

THEME: ACCOUNTING COST CONCEPTS

By John W. Day, MBA

ACCOUNTING TERM: Matching Principle

Revenue that has associated expenses within a given accounting period should be reported in the same period. Matching the expense element to the revenue element makes it possible to assess accurately whether a profit or a loss occurred within that period.

FEATURE ARTICLE: Historical Cost Concept

Imagine, for a moment, trying to read a financial statement that had listed assets such as: cash \$5,000; 14 boxes of oranges; 25 boxes of apples; 1000 board feet of lumber; 3 acres of land; and, 8 machines. A first question that might pop into your mind is: “How in the world do I add these assets to one another?”

It is immediately clear that for financial statements to be meaningful, amounts of dissimilar items must be stated in similar units. Money becomes the obvious choice of “similar units”. By converting different kinds of objects into monetary amounts, they can be dealt with arithmetically. This is called the “*money-measurement concept*” and is a fundamental principle of accounting.

This is great, but the problem is not yet solved. An asset may be recorded in dollars and cents (or whatever currency is appropriate for the country in which you live), but at what value? If I were allowed to choose the value I thought was appropriate for my assets, my tendency would be to state their value at the highest amount possible. That way, my financial statement would indicate that my business was strong, healthy, and worth a lot of money. Remember the “accounting equation”:

ASSETS - LIABILITIES = EQUITY

Higher assets mean higher equity. Wonderful, but what if I’m wrong? My banker and my investors are trusting that my financial statements are stated accurately. Furthermore, it is not reasonable to expect that every reader of my financial statements can or should have to appraise my assets.

In order to avoid the subjectivity of market value, an objective way of valuing assets had to be established. This was solved by using the “historical cost” concept. This concept states that the numbers reported on accounting financial statements shall be recorded at the amount that was actually *paid* for an asset, i.e., historical cost. Therefore, accounting does not record what an asset is actually worth, that is, its market value. This works out okay because most

businesses are using their assets to conduct operations and are not trying to sell them. When a business offers an asset for sale, or perhaps the entire business, an appraisal to determine fair-market-value of the assets must be performed.

So we (preparers of financial statements) are going to use money as a measurement system and we will record our assets at the amount actually paid for them. This will keep us out of trouble and make it easier to understand what others are doing.

QUESTION: When Does An Expenditure Become An Expense?

Now that you know why money is used as a unit of measurement at historical cost amounts, you need to understand how costs are viewed when purchasing assets for the business. Using the concept of “expenditures vs. expenses” helps clarify the “status” of costs within the business operation.

First, an *expenditure* occurs when a company acquires goods or services which usually results in a decrease in the asset Cash or an increase in a liability such as Accounts Payable. For example:

DESCRIPTION	DEBIT	CREDIT
Inventory	10,000	
Cash		10,000

Or

DESCRIPTION	DEBIT	CREDIT
Inventory	10,000	
Accounts Payable		10,000

Until the goods and services are used or consumed they are considered to be *unexpired*. Since they are still an unused resource available to the business, they are considered to be an asset of the business. However, once used or consumed they are considered to be *expired* and become an expense. An expenditure and an expense are *costs* to a business. Costs that are still “on hand” are unexpired and costs that are “gone” are expired. For example, if half of the Inventory purchased in the above journal entry was sold, then \$5,000 of the \$10,000 expenditure becomes an expense called Cost of Goods Sold:

DESCRIPTION	DEBIT	CREDIT
Cost of Goods Sold	5,000	
Inventory		5,000

When goods and services are acquired, there is no change in equity. An asset is increased (debit Inventory) and an asset is decreased (credit Cash) or a liability (credit Accounts Payable) is increased. When the asset is consumed and thereby expensed (debit Cost of Goods Sold) the resulting effect on the Net Profit of the income statement is lower. Since Net Profit or Loss is a line item in the equity section of the balance sheet, then a lower Net Profit means lower equity.

Of course, one should not forget that since the inventory items being expensed were sold they were then recorded as an increase in sales causing a higher Net Profit and thereby resulting in higher equity. In other words, income and expense offset each other.

It's important to understand what costs are and the impact they have on your business. In theory, when you buy some office supplies and record them into the expense category called Office Supplies, you had an expenditure that was immediately converted to an expense. What if you didn't "consume" the expenses immediately? Should the office supplies be recorded as an asset until you use them? No, because they are considered to be "small ticket" items that will most likely be consumed within one year. Avoid getting confused over the literal translation of the accounting principles and their practical application.

TIP: Matching Expense To Revenue

In the article titled, *Revenue Realization Principle*, you learned that the concept governing the recognition of revenues of a period is the realization concept, which states that revenue is recognized (recorded) in the period in which goods or services are delivered. The concept governing the recognition of expenses is the *matching principle*. When using the accrual method of accounting, costs associated with the revenues of a period are expenses of that period. (See definition of Matching Principle above) Keep in mind that expenses are matched to revenues; revenues are not matched to expenses. Another thing to remember is that, if you order a product over the phone, you don't record the purchase when you hang up. The cost is recognized when the product is delivered.

Understanding the matching principle will help you decide how to journalize transactions. Here are some examples:

(1) Let's say you paid for one full year of insurance premiums and it cost \$2,500. You have an expenditure of an unused asset for \$2,500 and it is recorded in the Other Assets section of the balance sheet in a category called Prepaid Insurance.

DESCRIPTION	DEBIT	CREDIT
Prepaid Insurance	2,500	
Cash		2,500

Using the matching principle, the expense is recognized in the period it was consumed. Therefore, in the first month of January \$208.33 (1/12th of \$2,500) is expensed to Liability Insurance in the Operating Expense section of the income statement. Prepaid Insurance is therefore decreased by the same amount.

DESCRIPTION	DEBIT	CREDIT
Liability Insurance	208.33	
Prepaid Insurance		208.33

During the month of January, sales revenue occurred. Part of the cost of generating the sales revenue was the cost of liability insurance. This journal entry matches the actual cost of insurance for the month of January with revenue for the same period. The unexpired asset called Prepaid Insurance is then carried forward to a future period for the business to use.

(2) Perhaps, instead of cash being paid in advance, it is paid after the good was purchased or the service performed. Let's say you bought computer consulting services "on account" from a local company. In other words, the services were performed, but you agreed to pay later. The account you use could be Computer Consulting, Outside Services, Repairs and Maintenance, whichever you prefer.

DESCRIPTION	DEBIT	CREDIT
Repairs & Maintenance	500	
Accounts Payable		500

The expenditure was immediately converted to an expense and matched against revenues generated in the same period. The fact that you paid for the services in a future period is incidental.

(3) Some of your assets may have suffered a decrease due to theft, fire, or other reasons. Accrual accounting insists that these *losses* be matched against revenue in the current period if the losses can recognize a *reasonably possible* decrease in the asset.

DESCRIPTION	DEBIT	CREDIT
Theft Loss	1,000	
Inventory		1.000

Under the accrual method, if there is a reasonably possible chance that you are going to be sued and it is reasonably possible that you will lose, then you should record a contingency loss for the amount in question.

These rules are governed by the Conservatism principle of accounting which states:

Revenues are recognized when they are reasonably certain. Expenses are recognized when they are reasonably possible.

These rules, concepts, principles, whatever you want to call them, exist because they foster more accuracy in financial statement reporting. This is why Generally Accepted Accounting Principles (GAAP) requires accrual based accounting.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.