

# The Application of the Principle of Prudence in the Practice of Enterprises

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**Abstract:** The principle of prudence plays an important role in the quality of accounting information and is widely used in accounting practice. But the principle of prudence also has some problems in practice. It is not advisable to be cautious enough or over, so it is very important to balance the principle of prudence and improve relevant laws and regulations, and strengthen the quality and professional ethics of enterprise managers.

**Keywords:** Prudence; Practice; Application; Problems; Measures

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## 1. The overview of the principle of prudence

The principle of prudence refers to the reasonable accounting of possible losses and expenses, and not more assets or income, less liabilities or expenses. The principle of prudence requires that when there are several different accounting treatment methods and procedures for certain economic businesses to be selected, the methods and procedures which have the least impact on the owner's rights and interests shall be selected as far as possible to conduct accounting treatment, and the possible losses and expenses shall be accounted reasonably. That is, the so-called "rather than the expected loss, not the possible income".

## 2. The application of the principle of the prudence in accounting practice

The principle of prudence plays an important role in accounting practice, and helps to operate financial work more rigorously. The application of caution principle in enterprise accounting mainly includes the following four aspects <sup>[1]</sup>.

### 2.1 Application of caution principle in revenue recognition

Accounting standards stipulate that income is only determined when economic benefits are likely to flow in, which leads to the increase of enterprise capital or decrease of liabilities, and the inflow of economic benefits can be reliably measured, thus preventing transactions or events that cannot be realized or recognized as income are recognized as income and avoid overestimating income. For example, when the after-sales repurchase business delivers the goods to the other party, the main risks and rewards in the ownership of the goods are not transferred with the goods, so the sales income of the related commodities cannot be recognized.

### 2.2 Application of caution principle in the recognition of asset impairment

#### loss

The specific application of caution principle in accounting includes long-term equity investment impairment reserve, construction in progress impairment reserve, fixed assets impairment reserve, intangible assets impairment reserve, and draw down the provision for impairment of financial assets, etc. When the enterprise uses assets, it will change the value of assets. For example, if the recoverable value of fixed assets is lower than the book value, the part of the recoverable amount lower than the book value shall be withdrawn from the provision for impairment of fixed assets. If only the book value of assets is used for accounting, it will lead to a huge gap between the book assets and the actual assets, and the accounting information distortion is serious. The occurrence of asset impairment loss has accounted for the loss and expenses of the enterprise reasonably.

## **2.3 Application of caution principle in the capitalization of loan cost**

Accounting standards stipulate that the amortization of interest or premium, discount and other expenses incurred by special borrowing is required. These borrowing costs shall meet certain requirements and conditions when accounting treatment. If a fixed asset under construction is not interrupted normally, it must be restored to normal within March. After more than three months, the cost capitalization of this period must be suspended according to the regulations, including the expenses such as interest incurred are not included in the cost capitalization, then it shall be included in financial expenses, and the capitalization of expenses can be re- included until the fixed assets can be restored to normal. This regulation can make the cash flow of the current period clearer and clear, and enable can make the enterprise make accurate accounting, which reflects the application of the principle of prudence in the capitalization of the loan costs.

## **2.4 Application of caution principle in debt restructuring**

The cautious in debt restructuring is not recognized as the income of debt restructuring, and the income from debt restructuring is recorded as capital reserve. When distinguishing income from capital reserve, we must use the principle of prudence. It is shown in the following aspects: one is to use cash to settle debts, and there are two situations in cash to settle debts. If the cash used is lower than the book value of the debt and the difference between the book value of the restructured debt and the book value of the transferred non- cash assets and the related taxes, if the income is generated, it is recorded as capital reserve., Otherwise, it is recorded as the current loss. If the debtor and the creditor decide to convert the debt to capital repayment, the difference between the actual book value after the debt restructuring and the share abandoned by the creditor shall be recorded as capital reserve. Second, it adopts other ways. For example, the purpose of reorganization can be achieved by modifying the debt terms by mutual consent and if the debt book value of the debt is greater than the amount to be paid, the portion of the write down should be recognized as capital reserve <sup>[2]</sup>.

## **3.The problems of prudence in accounting practice**

Based on the uncertainty of economic activities, the application of prudence principle in accounting can make accounting more reasonable. However, in the practical application of prudence principle, due to the limitation of ability, environment and economy, the operation of prudence principle will be problematic, and the reliability of enterprise accounting information will be adversely affected <sup>[3]</sup>.

### **3.1 Contradiction between prudent principle and other accounting principles**

#### **3.1.1 Contradiction with the principle of authenticity**

The principle of authenticity refers to the accounting of an enterprise should be based on the actual economic business and truthfully reflect the financial situation and operating results of the enterprise. However, the principle of caution requires that the enterprise must predict the possible or imminent losses in the future and include them in the losses or gains of the current period. It leads to a lack of authenticity.

#### **3.1.2 Contradiction with the principle of comparability**

Comparability principle refers to the same enterprise should adopt the same accounting policy for the same or similar transactions or similar transactions or matters in different periods, and shall not be changed at will. And the accounting policies should be adopted to ensure that the accounting information is consistent and comparable. However, the use of the principle of prudence allows the operational space of financial report to a certain extent, which leads to some contradiction between the principle of prudence and the principle of comparability.

### **3.1.3 Contradiction with the principle of relevance**

Relevance principle refers to the accounting information provided by enterprise accounting shall meet the requirements of national macroeconomic management, and meet the needs of all relevant parties to understand the financial situation and operating results of the enterprise. The purpose of caution is to estimate the possible loss rather than the possible income in the accounting process. At this time, too conservative accounting information will reduce the relevance of accounting information, and ultimately make the users of accounting information not better use the accounting information they have <sup>[4]</sup>.

### **3.2 The principle of prudence is not standardized**

The principle of prudence is a very important requirement in the quality of accounting information. However, in our accounting standards, it only takes the principle of prudence as the general principle, lacks clear provisions on the scope of application of the principle of prudence, and lacks the guidance on the application of the principle of prudence, which leads to the actual accounting. The application of caution principle will be limited by assets or interests. Especially, the subjective judgment of asset impairment reserves is high, which provides scalability for different accountants in the estimation of asset impairment amount, and serves as a tool for profit operation. This situation is quite different from the requirement of caution <sup>[5]</sup>.

## **4. The perfection measures of the principle of prudence in accounting**

### **practice**

In view of the current situation of the application of the principle of prudence in accounting practice, we need to take corresponding solutions in time, so as to make the principle of prudence play a guiding role in the accounting practice of enterprises and help enterprises achieve the goal of stable and sustainable development.

### **4.1 Relationship between balance and other accounting principles**

The reason why the principle of prudence contradicts other principles is mainly due to the randomness and tendency of prudence itself. To solve this problem, we can balance the relationship between accounting principles by determining the order of use reasonably. According to the actual situation of enterprise economic business, on the basis of reliability principle, reasonably determine the use order of caution principle and other principles, and maximize the role of each criterion. In addition, we should pay attention to the correct and appropriate use of the principle of prudence, and reduce the subjectivity and randomness in the actual accounting treatment by restricting the premise and conditions of the application of the principle.

### **4.2 Enhance the perfection of laws and systems**

The relevant departments of the state should issue relevant policies to revise and perfect the principle of prudence and some vague definitions, so as to improve the transparency of the interpretation of the principle of accounting prudence. Ensure that the enterprise can use it reasonably when dealing with accounting business. In addition, the internal enterprise should strengthen the accounting practice accounting work standard and business process, strengthen internal and external audit supervision and mechanism constraints, prevent the occurrence of the application of the principle of prudence as the reason, thus changing the accounting method, deliberately confusing the limits of cost and expense accounting, and adjusting income, cost and profit by manipulating the principle of prudence, Fraud or even tax evasion.

### **4.3 Strengthen the quality and professional ethics of the enterprise**

### **management personnel**

To a large extent, the application of the principle of caution is influenced by the subjective initiative of the managers of the enterprise, and there is no quantitative qualitative standard. Therefore, the principle of caution will inevitably be affected by the professional quality and professional skills of accounting personnel in the process of using. In order to ensure that every accountant has good professional quality and good professional judgment, it is necessary to carry out professional ability training for accounting personnel. The training methods can be selected according to the actual training needs, including rotation training, independent learning, internal and external training, etc. At the same time, the accounting personnel' experience in enterprise accounting can be improved [6].

## 5.Conclusion

The principle of prudence is an important principle in the quality of accounting information. However, in the application of accounting, we need to know more about the principle of caution, fully recognize the contradiction and know how to avoid it in the application of the principle of prudence, so that we can improve the application of accounting continuously and ensure the order and quality of accounting work. It provides more scientific accounting basis for business operators [10].

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