

46.2 An exercise on the nature of provisions

‘A provision is a warning sign’. But what is its purpose? What does it warn us to do or abstain from doing?

Response

A provision warns of the existence of a probable future liability, and shows how the liability would impact on the net assets of the firm, and hence on the owner’s claim on the firm.

Provisions therefore warn us to prepare for the eventual real existence of a probable liability, and to abstain from actions based on the assumption that such liability will not arise. Most notably, perhaps, provisions warn investors not to withdraw and spend extra net assets in a business, when the extra value may be needed pay off a probable liability in the future, and warn other readers of the firm’s accounts (creditors) not to assume that theirs are the only claims on the assets in the firm.