision for £50 to reflect the 50% chance of paying damages of £100, has an interesting appeal in logic, and might well be the best course of action if the firm were facing a large number of independent claims, each with a known probability.

This leaves Option 2 – making a provision of £100 – to be accepted by default. Investors would then at least be aware of the full extent of the potential loss involved.

NOTE: readers should be aware that there can hardly be a right answer to such questions as this, which do arise in real life, where both the values and the probabilities cannot be known with any degree of certainty. Accountants cannot escape the exercise of judgement.