Before looking at an example of an income statement using the accrual method, there are some financial terms that you need to know. You will also need to appreciate some accounting principles like the 'revenue recognition principle' and the 'matching principle.'

KEY POINTS

- ✔ Accrual accounting is considered to be the standard accounting practice for most organizations, and is mandated for organizations of any real size.
- ✔ Revenue is recognized once the customer has ownership.
- ✔ Costs are incurred in the period in which they arise.
- ✔ It provides a more accurate financial picture, but is more difficult to administer.

Basic Financial Terms

All of the following terms have precise definitions when used in business accounting:

- Sales or revenue
- Cost of goods sold
- Expenses
- Gross profit
- Fixed assets
- Current assets
- Current liabilities
- Working capital
- Liquidity
- Debtor
- Creditor
- Bad Debt
- Depreciation
- Accrual Accounting

Even though you may be familiar with some of them, it is important to know their exact meanings otherwise you may find the rest of this eBook and the others in this series difficult to follow. For example, you may hear the terms 'revenues' and 'receipts' used interchangeably in casual office conversation. However, as far as business accounting is concerned they are different things and you will find yourself becoming confused if you don't appreciate the difference.

Read the following definitions carefully and make sure that you understand exactly what is meant by each of these accounting terms.

Sales or Revenue

Revenue is the income that flows into an organization, and it is often used almost synonymously with sales. In government and nonprofit organizations it includes taxes and grants.

Don't confuse revenues with receipts. Under the accrual basis of accounting, revenues are shown in the period they are earned, not in the period when the cash is collected. Revenues occur when money is *earned;* receipts occur when cash is *received.*

Cost of Goods Sold

This is the purchase cost of the merchandise that was subsequently sold to customers.

Expenses

Refers to the other costs that are not matched with sales as part of the cost of goods sold. They may be matched with a specific time, usually monthly, quarterly, or annually or they may also be one-off payments. Expenses include: staff wages, rent, utility bills, insurance, equipment, etc.

Gross Profit

Refers to what is left after you subtract the cost of goods sold from the sales. It is also called gross margin. For example, if an organization buys in an item for $50 and sells it for $75 (plus sales tax), then the gross profit will be $25.

Fixed Assets

This refers to all of those things that the business owns which will have a value to the business over a long period. This is usually understood to be any time longer than one year. It includes freehold property, plant, machinery, computers, motor vehicles, and so on.

Current Assets

This refers to assets with the value available entirely in the short term. This is usually understood to be a period of less than a year. This is either because they are what the business sells or because they are money or can quickly be turned into money. Examples include inventory/stock, money owing by customers, money in the bank, or other short-term investments.

Current Liabilities

This refers to those things that the business could be called upon to pay in the short term—within the year. Examples include bank overdrafts and money owing to suppliers.

Working Capital

This is the difference between current assets and current liabilities. An organization without sufficient working capital cannot pay its debts as they fall due. In this situation it may have to stop trading even if it is profitable.

Liquidity

This is the ability to meet current obligations with cash or other assets that can be quickly converted into cash in order to pay bills as they become due. In other words the organization has enough cash or assets that will become cash so that it is able to write checks without running out of money.

Debtor

A debtor is a person owing money to the business, for example a customer for goods delivered.

Creditor

A creditor is a person to whom the business owes money, for example a supplier, landlord, or utility organization.

Bad Debt

All reasonable means to collect a debt have been tried and have failed so the amount owed is written off as a loss and becomes categorized as an expense on an income statement. This results in net income being reduced.

Depreciation

Assets have a certain length of time in which they operate efficiently, referred to as 'an asset's useful life.' During this period the value of that asset depreciates due to age, wear and tear, or obsolescence. The loss in value is recorded in accounts as a non-cash expense, which reduces earnings whilst raising cash flow.

Accrual Accounting

Accrual accounting relies on two principles, which have already been alluded to:

> ***The revenue recognition principle states that revenues are recognized when they are realized or realizable, and are earned (usually when goods are transferred or services rendered), no matter when the payment is received.***
>
> ***The matching principle states that expenses are recognized when goods are transferred or services rendered, and offset against recognized revenues, which were generated from those expenses, no matter when the cash is paid out.***

These two principles are absolutely central to understanding how accrual accounting works and are described in detail in the next sections.

KEY POINTS

- ✔ Terms like 'revenue,' 'expenses,' 'gross profit,' 'depreciation,' 'bad debt,' and 'fixed assets' have precise definitions when used in business accounting.
- ✔ You need to understand *exactly* what is meant by accounting terms like these.

The Revenue Recognition Principle

Organizations all have primary activities and it is the revenue or incomes generated by these activities that are referred to as 'sales' or 'sales revenue.' For example, a retailer will buy goods, which they then sell on. It is the sale of these products that creates their revenue.

For service organizations the primary activities are the acquisition of and selling of skills and expertise. These revenues are often referred to as fees earned, income, or service revenues.

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Under accrual accounting, revenues are reported as they occur—that is 'when they are recognized'—and not when the payment is received. For instance, your organization sells its service to a customer for $5,000 in December, offering them 60 days to pay. Your accounts would show a revenue figure of this amount in December.

When at the end of February the invoice is paid your accounts would show a *receipt* of cash for that amount. It would also show a reduction in your accounts receivable (some organizations refer to this as 'collection'). It is important to appreciate the distinction between receipts and revenues so that the latter are only recorded once when the primary activity has been performed.

You also need to appreciate how the following will be represented in your organization's accounts:

- When a pre-payment or deposit is taken
- When payment is made in cash
- When funds are received in the form of a loan (e.g. from a bank)

Where your organization requests a payment (or deposit) for a service or product in advance of any work being performed this is known as a 'receipt.' Only once the customer's work begins will it be shown in your accounts as a 'revenue' item. For example:

> ***Your organization sells a product for $800 in May and requests a $200 partial payment at the time of sale, prior to delivery in June. This $200 appears in your accounts as a liability in May and only when the product has been delivered to the client will the accounts show $800 revenue.***

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In circumstances where organizations are concerned about a customer's ability to pay or their creditworthiness a deposit can be requested prior to the work starting. This deposit would be recorded in the same way as a pre-payment in your accounts, i.e. as a receipt.

In the event that your organization receives cash in direct exchange for its product or service this will be recorded in the accounts as both a 'receipt' and 'revenue.' This is because it has been given the cash 'receipt' on the same day the actual service or product (the 'revenue') occurred. For example:

> ***A dealership sells a car on April 23 for $650 cash. This sale would be represented in the dealer's accounts as both a 'receipt of $650' and 'revenue of $650' on that date.***

In a situation where your organization needs to extend its mortgage or seeks a short-term loan, such funds are shown in your accounts as a 'receipt' and referred to as a current liability. There would not be 'revenue' for this amount within your accounts because no goods or services have been exchanged or performed. For example:

> ***The $12,500 extension to your organization's overdraft would be shown in your accounts only as a 'receipt' of $12,500 on the date such funds became available. It cannot be recorded as 'revenue' because it was not earned as a result of delivering a product a service.***

KEY POINTS

- ✔ Revenue is something that is generated by the business in exchange for goods or services.
- ✔ It does not include things like bank loans or overdraft facilities.
- ✔ Any payment for a service or product in advance of any work being performed is a 'receipt.'
- ✔ It only becomes a 'revenue' item once work (on behalf of the customer) actually begins.

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The Matching Principle

Your organization may prefer to use the matching principle when deciding how to record its financial performance. This is because it enables your financial accounts to show a better evaluation of actual profitability and performance.

This principle achieves this by minimizing, wherever possible, the mismatch in timing between when your organization incurs costs and when it realizes its revenue. This still has to be attained whilst adhering to the accounting standards of recording costs as they occur and revenue when it is earned.

The degree to which this can be achieved will be influenced by how complex your operations are. The more complicated they are, the more difficulty your organization will have in 'matching' the date costs occur with the date revenue or income is received.

This is especially true in the case of provisions for bad debt and depreciation. It is difficult to be exact in such cases because they are influenced by numerous factors, and many, such as changes within the economic climate, are outside of an organization's control. The way in which an organization can interpret an item of high-value capital equipment designed for longevity is open to interpretation, and a new model or changes in technology can drastically alter its life span.

The accounting standards and regulations of your operating country will dictate how such items are represented in your organization's published accounts. If you are required to produce such figures for internal use then you need to adhere to its internal definitions.

KEY POINT

- ✔ The matching principle aims to minimize any mismatch in timing between when an organization incurs costs and when it realizes any associated revenue.

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