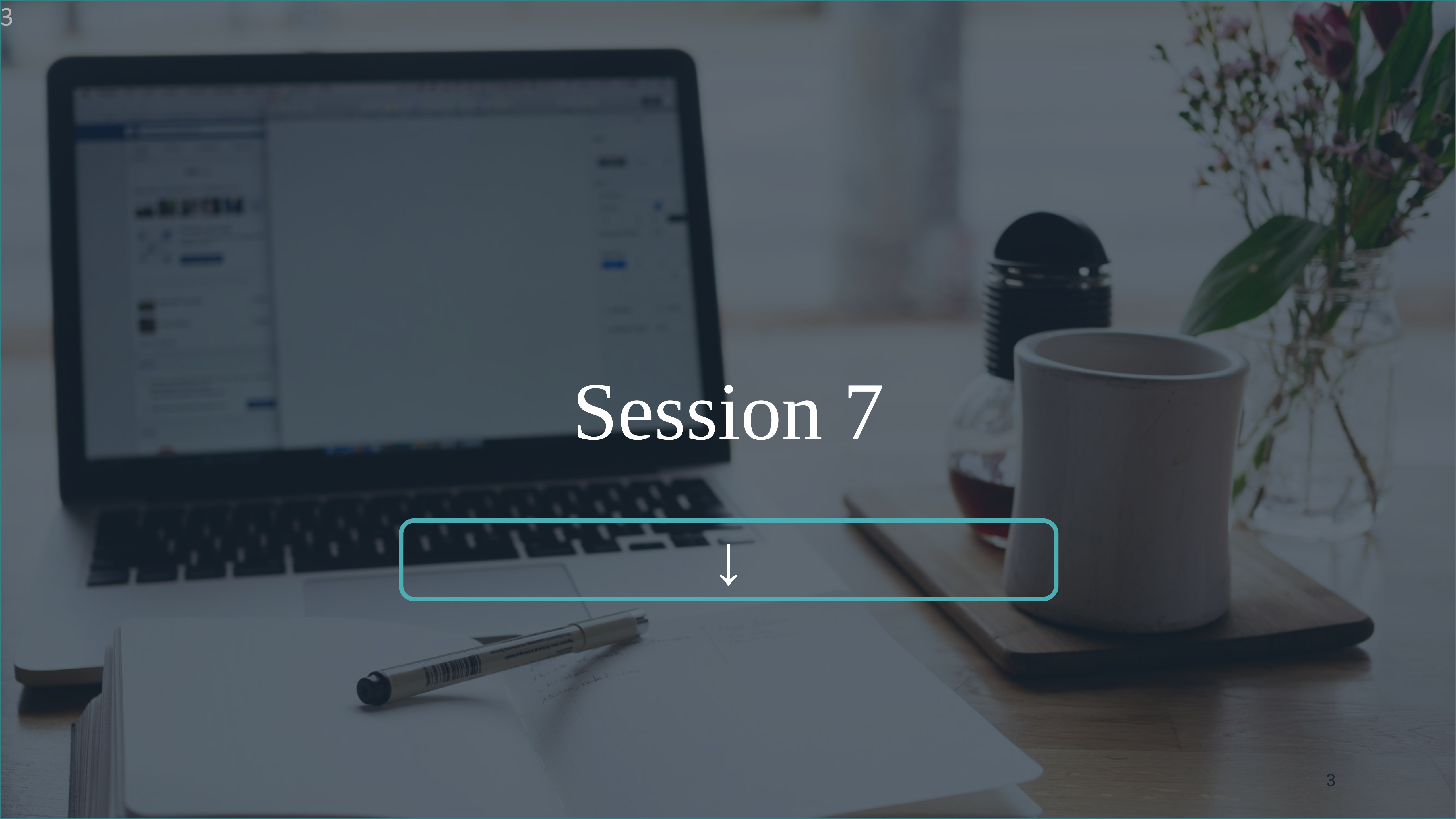
TrainUp
Never Stop Learning

Introduction to Accounting

Chapter One

Contents


Session 7
↓

Session 7

Time period assumption
Fiscal and Calendar Years
Accrual- versus Cash-Basis Accounting
Recognizing Revenues and Expenses
Adjusting Entries
Deferrals or Accruals

Time Period Assumption

↓

Time Period Assumption

Accountants divide the economic life of a business into artificial time periods.

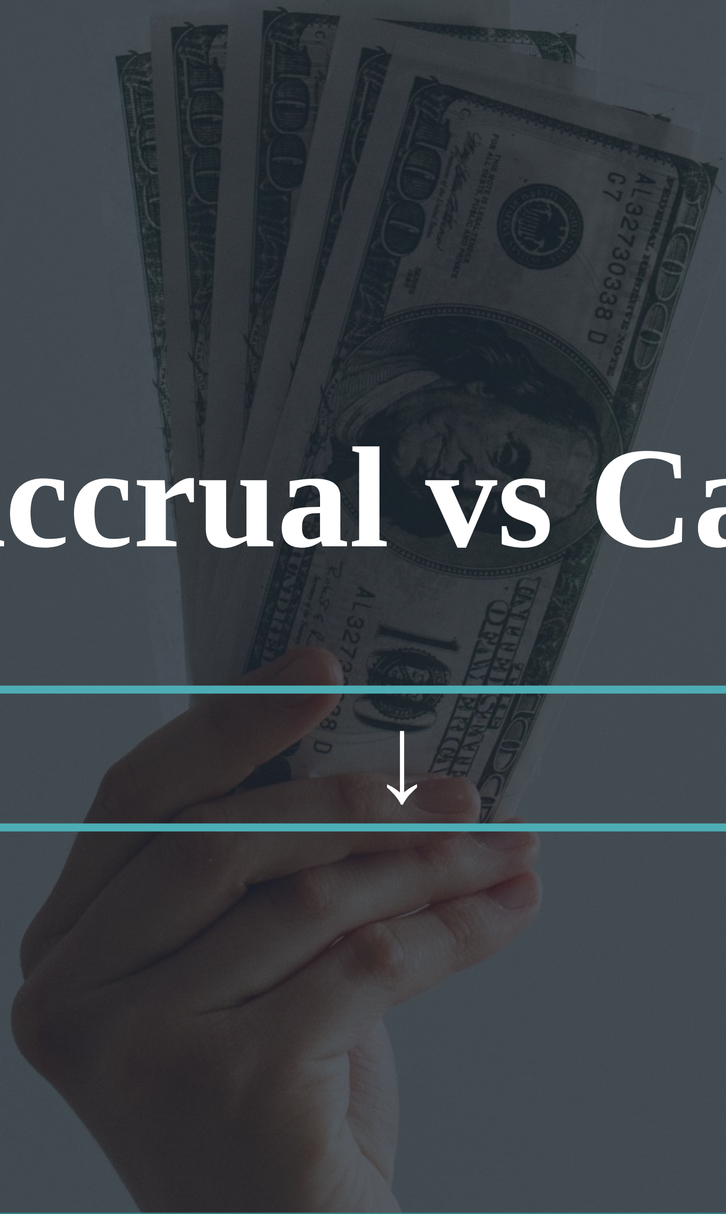
This convenient assumption is referred to as the **time period assumption**.

Both small and large companies prepare financial statements periodically in order to assess their financial condition and results of operations.

- **Fiscal year**
- **Calendar year**

Time Period Assumption

- **Fiscal Year**
  - An accounting time period that is one year in length is a **fiscal year**.
  - A fiscal year usually begins with the first day of a month and ends 12 months later on the last day of a month.
  - **E.g. July 1 – June 30 or September 1 – August 31**
- **Calendar Year**
  - the **calendar year** (January 1 to December 31) as their accounting period.



Accrual vs Cash

Accrual vs Cash

Accrual basis

- Under the accrual basis, companies record transactions that change a company's financial statements **in the periods in which the events occur**.
- Companies recognize revenues **when they perform services** (rather than when they receive cash).
- Companies recognize expenses **when incurred** (rather than when paid).

Accrual vs Cash

Cash-basis accounting

Under **cash-basis accounting**,

- Companies record revenue when they receive cash.
- They record an expense when they pay out cash.

Cash basis seems appealing due to its simplicity, but it often **produces misleading financial statements.**

Accrual vs Cash

Accrual-basis accounting is therefore in accordance with generally accepted accounting principles (GAAP).

The cash basis is justified for small businesses because they often have few receivables and payables.

Recognizing Revenues & Expenses

↓

Recognizing Revenues and Expenses

The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

Recognizing Revenues and Expenses

To illustrate,

- Assume that Dave Dry Cleaning cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July.

- Dave should **record revenue in June** when **it performed the service** (satisfied the performance obligation) **rather than in July when it received the cash.**

- **At June 30**, **Dave’s would report a receivable on its balance sheet and revenue in its income statement** for the service performed.

Recognizing Revenues and Expenses

EXPENSE RECOGNITION PRINCIPLE

Simple rule in recognizing expenses:
“Let the expenses follow the revenues.”

Recognizing Revenues and Expenses

To illustrate,

- In the dry cleaning example, Dave should report the salary expense incurred in performing the June 30 cleaning service in the same period in which it recognizes the service revenue.

- If Dave's does not pay the salary incurred on June 30 until July, it would report salaries payable on its June 30 balance sheet.

Recognizing Revenues and Expenses

This practice of expense recognition is referred to as the **expense recognition principle** (often referred to as the **matching principle**).

Adjusting Entries

↓

Adjusting Entries

?

Match the following

1. _____Accrual – basis accounting
2. _____Calendar year
3. _____Time period assumption
4. _____Expense recognition principle(matching principle)

- (a) expenses should be matched with revenues.
- (b) Accountants divide the economic life of a business into artificial time periods.
- (c) An accounting time period that starts on January 1 and ends on December 31.
- (d) Companies record transactions in the period in which the events occur.

Solution

1. d 2. c 3. b 4. a

Recognizing Revenues and Expenses

Adjusting Entries

- **Ensure that the revenue recognition and expense recognition principles are followed**.
- **Adjusting entries** are necessary because the **trial balance**—the first pulling together of the transaction data—**may not contain up-to-date** and **complete data.**
- **Every adjusting entry will include one income statement account and one balance sheet account.**

TrainUp

Never Stop Learning