to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com

# Glossary

## A

**accelerated methods of depreciation** Accelerated methods of depreciation are used to depreciate fixed assets. Under these methods, more costs are allocated to earlier periods than are allocated to later periods. Examples include double-declining-balance and sum-of-the-years'-digits. These methods are considered conservative since they recognize large amounts of depreciation in the early years of an asset's life.

**accounting equation** The accounting equation is the basis for the four financial statements. It is a mathematical equation stating that the dollar value of a company's assets equals the dollar value of its liabilities plus the dollar value of its shareholders' equity. The balance sheet is a statement of this equation; transactions are recorded on the financial statements in a way that maintains the equality of this equation.

**accounting period** An accounting period is the period of time between the preparation of the financial statements. Statements are often prepared monthly, quarterly, semiannually, or annually. Most companies report on a calendar-year basis, but for various reasons, some companies report on other 365-day cycles, called fiscal years.

**accounts payable** Accounts payable are dollar amounts owed to others for goods, supplies, and services purchased on open account. They arise from frequent transactions between a company and its suppliers that are normally not subject to specific, formal contracts. These extensions of credit are the practical result of a time lag between the receipt of a good, supply, or service and the corresponding payment. Accounts payable are normally included on the balance sheet under current liabilities.

**accounts payable turnover** *Cost of sales/Average accounts payable.* Accounts payable turnover measures how quickly, on average, accounts payable are paid to a company's suppliers. It reflects the number of times, during a given period, that these supplier accounts are turned over. Dividing this activity ratio by 365 changes it into an expression indicating how many days, on average, are required to pay off an account.

**accounts receivable** Accounts receivable is a balance sheet account indicating the dollar amount due from customers from sales made on open account. It arises when revenues are recognized before receipt of the associated cash payment. Accounts receivable is normally included as a current asset and for some companies can be quite large.

**accounts receivable turnover** *Net credit sales/Average accounts receivable.* Accounts receivable turnover reflects the number of times a company's accounts receivables are recorded and collected during a given period. This ratio is often divided into 365 days, which indicates how many days, on average, receivables are outstanding—often referred to as the collection period.

**accrual accounting** The accrual basis is a system of accounting that recognizes revenues and expenses when assets and liabilities are created or discharged because of operating activities. Accrual accounting differs from cash flow accounting, which reflects only cash inflows and outflows, and is the basis upon which the statement of cash flows is prepared. Statements prepared under accrual accounting, like the income statement, are designed to measure earning power.

**accruals** Accruals are accounting entries designed to ensure that the assets and liabilities created or discharged due to the operating activities of the current period are recognized as revenues or expenses on the income statement of that period. The recognition on the income statement occurs at a time different from the related cash flow, so

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


a receivable or payable must be recorded on the balance sheet. Common examples include accrued payables, bad debts, warranties, and deferred revenues.

**accrued payables** Accrued payables are obligations on the balance sheet that must be recognized at the end of each period because they build up over time. Accrued payables are normally included as current liabilities because they are expected to be paid with the use of assets presently listed as current on the balance sheet. Accrued payables normally include obligations associated with salaries, wages, interest, warranties, and taxes.

**accumulated comprehensive income** Accumulated comprehensive income is an account in the shareholders' equity section of the balance sheet that contains the accumulated balances of items that affect the wealth of the firm but are not reflected on the income statement. Examples include unrealized gains and losses on securities accounted for as available-for-sale, unrealized gains and losses on certain derivative securities, pension adjustments, and foreign currency translation adjustments.

**accumulated depreciation** Accumulated depreciation is a contra asset account on the balance sheet that reflects the dollar value of the total depreciation that has been previously recognized on the fixed assets up to the date of the balance sheet.

**activity method** The activity method is a method of depreciating fixed assets or depleting natural resource costs that allocates the cost of the long-lived asset to future periods on the basis of its activity. This method is used primarily in the mining, oil, and gas industries to deplete the costs associated with acquiring the rights to and extracting natural resources. The estimated life under the activity method is expressed in terms of units of activity (e.g., miles driven, units produced, barrels extracted) instead of years, as is done under the other common methods of depreciation (e.g., straight-line, double-declining-balance, sum-of-the-years'-digits).

**activity ratios** Activity ratios measure the speed with which assets or accounts payable move through operations. They involve the calculation of a number called turnover, which indicates the number of times during a given period that assets (or payables) are acquired, disposed of, and replaced. Dividing 365 by the turnover number produces the average number of days during the year that the assets (or payables) were carried on the balance sheet. Turnover is commonly calculated for accounts receivable, inventory, fixed assets, total assets, and accounts payable.

**actuary** An actuary is a statistician who estimates risks for a wide variety of purposes, including the determination of insurance premiums, the funding of pension and health plans, and other purposes that involve assessing future demographic trends.

**additional paid-in capital** Additional paid-in capital is included in the shareholders' equity section of the balance sheet and reflects capital contributions to the firm over and above the par value of issued common stock or preferred stock. It can also appear as the result of issuing stock dividends, stock options, and treasury stock, and is part of contributed capital.

**aging schedule** Aging is a method of estimating and analyzing uncollectible accounts receivable that categorizes individual accounts on the basis of the amount of time each has been outstanding. Each category is then multiplied by a different uncollectible percentage, under the assumption that older accounts are more likely than new accounts to be uncollectible. This method is used primarily by management to identify and maintain control over uncollectible accounts receivables.

**allowance method** The allowance method, under generally accepted accounting principles (GAAP), is the preferred method to account for uncollectibles and sales returns, both of which have a direct effect on the reported value of accounts receivable. The allowance method involves estimating the dollar amount of the uncollectibles or sales returns at the end of each accounting period and, based on that estimate, records an entry that reduces both net income and the balance in accounts receivable with a contra account called "allowance for uncollectibles."

**amortization** Amortization is the systematic allocation of deferred charge (e.g., prepaid expense, fixed asset, bond discount or premium, deferred revenue, intangible asset) over its life. Amortization is often used to describe the allocation of the cost of intangible assets to earnings, but prepaid expenses and discounts and premiums on long-term receivables and payables are also amortized to earnings. Depreciation is the amortization of fixed assets, and depletion is the amortization of natural resource costs.

**analytic review** Analytic review is an important part of financial statement analysis that focuses on whether balances in financial statement accounts deviate from expected levels and seeks to explain why such deviations occur. It includes analyzing common-size financial statements to identify relative changes in the sizes of financial accounts across periods as well as comparing these changes in an effort to infer management actions.

**annual report** An annual report is a document that a company publishes each year, containing the financial statements, a description of the company and its operations, an audit report, a management letter, footnotes to the financial statements containing supporting schedules, and other financial and nonfinancial information.

**annuity** An annuity is a periodic cash flow of an equal amount over time. Bond interest payments, lease and rental payments, and insurance payments are examples.

**appropriation of retained earnings** An appropriation refers to the act of making a portion of the retained

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com



earnings account unavailable for the payment of dividends. Such restrictions can be imposed contractually or voluntarily and are designed to ensure that cash is available in the future for some specific purpose.

**asset** An asset is an item listed on the left side of the balance sheet that has been acquired by the company in an objectively measurable transaction and has future economic benefit—additional purchasing power, cash, or the ability to generate revenues.

**asset depreciation range (ADR)** The Asset Depreciation Range (ADR) System contains guidelines published by the Internal Revenue Service that define the minimum allowable useful lives and maximum depreciation rates for various kinds of long-lived assets. These lives are used when depreciating long-lived assets in the computation of taxable income.

**asset impairment** An asset impairment occurs when the value of an asset is judged to be permanently reduced. See **asset retirement** and **restructuring charges.**

**asset mix** Asset mix is the combination of assets listed on the balance sheet as of a given date. For example, the percent of current assets, long-term investments, fixed assets, and intangibles to total assets can represent a company's asset mix. Common-size analysis across time can identify changes in a company's asset mix.

**asset retirement** An asset retirement refers to the discontinuation of the use of a fixed asset.

**asset turnover** *Sales/Average total assets.* Asset turnover measures how efficiently a company is using its assets to produce sales. A high ratio indicates that a company is producing a large amount of sales with relatively few assets. Asset turnover times profit margin equals return on assets, which is a direct determinant of return on equity.

**audit** An audit is an examination conducted by an individual or entity, having no financial interest in the company (i.e., independent), to determine whether the financial statements of the company fairly reflect its financial condition, whether the statements have been prepared in conformance with generally accepted accounting principles, and whether the company's internal control system is effective. The outcome of the audit is an audit report, or opinion letter, signed by the auditor, which states the extent of the auditor's activities and the conclusions.

**audit committee** The audit committee is a subcommittee of the board of directors, made up entirely of non-management directors, that works with management to choose the external auditor and monitor the audit so that it is conducted in a thorough, objective, and independent manner.

**audit opinion** See **audit report.**

**audit report** The audit report, which is written and signed by the external auditor, states whether, and to what extent, the information in the financial statements fairly reflects the financial performance and condition of the company. See **audit.**

**authorized shares** Authorized shares refers to the number of shares of stock a corporation is entitled to issue by its corporate charter, which is normally granted by the state in which the company is incorporated. Additional authorizations must be approved by the board of directors and are often subject to shareholder vote. Both preferred and common shares must be authorized before they can be issued.

**available-for-sale securities** Available-for-sale securities refer to relatively small investments (less than 20 percent of the outstanding voting stock) in marketable equity or debt securities that are not considered trading securities. Available-for-sale securities are readily marketable but are not intended to be sold in the near future—they can be listed as either current or noncurrent depending upon management's intention, and they are carried on the balance sheet at fair market value.

**averaging assumption** In addition to first-in, first-out (FIFO) and last-in, first-out (LIFO), averaging is one of the three most common inventory cost flow assumptions. Under the average method, cost of goods sold and ending inventory are determined by computing a weighted average cost of the items sold and the items remaining, respectively.

## B

**bad debts** See **uncollectibles.**

**balance sheet** The balance sheet is a financial statement that indicates the financial condition of a business as of a given point in time. It includes assets, liabilities, and stockholders' equity, and it represents a statement of the basic accounting equation. The assets and liabilities are divided into current and noncurrent classifications on the basis of liquidity, and comparisons of assets and liabilities often provide an indication about the company's ability to meet obligations as they come due (i.e., solvency).

**bank reconciliation** A bank reconciliation is a document that lists items explaining the difference between the cash balance indicated in the company's ledger and the cash balance indicated in the company's bank statement. Differences between the two balances arise from outstanding checks, unrecorded deposits, and bank charges. Maintaining up-to-date bank reconciliations is one component of a good internal control system.

**basic earnings per share** See **earnings per share.**

**betterment** A betterment is a material expenditure made after the acquisition of a long-lived asset that improves the asset by increasing its life, increasing the quality or quantity of its output, or decreasing the cost of operating it.

**"Big 4"** The four public accounting firms that audit most of the large companies in the United States are known as

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


the Big 4. They are Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers.

**board of directors** The board of directors is a group of individuals, elected annually by the stockholders of a corporation to represent the interests of those stockholders. In addition to setting overall corporate policies, the board has the power to declare dividends, set executive compensation, and hire and fire management. The board also appoints and monitors the compensation committee and audit committee.

**bond** Bonds are debt securities issued by an entity to a large number of investors to raise cash. The issuing company, in return, normally agrees to make cash interest payments to the bondholders until a specific future date (called maturity), usually five to thirty years in the future, at which time a large principal payment is made and the obligation is terminated. Companies issue bonds to raise large amounts of cash, and they are normally issued (sold) to the public through a third party (called an underwriter), such as an investment banker or financial institution. After bonds are initially issued, they are generally freely negotiable; that is, they can be purchased and sold in the open market.

**bonds payable** Bonds payable represents a balance sheet liability reflecting the book value of bonds that have been previously issued and are presently outstanding. This liability is normally considered to be long-term, except for the portion that is due within the time period of current liabilities. Bonds payable are carried on the balance sheet at the present value of the future cash (interest and principal) payments specified by the terms of the bonds, discounted at the effective interest rate at the time of issuance.

**book gain/loss** A book gain (or loss) is the difference between the value received (or given up) and the book value of the asset (or liability) disposed of. If, for example, an asset with a book value of $10,000 is sold for $12,000, a $2,000 book gain is recognized. Selling the same asset for $7,000 would create a book loss of $3,000.

**book value** Book value is the value of an account, a company, or a share of stock as indicated by the balance sheet. It is often referred to as balance sheet value.

**borrowing capacity** Borrowing capacity is the ability of a company to raise capital by issuing debt securities or other borrowings. Borrowing capacity is critical for successful businesses because debt financing is a method of raising much-needed capital to support operations, invest in assets, or pay off outstanding debts.

**business acquisition** In a business acquisition, a company (investor) acquires a controlling interest (51 percent or more of the voting stock) in another (investee) company. The investor company is called the parent, and the investee company is called the subsidiary; both companies normally continue to operate. The financial statements of the parent are prepared on a consolidated basis, where the assets, liabilities, income, and cash flows of the combined entity are included together. The financial statements of the subsidiary are unaffected.

**business combination** See **merger.**

**business environment** A business environment is the economic setting in which a company's operating, investing, and financing activities are conducted. The business environment consists of many items, most of which are not within management's control—including interest rates, market values of certain assets, competitive forces, the general state of the economy, changes in customer tastes and preferences, characteristics of the workforce, and government regulation.

**business segment** A business segment is a separate line of business, production line, or class of customer representing an operation that is independent of a company's other operations. Many large companies have multiple lines of business, and if material, the assets, liabilities, revenues, and profits associated with these separate lines are disclosed in the footnotes to the financial statements.

## C

**call provision** A provision in a debt contract that allows the issuing company to repurchase outstanding debt (e.g., bonds) after a specified date for a specified price is a call provision. Call provisions protect issuing companies from situations where market interest rates drop significantly. In such cases, issuing companies can exercise their call provisions (repurchase the debt) and reissue debt at lower interest rates.

**capital** Capital refers to funds (usually cash) generated by a company to support its operations. In a general sense, capital can refer to funds produced through issuing either debt or equity securities, but the capital section of the balance sheet normally refers to owners' or stockholders' (shareholders') equity—sources of equity capital.

**capital asset pricing model** The cost of equity can be estimated using the capital asset pricing model, which expresses the return an investor can reasonably expect on an equity investment (cost of equity) as a function of two factors: (1) the expected risk-free rate of return and (2) the expected risk premium associated with an investment in the firm itself.

**capital employed** Capital employed is an expression used to describe funds invested. See **capital.**

**capital lease** A capital lease is a lease treated as a purchase for purposes of financial accounting. If, at the date of the lease agreement, a lease meets certain criteria, it is classified and accounted for as a capital lease by the lessee. Under a capital lease, the lessee is considered to have the economic ownership of the leased asset,

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


which is financed through the periodic lease payments. The resulting accounting treatment recognizes both a balance sheet asset and a liability, which are initially placed on the books at the present value of the future cash payments, discounted at the effective rate of interest. The asset is then depreciated, and the effective interest method is used to amortize the liability as the lease payments are made.

**capital market** Transactions involving the buying and selling of debt and equity investments are conducted in the capital market. This market includes the global stock and bond markets and the banking system.

**capital structure** Capital structure refers to a company's financing sources: (1) borrowings or liabilities, (2) contributed capital, and (3) earned capital (primarily retained earnings). It is represented by the right side of the balance sheet—liabilities and shareholders' equity.

**capital structure leverage** *Average total assets/Average stockholders' equity.* Capital structure leverage or financial leverage indicates the extent to which a company relies on debt financing. As the ratio increases (decreases), the amount of debt financing is greater (less). A ratio of "1" indicates that there is no debt in the company's capital structure. Capital structure leverage is a direct determinant of return on equity.

**capitalization ratios** Capitalization ratios help analysts evaluate the capital structure of a company or, in general, the composition of the liability and shareholders' equity side of the balance sheet. They include: (1) debt/equity, (2) debt ratio, (3) capital structure leverage, and (4) common equity leverage.

**capitalize** To capitalize an expenditure means to place the cost of an expenditure on the balance sheet as an asset. Expenditures can be either expensed or capitalized.

**cash conversion cycle** *Accounts receivable turnover* (*days*) + *Inventory turnover* (*days*) − *Accounts payable turnover* (*days*). This metric combines three turnover measures in a way that indicates the time period over which a company's major working capital requirements must be financed. As this measure increases, it indicates a longer time period, a greater working capital investment, and higher financing requirements. See **operating cycle.**

**cash discount** When a good or service is sold on credit, the selling company wishes to collect the cash as soon as possible. To encourage prompt payment, many companies offer cash discounts on the gross sales price. Cash discounts specify that an amount of cash less than the gross sales price is sufficient to satisfy the obligation.

**cash equivalent** Cash equivalents are securities that can be converted into cash in a very short time. Examples include commercial paper and other debt instruments with maturity dates less than three months in the future. Such items are often included in the definition of cash for purposes of the balance sheet and the statement of cash flows.

**cash flow** Cash flow is the movement of cash associated with a company's operating, investing, and financing activities. Cash flow involves inflows and outflows of cash, and a company's cash flow is considered to be strong if it can generate large amounts of cash relatively quickly. Cash flow is an important part of solvency, and a historical description of cash flow is provided by the statement of cash flows.

**cash flow accounting** Cash flow accounting is a system that keeps a balance of cash and a record of cash inflows and outflows. The statement of cash flows is based on cash flow accounting.

**cash flow from financing** Cash flow from financing activities represents cash generated during a particular period through a company's financing activities. These cash flows are disclosed in the financing section of the statement of cash flows and reflect cash flows associated with additional long-term borrowings and repayments, equity issuances and treasury stock purchases, and dividend payments.

**cash flow from investing** Cash flow from investing activities includes cash inflows and outflows during a particular period from a company's investing activities. These flows are disclosed in the investing section of the statement of cash flows and reflect cash inflows and outflows associated with the acquisition and sale of a company's investments and long-lived assets.

**cash flow from operations** Cash flows from operating activities include cash receipts and payments during a particular period associated with a company's operating activities. Also called net cash flow from operations, these flows are disclosed in the operating section of the statement of cash flows and can be computed and presented in either of two ways: (1) a direct method, which lists the cash flow effects of each income statement item, or (2) the more common indirect method, which arrives at cash from operations by adjusting net income for differences between accruals and operating cash flows.

**cash flow projection** Cash flow projection is the process of predicting the amount and timing of future cash inflows and outflows and plays an important role in financial statement analysis.

**cash management** Cash management is the manner in which a company plans and executes the inflows and outflows of cash.

**certificate of deposit** A certificate of deposit is a short-term bank obligation that pays a given rate of interest for a specified period of time, ending on the maturity date. Often interest penalties are assessed when cash is withdrawn prior to the maturity date.

**certified public accountant** A certified public accountant (CPA) is an individual who has met a set of educational

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


requirements to sit for the national CPA exam, passed the exam, and met the experience requirements of the states in which he or she practices. Certified public accountants must also pass an ethics exam, periodically participate in continuing education courses, and maintain their membership with the American Institute of Certified Public Accountants (AICPA). CPAs are empowered to sign audit reports.

**classified balance sheet** A classified balance sheet is a balance sheet that is divided into classifications—including current assets, long-term investments, fixed assets, intangible assets, current liabilities, long-term liabilities, and shareholders' equity.

**clean audit opinion** See **standard audit report.**

**collateral** Collateral represents assets designated to be paid to a creditor in case of default on a loan by a debtor—often referred to as security on the loan. The balance sheet, which contains a listing of a company's assets, and the footnotes to the financial statements may help to identify various sources of collateral. Lenders often require that loans be backed by collateral, as a way of reducing the cost associated with default.

**collection period** See **accounts receivable turnover.**

**commercial paper** Commercial paper is a fast-growing means of providing short-term financing; it represents short-term notes (30 to 270 days) issued for cash by companies with good credit ratings to other companies.

**common equity leverage** (*Net income* − *Preferred stock dividends*)/(*Net income* − *Interest expense* [*1* − *Tax rate*]). Common equity leverage measures the portion of the return to the stockholders relative to the return to all capital providers (stockholders and creditors). Higher levels of this ratio indicate that greater amounts of the return generated by the company are available to the stockholders, an indication of the effectiveness of the company's leverage.

**common stock** Common stock is a certificate that represents an ownership (equity) interest in a corporation, carrying with it the right to receive dividends if they are declared and the right to vote for the corporation's board of directors at the annual shareholders' meeting. It also carries with it the right to the assets of the corporation, but this right is subordinate to that of the corporate creditors. Issuing common stock is a popular way used by corporations to raise capital.

**common-size financial statements** Common-size financial statements express dollar values as percentages of other dollar values on the same statement. On a common-size income statement, for example, expense items and the various measures of income (e.g., operating income, net income) are expressed as percentages of sales. On a common-size balance sheet, assets and liabilities are expressed as percentages of total assets (or liabilities plus shareholders' equity).

**compensating balance** Compensating balances are minimum cash balances that must be maintained in savings or checking accounts until certain loan obligations are satisfied. Compensating balances help financial institutions reduce the risks of default on outstanding loans by ensuring that at least some cash is available for scheduled loan payments.

**compensation committee** The compensation committee is a subcommittee of the board of directors charged with establishing the compensation packages of the company's officers. It is made up entirely of outside directors (not part of company management).

**compensation contracts** Compensation contracts specify the form and amount of compensation paid to the executives, managers, or employees of a company.

**comprehensive income** A measure of income that includes not only net income, but also other increases in a company's wealth not reflected on the income statement. Examples include unrealized price changes on available-for-sale securities and translation gains and losses related to the consolidation of foreign subsidiaries. A statement of comprehensive income, detailing the change in comprehensive income over a period of time, must be included in the financial statements.

**conservatism** Conservatism is an exception to the principles of accounting measurement stating that when in doubt, financial statements should understate assets, overstate liabilities, accelerate the recognition of losses, and delay the recognition of gains.

**consignment** A consignment is an agreement by which a consignor (owner) transfers inventory to a consignee (receiver) who takes physical possession and places the items up for sale. When the inventory is sold, the consignee collects the sales proceeds, keeps a percentage, and returns the remainder to the consignor.

**consistency** Consistency is a principle of accounting measurement stating that, although there is considerable choice among accounting methods, companies should choose a set of methods and use them from one period to the next. Consistency helps financial statement users to make useful comparisons across time.

**consolidated financial statements** Consolidated financial statements include a company's assets and liabilities as well as the assets and liabilities of its majority-owned subsidiaries. See **business acquisition and merger.**

**contingency** A contingency represents an existing condition, situation, or set of circumstances involving uncertainty concerning a possible gain or loss to a company. The uncertainty will ultimately be resolved when one or more future events occurs or fails to occur.

**contingent liability** See **contingency** and **loss contingency.**

**contra account** A contra account is a balance sheet account that offsets another balance sheet account.

**contributed capital** Contributed capital represents that portion of the shareholders' equity section of the

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


balance sheet of a corporation, reflecting contributions from stockholders. It represents the amount of a company's assets that have been generated through issuances of stock (common and preferred), including the dollar amounts of both the stock and additional paid-in capital accounts. Treasury stock purchases reduce contributed capital because they represent returns of capital to the shareholders.

**controlling interest** Technically, a controlling interest is ownership of 51 percent or more of the outstanding voting stock of a company. In such cases, consolidated financial statements must be prepared. Control may be possible, however, with less than 51 percent of the stock. A significant influence on either the board of directors or operations of the company, especially in cases where the remaining ownership is spread across many entities, may also represent control.

**convertible bonds** Convertible bonds are bonds that can be converted to other corporate securities (usually common stock) during some specified period of time. Convertible bonds combine the benefits of a bond (guaranteed interest) with the privilege of exchanging it for stock (potential appreciation and dividends) at the holder's option. They are considered hybrid securities because they possess features of both debt and equity.

**copyright** Copyrights are exclusive rights granted by law to control literary, musical, or artistic works. They are granted for fifty years beyond the life of the creator. The cost of acquiring a copyright is capitalized on the balance sheet as an intangible asset and normally amortized over its legal life, not to exceed forty years.

**corporate governance** Mechanisms that encourage management to report in good faith to—and act in the interest of—the stockholders. Effective corporate governance is critical for an effective financial reporting system. Components of corporate governance include financial information users and capital markets, contracts between management and debt and equity investors, financial reporting regulations and standards, independent auditors, boards of directors and audit committees, internal controls ensuring that the company is in compliance with financial reporting regulations, legal liability, professional reputation, and ethics.

**corporation** A corporation is a legal entity, separate and distinct from its owners (stockholders), who annually elect a board of directors, which in turn represents the stockholders' interests in the management of the business. A corporation has an indefinite life, which continues regardless of changes in ownership. Stockholders of a corporation are usually free to transfer their ownership interests. In a corporation, the liability of the stockholders is limited to the dollar amount of their investments, and in this way, the corporate structure provides a shield that protects the personal assets of the shareholders from corporate creditors. Companies in need of large amounts of capital therefore normally take the corporate form.

**cost** See **historical cost.**

**cost expiration** Cost expiration is the process of converting a capitalized cost to an expense. Accounting entries recorded at the end of the period are often used to expire previously capitalized costs, which appear as assets on the balance sheet.

**cost method** Under the cost method of accounting, assets are carried on the balance sheet at their original (historical) costs, and when an asset is sold, a gain or loss is recognized on the difference between the balance sheet value of the asset and the proceeds from the sale.

**cost of capital** If a company has available cash, cost of capital is the expected return forgone by investing the cash in a project rather than in comparable financial securities. If a company does not have available cash, it is the cost of acquiring the cash—i.e., the cost of raising debt (effective interest) capital or the cost of raising equity capital (dilution). Value is created for the shareholders when the management of operations and investments creates a return that exceeds the cost of capital.

**cost of debt** Because interest is tax deductible, the explicit cost of debt is equal to the annual debt-related interest expense times 1 minus the income tax rate (interest expense × [1 – tax rate]). Debt may have implicit costs as well, including covenant-imposed restrictions and security (collateral) requirements.

**cost of equity** The return an investor can reasonably expect on an equity investment in a firm, or the return (expressed as a percentage) forgone by a firm's shareholders, who have chosen to invest their funds in the firm instead of other equally risky investments. It can be estimated by the capital asset pricing model. Value creation, the key metric of management's success, is defined as the extent to which return on equity exceeds the cost of equity.

**cost of goods sold** Cost of goods sold appears on the income statement, indicating the cost of inventory sold during the period. In retail companies, cost of goods sold consists primarily of the cost of acquiring the inventory; in manufacturing companies, cost of goods sold consists of material, labor, and overhead costs.

**covenant** See **debt covenant.**

**CPA** See **certified public accountant.**

**credit quality** Credit quality refers to the likelihood that an individual or entity will pay an outstanding account in a timely manner. Customers or clients with high credit quality have a history of paying their obligations on time.

**credit rating** A credit rating is an assessment by an independent agency of the risk associated with a company and especially its outstanding debts. Credit ratings are usually expressed in alphabetic and/or numerical grades (e.g., AA1), and credit-rating agencies include

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


Standard & Poor's, Dun & Bradstreet, and Moody's Investors Service.

**credit terms** Credit terms are the contractual terms associated with outstanding credit (accounts receivable and accounts payable) accounts.

**creditor** A creditor is an individual or entity to which a company owes money or services or to which the company has an outstanding debt.

**cumulative preferred stock** Cumulative preferred stock is a type of preferred stock with a cumulative feature, which means that when a company misses a dividend on cumulative preferred stock, the missed dividend becomes a dividend in arrears. Most preferred stock is cumulative.

**current assets** Current assets are assets on the balance sheet expected to be converted to cash or expired in one year or the operating cycle, whichever is longer.

**current cost** See **replacement cost.**

**current liabilities** Current liabilities refers to obligations listed on the balance sheet expected to be paid with the use of current assets listed on the balance sheet.

**current maturity of long-term debts** Current maturity of long-term debts is a balance sheet current liability representing that portion of a long-term liability due in the current period. This liability is expected to require the use of current assets.

**current ratio** *Current assets/Current liabilities.* The current ratio is often used to assess a company's current asset management and its solvency position. It is normally an important part of financial statement analysis.

# D

**debenture** A debenture is an unsecured bond.

**debt** Debt is a form of financing a borrowing that involves an obligation, stated in a formal contract, which indicates the time period of the obligation in addition to the amount and timing of the required cash payments. Often, the contract also identifies security (collateral) in the case of default and other provisions (debt covenants) normally designed to protect the interests of the lender.

**debt covenant** A debt covenant is an agreement between a company's debtholders and its managers that often restricts the managers' behavior. These restrictions are usually designed to protect the debtholder's investment (i.e., increase the likelihood of receiving the contractual debt payments on a timely basis), and they are often written in terms of numbers and ratios taken from the financial statements. Violating a debt covenant puts the issuing company (debtor) into technical default.

**debt investment** A debt investment involves the purchase of a debt security or a loan of goods or services to another entity, with the expectation that some payment (principal and interest) will be received in return. Debt investments are usually backed by contracts that specify the terms of the arrangement—maturity date interest and principal payments, security, and collateral as well as other features that transfer risk from one party to the other (e.g., debt covenants, call provisions).

**debt ratio** *Total liabilities/Total assets.* Assets are generated from three sources: borrowings, contributions from owners, and profitable operations not paid out in the form of dividends. The debt ratio reflects that portion provided by borrowings.

**debt redemptions** See **redemption.**

**debt/equity ratio** *Total liabilities* (*both current and noncurrent*)/*Shareholders' equity.* (*Note: Sometimes contractual debt only is used in the numerator.*) The debt/equity ratio indicates the extent to which a company can sustain losses without jeopardizing the interests of its creditors. Creditors have priority claims over stockholders, and in case of liquidation, the creditors have first right to a company's assets. From an individual creditor's standpoint, therefore, the amount of equity in the company's capital structure can be viewed as a buffer, helping to ensure that there are sufficient assets to cover individual claims. It also represents a measure of the extent to which a company is relying on leverage as a source of financing.

**default** A default occurs when an individual or entity fails to make a contractual payment on a debt. See **technical default.**

**deferred cost** A deferred cost is a miscellaneous category of assets listed on the balance sheet that often includes prepaid expenses extending beyond the current accounting period and intangible assets such as organizational costs, capitalized legal fees, and other startup costs.

**deferred income** See **deferred revenue.**

**deferred income taxes** Deferred income taxes can appear in either the liability or asset section of the balance sheet—arising when companies recognize revenues and expenses for financial reporting and income tax purposes in different time periods. Deferred income tax liabilities (assets) arise in periods when temporary timing differences between tax and financial reporting cause taxable income to be different from net income on the income statement. Deferred tax liabilities (assets) represent expected increases (decreases) in taxes payable in future periods when these temporary timing differences reverse—at which time the deferred income tax liabilities (assets) are written off the books.

**deferred revenue** Deferred revenue is a balance sheet liability reflecting services yet to be performed by a company for which cash payments have already been collected. Deferred revenues are also referred to as payments in advance, deferred income, and unearned revenues.

**defined benefit pension plan** In a defined benefit pension plan, an employer promises to provide each employee

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


with a specified benefit at retirement. This promise is difficult to plan for because the benefits are received by the employees in the future. The benefits must be predicted, and the employer must contribute enough cash to a pension fund so that the contributions plus the earnings on the fund assets will be sufficient to provide the promised benefits. See **defined contribution pension plan.**

**defined contribution pension plan** In a defined contribution pension plan, an employer agrees only to make a series of contributions of a specified amount to a pension fund. These periodic cash payments are often based on employee wages or salaries, and each employee's percentage interest in the total fund is determined by the proportionate share contributed by the employer on the employee's behalf. Under this type of plan, the employer makes no promises regarding how much the employees will receive upon retirement.

**depletion** Depletion is the amortization of the costs incurred to acquire rights to mine natural resources. For mining and oil and gas companies, such costs can be substantial, and these costs are normally depleted as the natural resource is extracted, using the activity method.

**depreciation** Depreciation is the periodic allocation of the cost of a fixed asset to the income statement over the asset's useful life. Such allocation is necessary if the costs are to be matched against the benefits produced by the asset. For financial reporting purposes, management has much discretion over how depreciation is computed. For income tax purposes, there is much less leeway.

**depreciation base** The depreciation (amortization) base is the portion of the cost of a long-lived asset subject to depreciation or amortization—capitalized cost less estimated salvage value.

**depreciation expense** A depreciation expense is an item on the income statement, reducing net income, that reflects the depreciation recognized on a company's fixed assets during the period of time covered by the income statement. Depreciation is a cost expiration; it does not represent a cash outflow.

**diluted earnings per share** Diluted earnings per share is a disclosure required by generally accepted accounting principles (GAAP) for companies that have the potential for significant dilution. This ratio, which must be disclosed on the face of the income statement, is computed by adjusting the earnings per share ratio for an estimate of the equity securities likely to be issued in the near future. Diluted earnings per share is less than earnings per share because the potential for additional equity issuances increases the denominator of the earnings per share ratio.

**dilution** Dilution is the reduction in a stockholder's relative ownership interest due to the issuance of additional equity securities to others.

**dilutive securities** Dilutive securities are outstanding securities that can lead to future equity issuances. Shareholders and potential shareholders should be aware of dilutive securities because when the options on dilutive securities are exercised, the equity positions of the existing shareholders are diluted. Examples include stock options and convertible bonds. Fully diluted earnings per share, which is a required disclosure under generally accepted accounting principles (GAAP), reflects the dilutive effects of these kinds of securities.

**direct method** Under the direct method of presentation in the operating section of the statement of cash flows, the cash effects of the operating expenses are subtracted from the cash effects of the operating revenues in the computation of net cash from operating activities. This form of presentation is called the direct method because the cash inflows and outflows are taken directly from the cash account in the ledger— that is, they represent real cash flows.

**direct write-off method** The direct write-off method of accounting for bad debts records bad debt expense and removes the outstanding receivable from the balance sheet at the point in time when a specific account is deemed uncollectible. This method of accounting for bad debts is normally considered unacceptable under generally accepted accounting principles (GAAP) because it does not attempt to record all expected bad debts in the same period in which the sales revenue is recorded, thereby violating the matching principle.

**discount on bond payable** Discount on bond payable is a contra liability account representing the amount by which the face (maturity) value of a bond exceeds the present value of the bond's future cash payments, discounted at the effective rate of interest as of the date when the bonds were issued. Such discounts are amortized over the remaining life of the bond issuance under the effective interest method, increasing periodic interest expense to reflect the fact that the bonds were issued at a discount (i.e., the proceeds at the initial bond issuance were less than the face value of the bond).

**discount rate** Discount rate is used to describe the rate used in present value computations. To compute the present value of a future cash flow, for example, the cash flows are discounted at the discount rate, which reflects both the timing of the cash flows and the risk associated with receiving them. In this sense, the discount rate reflects the company's cost of capital—the cost of its debt and/or its equity.

**dissimilar asset** Dissimilar asset is a classification of long-lived assets used in determining the proper method of accounting for long-lived asset exchanges. The methods used to account for exchanges of dissimilar assets are different from those used to account for exchanges of similar assets. When dissimilar

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


assets are exchanged, book gains or losses are recognized on the transactions—in the amount of the difference between the market value of that received and the market value of that given up. When similar assets are exchanged, book gains or losses are not recognized. Instead, the difference between the market value of that received and the market value of that given up serves to adjust (increase or decrease) the cost of the asset received in the exchange. See **trade-in.**

**divestiture** A divestiture is the sale of an asset or investment and normally refers to the sale of a major equity interest in another company.

**dividend yield** *Dividends per share/Market price per share.* Dividend yield indicates the cash return on the stockholders' investment. Recall that a return on an investment in common stock can come in two forms: dividends and market price appreciation. This financial ratio measures the size of the first. Dividend yields tend to be relatively small, especially for fast-growing companies that choose to pay little or no dividends.

**dividends** Dividends are payments made to the stockholders of a corporation that provide a return on their equity investments. Dividends are declared by the board of directors and are normally paid in the form of cash, although dividends in the form of other assets and shares of stock in the company are not unusual.

**dividends in arrears** Dividends in arrears are missed dividends on preferred stock with a cumulative feature. Dividends in arrears are not listed on the balance sheet as liabilities, but they must be disclosed in the footnotes to the financial statements, and they must be paid if and when the company declares a dividend.

**double taxation** Double taxation is a phenomenon that occurs when corporate profits and dividends received by the shareholders are both subject to federal income taxes. Double taxation occurs because the Internal Revenue Service treats corporations and their shareholders as separate taxable entities. It is a major disadvantage of the corporate form of business.

**double-declining-balance method** Double-declining-balance is the most extreme form of accelerated depreciation. Each period, depreciation expense is computed by multiplying the book value of the depreciable asset (cost − accumulated depreciation) by two times the straight-line rate (1/estimated useful life). This conservative method recognizes large amounts of depreciation expense in the early periods of the asset's life and small amounts in the later periods. It is very popular for tax purposes.

**DuPont (ROE) Model** Using the DuPont (ROE) Model to analyze financial ratios provides an important starting point for financial statement analysis. While there are a number of different forms of this model, all are designed to explain the changes in return on equity by breaking it down into the following components: profit margin, asset turnover, and leverage.

# E

**earned capital** Earned capital is a measure of the amount of a company's assets that has been generated through profitable operations and not paid out in the form of dividends. On the balance sheet, earned capital is part of the shareholders' equity section and is composed of retained earnings and other accumulated comprehensive income.

**earning power** Earning power is the ability of a company to generate profits and increase net assets in the future. Net income, especially the persistent components of net income, is considered an indication of earning power.

**earnings** See **net income.**

**earnings management** The expression "earnings management" refers to cases when management uses its discretion to produce financial statements that place management's performance in a particular light, often reducing the ability of the financial statements to fairly represent the financial performance and condition of the company. Earnings management can involve reporting discretion or the structuring of transactions to achieve certain reporting goals (called real earnings management).

**earnings per share** *Net income/Average number of common shares outstanding.* Earnings per share or basic earnings per share is perhaps the best known of all financial ratios, largely because it is often treated by the financial press as the primary measure of a company's performance. According to generally accepted accounting principles (GAAP), earnings per share must appear on the face of the income statement and be calculated in accordance with an elaborate set of complex rules. See **diluted earnings per share.**

**earnings persistence** Earnings persistence is the extent to which a particular earnings dollar amount can be expected to continue in the future and thus generate future cash flows. Earnings amounts with high levels of persistence are expected to continue in the future, while those with low levels of persistence are not.

**earnings quality** Earnings quality refers to the extent to which net income reported on the income statement differs from true earnings. This difference is the result of two factors: (1) financial reports based on an objective application of generally accepted accounting principles (GAAP) are inherently limited and (2) management uses its subjective discretion to apply GAAP when preparing the statements (earnings management). Low earnings quality means that GAAP financial statements do not accurately reflect the company's true financial situation and/or management has used much of its discretion in preparing the financial statements.

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


**economic entity assumption** The economic entity assumption states that the financial statements refer to entities that are distinct from both their owners and all other economic entities. This assumption is important in determining the methods to account for consolidated financial statements, investments in equity securities, and business segments.

**economic value added** Economic value added (EVA) represents the extent to which a return generated by management exceeds the cost of the capital (debt and equity) invested to generate that return. See value creation.

**effective interest method** The effective interest method is used to value long-term liabilities (e.g., bonds) and long-term notes receivable and the related interest charges, so that the book value of the note represents an estimate of the present value of the note's future cash flows. The future cash flows are discounted using the effective rate of interest as of the date the note was issued. The effective interest method is required under generally accepted accounting principles (GAAP).

**effective interest rate** The effective rate of interest is the actual rate of interest on an obligation or receivable, and it often differs from the stated interest rate. It is that rate which, when used to discount the future cash payments associated with the obligation or receivable, results in a present value equal to the fair market value of that which was initially exchanged for the obligation or receivable. Generally accepted accounting principles (GAAP) require that the effective interest rate be used to compute the periodic interest expense and revenue that appears on the income statement.

**equity** Equity is an ownership interest. Equity holders in a company own common stocks that have been issued by that company. Two rights are associated with owning a common stock: (1) the right to vote for the board of directors at the annual shareholders' meeting and (2) the right to receive dividends if they are declared by the board. The shareholders' equity section of the balance sheet represents the investment made by the equity holders in the company and is a measure of the assets that would remain for the equity holders after all liabilities have been paid.

**equity investment** An equity investment is the purchase of an ownership interest (e.g., common stock) in a company.

**equity issuance** An equity issuance is the sale of common shares (stock). Equity issuances raise funds—often large amounts—for a variety of reasons, including business acquisitions, investments in long-lived assets, payments on outstanding debt, or simply to support operations.

**equity method** The equity method is used to account for equity investments in the amount of 20 to 50 percent of the investee company's outstanding common (voting) stock. Such a significant influence on the investee company indicates a substantive economic relationship between the two companies and may also be evidenced, for example, by representation on the board of directors, the interchange of management personnel between companies, frequent or significant transactions between companies, or the technical dependency of one company on the other.

**equity security** See **equity investment.**

**ERISA** The Employment Retirement Income Securities Act passed by Congress in 1974 requires employers to fund their pension plans at specified minimum levels and provide other safeguards designed to protect employees. See **defined benefit pension plan.**

**escrow** Escrow is the state of an item (e.g., cash) that has been put into the custody of a third party until certain conditions are fulfilled. Damage deposits on rental agreements, for example, are often held in escrow until the end of the rental period.

**exchange rate** The exchange rate is the value of one currency expressed in terms of another currency. Like the prices of all goods and services, the exchange rates among currencies vary from one day to the next. Companies that transact in more than one currency face the risks associated with fluctuating exchange rates, which can give rise to gains and losses—some of which are reflected on the financial statements. Hedging is a strategy that can be used to reduce such risks.

**expense** An expense is the outflow of assets or the creation of liabilities in an effort to generate revenues for a company. Examples include cost of goods sold, salaries, interest, advertising, taxes, utilities, depreciation, and others. Revenues less expenses is equal to net income—the income statement. While some expenses involve cash outflows, many do not; expenses can also be accrued (e.g., salaries, wages, interest) or the result of cost expirations (e.g., depreciation, amortization).

**expensed** Expensed means to treat an expenditure as an expense by running the account through the income statement and closing it to retained earnings. Expense items appearing on the income statement have been expensed.

**external financing** External financing refers to the generation of funds to support operations and growth through the issuance of debt and/or equity, instead of retained earnings. Externally financed companies normally have capital structures with relatively large balances in debt and/or contributed capital.

**extraordinary item** Extraordinary items appear on the income statement and represent the financial effects of events that are significantly different from the typical, customary business activities of an entity. Such events are not expected to recur frequently in the ordinary activities of the business. Extraordinary items are neither usual nor frequent.

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


# F

**face value** See **maturity value.**

**fair market value** Fair market value is the dollar amount at which an item can be sold—exchanged for cash.

**fair market value accounting** Fair market value accounting is a method of accounting for an asset or liability that carries the asset or liability on the balance sheet at its fair market value, and changes in price from one period to the next either directly affect shareholders' equity (other comprehensive income) or are reported on the income statement and ultimately are reflected in retained earnings.

**fair value option** Fair value option is a relatively recent U.S. reporting standard that allows companies to use fair market value accounting for their financial instruments.

**fees earned** See **service revenue.**

**financial accounting** Financial accounting is a process through which managers report financial information about an economic entity to a variety of individuals who use this information for various decision-making purposes. The financial accounting process produces the financial statements and the associated footnotes.

**financial accounting standards** In the U.S., financial accounting standards represent the official statements of the Financial Accounting Standards Board (FASB) and its predecessor bodies as well as the official statements from the Securities and Exchange Commission (SEC). The complete set of financial accounting standards currently in force comprises U.S. generally accepted accounting principles (GAAP). Many non-U.S. countries have their own financial accounting standards, and International Financial Accounting Standards (IFRS) are also used by many non-U.S. firms. IFRS are established by the International Accounting Standards Board (IASB), successor to the International Accounting Standards Committee (IASC), which was formed in 1973 to develop worldwide accounting practices. The IASC's pronouncements are known as International Accounting Standards (IAS).

**Financial Accounting Standards Board** The Financial Accounting Standards Board (FASB) is the professional body currently responsible for establishing financial accounting standards. The FASB consists of seven well-compensated, full-time individuals who have severed all ties with previous employers and represent many business backgrounds. Since 1973, this private-sector body has issued well over 100 statements of financial accounting standards, covering a wide variety of topics.

**financial condition** Financial condition refers to the economic strength of a company as of a specific point in time. The balance is designed to measure financial condition.

**financial flexibility** Financial flexibility refers to a company's capacity to raise cash through methods other than operations. Examples include short- and long-term borrowings, issuing equity, or selling assets. Financially flexible companies can readily borrow, issue equity, and/or sell liquid assets that are not essential to their operations.

**financial performance** Financial performance refers to the economic success of a company over a specified time period. The income statement is designed to measure financial performance.

**financial ratio analysis** Financial ratio analysis is one of several techniques used to analyze financial statements in an effort to assess earning power, solvency, and earnings persistence. Financial ratio analysis involves computing and analyzing ratios that use two or more financial statement numbers. These ratios are often divided into five categories: (1) profitability, (2) solvency, (3) activity, (4) capitalization, and (5) market ratios. The DuPont (ROE) Model is used by many analysts to asses the determinants of return on equity (ROE), which is directly related to shareholder value creation (ROE – cost of equity).

**financial statement analysis** Financial statement analysis is the process of reading, studying, and analyzing the information contained in the annual report and other relevant documents to predict the future financial performance and condition of a company. Financial statement analysis involves assessing (1) earning power, (2) solvency, (3) earnings persistence, and (4) earnings quality.

**financial statements** Financial statements are a summary of the financial condition and performance of a company, prepared by its management and in some cases reviewed by independent auditors. The financial statements consist of the income statement, balance sheet, statement of cash flows, statement of shareholders' equity, and related footnotes. The ability to read, understand, and interpret the financial statements is a key element of financial statement analysis.

**financing activities** Financing activities are the activities of a company that affect its capital structure. They involve the collection of capital through equity or debt issuances and any related payments such as dividends, debt payments, and treasury stock purchases.

**financing cost** Financing cost is an expression used to describe the cost of financing an activity. It includes the cost of debt and the cost of equity. See **cost of capital, cost of debt**, and **cost of equity.**

**first-in, first-out** First-in, first-out (FIFO) is a cost flow assumption used to value inventory and cost of goods sold. It assumes that the first items purchased are the first items sold. FIFO is one of three commonly used cost flow assumptions; last-in, first-out (LIFO) and averaging are the other two.

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


**fiscal period assumption** The fiscal period assumption states that the life of an economic entity can be divided into fiscal periods and that performance can be measured over those periods. This assumption allows the measurement of income for a given period of time (quarterly or annually) and raises questions about how the benefits and costs of a company should be allocated across periods for financial accounting purposes.

**fiscal year** Fiscal years end on dates other than December 31. Most companies report on a calendar-year (December 31) basis (e.g. seasonality), but for various reasons, some companies report on other 365-day cycles, called fiscal years.

**fixed asset turnover** *Net sales/Average fixed assets.* Fixed asset turnover is a measure of how efficiently a company is using its fixed assets. For many companies, this activity ratio is an important component of asset turnover and, in general, financial ratio analysis. Asset turnover times profit margin equals return on assets, a direct determinant of return on equity.

**fixed assets** Fixed assets, sometimes called property, plant, and equipment, is a category of long-lived assets including buildings, machinery, and equipment.

**FOB destination** FOB (free on board) destination represents freight terms indicating that the seller is responsible for the sold merchandise until it is received by the buyer. Goods shipped FOB destination are considered owned by the seller until they reach their destination. See **FOB shipping point.**

**FOB shipping point** FOB (free on board) shipping point describes freight terms indicating that the seller is responsible for the sold merchandise only to the point from where it is shipped. Goods shipped FOB shipping point are considered owned by the seller until they reach the designated shipper, at which time they become the responsibility of the buyer. See **FOB destination.**

**footnotes** Footnotes are descriptions and schedules included in the annual report that further explain the numbers on the financial statements. The footnotes are audited by the independent auditor, and they are considered part of the financial statements.

**forward contract** A forward contract enables the holder to buy or sell an asset or liability at a future date at a prespecified price. Forward contracts are also written to enable the holder to buy or sell currencies at a prespecified exchange rate. Companies enter into forward contracts often to hedge the risks of holding assets and/or liabilities denominated in foreign currencies.

**freight-in** Freight-in, also called transportation-in, is the freight cost associated with purchased inventory.

**frequent transactions** A frequent transaction is an operating transaction that affects the income statement and is expected to recur repeatedly in the foreseeable future. See **extraordinary item.**

## G

**gain contingency** A gain contingency refers to an event that leads to a possible future outcome involving an increase in assets or a decrease in liabilities. See **loss contingency.**

**generally accepted accounting principles** Generally accepted accounting principles (GAAP) are the standards that guide the preparation of financial accounting statements. See **financial accounting standards, U.S. GAAP,** and **international financial reporting standards (IFRS).**

**going concern** A going concern is an entity that is expected to exist into the foreseeable future. No financial problems indicating financial failure over the planning horizon are apparent. Going concern is an assumption that underlies the financial statements, and auditors are expected to qualify their audit reports if there is doubt about the ability of the audited company to continue as a going concern.

**goods in transit** Goods in transit are between the buyer and the seller as of the end of an accounting period. See **freight-in, FOB destination,** and **FOB shipping point.**

**goodwill** In general, goodwill often refers to items of value to a company that are not listed on the balance sheet. However, a goodwill account is often recognized on the balance sheet when a company purchases another company in a business acquisition for a dollar amount greater than the fair market value of the purchased company's net assets (assets – liabilities). This purchased goodwill is the difference between the purchase price and the fair market value of the purchased company's net assets; it represents the purchaser's assessment that the purchased company is worth more as a working unit than is indicated by the value of its individual assets and liabilities.

**government accounting** See **nonprofit entity** and **not-for-profit accounting.**

**gross margin** *Gross profit/Sales.* Gross margin measures the extent to which the selling price of sold inventory exceeds its cost.

**gross profit** Gross profit is equal to sales revenues minus cost of good sold. See **gross margin.**

## H

**hedging** Hedging is a strategy used by management to reduce the risk associated with fluctuations in the values of assets and liabilities.

**hidden reserves** Hidden reserves refer to subjectively understated assets or overstated liabilities. Building hidden reserves is a reporting strategy used by management that allows it to "smooth" reported earnings from one period to the next. It is accomplished by subjectively recognizing accounting losses, normally in periods of high income, which reduces earnings in the

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


current period and ensures that these losses are not recognized in future periods when reported earnings may be lower.

**historical cost** Historical cost is the dollar amount incurred to acquire an asset (investment) or bring it to sellable (inventory) or serviceable (long-lived asset) condition. Historical cost is also referred to as original cost or cost.

**human capital** Human capital refers to a company's human resources, including its workforce and management.

**human resources** See **human capital.**

**hurdle rate** See **cost of capital.**

**hybrid security** Hybrid securities have characteristics of both debt and equity. Issuing these securities is becoming an increasingly popular means of corporate financing.

# I

**income** See **net income.**

**income smoothing** Income smoothing is an expression used to describe a management practice where accounting discretion is used to maintain a smooth earnings stream across time. See **earnings management** and **hidden reserves.**

**income statement** The income statement is a financial statement, prepared on an accrual basis, indicating the performance of a company during a particular period (usually a quarter or a year). It consists of revenues minus expenses, leading to net income, an important indication of a company's earnings power.

**independent auditor** Independent auditors have no personal or financial interest in their clients. To ensure objective audits, the audit profession requires that auditors maintain complete independence from their clients when conducting audits.

**indirect method** Under the indirect method, the operating section of the statement of cash flows contains a series of adjustments that reconcile net income with net cash from operations. This form of presentation is called the indirect method because net cash from operating activities is computed indirectly—starting with net income and then adjusting it for the differences between accrual and cash flow accounting.

**industry** An industry is a classification of a group of companies based on the similarity of their operations, product lines, and/or customers. Three basic categories are manufacturing, retailing, and services (general and financial).

**inflation** Inflation refers to the eroding of the purchasing power of a monetary unit over time. In an inflationary environment, a dollar at the beginning of a period of time will buy fewer goods and services than at the end of the period.

**input market** The input market is where an entity purchases the inputs for its operations. Historical cost, which is used extensively on the balance sheet, represents the cost of a company's inputs (e.g., inventory and long-lived assets) when they were acquired previously. Replacement cost, which is used selectively on the balance sheet (e.g., lower of cost or market applied to inventory), represents the current cost of a company's inputs.

**installment obligation** An installment obligation requires periodic payments covering both interest and principal. Installment obligations are normally represented in the long-term liability section of the balance sheet, but the current installment is often carried as a current liability.

**intangible asset** Intangible assets are characterized by the rights, privileges, and benefits of possession rather than by physical existence. Also, they are normally considered to have a higher degree of uncertainty than tangible assets.

**intention to convert** Intention to convert is a phrase that describes one of the criteria by which an investment in a security is classified in the current assets section of the balance sheet. For an asset to be listed as current, management must intend and be able to convert the investment into cash within the time period that defines current assets.

**interest** Interest is the price, usually expressed as an annual percentage rate, associated with transferring (borrowing or lending) money for a period of time. See **stated interest rate, effective interest rate,** and **cost of debt.**

**interest coverage ratio** See **times interest earned.**

**interest-bearing obligation** Interest-bearing obligations are notes requiring periodic interest payments determined as a percentage of face value; notes with stated annual rates of interest greater than zero. Interest-bearing obligations differ from non–interest-bearing obligations, where no interest payments are made until the maturity date. Both interest- and non–interest-bearing notes (receivables and payables) are accounted for under the effective interest method.

**interest rate swaps** An interest rate swap is a contract that serves to exchange a fixed-interest obligation for interest payments at market rates. Such contracts are used to hedge the risk of holding fixed-interest debt. See **hedging.**

**internal control system** The internal control system consists of procedures and records designed and followed by company personnel to ensure that (1) the company's assets are adequately protected from loss or misappropriation and (2) all relevant and measurable economic events are accurately reflected in the company's financial statements.

**internal financing** Internal financing refers to the generation of funds to support operations and growth through profits instead of debt or equity capital. Internally financed companies normally have capital structures

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


with relatively large balances in retained earnings, usually a sign of financial strength.

**Internal Revenue Code** The Internal Revenue Code contains the official federal income tax laws. The Internal Revenue Service monitors and enforces adherence to these laws.

**Internal Revenue Service** The Internal Revenue Service is the government agency charged with monitoring and enforcing the payment of federal income taxes. See **Internal Revenue Code.**

**International Accounting Standards Board (IASB)** The IASB is a private-sector body, based in Britain and successor to the International Accounting Standards Committee, formed in 1973. The IASB, which represents over one hundred countries, has issued a number of international financial reporting standards (IFRS) recognized as acceptable financial reporting by many of the major stock exchanges in the world, and may soon be accepted by the U.S. Securities and Exchange Commission.

**international financial reporting standards (IFRS)** IFRS are the financial reporting standards issued by the International Accounting Standards Board. These standards are considered as acceptable reporting in most of the stock exchanges throughout the world, and may soon be accepted by the U.S. Securities and Exchange Commission.

**inter-period tax allocation** Inter-period tax allocation refers to the methods used to account for the timing differences that arise between tax and financial reporting across periods. It involves accounting for deferred income taxes.

**intra-period tax allocation** Intra-period tax allocation is the practice of disclosing the income tax effect of certain non-operating items on the income statement or statement of retained earnings with the item itself. The income taxes associated with operating income are disclosed on the income statement in a single line item immediately below operating income. The effects on income of non-operating items—such as disposals of segments, extraordinary items, changes in accounting principles, and prior-period adjustments—are disclosed on the financial statements net of their income tax effects.

**inventory** Inventory refers to items or products that are either available for sale in the normal course of business or support the operations of the business. See **merchandise inventory** and **supplies inventory.**

**inventory recovery** Inventory recovery is an expression used to describe an increase in the value of an inventory item that has previously been written down. The recovery can be no larger than the amount of the write-down. Inventory recoveries are recognized under IFRS, but not under U.S. GAAP.

**inventory turnover** *Cost of goods sold/Average inventory.* Inventory turnover measures the speed with which inventories move through operations. This activity ratio compares the amount of inventory carried by a company to the volume of goods sold during the period, reflecting how quickly, in general, inventories are sold. By dividing this ratio into 365 days, it can be converted to an expression indicating how many days it takes, on average, to turn over the inventory. For retail and manufacturing companies this ratio is an important component of asset turnover, which, when multiplied times profit margin, equals return on assets, a direct determinant of return on equity.

**investing activities** Investing activities involve the management of a company's long-term assets. The investment activities of a given period are summarized in the investing section of the statement of cash flows, involving primarily purchases and sales of fixed assets and investments in equity securities.

## L

**land** Land refers to real estate held for investment purposes, usually appearing in the long-term investments section of the balance sheet. Land used in the operations of a business is considered a long-lived asset and is normally referred to as property. Land is carried at historical cost on the balance sheet, not fair market value, and is normally not subject to depreciation.

**last-in, first-out** Last-in, first-out (LIFO) is a cost flow assumption used to value inventory and cost of goods sold. It assumes that the last items purchased are the first items sold. LIFO is one of three commonly used cost flow assumptions; FIFO (first-in, first-out) and averaging are the other two. See **LIFO conformity rule, LIFO liquidation,** and **LIFO reserve.**

**lease** A lease is a contract granting use or occupation of property during a specified period of time in exchange for some form of payment, usually cash. Leases are a popular way to finance business activities. Companies often lease, rather than purchase, land, buildings, machinery, equipment, and other holdings, primarily to avoid the risks and associated costs of ownership. For purposes of financial accounting, leases are divided into two categories: operating leases and capital leases.

**leasehold obligation** Leasehold obligations are the balance sheet liabilities associated with capital leases reported by the lessee. This liability is equal to the present value of the future payments associated with a capital lease, discounted at the effective interest rate existing at the original date of the lease. Leasehold obligations are listed on the balance sheet as long-term and are accounted for under the effective interest method.

**Level 1, 2, or 3 measurements** Because fair market values can be very subjective, an important disclosure that is required when a company uses market values on its balance sheet relates to the basis for the market

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


value estimate. Market values based on quoted prices in active markets for identical securities are called **Level 1 measurements;** market values based on less reliable, less observable, indirect inputs are called **Level 2 measurements;** and market values based on much less reliable, unobservable inputs are called **Level 3 measurements.** These disclosures help the reader to better assess the uncertainties inherent in the market value estimates.

**leverage** Leverage involves borrowing funds and investing them in assets that produce returns exceeding the after-tax cost of the borrowing. In such cases, a company is managing its debt effectively and creating benefits for the stockholders, which should manifest themselves as increases in return on equity. Leverage, however, involves the commitment of future cash outflows, which increases the risk associated with the leverage company.

**liability** A liability is a probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

**life of a bond** The life of a bond is the period of time from the issuance of the bond to the maturity date, at which time the face value is paid to the bondholders. See **bond.**

**LIFO conformity rule** The LIFO conformity rule is a federal income tax requirement stating that if a company uses the LIFO cost flow assumption to value inventory for tax purposes, it must also use the LIFO assumption when preparing its financial statements. Consequently, those companies that use LIFO to save taxes must report the LIFO cost of goods sold amount on the income statement—normally leading to lower reported net income values.

**LIFO liquidation** A LIFO liquidation occurs when companies that use the LIFO cost flow assumption have sales that exceed production. LIFO users must pay close attention to inventory levels because when inventory liquidations occur, abnormally high profits can be reported. This is due to matching inventory having old (often lower) costs against current revenues.

**LIFO reserve** The LIFO reserve is the difference between inventory reported under LIFO and inventory reported under FIFO. Under U.S. GAAP, companies that use LIFO are required to report what inventory would have been had they used FIFO. The difference between these two amounts (the LIFO reserve) represents the accumulated amount by which net income reported by the LIFO user has been understated, relative to FIFO, since the adoption of LIFO. The increase (decrease) in the LIFO reserve over the current period, when added to (subtracted from) LIFO net income for that period, is equal to FIFO net income (before taxes) for that period.

**line of credit** A line of credit is a borrowing arrangement granted to a company by a bank or group of banks, allowing it to borrow up to a certain maximum dollar amount, with interest being charged only on the outstanding balance.

**liquidation** Liquidation is the process of selling assets for cash. When companies go through liquidation, they normally sell their existing assets for cash, which is used to pay off creditors in order of priority. Any remaining cash is distributed to the stockholders. Liquidation is also used to describe an inventory reduction, where sales in a given period exceed inventory production or acquisition. See, for example, **LIFO liquidation.**

**liquidity** Liquidity is the speed with which an asset can be converted into cash. Assets on the balance sheet are listed roughly in order of liquidity. For example, current assets are considered to be more liquid than intangible assets. Of the current assets, cash is considered to be more liquid than accounts receivable, which is more liquid than inventory, which is more liquid than prepaid expenses.

**listed company** A listed company has its equity shares listed on a public stock exchange. See **stock market** and **stock price.**

**loan contract** A loan contract is a written agreement describing the terms of a borrowing arrangement, including the timing of cash payments (interest and principal), the maturity date, collateral (security) in case of default, and restrictions on the actions of management (called covenants).

**loan covenant** See **debt covenant.**

**long-lived assets** Long-lived assets are used in the operations of a business, providing benefits that extend beyond the current operating period. Examples include property, plant, and equipment and intangible assets.

**long-term debt** Long-term debt refers to obligations listed on the balance sheet, backed by formal contract, expected to be paid with the use of assets listed as noncurrent on the balance sheet. See **debt and liability.**

**long-term debt ratio** *Total long-term liabilities/Total assets.* The long-term debt ratio reflects that portion of assets provided by long-term borrowings.

**long-term investments** Long-term investments refer to assets on the balance sheet that are not intended to be sold in the near term, and are expected to generate benefits over a time period extending beyond that which defines current assets.

**loss** A loss occurs when the expenses of a given period exceed the revenues. Loss also refers to a situation where an item on the balance sheet is exchanged for something with a value lower than the item's book value.

**loss contingency** A loss contingency (or contingent loss) is an existing condition, situation, or set of circumstances

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


involving uncertainty concerning a possible loss to a company that will ultimately be resolved when one or more future events occurs or fails to occur. See **contingency** and **gain contingency.**

**lower-of-cost-or-market rule** Lower-of-cost-or-market is a rule applied to accounting for inventories, which states that the balance sheet value of inventory will be its historical cost or its market value, whichever is lower.

## M

**MACRS** The Modified Accelerated Cost Recovery System is the set of rules defining the maximum amount of depreciation that can be recognized on a fixed asset for the purpose of determining taxable income in a given year. To determine this amount, a fixed asset is placed into one of eight categories, based on its estimated useful life as specified in the Asset Depreciation Range (ADR) system. Each of the eight categories is then linked with an allowable depreciation method.

**maintenance expenditure** A maintenance expenditure is a post-acquisition expenditure that serves to repair or maintain a fixed asset in its present operating condition.

**management accounting** Management accounting systems produce information used for decisions within a company. Such systems produce reports that cover such areas as performance evaluation, production output, product costs, and capital budgeting. This information is not available to individuals outside the company.

**management discretion** Management discretion refers to the latitude exercised by management when applying accounting methods. Management can choose from a variety of accounting methods, estimates, and assumptions when preparing the financial statements and still be within the guidelines defined by GAAP. The financial statements are also influenced by the timing and execution of transactions planned in advance by management. By using its discretion in these ways, management can make choices that serve its own interest—choices that may or may not be in the best interest of the company's owners. This discretion also makes it difficult for analysts to ascertain a company's true financial condition and performance from the financial reports.

**management letter** The management letter appears in the annual report and normally states that management is responsible for the preparation and integrity of the financial statements. While management letters differ from one company to the next, most contain references to GAAP, ethical and social responsibilities, the quality and reliability of the company's internal control system, the independent audit, and the audit committee of the board of directors.

**manufacturing company** Manufacturing companies acquire raw materials and, through a process, combine labor and overhead to manufacture inventory. Manufacturing companies are normally characterized by large investments in property, plant, and equipment and inventory.

**margin** See **profit margin** and **gross margin.**

**mark-to-market accounting** Under mark-to-market accounting, investments are carried on the balance sheet at their market values. Realized gains and losses are recognized on the income statement, and unrealized gains and losses are either reflected on the income statement or in the shareholders' equity section of the balance sheet, depending on the classification of the investment. See **marketable securities.**

**markdown** A markdown is a reduction in sales price normally due to decreased demand for an item. Markdowns are very common in the retail industry, especially at the close of the seasons. These discounts are designed to accelerate sales of old items (boosting inventory turnover), making room for new inventories.

**market price** The market price is the price at which an asset can be exchanged in the open (output) market as of a particular point in time. See **fair market value** and **stock price.**

**market ratios** The market ratios are the financial ratios that measure returns to common stockholders due to changes in the market price of the common stock and the receipt of dividends.

**market share** Market share is the proportion of the total market for a particular good or service held by a company. For example, if the total market for boys' tennis shoes is $50 million per year and Company A sells boys' tennis shoes valued at $5 million in a given year, Company A has a 10 percent market share. Market share and changes in market share measure how well a company is competing with other firms in a given market.

**market value** See **market price** or **fair market value.**

**market-to-book ratio** (*Number of outstanding common shares* × *Market price per share*)/*Net assets.* The market-to-book ratio indicates the extent to which the market believes that shareholders' equity on the balance sheet reflects the company's true market value.

**marketable securities** Marketable securities are investments that are readily marketable and intended to be sold within the time period of current assets. They are carried on the balance sheet at current market prices. See **short-term investments.**

**matching principle** The matching principle is a measurement principle of financial accounting stating that performance is measured by matching efforts against benefits in the time period in which the benefits are realized. Net income on the income statement is the result of matching expenses against revenues in the time period when the revenues are realized. The matching principle

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


is applied by first recognizing revenues and then matching against those revenues the expenses required to generate them.

**materiality** Materiality is an exception to the principles of financial accounting stating that only those transactions dealing with dollar amounts large enough to make a difference to financial statement users need be accounted for in a manner consistent with GAAP. The dollar amounts of some transactions are so small that the method of accounting has virtually no impact on the decisions based upon information in the financial statements. Such transactions are referred to as immaterial, and management is allowed to account for them as expediently as possible.

**maturity date** The maturity date is the date when a loan agreement ends. As of the maturity date, if all payments (interest and principal) have been made on the loan, the associated debt is satisfied. For most bonds, the face value of the bond is paid to the holder on the maturity date.

**maturity value** The maturity value is the dollar amount written on the face of the note or bond certificate that is paid to the holder at the maturity date. Face value and par value are terms often used interchangeably with maturity value.

**measurement theory** Underlying the measurement of assets, liabilities, revenues, and expenses—the key components of the financial statements—is a theoretical framework consisting of assumptions, principles, and exceptions. The assumptions include economic entity, stable dollar, fiscal period, and going concern; the principles include objectivity, matching, revenue recognition, and consistency; and the exceptions include materiality and conservatism.

**merchandise inventory** Merchandise inventory represents items held for sale in the ordinary course of business. It is especially important to retail and manufacturing enterprises, whose performance depends significantly on their ability to market their inventory. Indeed, the demand for such companies' products is often the most important determinant of their success.

**merger** A merger is a business combination whereby two or more companies combine to form a single legal entity. In most cases, the assets and liabilities of the smaller company are merged into those of the larger company, and the stock of the smaller, merged company is retired.

**misclassification** Misclassification involves including a financial statement account in an inappropriate section of the financial statements.

**mortgage** A mortgage is a cash loan exchanged for an installment note that is secured by real estate. The mortgage gives the holder the right to take possession of the real estate in case of default.

**mortgage payable** A mortgage payable is a balance sheet account that indicates the outstanding obligation associated with a mortgage. Mortgage payables are included in the long-term liability section of the balance sheet, except for that portion expected to use assets presently listed as current. This portion is included as a current liability.

**multinational corporation** Multinational corporations have their home in one country but operate and have subsidiaries operating within and under the laws of other countries.

**multistep format** Under a multistep format, the income statement is designed in a way that separates cost of goods sold from operating expenses, highlighting gross profit. This format also separates usual and frequent operating items from those that are unusual and/or infrequent, often referred to as other revenues and expenses or extraordinary items.

## N

**natural resource cost** Natural resource costs are the costs of acquiring the rights to extract natural resources. Natural resource costs, which appear in the long-lived asset section of the balance sheet, are quite large in the extractive (e.g., oil, gas, mining) industries, and they are normally depleted under the activity (units-of-production) method.

**net assets** Net assets equals total assets minus total liabilities, or shareholders' equity. A company's net assets are also referred to as the company's book value, balance sheet value, and net worth.

**net book value** Net book value is the dollar value assigned to an item on the balance sheet. When used in reference to an entire company, net book value is equal to net assets or shareholders' equity. The net book value of a company is also referred to as simply the company's book value, balance sheet value, shareholders' equity, and net worth.

**net credit sales** Net credit sales is equal to gross sales on account less an estimate of sales returns and allowances.

**net earnings** See **net income.**

**net income** Net income is the difference between the revenues generated by a company in a particular time period and the expenses required to generate those revenues. Net income is the "bottom line" of the income statement.

**net of tax** To disclose an item net of tax on the income statement means to reduce its dollar value by the income tax effect associated with the item.

**net operating income** Net operating income is equal to the operating revenues minus operating expenses. It is also referred to as operating income.

**net profit** See **net income.**

**net realizable value** Net realizable value is the net cash amount expected from the sale of an item, usually equal to the selling price of the item less the cost to complete and sell it.

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


**net sales** Net sales is equal to gross sales less an estimate of sales returns and allowances.

**net worth** See **net assets** and **net book value.**

**non–interest-bearing notes** Non–interest-bearing notes are debt instruments that do not require periodic interest payments determined as a percentage of the face value; the entire interest amount is paid at maturity. Non–interest-bearing notes have stated annual rates of interest equal to zero, but the effective (actual) rate of interest is greater than zero.

**nonoperating items** Nonoperating items appear on the income statement below net operating income and are considered unusual and/or infrequent. Nonoperating items are considered less persistent than operating items.

**nonparticipating preferred stock** Nonparticipating preferred stock, a common form, carries the right—if dividends are declared—only to an amount designated by the dividend percentage expressed in the terms of the preferred stock. Unlike participating preferred stock, there is no right to an additional dividend.

**nonprofit entity** A nonprofit entity is an organization where the operations are not designed to make a profit. Rather, most nonprofit entities generate funds through contributions, user fees, or taxes and use these funds to achieve some organizational or social purpose. Nonprofit entities are also referred to as not-for-profit and/or government entities.

**nonsufficient funds penalty** A nonsufficient funds penalty is an assessment charged by banks against their customers for writing checks that are not backed by adequate funds.

**not-for-profit accounting** See **nonprofit entity.**

**notes payable** Notes payables are obligations evidenced by formal notes. They involve direct borrowings from financial institutions or other companies, and often are established to finance the purchase of long-lived assets. Notes payable appear on the balance sheet in either the current or long-term debt section.

**notes receivable** Notes receivable are assets backed by formal loan contracts. They normally arise from issuing loans, the sale of inventory, or the provision of a service and are often listed in the long-term assets section of the balance sheet.

## O

**objectivity** Objectivity is a principle of financial accounting measurement stating that the values of transactions and the assets and liabilities created by them must be verifiable, i.e., backed by documents and prepared in a systematic and reasonable manner.

**obsolescence** Obsolescence, often referred to as physical obsolescence, is the state of an asset when repairs are no longer economically feasible.

**off-balance-sheet financing** Off-balance-sheet financing is a reporting strategy designed to depict a company as less reliant on debt than it actually is. For example, managers have been known to structure financing transactions and choose certain accounting methods so that liabilities need not be reported in the liability section of the balance sheet.

**open account** An open account is an informal credit trade agreement used in cases where frequent credit transactions are conducted and a running balance of the obligation or receivable is maintained. If payments are made regularly within reasonable time periods, interest charges are not usually assessed. Open account is normally used to describe the trade terms underlying accounts receivable and accounts payable.

**operating activities** Operating activities are the activities of a company associated with the acquisition and sale of a company's products and services.

**operating cycle** Operating cycle is the time it takes, in general, for a company to begin with cash, convert the cash to inventory (or a service), sell the inventory (or service), and receive cash payment.

**operating expenses** Operating expenses are the costs incurred to generate operating revenues associated with the normal activities of a company. They are disclosed in the operating section of the income statement, leading to net operating income.

**operating income** See **net operating income.**

**operating lease** An operating lease is treated as a simple rental for financial reporting purposes, where the periodic lease payments are treated as an expense, and no asset or liability is recognized on the balance sheet. See **capital lease** and **off-balance-sheet financing.**

**operating margin** Operating margin equals net operating income divided by sales. It indicates the number of cents of operating income earned from every dollar of sales.

**operating performance** An operating performance represents a company's ability to increase its net assets through operating activities.

**operating revenues** Operating revenues are revenues generated through the usual and frequent transactions of a company. They are disclosed in the operating section of the income statement, leading to net operating income.

**operating transactions** Operating transactions are usual and frequent transactions involving the acquisition and sale of a company's inventories or services.

**opinion letter** See **audit report.**

**ordinary stock dividend** An ordinary stock dividend is a relatively small dividend paid in the form of a company's own equity shares. It is normally expressed as a percent of a company's outstanding shares. For example, a 5 percent stock dividend declared by a company with 100,000 shares outstanding would involve the issuance of 5,000 (100,000 × 0.05) new shares to the stockholders. Under an ordinary stock dividend, the number of shares issued represents less than 25 percent of the

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


number of shares outstanding before the issuance. Ordinary stock dividends are also just called stock dividends.

**organizational forms** The most common forms of business organization are sole proprietorship, partnership, subchapter S corporation, and corporation.

**original cost** See **historical cost.**

**other comprehensive income** Other comprehensive income is a concept that refers to items that affect the firm's wealth but are not reflected on the income statement. See **comprehensive income, accumulated comprehensive income, statement of comprehensive income,** and **statement of recognized income and expense.**

**other gains and losses** Other gains and losses appear in the nonoperating section of the income statement and refer to transactions that are either unusual or infrequent, but not both. This section of the income statement is also called other revenues and expenses.

**other revenues and expenses** See **other gains and losses.**

**output market** The output market is the market where an entity sells the outputs from its operations. Fair market value, market price, and net realizable value are all output market values.

**outstanding shares** Outstanding shares are shares of stock that have been issued and are presently held by stockholders. They have not been repurchased (as treasury stock) by the company.

**overhead** Overhead refers to manufacturing costs that cannot be directly linked to particular products.

**overstating financial performance and condition** Overstating financial performance and condition, sometimes called providing a favorable financial picture, is a reporting strategy in which management attempts to depict a more favorable picture of the financial statements by overstating the company's financial performance and condition.

**owners' equity** Owners' equity refers to the section of the balance sheet that measures the results of the activities (contributions and withdrawals) of the owners of a partnership or sole proprietorship. See **stockholders' equity,** the term used to describe these activities for the owners (stockholders) of a corporation.

## P

**paper profits** Paper profits is an expression used to describe profits that appear on the income statement but do not reflect increases in a company's economic wealth. Paper profits can be created by cosmetic changes in accounting estimates, judgments, and methods. Quality of earnings assessment is designed to identify and remove paper profits from the financial statements.

**par value** In the context of preferred stock, par value is often used in the determination of the amount of the annual preferred dividend payment. It also determines the dollar amount disclosed in the preferred stock account on the balance sheet. In the context of common stock, par value has little economic significance, but it is used to determine the dollar amount disclosed in the common stock account on the balance sheet.

**parent company** Parent companies own controlling interests in other companies, called subsidiaries. The consolidated financial statements of the parent company include the financial statements of all subsidiaries under its control. See **business acquisition** and **merger.**

**participating preferred stock** Participating preferred stock carries the right, if dividends are declared, not only to an annual dividend amount (determined by the dividend percentage expressed in the terms of the preferred stock) but also to a portion of the remaining dividend paid to the common stockholders. Most preferred stock is nonparticipating.

**partnership** A partnership is an organizational form where two or more people agree, by means of a contract, on how the business is to be conducted and how the profits and losses will be shared. A partnership is not a legal entity; the partners are legally liable for each other's business activities and the partnership itself is not subject to federal income taxes. The partners themselves are taxed on their share of the partnership profit.

**patent** Patents are granted by the U.S. Patent Office and give the holders exclusive rights to use, manufacture, or sell a product or process for a period of ten years. See **intangible asset.**

**payments in advance** See **deferred revenue.**

**pension** A pension is a sum of money paid to a retired or disabled employee, the amount of which is usually determined by the employee's years of service. For most large companies, pensions are an important part of the employees' compensation packages, and they are part of almost all negotiated wage settlements. There are two primary types of pension plans: a defined-contribution plan and a defined-benefit plan.

**percentage-of-credit-sales approach** The percentage-of-credit-sales approach is a method of estimating bad debts that multiplies a given percentage by the credit sales of a given accounting period. Percentage-of-credit-sales is a common method of estimating uncollectibles, used in conjunction with the allowance method, when accounting for accounts receivable.

**periodic inventory method** The periodic inventory method is a method of accounting for inventory that does not record the outflow of inventory at each sale, but relies on an inventory count at the end of the accounting period to compute ending inventory and cost of goods sold. It does not maintain a perpetual record of the inventory balance.

**perpetual method** The perpetual method is a method designed to keep track of, and close control over,

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


inventories. It maintains an up-to-date record, recording each purchase as it occurs and recording an inventory outflow at each sale. The perpetual method is becoming increasingly popular, especially with retailers, because it helps to maintain close control over inventories. Also, computer systems have dramatically reduced the cost of using this method. Bar code sensor systems, for example, are used to implement the perpetual method.

**physical obsolescence** See **obsolescence.**

**portfolio** A portfolio is a group of securities, investments, or assets held by an individual or company.

**postacquisition expenditures** Postacquisition expenditures refer to costs incurred subsequent to the acquisition or manufacture of a long-lived asset. They serve either to improve the existing asset (betterment) or merely to maintain it (maintenance expenditure).

**postretirement costs** Postretirement costs refer to health care and insurance costs incurred by employees after retirement. Most large companies cover a portion of such costs, and similar to pensions, such coverage is part of employee compensation and is earned over an employee's years of service.

**preemptive right** A preemptive right, which is attached to some equity shares, allows the holder to purchase a proportionate interest in any new equity issuance. It enables shareholders to maintain their relative equity interests, reducing the dilutive effect associated with a new issuance.

**preferred stock** Preferred stock is issued by companies to raise capital. It has special rights that make it a hybrid between debt and equity. These rights relate either to the receipt of dividends or to claims on assets in case of liquidation.

**premium on bonds payable** Bond premium is a financial statement account, included in the liability section of the balance sheet and added to the bond liability, representing the fact that the proceeds of a bond issuance exceeded the face value (i.e., the bonds were issued at an effective rate of interest greater than the stated rate of interest). Bond premiums are amortized over the life of the bonds, reducing interest expense. See **effective interest method.**

**prepaid expenses** Prepaid expense is an asset account that reflects payments for certain items (e.g., insurance and rent) before the corresponding service or right is actually used. Prepaid expenses are considered assets because they represent benefits to be enjoyed by the company in the future. For most companies, prepaid expenses are a relatively small, often insignificant, part of total assets.

**present value** Present value is a technique used to place a value, as of the present day, on a set of future cash flows. It is computed by discounting future cash flows at an interest rate that reflects a company's cost of capital.

**price/earnings ratio** *Market price per share/Earnings per share.* The price/earnings (P/E) ratio is a measure of the extent to which the stock market believes that a company's current reported earnings signals future cash inflows.

**prime interest rate** The prime interest rate is the rate charged by a bank to its best (lowest-risk) customers.

**principal** Principal is the sum of money owed as a debt, upon which interest is calculated. In the case of a bond, the principal can be referred to as the face value, par value, or maturity value.

**prior period adjustment** Prior period adjustment refers to the financial effects of certain events that result in direct adjustments to the retained earnings account. They are relatively unusual and are disclosed on the statement of shareholders' equity, normally representing corrections of errors made in prior periods.

**private company** Private companies have equity shares that are not listed and traded on the public stock exchanges.

**proceeds** Proceeds refers to the amount of cash collected on a sale, a borrowing, a bond issuance, or a stock issuance.

**production capacity** Production capacity refers to the number of goods or services a company can produce over a specified period of time given its resources. Production capacity tends to increase when (1) companies expand through business acquisitions and investments in long-lived assets and/or (2) companies increase the efficiency of their available resources. Companies act to increase production capacity when present capacity is insufficient to meet the existing and/or future demand for the company's products and services.

**production efficiency** Production efficiency refers to the number of items produced (of a given quality) divided by the cost of producing those items. Companies are continually attempting to improve production efficiency by producing more high-quality output at lower costs.

**pro forma financial statements** Pro forma financial statements are financial statements projected into the future.

**pro forma reporting** Pro forma reporting is a controversial management disclosure where management recalculates reported net income in a manner it considers to be more meaningful. For example, by highlighting truly one-time items and removing them from the income statement in arriving at pro forma earnings, management may be helping users to more clearly interpret the results of current operations and better predict future results. Pro forma reporting could also be presented by management to undo the distortions generated by accounting rules that may not fit the situation.

**profit** See **net income.**

**profit and loss statement** See **income statement.**

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


**profit margin** See **return on sales.**

**profitability** See **earning power.**

**profitability ratios** Profitability ratios assess performance, normally measured in terms of some measure of earnings as a percent of some level of activity or investment. Profitability ratios are designed to measure earning power and include return on equity, return on assets, earnings per share, return on sales (profit margin), and the times interest earned ratio.

**property** Property is a long-lived asset account representing the real estate upon which a company's operations are conducted. It is not subject to depreciation and normally not held for sale in the normal course of business. It is carried on the balance sheet at historical cost.

**property, plant, and equipment** See **fixed assets.**

**prospectus** A prospectus is a document containing a set of pro forma financial statements and other relevant information (e.g., contractual terms of debt agreements) that is filed with the SEC when a company issues equity or debt to the public.

**provision** Provision is an accounting expression used often by non-U.S. companies, many of which use IFRS, to describe a contingency write-down. Provisions normally appear as liabilities on the balance sheet, and usually result from relatively subjective accruals made by management. The expression is sometimes used by U.S. firms to describe accruals and contingent liabilities.

**proxy statement** A proxy statement is mailed to the stockholders of the company, inviting them to attend and vote for the board of directors at the annual shareholders' meeting. It also contains extensive information about the company and the compensation packages of the board of directors and management.

**public accounting firms** Public accounting firms are concerned primarily with providing independent audits of financial statements prepared by companies. The result of the audit is an opinion letter, signed by a certified public accountant, that provides a brief description of the auditor's procedures and responsibilities and states whether the statements present fairly the financial condition and performance of the company and are in conformance with GAAP, and whether the internal control system is considered effective. In addition to auditing, public accounting firms also perform tax and business advisory services for their clients.

**purchase method** Under the purchase method of accounting for business acquisitions, the assets and liabilities of the acquired company (subsidiary) are added to those of the parent at their fair market values as of the time of the acquisition. The difference between the purchase price and the fair market value of the subsidiary's assets is recorded as goodwill.

**purchasing power** Purchasing power is the amount of goods and services a monetary amount can buy at a given point in time. See **inflation.**

## Q

**qualified audit report** A qualified audit report departs from the language in the standard audit report. The departure can be due to any of a wide variety of reasons—some of which are serious, others not. See **audit report.**

**quick ratio** (*Cash* + *Marketable securities accounts receivable*)/*Current liabilities.* The quick ratio compares a company's highly liquid assets to its current liabilities, providing a measure of the portion of the current liabilities that could be paid off in the near future.

**quality of earnings** See **earnings quality.**

## R

**rate of return** See **return on investment.**

**readily marketable** Readily marketable refers to how quickly an asset can be converted to cash. It is normally used in the context of short-term investments (marketable securities) and describes securities that can be sold and converted into cash on demand. Securities traded on the public stock exchanges are considered readily marketable.

**realized gain or loss** A realized gain or loss occurs when an asset (liability) is exchanged for another asset (liability) with a market value that differs from the book value of the asset (liability) given up.

**recognized gain or loss** A recognized gain or loss occurs when a gain or loss is recorded on the financial statements. All gains and losses disclosed on the income statement are recognized.

**recovery** Recovery refers to an increase in the value of an asset that has previously been written down. The amount of the recovery is limited to the amount of the previous write-down. Recoveries tend to be recognized under IFRS, but not under U.S. GAAP.

**redemption** Redemption normally refers to the repurchase of outstanding debt (e.g., bonds) either before or at the maturity date. Depending on the terms of the debt, such repurchases can be at the option of either the issuing company or the debtholders, and the price of the repurchase can be prespecified or at the market price existing at the time of the transaction.

**refinancing** A refinancing occurs when a company satisfies an outstanding debt by issuing another outstanding debt. A company may also refinance by first redeeming debt and then issuing new debt.

**related party transaction** A related party transaction occurs when a company executes a transaction with an owner, an officer, or someone with a special interest in the welfare of the company. These transactions should be viewed cautiously by analysts because they may be

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


designed to benefit the related party, often at the expense of the other stakeholders in the company.

**replacement cost** Replacement cost is the current price a company would have to pay in the input market to replace an existing asset while maintaining operations at the present level.

**reporting strategies** Reporting strategies are policies used by management when choosing accounting methods, normally designed to achieve specific reporting objectives. There are four common strategies: (1) overstating financial performance and condition, (2) building hidden reserves, (3) taking a bath, and (4) off-balance-sheet financing.

**residual interest** Residual interest represents the right of the common stockholders to receive corporate assets in case of liquidation, after the creditors and preferred stockholders, in that order, have received their shares. The shareholders' equity section of the balance sheet represents one rough measure of the value of the stockholders' residual interest.

**restrictive covenant** See **debt covenant.**

**restructuring charges** A restructuring charge is an expense or loss that appears on the income statement in a given year, reflecting anticipated future costs. Many companies restructure their operations, planning to close plants, lay off employees, and incur other related expenses, choosing to record a charge to income in a period prior to the time they actually close the plants, lay off the employees, etc.

**retail company** A retail company purchases inventory and attempts to sell it for a price greater than its cost. Retailers purchase inventory from manufacturers or wholesalers and sell it to customers—providing primarily a distribution service, doing little to change or improve the inventory product.

**retained earnings** Retained earnings is an account listed in the shareholders' equity section of the balance sheet, representing the dollar amount of the company's assets generated through prior profits and not paid out in the form of dividends.

**retirement** In the context of business activities, retirement normally refers to either discontinuing the use of a fixed asset or purchasing outstanding debt.

**return on assets** (*Net income* + *Interest expense* [1 − *Tax rate*])/*Average total assets.* Return on assets measures the returns to both the stockholders (net income) and the creditors (interest expense) on their total investment in the firm (average total assets). The cost of interest is reduced by (1 − Tax rate) because interest is tax deductible. Changes in this ratio can be explained by changes in return on sales and asset turnover. Return on assets is a direct determinant of return on equity. See **DuPont Model, financial statement analysis,** and **profitability ratios.**

**return on equity** (*Net income* − *Preferred stock dividends*)/*Average stockholders' equity.* Return on equity compares the profits generated by a company to the investment made by the company's stockholders. Net income, which appears in the numerator, is viewed as the return to the company's owners, while the balance sheet value of stockholders' equity, which appears in the denominator, represents the amount of resources invested by the stockholders. Changes in this ratio can be explained by changes in return on assets, common equity leverage, and capital structure leverage. Value is created for the shareholders when return on equity exceeds the cost of equity.

**return on equity from financial leverage** *Return on equity* − *Return on assets.* The difference between the two ratios measures the extent to which the return to the stockholders exceeds the return to all capital providers, including creditors. When return on equity is greater (less) than return on assets, it is a measure of the economic benefit (loss) to stockholders from financial leverage. When a company has no liabilities, then the return on equity will equal return on assets.

**return on equity (ROE) model** See **DuPont Model.**

**return on investment** (*Market price*[*n* − 1] − *Market price*[*n*] + *Dividends*[*n*−1])/*Market price*[*n*]. Return on investment provides a measure of the pretax performance of an investment in a share of common stock. The numerator reflects the pretax return to the stockholder (market price appreciation and dividends), and the denominator reflects the amount of the stockholders' investment.

**return on sales** (*Net income* + *Interest expense* [1 − *Tax rate*])/*Net sales.* Return on sales provides an indicator of operating efficiency—increasing if operating expenses increase (decrease) at a slower (faster) rate than net sales. An efficient company, for example, will generate increased net sales with a constant level of operating expenses. Changes in this ratio can be analyzed by examining how the items on the income statement changed as a percentage of sales (i.e., common-size income statement). Return on sales times asset turnover equals return on assets, a direct determinant of return on equity. See **profit margin.**

**revaluation adjustment** Revaluation adjustments are designed to bring the dollar amount of certain accounts on the financial statements in line with the existing facts.

**revenue** Revenue refers to inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or performing other activities that constitute the entity's ongoing major or central operations.

**revenue recognition** Revenue recognition is a principle of accounting measurement that determines when revenue from the sale of a good or the provision of a service is entered into the financial statements. Revenue recognition is a critical question in the matching process because

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


the expenses incurred to generate revenues should not be reflected on the income statement until the revenues are recognized. The sale of a good or provision of a service normally involves a series of steps—including ordering the good or service, producing it, transferring it to the customer, and receiving payment. The principle of revenue recognition helps to determine at which of these steps the revenue should be recorded in the books.

**reverse account analysis** Reverse account analysis (also called T-account analysis) is a mechanical process that involves examining the activity in a given balance sheet account to acquire information not directly disclosed in the financial statements or footnotes.

**risk** Risk refers to variation in the returns of a given investment. Risky investments are characterized by large fluctuations in their returns across time—providing large returns in some periods while providing small, zero, or even negative returns in other periods. Risk, when applied to a potential borrower, refers to the probability of receiving timely interest and principal loan payments, sometimes called the risk of default. Equity and debt investors normally require larger expected returns to compensate for bearing additional risk.

**risk premium** Risk premium refers to the percentage return on investment over and above the risk-free rate that reflects the level of risk associated with an uncertain investment. The risk-free rate plus the risk premium equals the expected rate of return that must be met before an investment will be accepted. In short, larger expected returns are necessary for higher-risk investments.

**risk-free return** The risk-free return is the return provided by riskless securities (e.g., treasury notes, certificates of deposit). It varies across time due to macroeconomic factors such as economic activity, inflation, exchange rates, and monetary policy, but recently has been relatively low (4–5 percent).

## S

**sales** Sales is a revenue associated with the sale of a good or product. Sales for a given period is computed by multiplying the number of items sold by the sales price, and it is typically the major revenue for manufacturers and retail companies.

**sales growth** Sales growth is an important indicator of a company's performance over a period of time. It can be determined by comparing sales dollar amounts on the income statement across reporting periods. It normally reflects changes in customer demand for a company's goods or services—due to changing prices and/or quantities sold.

**sales returns** Sales returns refer to recorded sales that are subsequently returned to the seller. The returns may be due to faulty merchandise and customer dissatisfaction; in a large number of cases, relatively open returns are part of normal business practices.

**salvage value** Salvage value refers to the dollar value of a long-lived asset at the completion of its useful life. Salvage values must be estimated before long-lived assets are placed into service so that the depreciable base can be depreciated, or amortized, over the estimated useful life. Estimating salvage values is extremely subjective, so many companies assume them to be zero.

**Sarbanes–Oxley Act** In an attempt to bolster corporate governance and restore confidence in the U.S. financial reporting system, this Act was passed by Congress in 2002. It enacted sweeping changes in the responsibilities of management, financial disclosures, independence and effectiveness of auditors and audit committees, and oversight of public companies and auditors. The Act requires the principal executive and financial officers to certify that the financial reports have been reviewed, do not contain untrue statements or omit important information, and fairly present the company's financial condition and performance. It also places additional responsibilities on management and the auditor to ensure that adequate internal controls are in place to provide reasonable assurance that the financial records are complete and accurate. Management must also file an annual report on internal control over financial reporting, and the external auditor must attest to and report on management's assessment of internal controls.

**secured note** Secured notes are formal promissory notes backed by assets (collateral) that are distributed to creditors in the event of default.

**Securities and Exchange Commission** In 1934, the U.S. Congress created the Securities and Exchange Commission, a federal agency with powers to implement and enforce the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act of 1933 requires that companies issuing securities on the public security markets file a registration statement (Form S-1) with the SEC prior to the issuance. The Securities Exchange Act of 1934 states that companies with securities listed on the public security markets must (1) annually file audited financial reports with the SEC (Form 10-K), (2) file quarterly financial statements with the SEC (Form 10-Q), and (3) provide audited financial reports annually to the stockholders. The SEC is also currently active in establishing financial accounting standards.

**security** See **collateral.**

**service company** A service company provides a service, as opposed to a good, for its clients or customers. Service companies carry no inventories and do not recognize cost of goods sold on the income statement. Service revenue or fees earned represent its main revenues. The service industry is normally divided into two groups: general services and financial services.

**service revenue** Service revenue (also called fees earned) represents revenues from the provision of services.

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


This account is normally found in the operating section of the income statement.

**SG&A** SG&A refers to selling, general, and administrative expenses—often one of the most important expense categories on the income statement.

**shareholders** See **stockholders.**

**shareholders' equity** Shareholders' equity consists of contributed capital and earned capital. Contributed capital represents the original investment in the company made by the shareholders, and earned capital primarily represents funds earned by the entity that the shareholders (normally through the board of directors) have chosen to reinvest in the entity, called retained earnings. Earned capital can also include accumulated comprehensive income, a measure of changes in the wealth of the entity not reflected on the income statement. In total, shareholders' equity represents the total investment made by the owners in the entity.

**short-term debt** Short-term debt refers to obligations on the balance sheet, backed by formal contract, expected to be paid with the use of assets presently listed as current on the balance sheet. Short-term debt is normally listed in current liabilities.

**short-term investments** Short-term investments consist of investments in equity securities, bonds, and similar financial instruments that are both readily marketable and intended by management to be sold within the time period that defines current assets. Companies often purchase these kinds of securities to earn income with cash that would otherwise be idle for a short time. These investments are carried on the balance sheet at fair market value and, according to GAAP, must be classified as either trading securities or available-for-sale securities.

**similar asset** Similar assets are those that perform essentially the same function. See **trade-in.**

**sole proprietorship** A sole proprietorship is considered to be a partnership with a single partner. It is not a legal entity and therefore not subject to federal income taxes. The sole proprietor is taxed and is personally liable for the activities of the business.

**solvency** Solvency refers to a company's ability to meet debts as they come due. Assessing solvency is a very important part of financial statement analysis.

**solvency ratios** Solvency ratios refer to financial ratios designed to measure a company's ability to meet its debts as they come due. The current and quick ratios are the two solvency ratios.

**special-purpose entities (SPE)** Special-purpose entities are created by a company solely to carry out an activity or series of transactions directly related to a specific purpose. The most common purposes include raising funds and transferring risk. The main accounting issue with SPEs concerns whether to consolidate the SPE into the financial statements of the creating company.

**specific identification** Specific identification is a procedure used to value cost of goods sold and inventory. It is used when companies can specifically identify the inventory items acquired and sold during the period, as well as those that remain at the end of the period. In such cases, the actual costs of the items sold and retained can be allocated to cost of goods sold and inventory, respectively.

**stable dollar assumption** The stable dollar assumption states that the value of the monetary unit used to measure a company's performance and financial condition is stable across time. That is, the inflation rate is assumed to be zero. This assumption allows mathematical operations (addition, subtraction, multiplication, and division) to be performed on account values that are established at different points in time.

**standard audit report** A standard audit report, often referred to as an unqualified report, states that the auditor was able to conduct an appropriate audit and render an opinion that the financial statements were prepared in accordance with GAAP and fairly reflect the financial performance and condition of the company, and the internal control system is effective. See **qualified audit report.**

**stated interest rate** The stated interest rate is the annual rate of interest stated on the face of a formal promissory note or bond certificate. The stated interest rate times the face value determines the periodic interest payments.

**statement of cash flows** The statement of cash flows is a financial statement that provides a summary of the activity in a company's cash account over a period of time. This statement divides cash activity into three categories: (1) operating, (2) investing, and (3) financing activities.

**statement of cash flows (direct method)** The direct method is evident when the operating section of the statement of cash flows contains the actual cash inflows and outflows associated with the operating activities of the company.

**statement of cash flows (indirect method)** The indirect method is evident when the operating section of the statement of cash flows begins with net income, which is followed by accrual adjustments in the computation of net cash from operations.

**statement of comprehensive income** The statement of comprehensive income contains net income for the period as well as other objectively measurable items that affect the firm's wealth but are not reflected on the income statement. This statement is not required under U.S. GAAP, but a reconciliation between net income and comprehensive income is required. This statement is very similar to the statement of recognized income and expense, which is required under IFRS. See **comprehensive income** and **other comprehensive income.**

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


**statement of recognized income and expense (SORIE)** The statement of recognized income and expense is required under IFRS and contains net income for the period as well as other objectively measurable items that affect the firm's wealth but are not reflected on the income statement. This statement is very similar to the statement of comprehensive income, which is required under U.S. GAAP.

**statement of retained earnings** The statement of retained earnings represents the portion of the statement of shareholders' equity that reconciles the balance in the retained earnings account at the beginning of an accounting period with the balance at the end of the period. It normally takes the following form: beginning retained earnings plus (minus) net income (loss) less dividends equals ending retained earnings. See **internal financing.**

**statement of shareholders' equity** The statement of shareholders' equity is a financial statement included in the annual reports of major U.S. companies. It explains the changes in the accounts of the shareholders' equity section of the balance sheet during an accounting period. GAAP requires that these changes be described somewhere in the annual report, and many companies include them in the footnotes.

**stock** In the United States, the term stock normally refers to common or preferred stock. On occasion, especially outside the United States (e.g., Britain), the term stock refers to inventory.

**stock dividend** See **ordinary stock dividend.**

**stock market** The stock market consists of a number of stock exchanges where equity securities are traded in a public forum. The New York Stock Exchange, the American Stock Exchange, and the Over-the-Counter (OTC) market are located in the United States and are the most active in the world. However, there are a number of other exchanges located in virtually all major cities outside the United States.

**stock options** A stock option is an option to purchase common stock at a prespecified price during a specific time period.

**stock price** Stock price is the market price of an equity security that has been previously issued and is presently listed on one of the public stock markets. Stock prices increase and decrease as investor expectations about a company change.

**stock split** Stock splits are used by corporations to increase the number of shares outstanding and simultaneously reduce the market price. Stock splits are expressed in terms of a ratio that describes how the existing shares are to be divided. In a 2:1 split, for example, the existing shareholders each receive an additional share for every share owned. Consequently, the number of outstanding shares are doubled, and the market price per share is approximately cut in half. A 3:1 stock split effectively triples the number of outstanding shares, which the company executes by distributing two additional shares for each one outstanding. In a 3:2 stock split, one additional share is issued for every two outstanding.

**stock split in the form of a dividend** Stock splits in the form of dividends are relatively large stock dividends where 25 percent or more of the outstanding stock is issued, as a dividend, to the existing shareholders. They are treated as stock splits.

**stockholders** Stockholders (also called shareholders) are individuals or entities that hold ownership interests in a corporation. These interests include (1) the right to vote in the elections of the board of directors, (2) the right to receive dividends if they are declared by the board of directors, (3) a residual interest to the corporation's assets in the event of liquidation, and, in some cases, (4) a preemptive right. *Stockholder* and *shareholder* are used interchangeably.

**stockholders' equity** Stockholders' equity is the section of a corporate balance sheet that represents the stockholders' interests (or investment) in the corporation. It consists primarily of contributed capital and earned capital (retained earnings + other accumulated comprehensive income). The total dollar value of stockholders' equity also represents the company's net book value and its net worth.

**straight-line method** The straight-line method is a procedure for depreciating or amortizing long-lived assets that recognizes equal amounts of depreciation or amortization in each year of the asset's useful life. To compute straight-line depreciation for a given period, divide the depreciation base by the estimated useful life. Straight-line is the most common method for depreciating fixed assets and amortizing intangible assets.

**subchapter S corporation** A subchapter S corporation is primarily the same as a corporation, with one important difference: It is taxed like a partnership. It is popular with many small businesses because it has the advantages of a corporation (e.g., stockholders are liable only up to the amount of their investment) without one of the major disadvantages (double taxation).

**subsidiary** A subsidiary is a company with the majority of its common stock owned by another company, called the parent. Normally, the subsidiary prepares its own financial statements separately from the parent, but these statements are usually not available to the public because the shares of the subsidiary owned by the parent are no longer publicly listed. Under GAAP, the parent must prepare consolidated financial statements.

**sum-of-the-years'-digits method** Sum-of-the-years'-digits is a method of accelerated depreciation that is less extreme than the double-declining-balance method. To compute depreciation for a given period, the depreciation base is multiplied by a ratio—the

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


remaining estimated life serves as the numerator and the sum of the estimated life's digits serves as the denominator. This method recognizes relatively large amounts of depreciation in the early periods of an asset's life and smaller amounts in later periods.

**supplies inventory** Supplies inventory refers to items available to support the operations of a business, such as office supplies and spare parts. Supplies inventory can be listed on the balance sheet under either current assets (e.g., office supplies) or long-lived assets (e.g., spare parts used to maintain long-lived assets). Supplies inventory is normally a relatively small asset on the balance sheet.

# T

**T-account analysis** See **reverse account analysis.**

**takeover** In a takeover, an investor, group of investors, or another company purchases enough of the outstanding voting stock to gain a controlling interest (51 percent or more) in the acquired company. Takeovers are often classified as "unfriendly" (the existing board of directors and management are removed) or "friendly" (the existing board of directors and management are maintained). The threat of a takeover creates an important incentive for the board of directors and management to act responsibly and in the interest of the shareholders. Takeovers are accounted for under either the purchase or pooling-of-interests method.

**taking a bath** Taking a bath is a reporting strategy that recognizes excessive losses or expenses in a single period. This strategy helps to ensure that future periods will show improved performance because losses and expenses recognized in the current period will not have to be recognized in the future.

**tax accounting** Tax accounting systems produce information that is reported to the Internal Revenue Service and is used in the computation of the company's tax liability.

**tax deductible** An expense is tax deductible if—according to tax law—it is an allowable reduction of taxable income, the dollar amount upon which the tax liability is based. Many transactions are structured so that the related costs and expenses can be deducted for tax purposes.

**taxable income** Taxable income is the number used to determine income tax liability. It is computed by subtracting tax-deductible expenses from revenues that must be included for tax purposes. Deductible expenses and includible revenues are determined primarily by the Internal Revenue Code. Taxable income normally differs from net income reported on the income statement, which is based on GAAP.

**technical default** In a technical default, a company violates the terms of a debt covenant. For example, a debt covenant may require that the company maintain a current ratio of at least 1.0. If the company allows the ratio to fall below 1.0, it is in technical default. Technical default normally leads to renegotiation of the debt terms and is normally a negative signal for the company.

**technical obsolescence** Technical obsolescence is the state of an asset when technical advances have rendered its services no longer useful.

**term loan** Term loans are paid in installments over a period longer than one year from the operating cash flow of a business.

**times interest earned** *Net income before interest and taxes/Interest expense.* Times interest earned, also referred to as interest coverage, is a financial ratio that measures the extent to which a company's annual profits cover its annual interest expense. The profit number in the numerator should reflect the primary, recurring business operations of the company and should be calculated before income taxes because interest is deductible for tax purposes. The denominator, interest expense, can usually be found on the income statement.

**trade-in** In a trade-in, an old asset (and usually cash) is exchanged for a new asset. The methods used to account for trade-ins depend upon whether the assets in the exchange are similar or dissimilar.

**trademark or trade name** Granted by the U.S. Patent Office, a trademark or trade name is a word, phrase, or symbol that distinguishes or identifies a particular enterprise or product. Trademarks last for a fixed period of time but can be renewed indefinitely. See **intangible asset.**

**trading securities** Trading securities are relatively small investments (less than 20 percent of the outstanding voting stock) in marketable equity (or debt) securities that are purchased and held principally for the purpose of selling them in the very near future with the objective of generating a profit on short-term price changes. Trading securities are always listed as current assets on the balance sheet and are carried at market value. Changes in the market prices of trading securities are reflected as income or loss on the income statement, normally in the nonoperating section.

**transportation-in** See **freight-in.**

**treasury notes** Treasury notes are obligations of the federal government that pay interest at a specified rate for a specific period of time, usually less than six months. These notes are very low risk, and companies often purchase treasury notes to temporarily earn interest with excess cash. Such investments are classified as short-term on the balance sheet. The rate paid by treasury notes can also be used as a measure of the riskless rate of return. See **short-term investments.**

**treasury stock** Treasury stock is previously issued stock that has been repurchased by the issuing company and

to download more slides, ebooks, and solution manual visit http://downloadslide.blogspot.com


held in the corporate treasury. It is often reissued at a later date.

**turnover** Turnover is an expression used to describe how quickly certain assets (receivables, inventories, noncurrent assets, and total assets) and liabilities are used in the operations of a company. See **inventory turnover, accounts receivable turnover, fixed asset turnover, asset turnover,** and **accounts payable turnover.** Turnover is also used by many non-U.S. companies to describe sales.

## U

**uncollectibles** Uncollectibles, sometimes called bad debts, refer to outstanding accounts or notes receivable that will never be received. Under GAAP, management is required to estimate the value of uncollectibles periodically and recognize an expense on the income statement as well as reduce receivables on the balance sheet.

**unearned revenue** See **deferred revenue.**

**uniformity** Uniformity would be achieved if all businesses used the same accounting methods.

**unqualified audit report** See **standard audit report.**

**unrealized gain or loss** An unrealized gain or loss occurs when the market value of an asset (liability) on the balance sheet changes and no exchange has taken place. When the market value of an asset increases, for example, an unrealized gain occurs.

**unsecured notes** Unsecured notes are formal promissory notes (contracts) that are not backed by any form of security—collateral. For this reason, they tend to be high risk but normally can only be successfully issued by strong companies. The presence of unsecured debt on the balance sheet of a company, therefore, is often a signal of financial strength; that company's creditors apparently have not required that the debt be secured by the company's assets. Unsecured bonds are called debentures.

**useful life** The useful life of an asset is the estimated time period, or activity, over which a long-lived asset is expected to provide revenue-producing services. The estimated lives of intangible assets can be as long as forty years, while fixed asset lives normally range from three to thirty years. The estimated useful life of an automobile may be more appropriately expressed in terms of miles driven (e.g., 150,000 miles), instead of years.

**U.S. GAAP** U.S. GAAP refers to generally accepted accounting principles used in the United States.

**usual transactions** Usual transactions are part of the normal operating activities of a company. They involve the sale of a company's merchandise inventory or the provision of services expected in the normal course of business. If these transactions occur frequently, they are considered operating transactions and are disclosed as part of net operating income. If they occur infrequently, they are considered nonoperating items and classified as such on the income statement.

## V

**valuation base** Valuation base refers to the values (e.g., historical cost, replacement cost, fair market value, net realizable value, present value) used to determine the dollar amount of an entity's assets and liabilities on the balance sheet.

**value creation** Value creation is a key metric of management's success, defined as the extent to which return on equity exceeds the cost of equity. It can be computed as a percentage (return on equity – cost of equity) or as a dollar value (net income – [cost of equity × average shareholders' equity]), and the market value of the firm can be expressed in terms of the book value of the firm plus the discounted future value creation.

## W

**warranty** A warranty is an agreement by which a seller promises to remove deficiencies in the quantity, quality, or performance of a product sold to a buyer.

**window dressing** Window dressing is a phrase used to describe the activity of managers who use accounting methods, judgments, and estimates or make operating decisions purely to make the financial statements appear more attractive to financial statement users.

**working capital** *Current assets − Current liabilities.* Working capital measures the extent to which a company's current assets cover its current liabilities. It is viewed as a measure of solvency and is often used in debt covenants to ensure that the borrower maintains a sufficient buffer of current assets to current liabilities. Like the current and quick ratio, however, working capital is a relatively weak measure of a company's solvency position.