

## 40.2 An exercise on prudence and the principle of accruals

Is the principle of accruals fully consistent with the principle of prudence?  
Identify two cases in which you think they may conflict, and explain how you would resolve the difficulty.

### Response

The principle of accruals or matching is the doctrine that income and related expenditure should be matched against each other and presented in the same P&L Account.

The principle of prudence is the doctrine that the accountant should take special care to ensure that revenue is not recognized in the P&L Account until it has been properly earned by the delivery of goods or services, that profits and net assets are not overstated, and that losses and liabilities should be recognized as soon as they occur.

Clearly there is scope for conflict when transactions concerning income and related expenditure do not occur in the same period. Normally a firm must incur expenses in order to create goods or services, before it is able to collect any revenue from selling goods and services. To apply the principle of matching very strictly, we should not show such expenses in the P&L Account until there are related sales to match them against. By deferring the recognition of expenses, this would conflict with the principle of prudence.

One such case would be the cost of exploring for oil or other mineral resources. This is a cost that may be matched against the future revenues to be gained from extracting and selling the resources. But in view of the uncertainty as to whether the exploration will be successful, it would be advisable to follow the principle of prudence, and recognize the costs of exploration as an expense in the current P&L Account as it occurs.

A contrasting case might be the costs of developing infrastructure to exploit a proven mineral resource. In this case, it may be preferable to follow the principle of accruals, and treat such costs as relating to the creation of a fixed asset, to be matched through depreciation against the revenue to be gained from exploitation of the resource.