

41.1 An exercise on the principle of prudence

Firm A has been notified that it will almost certainly have to pay a fine of £1 000 in the near future, while Firm B has been notified that it will almost certainly be awarded a prize of £1 000 in the near future.

How should each firm account for the news? Explain your answer with reference to the accounting principle of prudence.

Response

The principle of prudence demands that provision must be made for all known losses and liabilities, even if these are not known with certainty. It follows that Firm A should immediately recognize the loss associated with the fine in its current P&L Account, and recognize its almost certain liability to pay the fine in its balance sheet.

Firm B could likewise recognize the profit associated with the award in its current P&L Account, and the possible right to receive the award as an asset in its balance sheet. However, the principle of prudence states that revenue should not be anticipated – that is, revenue should not be recognized in the P&L Account until it is properly earned and/or the business has collected money or has a right to collect money. Thus Firm B should not recognize the prize in its accounts until the result is officially confirmed.