Differentiating Realisation, Matching and Accrual Principles

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For many students, relating accounting principles to practices seems a daunting task. Many take the common approach of memorising the meaning of the principles and also examples relating to them. This approach has many shortcomings. First, it may retard the students' ability to apply the principles in examples other than what they have learnt. Second, it may curtail the interest of the students to pursue the accounting discipline further as they don't really understand the link between theory and practice clearly. Hence, a good understanding of accounting principles is necessary and imperative to appreciate accounting practices profoundly.

I have chosen to write about the realization, matching and accrual principles because students are usually confused on their meanings and their distinct applications. Some texts accentuate students' comprehension problems by equating them. In accounting, guidelines are provided to help one understand recognition, measurement, recording and disclosure of financial transactions. In this case, these principles provide guidelines to recognize and measure correctly the income, expenses and the profit or loss of a business entity in an accounting period.

Specifically, the realization principle relates to the issue of recognizing a business income. It states that income must be recognized when it is realized. The word realized is equated with what is earned. The difficulty arises as the point the income earned is dependent on the business operating cycle. For the most common business, trading and services, an income is earned when the goods and services are transferred to the buyer. There is no need to wait till the money is received to recognize income. Applying this realization principle to other business operating cycle, such as production of mineral and agricultural produces, construction of building and hire purchases, the point of recognition will change accordingly taking what is earned as the underlying criteria. The term "what is earned" may be vague and without proper understanding it may lead to wrongful applications. To solve this, the accounting standard has a lengthy discussion on the meaning of what is earned. That will be beyond the scope of this article. So, the realization principle is specifically applied to recognize business income.

The matching principle is the most commonly confused principle. It is seen as a guide to measure profit or loss. It is not to measure profit or loss. It is a guide that helps to recognize business expenses in an accounting period. Expenses are recognized through a matching process with the income earned in a period as per the realization principle. It can be matched either directly to the income earned or to the period in which the income is earned. There are four categories of expenses identified under this matching methods. These are:

- Expenses that are matched directly to the income earned in the period, such as cost of sales.
- Expenses that are consumed in a period where income is earned, such as rent, utilities, insurance, interest and etc.
- Expenses that are considered as systematic allocation of its useful value in the period where income is earned, such as depreciation of assets.
- Expenses that are written off during a period where the income is earned, such as bad debts and unviable R&D expenditure.

Recognition of expenses will be more accurate if all expenses can be matched like in the case of cost of sales. But, alas, it is not always possible. Nevertheless, attempts to match is diligently sought. For instance, the estimation of the allowance for doubtful debts calculated on the basis of a percentage on credit sales tends to give credence to the matching principle. However, this method of providing allowance raises other issues. Again, the discussion on why it is not allowed even though it subscribes to the matching principle of expenses recognition is beyond the scope of this article. Here, I just want to highlight that the matching principle is a guideline to recognize expenses for an accounting period vis-à-vis the income recognized through the realization principle.

The accrual principle is the income measurement rule to be applied in calculating an entity's profit or loss for a specific period. There are many income measurement rules. But, the main ones are the accrual method and the cash method. Commonly, they are known as accrual-basis accounting and cash-basis accounting. The other measurement methods use a combination of these two methods. As per pronounced accounting standards, all business entities are required to present their income statement based on the accrual-basis accounting, meaning using the accrual principle to calculate the periodic profit or loss.

The accrual principle states that profit or loss is measured by matching the income recognized as per the realization principle with the expenses recognized based on the matching principle. For objectivity purpose, accounting records are made when it happens. Hence, some income earned may not be the same as income received (recorded). This discrepancy between income earned and income received in a period necessitates adjustments for accrual or prepayment before the periodic income earned is used for the measurement of profit or loss. Similarly, expenses recognized under matching principle may be different from expenses paid. Once again, adjustments for accruals or prepayments are done to determine the periodic expenses. With adjustments, we are able to match the actual income earned in a period with the actual expenses incurred in the same period. This is the guide provided by the accrual principle and it leads to the correct and logical measurement of profit or loss for a specific period.

Summarily, the three principles, realization, matching and accrual, are guidelines necessary to determine the financial performance of a business entity. The financial performance information is very critical to many stakeholders. Incorrect measurement will lead to wrong decision being made and can lead to damaging outcomes.

The writer is the founder and content manager of www.kvk-accounting.com who advocates strongly on building cognitive thinking skills via better understanding of accounting concepts and simulating artificial intelligence process of learning from experiences. He views his exercises as a form of providing these learning experiences.