Introduction: Accounting communicates relevant and reliable information to users. The biggest challenges in accounting deal with recognition and measurement issues. Transactions and events must be analyzed to determine whether they should be recognized in the financial statement and how they should be measured.

Unit 2 presents the concept of accrual accounting which underlies financial statements. When revenue recognition and matching concepts are reflected in the income statement, the report becomes a useful tool for managers, investors and creditors to assess profitability. In accounting, data collection begins with recording transactions. Information is captured in journals and ledgers. Adjustments are made to bring the account balances into conformity with generally accepted accounting principles (GAAP). The end product of the accounting cycle is a set of financial statements in a format that is useful for making financial decisions.

Recognition and measurement are significant issues in financial reporting. Economic event recognition and measurement are determined by two guiding principles: recognition and matching.

Financial statements may be prepared on a cash basis or on an accrual basis. Generally accepted accounting principles require financial statements to be prepared using the accrual basis. Accrual accounting reports revenues when they are earned and matches expenses in the period they are consumed in the effort to produce that period’s income.

In order to prepare financial statements consistent with accrual accounting concepts, adjustments must be made in the accounting records. There are four types of adjustments: existing assets are expensed, and new assets are recognized, existing liabilities are considered settled and new liabilities are recognized.

For companies with inventory, it is important to compute the cost of goods sold. The cost of goods sold reflects the cost of all units sold whether they were purchased during the current period or were sold from inventory. The cost of goods sold is also affected by the inventory cost flow assumption and many valuation issues.

Managers, creditors and investors assess profitability in order to make predictions about future cash flows. Inventory turnovers measure how well the inventory is managed. The gross profit ratio and profit margin ratios provide valuable information to managers, investors and creditors.