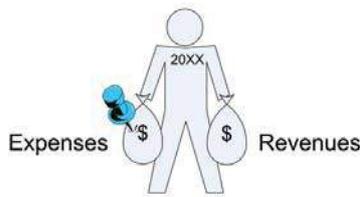


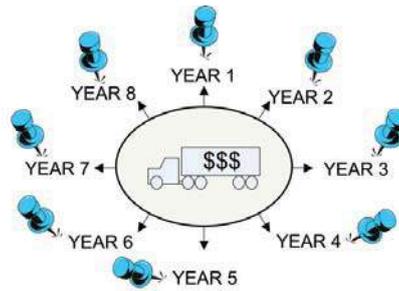
15. Basic Elements of Expense Recognition

Expense recognition will typically follow one of three approaches, depending on the nature of the cost:

- **Associating cause and effect:** Many costs can be directly linked to the revenue they help produce. For example, a sales commission owed to an employee is directly based on the amount of a sale. Therefore, the commission expense should be recorded in the same accounting period as the sale. Likewise, the cost of inventory delivered to a customer should be expensed when the sale is recognized. This is what is meant by “associating cause and effect,” and is most often referred to as the matching principle.
- **Systematic and rational allocation:** In the absence of a clear link between a cost and revenue item, other expense recognition schemes must be employed. Some costs benefit many periods. Stated differently, these costs “expire” over time. For example, a truck may last many years; determining how much cost is attributable to a particular year is difficult. In such cases, accountants may use a systematic and rational allocation scheme to spread a portion of the total cost to each period of use (in the case of a truck, through a process known as depreciation).
- **Immediate recognition:** Last, some costs cannot be linked to any production of revenue, and do not benefit future periods either. These costs are recognized immediately. An example would be severance pay to a fired employee, which would be expensed when the employee is terminated.



MATCHING



ALLOCATION



IMMEDIATE

15.1 Payment and Expense Recognition

It is important to note that making payment is not a criterion for initial expense recognition. Expenses are based on one of the three approaches just described, no matter when payment of the cost occurs. Recall the earlier definition of expense (outflows and obligations arising from the production of goods and services), noting that it contemplates something more than simply making a cash payment.

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