What is the Conservatism Principle?

Worksheet

The conservatism principle states that when accounting choices are uncertain, a company should choose the option that understates assets and revenue and overstates liabilities and expenses, so financial statements never look better than reality.

Questions

1. The conservatism principle says accountants should:
A) Always report the highest possible income
B) Anticipate losses but not gains
C) Ignore uncertain outcomes
D) Overstate assets when unsure

2. Under conservatism, inventory should be valued at:
A) Original cost only
B) Market value only
C) Lower of cost or market
D) Highest of cost or market

3. A company has a probable lawsuit loss of $10,000. Under conservatism it should:
A) Ignore it until the case ends
B) Record it as a liability now
C) Report it as income
D) Wait until it becomes a gain

4. Which of these violates the conservatism principle?
A) Recording a doubtful-accounts allowance
B) Reporting inventory at market when market is lower
C) Recognizing an uncertain future gain now
D) Writing down an impaired asset

5. A company has $200,000 in accounts receivable and estimates 4% will be uncollectible. What allowance should it record?

6. Inventory cost $50,000 but its current market value has dropped to $42,000. At what value should it be reported under conservatism?

7. A lawsuit against the company makes a $30,000 loss probable, while a separate lawsuit the company filed might bring in $20,000 of income (not yet certain). What should it record?

8. Define: What is the conservatism principle?

9. Define: How does conservatism affect inventory valuation?

10. Define: Does conservatism mean understating everything?

Answer Key

1. B) Anticipate losses but not gains - Conservatism means recognizing probable losses immediately while waiting for gains to be certain.
2. C) Lower of cost or market - The lower-of-cost-or-market rule is a direct application of conservatism.
3. B) Record it as a liability now - Probable losses are recorded immediately, even before they are finalized.
4. C) Recognizing an uncertain future gain now - Uncertain gains should never be recognized before they are realized.
5. Allowance = AR Rate Allowance = 200,000 0.04 Allowance = $8,000
6. Compare cost vs. market: 50,000 vs 42,000 Conservatism requires the lower value Report inventory at $42,000
7. Probable loss of $30,000: record as a liability/expense now Possible gain of $20,000: not certain, do NOT record yet Net effect: only the $30,000 loss appears in the statements
8. Anticipate losses, never anticipate gains - when in doubt, choose the less favorable outcome.
9. Inventory is reported at the lower of cost or market value.
10. No - it only applies under genuine uncertainty; it should not be used to intentionally create hidden reserves.