

46.3 An exercise to compare the treatment of potential liabilities against the treatment of potential assets

While provisions are commonplace, there is no device in accounting for the recognition of potential assets or revenue that will be earned in the future. If such a device did exist, how would it work? Give a numerical example. Explain why no such device is openly used in accounting.

Response

A potential asset could be recognized in the accounts with a DR in a provisional asset account. The corresponding CR could be made either in the P&L Account (in which it would contribute to the profit that would be transferred to the capital account) or directly in the Capital Account itself, or in a dummy capital account (in the same way that a provision is a dummy liability account). The double entry would be:

DR	Provisional Asset	£X	
CR	P&L or Capital Account		£X

Thus if a firm with assets £700 and liabilities £200 decided to recognize a provisional asset value £100, its balance sheet would change as shown below:

<i>BALANCE SHEET before provision</i>		<i>BALANCE SHEET after provision</i>	
	£		£
Assets	700	Assets	700
Liabilities	(200)	<i>Provisional Asset</i>	<u>100</u>
Net Assets	<u>£500</u>		800
		Liabilities	(200)
Capital	<u>£500</u>	Net Assets	<u>£600</u>
		Capital b/f	500
		<i>'profit' from recognition of provisional asset</i>	<u>100</u>
		Capital c/f	<u>£600</u>

This procedure is not properly employed in accounting, because by potentially overstating assets and profits, it violates the principle of prudence.