

Financial Accounting Basics

Second Edition

Ralph E. Smith • Rick Birney

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Ralph E. Smith
Professor of Accountancy
School of Accountancy
Arizona State University

Rick Birney
Director of Instructional Technology
College of Business
Arizona State University



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FINANCIAL ACCOUNTING BASICS

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Ralph E. Smith and Rick Birney
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About the Authors

Ralph E. Smith, PhD, CPA, is a Professor of Accountancy at Arizona State University where he has taught graduate and undergraduate courses and seminars in financial accounting. He has also been active in developing and conducting a number of professional development seminars. Professor Smith received his PhD in accounting from the University of Kansas. He is a member of the American Accounting Association and the American Institute of Certified Public Accountants. He has served on several committees of the American Accounting Association and also holds membership in Beta Gamma Sigma and Beta Alpha Psi. He has written a number of articles on financial accounting and related business topics that have been published in *The Accounting Review*, the *Journal of Accountancy*, the *Journal of Financial and Quantitative Analysis*, and other professional and academic journals.

Rick Birney is the Director of Instructional Technology for the College of Business at Arizona State University. His primary responsibilities include the integration of technology into the business curriculum. Mr. Birney teaches upper-division courses in Instructional Courseware Design, Computer Based Training and Accounting Authoring Software. In addition, he holds faculty and staff workshops on classroom presentation and multi-media development techniques. He worked over 20 years in engineering management, systems applications and training for Hughes Aircraft, Pioneer Corporation of America and Kaiser Aerospace and Electronics. Mr. Birney has published articles in various publications, including the *IEEE Journal*. He has been a featured presenter at numerous American Accounting Association and American Institute of Certified Public Accountants workshops and conferences. He serves on the board of directors for the new Center for Educational Technology in Accounting at the University of North Texas.

PREFACE

The objective of this manual is to introduce you to the procedural aspects of accounting. It is designed to accompany *The Introductory Accounting Lab: An Interactive Tutorial* which is available from McGraw-Hill, Inc. The contents of this manual introduces the accounting procedures that are considered generally accepted accounting practices in this country. As you perform your assignments you must keep this in mind. Although the manual and companion courseware focus on accounting rules and procedures, you must understand, apply, and be able to explain the rules and procedures. As you read this manual and do the computer assignments, you should strive to understand each procedure and its relationship to accounting information.

ORGANIZATION OF THE MANUAL

The manual is organized into two parts. There are 12 chapters included in Part I. The first eight chapters of this manual contain a detailed discussion of the accounting cycle for a service firm. Accounting for a merchandising firm is described in chapters 9 through 12. The chapters in this part of the manual are:

Chapter	1	The Accounting Equation
Chapter	2	Analyzing Business Transactions
Chapter	3	Transaction Analysis: Debit and Credit Rules
Chapter	4	Recording Transactions in the General Journal and Posting to the General Ledger
Chapter	5	Accrual Basis and Cash Basis Methods of Accounting
Chapter	6	Preparing Adjusting Entries
Chapter	7	Preparation of a Worksheet and Completion of the Accounting Data Processing Cycle-Service Firm
Chapter	8	An Alternative Method of Recording Deferrals and Preparing Reversing Entries
Chapter	9	Accounting for Merchandising Operations-Perpetual Inventory System
Chapter	10	Accounting for Merchandising Operations-Periodic Inventory System
Chapter	11	Subsidiary Ledgers and Special Journals
Chapter	12	Inventory Cost Flow Methods

To test your understanding of the topics covered in these chapters, a practice activity is provided after each major section. Answers to these activities are provided at the end of each chapter.

The computer courseware for the topics contained in Part I is used to simulate a manual accounting system. When performing your computer assignments you will be maintaining accounting records for fictional clients. Using the computer software allows you to practice accounting procedures and receive immediate feedback. However, the

accounting topics are introduced in this manual. You should read and study the related chapter in this accounting manual first, then complete the computer assignments.

Part I introduces you to the accounting cycle and accounting for a merchandising firm. Except for the merchandising chapters, specific assets, liabilities, and stockholders' equity accounts were not discussed in detail. Part II, consisting of Chapters 13 through 20, is included in order to provide a comprehensive coverage of principles of financial accounting. Chapters 13 through 15 discuss accounting for assets. Accounting for liabilities and stockholders' equity are described in Chapters 16 through 18. Other financial accounting issues are discussed in chapters 19 and 20.

The objective of the chapters contained in Part II of this manual is to provide an introduction to and overview of the exercises covered in the software. Each chapter is typically organized into three parts. First, the chapter begins with a description of the coverage of the chapter. This is followed by a concise coverage of the topics emphasized in the exercises presented in the software. Each chapter concludes with a print out of the *Reference Book* contained in the software. (The *Reference Book* is the focus of the chapter when a subject matter of the chapter consists of numerous individual components.) In some cases, the discussion of an individual topic contained in the *Reference Book* is expanded to illustrate certain computations. The software for these chapters consist of a series of exercises.

ACKNOWLEDGEMENTS

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Ralph E. Smith
Rick Birney

FINANCIAL ACCOUNTING BASICS:

PART I ACCOUNTING DATA PROCESSING CYCLE AND ACCOUNTING FOR A MERCHANDISING FIRM

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CHAPTER 1

The Accounting Equation

Contents

- Chapter Overview and Objectives
- The Accounting Process
- Entity Assumption
- Assets
- Liabilities
- Owners' Equity
- Accounting Equation
- Communicating Accounting Information through Financial Statements
- External Financial Statements -- An Overview

CHAPTER OVERVIEW AND OBJECTIVES

This chapter presents an overview of the purpose of accounting and a review of the financial statements. When you have completed this chapter, you will be able to:

1. Explain the accounting process.
2. Recognize typical transactions entered into by a business.
3. Describe the relevance of the entity assumption.
4. Define what the accountant means by the terms assets, liabilities, and owners' equity.
5. Identify two forms of the accounting equation and its basic components.
6. Describe the functions and the content of the balance sheet, income statement, and retained earnings statement.
7. Define each of the following terms:

Accounting
Entity assumption
Asset
Cost principle
Liability
Creditors

Owners' equity
Capital stock
External statements
Fiscal year
Interim reports
Income statement

Revenues
Expenses
Gains
Losses
Retained earnings statement
Balance sheet

Accounting is often thought of as an information processing system because it is a means of communication that involves a flow of information about a business. The accounting information is intended to be useful in making economic decisions. In this chapter, you will see that accounting information is accumulated in terms of an accounting model called the accounting equation. It will be shown that the accounting model consists of three elements: assets, liabilities, and owners' equity. As we develop the procedural aspects of accounting, you will see that there are subelements of owners' equity. Financial statements are then reviewed in the context of the accounting model.

THE ACCOUNTING PROCESS

Accounting has developed to at least partially satisfy the need for information by various user groups. It is an information system that is designed to collect and report particular kinds of financial information about an organization to interested parties. Thus, accounting is a service activity producing information. The accounting process does not result in the production and sale of a tangible product such as a desk or computer.

Accounting can be defined as the process of recording and communicating financial information that is intended to be useful in making economic decisions. The accounting process consists of the following:

1. **Recording financial information:** A business engages in a continuous series of economic activity. Accountants observe this activity and identify those events that can be measured in monetary terms and that meet the criteria for being entered in the accounting records. Money serves as a common measurement for expressing each transaction. Events that are measured in money and recorded in the accounting records are called transactions. The purchase of equipment for \$10,000 cash is an example of a transaction. Borrowing money from a bank is another example. The recording phase consists of: (1) observing business activity, (2) identifying recordable information, (3) measuring the transaction in monetary terms, and (4) entering the information in the accounting records.
2. **Communicating financial data:** The effects of the recorded transactions on the reporting entity are communicated to statement users through financial statements and special reports. To make the accounting data more useful in making decisions, the effects of possibly thousands of transactions are classified and summarized. For example, all transactions involving the sale of merchandise can be grouped into one total sales figure, all transactions involving cash can be grouped into one single net cash figure, and a total amount is reported for amounts due from customers rather than listing the amount due from each individual customer. This information is then classified into useful groups or categories. For example, debts of a service or retailing firm are usually classified into two categories: those due within one year and those due beyond a one-year period. The financial statements and special reports usually

summarize the effects of all business transactions occurring during some period of time such as a month, a quarter, or a year.

In summary, the function of the accounting process is to record and communicate economic data about an organization to interested parties for decision making.

An *accounting system* consists of the business forms, records, procedures, management policies and controls, and data-processing methods used to transform economic data into useful information. The accounting system may take the form of a simple manual system or a sophisticated computerized system. Regardless of its form, the dual purpose of any accounting system is to keep track of a firm's business transactions and report their effects on its operating performance and financial position.

In this course you will be exposed to accounting procedures used in a manual accounting system. In even relatively small businesses, much of the routine accounting work has become highly automated. An accountant, however, must have a thorough understanding of the underlying accounting framework. Such knowledge is more easily acquired by studying and actually performing the procedures.

ENTITY ASSUMPTION

If the transactions of a business are to be recorded, summarized, and reported in the financial statements, the accountant must be able to identify clearly the boundaries of the unit for which accounting records are maintained. Under the **entity assumption**, a business is considered a separate entity distinguishable from its owners, creditors, employees, and all other entities. For example, a retail clothing store is a separate accounting entity from the owners of the business. If the clothing store borrows money from a bank, the bank is another accounting entity. The clothing store is considered an entity separate and apart from its employees. A separate set of accounting records is maintained for each business, and the prepared financial statements represent the financial position and results of operations of that business only.

ASSETS

A business needs resources such as money, supplies, equipment, and furniture to start and to operate. In accounting, resources owned by a business that have money value are called **assets**. Assets may take different forms, and the type owned by a business depends on the nature of the business. They may be tangible or intangible in form. A tangible asset has a physical existence (e.g., land, buildings, furniture, and equipment). An intangible asset is characterized by legal claims or rights (e.g., accounts receivable, patent rights, or rights to use leased assets). Assets have economic value because they contain service benefits that can be used in future operations or sold to another entity.

Under the **cost principle** in accounting, business transactions are entered in the accounting system at cost. Cost assigned to an asset includes its purchase price, sales tax,

freight, and any other cost needed to prepare the asset for sale or for its intended use. Subsequent increases in value are not recorded until that item is involved in a transaction with another entity. In other words, accountants do not enter increases in value in the accounting records until there is a transaction to confirm, or provide evidence of, the increase in value.

A business obtains its assets to operate from two sources: investment by individuals in the business or from other entities. The investment by the owners is called owners' equity. A company may also acquire assets from a variety of financing sources such as a bank or from buying goods or services on credit. Debts owed by the business are called liabilities.

The first transaction entered in the accounting records is the investment by the owners. Although investments may take various forms (such as cash, land, or equipment), the initial investment is frequently cash. Individuals invest in a business in anticipation of eventually being able to withdraw assets in excess of those invested. In other words, they expect that the firm will operate at a profit and that they will receive a return on their investment. The mere holding of cash invested by the owners will not provide a return. Cash is useful as a medium of exchange or as a measure of value, but essentially it is a nonproductive asset. One of the primary reasons for making a cash investment is to use the cash to purchase productive assets, such as equipment, buildings, and inventory for sale to its customers. These assets may be purchased with cash or financed on credit. The noncash assets are used to provide goods or services for customers in exchange for cash or the customer's promise to pay cash in the future. The cash received is then used to pay expenses, or to pay debts owed, retained in the business for expansion, or distributed to the owners as a return on their investment.

PRACTICE ACTIVITY 1-1

1. The owner of Bill's Towing Service purchased a tow truck. The truck had an invoice price of \$28,600, but the dealer and Bill agree to a purchase price of \$27,400 plus freight cost of \$780. Bill would have been willing to pay \$28,400 including the freight. In addition, Bill must pay a sales tax of \$1,680. Compute the cost of the tow truck to be recorded on the books of Bill's Towing Service. \$_____
 2. A firm was offered \$120,000 for land that it had purchased for \$70,000 ten years ago. What amount should the land be recorded at on the firm's records? \$_____ This is an example of applying the _____.
 3. A company that includes the personal assets of a stockholder in its records is violating the _____.
-

LIABILITIES

Liabilities are the debts owed by a business. The person or entity to whom the debt is owed is called a **creditor**. Liabilities include amounts owed to suppliers for goods or services purchased on credit (accounts payable), amounts borrowed from banks or other lenders (notes payable), amounts owed to employees for salaries and wages, and amounts owed to tax agencies for taxes incurred but not yet paid. Liabilities may also be thought of as creditors' claims against the assets of the business.

Liabilities also include amounts received in advance from customers for goods or services to be provided by the firm. Such an advance is reported as a liability, called unearned revenue, because the cash has been received and the firm has an obligation to provide the goods or services. Examples include the collection of the current month's rent at the beginning of the month from a tenant and cash received for an airline ticket for a flight to be flown next month. The liability is satisfied as the tenant uses the building and when the traveler takes the flight. Such liabilities do not represent monetary debt, but the firm is liable to provide goods or perform services. Thus, cancellation of a liability requires either an outlay of assets (generally cash) or the performance of future services.

PRACTICE ACTIVITY 1-2

Listed below are items normally found in the accounting records of a business. Indicate whether the item is an asset or a liability by placing a check mark in the proper box.

<u>Item</u>	<u>Asset</u>	<u>Liability</u>
Accounts Payable	_____	_____
Office Supplies	_____	_____
Building	_____	_____
Notes Payable	_____	_____
Land	_____	_____
Salaries Payable	_____	_____
Patent	_____	_____
Cash received by a publisher for a three-year magazine subscription	_____	_____

OWNERS' EQUITY

Owners' equity is the owners' interest in the assets of the business. Owners' equity for a corporation is often referred to as stockholders' equity. Owners' equity may be thought of as the owners' claims against the assets. Creditors' claims take legal precedence over owners' claims; if the assets are sold, creditors must be paid before the claims of the owners are recognized. Thus, owners have a claim to the assets remaining after creditors

are satisfied, called a residual claim. The claims of the owners are subdivided into two parts: paid-in capital and retained earnings.

1. Paid-in capital (direct investment by the owners)-- Owners' equity is increased when the owners of the business invest cash or other assets in the entity. This may be either the initial investment made at the time of formation to start the business or additional investments made at a later date. When stockholders invest in a corporation, they are given shares of the corporation's stock as evidence of their ownership. A corporation may be authorized to issue two basic types of stock, *preferred and common*. The term **capital stock** refers to all classes of ownership shares, both preferred and common, issued by a corporation. In this course, we will assume that one type of stock is issued, *common stock*. Since common stock is the only class of stock purchased by the stockholders from the company, we may also use the term capital stock.
2. Retained earnings--Retained earnings represent the interest of the stockholders in the accumulated earnings that have not yet been distributed to them. This claim of the owners can be explained as follows. Revenues are the inflows of assets to an entity resulting from the sale and delivery of goods or the rendering of services. That is, when a business either sells goods or provides services, it receives an asset from its customers, usually cash or the customer's promise to pay in the future (an account receivable). Revenues are measured by the amount of cash or other assets received. Expenses are the cost of assets used in the operations of the business to sell the goods or render the services. (An expense may result in an increase in a liability, but for simplicity, this possibility is ignored for now.)

Net income, which is sometimes referred to as *earnings* or *profit*, for the period is the excess of revenues over expenses. (Gains and losses are also included in net income but are defined in a later section of this chapter.) Since revenues increase assets and expenses decrease assets, assets are increased if the business operates at a net income. Since the owners have the residual interest in the firm, net income also represents an increase in owners' equity. That is, the increase in assets that result from profitable operations belongs to the company's owners. Conversely, a net loss decreases assets and owners' equity. Owners' equity is also decreased by paying dividends to the owners. A dividend is a distribution of assets, usually cash, to the stockholders. Such a distribution is based on the increase in assets generated from previously earned profit. The accumulated business earnings that have not been distributed to its owners are called retained earnings.

The owners' interest in the assets of the firm is equal to the sum of these two elements. The owners' equity in the business, however, is an aggregate or a general claim against the total assets. That is, the owners do not have claims against a specific asset.

PRACTICE ACTIVITY 1-3

1. Retained earnings are increased if the business operates at a net _____ and are decreased if it operates at a net _____ or pays a _____ to its stockholders.
2. Net assets are increased if the business operates at a net _____.
3. Indicate in the space provided whether the type of change increases or decreases the owners' interest in the business.

<u>Type of Change</u>	<u>Effect on Owners' Equity</u>
Owners' investment	_____
Revenues	_____
Expenses	_____
Net loss	_____
Dividend payment	_____

ACCOUNTING EQUATION

Assets of a firm must be equal to the sources of the assets, or stated another way, the total assets of the business must be equal to the claims against the assets. The relationship may be shown mathematically as:

$$\text{Assets} = \text{Sources of assets}$$

or

$$\text{Assets} = \text{Claims against the assets}$$

Assets are obtained from two sources: creditors and owners. Thus the equation can be restated to:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

The two sides of the equation are always equal because they simply reflect two views of the same thing. The sum of the assets shows the resources owned by the business. The right side shows the amounts of resources provided to the business by the creditors and the owners, respectively. This equation is known as the accounting equation, sometimes referred to as the balance sheet equation.

As noted earlier, creditors' claims have priority over claims of the owners. The owners have a claim against the remaining assets, called a residual interest. Because the owners have a residual interest in the assets, the equation is sometimes stated as:

$$\text{Assets} - \text{Liabilities} = \text{Owners' equity}$$

The owners' equity component of the accounting equation may be expanded as follows:

$$\text{Owners' equity} = \text{Paid-in capital} + \text{Retained earnings}$$

$$\begin{aligned} \text{Retained earnings} = & \text{Beginning balance} + \text{Revenues} \\ & - \text{Expenses} - \text{Dividends} \end{aligned}$$

PRACTICE ACTIVITY 1-4

Compute the missing element for each independent case.

Case	Assets	Liabilities	Paid-in Capital	Retained Earnings
1.	\$142,000	\$48,000	\$60,000	?
2.	?	\$16,000	\$30,000	\$12,000
3.	\$88,000	?	\$35,000	\$15,000

Case	Beginning Retained Earnings	Revenue	Expense	Dividends	Ending Retained Earnings
4.	\$30,000	\$60,000	\$40,000	\$10,000	?
5.	\$30,000	\$60,000	?	\$10,000	\$15,000
6.	?	\$60,000	\$28,000	\$12,000	\$40,000

COMMUNICATING ACCOUNTING INFORMATION THROUGH FINANCIAL STATEMENTS

Accounting is an information system designed to provide financial data to interested parties for decision-making purposes. The final result of the accounting process is the preparation of various financial statements that serve as important communication devices. The financial statements are generally classified into two types: internal statements and external statements. Internal statements are prepared at the request of management for the sole use of managers within the firm. Consequently, they are *not* intended for use by external users.

External statements, however, are designed and prepared specifically for use by outside parties such as creditors and stockholders. Because these outside parties are unable to specify the content and procedures to be followed in the preparation of the statements, generally accepted accounting procedures (GAAP) serve as guides in the preparation of the statements. External financial statements must be prepared in accordance with GAAP.

The life of a firm is divided into a series of time periods of equal length called accounting periods. Accounting periods of approximately equal length are established to enable the users of the financial statements to make meaningful comparisons of operating results of the current period with those of prior periods. A complete set of financial statements is issued to interested parties at least once a year as part of a firm's annual report.

A firm may select any 12 consecutive months for reporting. This period is called a **fiscal year**. If a firm's annual period begins on January 1 and ends on December 31, it is referred to as a calendar year firm. Many firms select a *natural business year* as a reporting period. A natural business year is a 12-month period that ends when business activities are at their lowest level during the year. For example, a retail firm's inventory is usually lowest after the post-Christmas sales. Thus, retail firms often select a fiscal year of February 1 to January 31 because the employees generally have more time to complete the year-end accounting and there is less inventory to count. An added plus is that accounting cost is reduced.

Annual reports are used by creditors, investors, and other interested parties to assess the firm's progress from year to year. Although the basic accounting period for which financial statements are presented is one year, quarterly statements are commonly issued to external parties to provide timely information on the operations of the firm. Generally, quarterly statements are not as detailed as annual reports. Many firms also prepare monthly or weekly statements for internal use by management. Statements prepared before the end of the annual period are called **interim reports**.

The emphasis in this course is on the processing of information for the preparation of external financial statements.

PRACTICE ACTIVITY 1-5

A firm's _____ year is any 12 consecutive month period selected for reporting.

A firm whose annual period ends on December 31 is called a _____ year firm.

A _____ year is a 12-month period that ends when business activities are at their lowest level during the year.

Accounting reports prepared for shorter time intervals than the fiscal period are called _____.

EXTERNAL FINANCIAL STATEMENTS -- AN OVERVIEW

Some knowledge of the content of external financial statements (hereafter simply called financial statements) and the types of information they are designed to communicate will help you better understand the underlying concepts and measurement process followed in accounting. The twofold purpose of such financial statements is to communicate to users (1) the results of operating activities during a specified time period and (2) the business's financial position at the end of the period. The four main financial statements prepared for use by external decision makers are:

1. Income statement
2. Retained earnings statement
3. Balance sheet
4. Statement of cash flow

These statements are often called general-purpose financial statements because they provide general information for use by all external users. To facilitate the analysis and interpretation of financial data, relatively standard classification schemes have evolved over time. If the structure and content of the financial statements are based on the general needs of users, and if that structure is followed consistently, then the information most user groups want should be available.

Preparation of the statement of cash flows is not covered in this course. The accounting system is not designed to prepare a statement of cash flows directly from the accounting records as is the case with the other statements. Thus, the preparation is rather complex and coverage is deferred to more advanced accounting courses. However, do not infer from this that the statement is unimportant.

USE OF DOLLAR SYMBOL, COMMAS, AND PERIODS

Before we review a set of financial statements, we need to examine the procedures followed by accountants in the use of the dollar symbol, commas, and periods. A common practice in formal reports, such as financial statements, is to place a dollar sign before the first amount in a column of figures, and also before the total amount. (Some accountants place a dollar symbol before a subtotal amount as well as the total amount.) Also, a single ruled line is placed under a column of figures to indicate that the amounts above the line are added or subtracted. A double line is placed after a total.

When dollar amounts are entered in ruled columns, commas and periods are not necessary. For the convenience of the statement reader, commas and periods should be