

CHAPTER 1

GLOSSARY OF COST MANAGEMENT CONCEPTS*

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The definitions of many words and phrases in the glossary use other glossary terms. In a given definition, we *italicize* terms that themselves (or variants thereof) appear elsewhere under their own listings. The cross-references generally take one of two forms:

1. **absorption costing.** See *full absorption costing*.
2. **ABC.** *Activity-based costing*.

Form (1) refers you to another term for discussion of this bold-faced term. Form (2) tells you that this bold-faced term is synonymous with the *italicized* term, which you can consult for discussion if necessary.

A

AAA. *American Accounting Association.*

Abacus. A scholarly journal containing articles on theoretical aspects of accounting, published by Basil Blackwell for the Accounting Foundation of the University of Sydney.

abatement. A complete or partial cancellation of a levy imposed by a government unit.

ABC. *Activity-based costing.*

abnormal spoilage. Actual spoilage exceeding that expected when operations are normally

efficient. Usual practice treats this cost as an *expense* of the period rather than as a *product cost*. Contrast with *normal spoilage*.

aboriginal cost. In public utility accounting, the *acquisition cost* of an *asset* incurred by the first *entity* devoting that asset to public use; the cost basis for most public utility regulation. If regulators used a different cost basis, then public utilities could exchange assets among themselves at ever-increasing prices in order to raise the rate base and, then, prices based on them.

* I have developed this glossary over the last 30 years with the help of named co-authors Sidney Davidson, Michael Maher, Patricia O'Brien, James Schindler, and Clyde Stickney. In addition, Katherine Schipper and Steven Zeff have provided much helpful input. My thanks to all of you. RLW

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absorbed overhead. *Overhead costs* allocated to individual products at some *overhead rate*; also called *applied overhead*.

absorption costing. See *full absorption costing*.

Abstracts of the EITF. See *Emerging Issues Task Force*.

accelerated cost recovery System (ACRS). A form of accelerated depreciation that Congress enacted in 1981 and amended in 1986, so that now most writers refer to it as *MACRS*, or *Modified Accelerated Cost Recovery System*. The system provides percentages of the asset's cost that a firm depreciates each year for tax purposes. The percentages derive, roughly, from 150-percent *declining-balance depreciation* methods. ACRS ignores salvage value. We do not generally use these amounts for *financial accounting*.

accelerated depreciation. In calculating *depreciation* charges, any method in which the charges become progressively smaller each period. Examples are *double declining-balance depreciation* and *sum-of-the-years'-digits depreciation* methods.

acceptance. A written promise to pay; equivalent to a *promissory note*.

account. A device for representing the amount (*balance*) for any line (or a part of a line) in the *balance sheet* or *income statement*. Because income statement accounts explain the changes in the balance sheet account Retained Earnings, the definition does not require the last three words of the preceding sentence. An account is any device for accumulating additions and subtractions relating to a single *asset*, *liability*, or *owners' equity* item, including *revenues* and *expenses*.

account analysis method. A method of separating *fixed costs* from *variable costs* based on the analyst's judgment of whether the cost is fixed or variable. Based on their names alone, the analyst might classify *direct labor*

absorbed overhead — accounting adjustments

(*materials*) costs as variable and *depreciation* on a factory building as fixed. In our experience, this method results in too many fixed costs and not enough variable costs—that is, analysts have insufficient information to judge management's ability to reduce costs that appear to be fixed.

account form. The form of *balance sheet* in which *assets* appear on the left and *equities* appear on the right. Contrast with *report form*. See *T-account*.

accountability center. *Responsibility center*.

accountancy. The British word for *accounting*. In the United States, it means the theory and practice of accounting.

accountant's comments. Canada: a written communication issued by a public accountant at the conclusion of a review engagement. It consists of a description of the work performed and a statement that, under the terms of the engagement, the accountant has not performed an audit and consequently expresses no opinion. (Compare *auditor's report*; *denial of opinion*.)

accountant's opinion. *Auditor's report*.

accountant's report. *Auditor's report*.

accounting. A system conveying information about a specific *entity*. The information is in financial terms and will appear in accounting statements only if the accountant can measure it with reasonable precision. The *AICPA* defines accounting as a service activity whose "function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions."

accounting adjustments. *Prior-period adjustments*, changes in accounting principles accounted for on a cumulative basis, and corrections of errors. See *accounting changes*. The *FASB* indicates that it will tend to call these items "accounting adjustments," not

“accounting changes,” when it requires the reporting of *comprehensive income*.

Accounting and Tax Index. A publication that indexes, in detail, the accounting literature of the period. Published by UMI, a subsidiary of Bell & Howell.

accounting changes. As defined by *APB Opinion No. 20*, a change in (1) an *accounting principle* (such as a switch from *FIFO* to *LIFO* or from *sum-of-the-years'-digits depreciation* to *straight-line depreciation*), (2) an accounting estimate (such as estimated useful lives or salvage value of depreciable assets and estimates of *warranty costs* or *uncollectible accounts*), or (3) the reporting *entity*. The firm should disclose changes of type (1). It should include in reported earnings for the period of change the cumulative effect of the change on *retained earnings* at the start of the period during which it made the change. The firm should treat changes of type (2) as affecting only the period of change and, if necessary, future periods. The firm should disclose reasons for changes of type (3) in statements reporting on operations of the period of the change, and it should show the effect of the change on all other periods, for comparative purposes. In some cases (such as a change from *LIFO* to other inventory *flow assumptions* or a change in the method of accounting for long-term construction contracts), *GAAP* treat changes of type (1) like changes of type (3). That is, for these changes the firm should restate all statements shown for prior periods to show the effect of adopting the change for those periods as well. See *all-inclusive (income) concept* and *accounting errors*.

accounting conventions. Methods or procedures used in accounting. Writers tend to use this term when the method or procedure has not yet received official authoritative sanction by a pronouncement of a group such as the *APB*, *EITF*, *FASB*, or *SEC*. Contrast with *accounting principles*.

accounting cycle. The sequence of accounting procedures starting with *journal entries* for various transactions and events and ending with the *financial statements* or, perhaps, the *post-closing trial balance*.

accounting deficiency. Canada: a failure to adhere to generally accepted *accounting principles* or to disclose essential information in *financial statements*.

accounting entity. See *entity*.

accounting equation. $Assets = Equities; Assets = Liabilities + Owners' equity$.

accounting errors. Arithmetic errors and misapplications of *accounting principles* in previously published financial statements. The firm corrects these during the current period with direct *debits* or *credits* to *retained earnings*. In this regard, the firm treats them like *prior-period adjustments*, but technically *APB Opinion No. 9* does not classify them as prior-period adjustments. See *accounting changes*, and contrast with changes in accounting estimates as described there.

accounting event. Any occurrence that is recorded in the accounting records.

Accounting Horizons. A quarterly journal of the *American Accounting Association*.

accounting methods. *Accounting principles*; procedures for carrying out accounting principles.

accounting period. The time period between consecutive *balance sheets*; the time period for which the firm prepares *financial statements* that measure *flows*, such as the *income statement* and the *statement of cash flows*. See *interim statements*.

accounting policies. *Accounting principles* adopted by a specific *entity*.

accounting principles. The methods or procedures used in accounting for events reported in the *financial statements*. We tend to use this term when the method or procedure has

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received official authoritative sanction from a pronouncement of a group such as the *APB*, *EITF*, *FASB*, or *SEC*. Contrast with *accounting conventions* and *conceptual framework*.

Accounting Principles Board. See *APB*.

accounting procedures. See *accounting principles*. However, this term usually refers to the methods for implementing accounting principles.

accounting rate of return. Income for a period divided by average investment during the period; based on income, rather than discounted cash flows, and hence a poor decision-making aid or tool. See *ratio*.

Accounting Research Bulletin (ARB). The name of the official pronouncements of the former *Committee on Accounting Procedure (CAP)* of the *AICPA*. The committee issued 51 bulletins between 1939 and 1959. *ARB No. 43* restated and codified the parts of the first 42 bulletins not dealing solely with definitions.

Accounting Research Study (ARS). One of a series of studies published by the Director of Accounting Research of the *AICPA* and “designed to provide professional accountants and others interested in the development of accounting with a discussion and documentation of accounting problems.” The *AICPA* published 15 such studies in the period 1961–1973.

Accounting Review. A journal of the *American Accounting Association*.

Accounting Series Release (ASR). See *SEC*.

accounting standards. *Accounting principles*.

Accounting Standards Executive Committee (AcSEC). The senior technical committee of the *AICPA* authorized to speak for the *AICPA* in the areas of *financial accounting* and reporting as well as *cost accounting*.

accounting system. The procedures for collecting and summarizing financial data in a firm.

Accounting Principles Board — accrual

Accounting Terminology Bulletin (ATB). One of four releases of the Committee on Terminology of the *AICPA* issued in the period 1953–57.

Accounting Trends and Techniques. An annual *AICPA* publication that surveys the reporting practices of 600 large corporations. It presents tabulations of specific practices, terminology, and disclosures along with illustrations taken from individual annual reports.

accounts payable. A *liability* representing an amount owed to a *creditor*; usually arising from the purchase of *merchandise* or materials and supplies, not necessarily due or past due; normally, a *current liability*.

accounts receivable. Claims against a *debtor*; usually arising from sales or services rendered, not necessarily due or past due; normally, a *current asset*.

accounts receivable turnover. Net sales on account divided by average accounts receivable. See *ratio*.

accretion. Occurs when a *book value* grows over time, such as a *bond* originally issued at a *discount*; the correct technical term is “accretion,” not “amortization.” This term also refers to an increase in economic worth through physical change caused by natural growth, usually said of a natural resource such as timber. Contrast with *appreciation*. See *amortization*.

accrual. Recognition of an *expense* (or *revenue*) and the related *liability* (or *asset*) resulting from an *accounting event*, frequently from the passage of time but not signaled by an explicit cash transaction; for example, the recognition of interest expense or revenue (or wages, salaries, or rent) at the end of a period even though the firm makes no explicit cash transaction at that time. Cash flow follows accounting recognition; contrast with *deferral*.

accrual basis of accounting — activity-based costing (ABC)

accrual basis of accounting. The method of recognizing *revenues* as a firm sells *goods* (or delivers them) and as it renders *services*, independent of the time when it receives cash. This system recognizes *expenses* in the period when it recognizes the related revenue, independent of the time when it pays cash. *SFAC No. 1* says,

Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise.

Contrast with the *cash basis of accounting*. See *accrual* and *deferral*. We could more correctly call this “accrual/deferral” accounting.

accrue. See *accrued*, and contrast with *incur*.

accrued. Said of a *revenue (expense)* that the firm has earned (recognized) even though the related *receivable (payable)* has a future due date. We prefer not to use this adjective as part of an account title. Thus, we prefer to use Interest Receivable (Payable) as the account title rather than Accrued Interest Receivable (Payable). See *matching convention* and *accrual*. Contrast with *incur*.

accrued depreciation. An incorrect term for *accumulated depreciation*. Acquiring an asset with cash, capitalizing it, and then amortizing its cost over periods of use is a process of *deferral* and allocation, not of *accrual*.

accrued payable. A *payable* usually resulting from the passage of time. For example, *salaries* and *interest* accrue as time passes. See *accrued*.

accrued receivable. A *receivable* usually resulting from the passage of time. See *accrued*.

accumulated benefit obligation. See *projected benefit obligation* for definition and contrast.

accumulated depreciation. A preferred title for the asset *contra account* that shows the sum of *depreciation* charges on an asset since the time the firm acquired it. Other account titles are *allowance for depreciation* (acceptable term) and *reserve for depreciation* (unacceptable term).

accumulated other comprehensive income. *Balance sheet* amount in *owners' equity* showing the total of all *other comprehensive income* amounts from all prior periods.

accurate presentation. The qualitative accounting objective suggesting that information reported in financial statements should correspond as precisely as possible with the economic effects underlying transactions and events. See *fair presentation* and *full disclosure*.

acid test ratio. *Quick ratio*.

acquisition cost. Of an *asset*, the net *invoice* price plus all *expenditures* to place and ready the asset for its intended use. The other expenditures might include legal fees, transportation charges, and installation costs.

ACRS. *Accelerated Cost Recovery System*.

AcSEC. *Accounting Standards Executive Committee* of the AICPA.

activity accounting. *Responsibility accounting*.

activity-based costing (ABC). Method of assigning *indirect costs*, including nonmanufacturing *overhead costs*, to products and services. ABC assumes that almost all overhead costs associate with activities within the firm and vary with respect to the *drivers* of those activities. Some practitioners suggest that ABC attempts to find the drivers for all indirect costs; these people note that in the long run, all costs are *variable*, so *fixed* indirect costs do not occur. This method first assigns costs to activities and then to products based on the products' usage of the activities.

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activity-based depreciation — adjusted book balance of cash

activity-based depreciation. *Production method (depreciation).*

activity-based management (ABM). Analysis and management of activities required to make a product or to produce a service. ABM focuses attention to enhance activities that add value to the customer and to reduce activities that do not. Its goal is to satisfy customer needs while making smaller demands on costly resources. Some refer to this as “activity management.”

activity basis. *Costs are variable or fixed (incremental or unavoidable) with respect to some activity, such as production of units (or the undertaking of some new project). Usage calls this activity the “activity basis.”*

activity center. Unit of the organization that performs a set of tasks.

activity variance. *Sales volume variance.*

actual cost (basis). *Acquisition or historical cost. Also contrast with standard cost.*

actual costing (system). Method of allocating costs to products using actual *direct materials*, actual *direct labor*, and actual *factory overhead*. Contrast with *normal costing* and *standard costing*.

actuarial. An adjective describing computations or analyses that involve both *compound interest* and probabilities, such as the computation of the *present value* of a life-contingent *annuity*. Some writers use the word even for computations involving only one of the two.

actuarial accrued liability. A 1981 report of the Joint Committee on Pension Terminology (of various actuarial societies) agreed to use this term rather than *prior service cost*.

ad valorem. A method of levying a tax or duty on goods by using their estimated value as the tax base.

additional paid-in capital. An alternative acceptable title for the *capital contributed in excess of par (or stated) value account*.

additional processing cost. *Costs incurred in processing joint products after the split-off point.*

adequate disclosure. An auditing standard that, to achieve *fair presentation of financial statements*, requires *disclosure* of *material items*. This *auditing standard* does not, however, require publicizing all information detrimental to a company. For example, the company may face a lawsuit, and disclosure might require a *debit* to a *loss* account and a *credit* to an *estimated liability*. But the court might view the making of this entry as an admission of liability, which could adversely affect the outcome of the suit. The firm should debit expense or loss for the expected loss, as required by *SFAS No. 5*, but need not use such accurate account titles that the court can spot an admission of liability.

adjunct account. An *account* that accumulates additions to another account. For example, Premium on Bonds Payable is adjunct to the liability Bonds Payable; the effective liability is the sum of the two account balances at a given date. Contrast with *contra account*.

adjusted acquisition (historical) cost. Sometimes said of the *book value* of a *plant asset*, that is, *acquisition cost* less *accumulated depreciation*. Also, cost adjusted to a *constant-dollar* amount to reflect *general price-level changes*.

adjusted bank balance of cash. The *balance* shown on the statement from the bank plus or minus amounts, such as for unrecorded deposits or outstanding checks, to reconcile the bank’s balance with the correct cash balance. See *adjusted book balance of cash*.

adjusted basis. The *basis* used to compute gain or loss on the disposition of an *asset* for tax purposes. See also *book value*.

adjusted book balance of cash. The *balance* shown in the firm’s account for cash in bank plus or minus amounts, such as for *notes*

adjusted trial balance — agency cost

collected by the bank or bank service charges, to reconcile the account balance with the correct cash balance. See *adjusted bank balance of cash*.

adjusted trial balance. *Trial balance* taken after *adjusting entries* but before *closing entries*. Contrast with *pre-* and *post-closing trial balances*. See *unadjusted trial balance* and *post-closing trial balance*. See also *work sheet*.

adjusting entry. An entry made at the end of an *accounting period* to record a *transaction* or other *accounting event* that the firm has not yet recorded or has improperly recorded during the accounting period; an entry to update the accounts. See *work sheet*.

adjustment. An *account* change produced by an *adjusting entry*. Sometimes accountants use the term to refer to the process of restating *financial statement* amounts to *constant dollars*.

administrative costs (expenses). *Costs* (*expenses*) incurred for the firm as a whole, in contrast with specific functions such as manufacturing or selling; includes items such as salaries of top executives, general office rent, legal fees, and auditing fees.

admission of partner. Occurs when a new partner joins a *partnership*. Legally, the old partnership dissolves, and a new one comes into being. In practice, however, the firm may keep the old accounting records in use, and the accounting entries reflect the manner in which the new partner joined the firm. If the new partner merely purchases the interest of another partner, the accounting changes the name for one capital account. If the new partner contributes *assets* and *liabilities* to the partnership, then the firm must recognize them. See *bonus method*.

ADR. See *asset depreciation range*.

advances from (by) customers. A preferred title for the *liability* account representing *receipts*

of *cash* in advance of delivering the *goods* or rendering the *service*. After the firm delivers the goods or services, it will recognize *revenue*. Some refer to this as “deferred revenue” or “deferred income,” terms likely to confuse the unwary because the item is not yet *revenue* or *income*.

advances to affiliates. *Loans* by a parent company to a *subsidiary*; frequently combined with “investment in subsidiary” as “investments and advances to subsidiary” and shown as a *noncurrent asset* on the parent’s *balance sheet*. The consolidation process eliminates these advances in *consolidated financial statements*.

advances to suppliers. A preferred term for the *asset* account representing *disbursements* of cash in advance of receiving *assets* or *services*.

adverse opinion. An *auditor’s report* stating that the financial statements are not fair or are not in accord with GAAP.

affiliated company. A company controlling or controlled by another company.

after closing. Post-closing; a *trial balance* at the end of the period.

after cost. *Expenditures* to be made after *revenue* recognition. For example, *expenditures* for *repairs* under warranty are after cost. Proper recognition of after cost involves a debit to expense at the time of the sale and a credit to an *estimated liability*. When the firm discharges the liability, it debits the estimated liability and credits the assets consumed.

AG (Aktiengesellschaft). Germany: the form of a German company whose shares can trade on the stock exchange.

agency cost. The *cost* to the *principal* caused by *agents* pursuing their own interests instead of the principal’s interests. Includes both the costs incurred by principals to control agents’ actions and the cost to the principals if agents

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agency fund — allowance for funds used during construction

pursue their own interests that are not in the interest of the principals.

agency fund. An account for *assets* received by governmental units in the capacity of trustee or agent.

agency theory. A branch of economics relating the behavior of *principals* (such as owner nonmanagers or bosses) and that of their *agents* (such as nonowner managers or subordinates). The principal assigns responsibility and authority to the agent, but the agent's own risks and preferences differ from those of the principal. The principal cannot observe all activities of the agent. Both the principal and the agent must consider the differing risks and preferences in designing incentive contracts.

agent. One authorized to transact business, including executing contracts, for another.

aging accounts receivable. The process of classifying *accounts receivable* by the time elapsed since the claim came into existence for the purpose of estimating the amount of uncollectible accounts receivable as of a given date. See *sales contra, estimated uncollectibles*, and *allowance for uncollectibles*.

aging schedule. A listing of *accounts receivable*, classified by age, used in *aging accounts receivable*.

AICPA (American Institute of Certified Public Accountants). The national organization that represents *CPAs*. See *AcSEC*. It oversees the writing and grading of the Uniform CPA Examination. Each state sets its own requirements for becoming a CPA in that state. See *certified public accountant*. Web Site: <http://www.aicpa.org>. Although the AICPA sets many auditing and professional standards for public accountants, the *PCAOB* regulates auditing of public companies and the profession.

all-capital earnings rate. *Rate of return on assets*.

all-current method. *Foreign currency translation* in which all *financial statement* items are translated at the *current exchange rate*.

all-inclusive (income) concept. A concept that does not distinguish between *operating* and *nonoperating revenues* and *expenses*. Thus, the only entries to retained earnings are for *net income* and *dividends*. Under this concept, the *income statement* reports all *income, gains, and losses*; thus, net income includes events usually reported as *prior-period adjustments* and as *corrections of errors*. *GAAP* do not include this concept in its pure form, but *APE Opinions No. 9 and No. 30* move far in this direction. They do permit retained earnings entries for prior-period adjustments and correction of errors.

allocate. To divide or spread a *cost* from one *account* into several accounts, to several products or activities, or to several periods.

allocation base. The systematic method that assigns *joint costs* to *cost objectives*. For example, a firm might assign the cost of a truck to periods based on miles driven during the period; the allocation base is miles. Or the firm might assign the cost of a factory supervisor to a product based on *direct labor* hours; the allocation base is direct labor hours.

allocation of income taxes. See *deferred income tax*.

allowance. A balance sheet *contra account* generally used for *receivables* and depreciable assets. See *sales (or purchase) allowance* for another use of this term.

allowance for funds used during construction. In accounting for public utilities, a *revenue account credited* for *implicit interest* earnings on *shareholders' equity* balances. One principle of public utility regulation and rate setting requires that customers should pay the full costs

allowance for uncollectibles (accounts receivable) — allowance method

of producing the services (e.g., electricity) that they use, nothing more and nothing less. Thus, an electric utility must capitalize into an *asset* account the full costs, but no more, of producing a new electric power-generating plant. One of the costs of building a new plant is the *interest* cost on cash tied up during construction. If *funds* are explicitly borrowed by an ordinary business, the journal entry for interest of \$1,000 is typically:

Interest Expense	1,000	
Interest Payable		1,000
Interest expense for the period.		

If the firm is constructing a new plant, then another entry would be made, capitalizing interest into the plant-under-construction account:

Construction Work-in-Progress . . .	750	
Interest Expense		750
Capitalize relevant portion of interest relating to construction work in progress into the asset account.		

The cost of the *plant asset* increases; when the firm uses the plant, it charges *depreciation*. The interest will become an expense through the depreciation process in the later periods of use, not currently as the firm pays for interest. Thus, the firm reports the full cost of the electricity generated during a given period as expense in that period. But suppose, as is common, that the electric utility does not explicitly borrow the funds but uses some of its own funds, including funds raised from equity issues as well as from debt. Even though the firm incurs no explicit interest expense or other explicit expense for capital, the funds have an *opportunity cost*. Put another way, the plant under construction will not have lower economic cost just because the firm used its own cash rather than borrowing. The public utility using its own funds, on which it would have to pay

\$750 of interest if it had explicitly borrowed the funds, will make the following entry:

Construction Work-in-Progress . . .	750	
Allowance for Funds Used during Construction		750
Recognition of interest, an opportunity cost, on own funds used.		

The allowance account is a form of *revenue*, to appear on the income statement, and the firm will close it to Retained Earnings, increasing it. On the *statement of cash flows* it is an income or revenue item not producing funds, and so the firm must subtract it from net income in deriving *cash provided by operations*. *SFAS No. 54* specifically prohibits nonutility companies from capitalizing, into plant under construction, the opportunity cost (interest), on their own funds used.

allowance for uncollectibles (accounts receivable). A *contra account* that shows the estimated *accounts receivable* amount that the firm expects not to collect. When the firm uses such an allowance, the actual write-off of specific accounts receivable (*debit* allowance, *credit* specific customer's account) does not affect *revenue* or *expense* at the time of the write-off. The firm reduces revenue when it debits *bad debt expense* (or, our preference, a revenue contra account) and credits the allowance; the firm can base the amount of the credit to the allowance on a percentage of sales on account for a period of time or compute it from *aging accounts receivable*. This contra account enables the firm to show an estimated receivables amount that it expects to collect without identifying specific uncollectible accounts. See *allowance method*.

allowance method. A method of attempting to match all *expenses* of a transaction with their associated *revenues*; usually involves a debit to expense and a credit to an *estimated liability*, such as for estimated warranty

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American Accounting Association (AAA) — annuitant

expenditures, or a debit to a revenue (*contra*) account and a credit to an asset (*contra*) account, such as in some firms' accounting for uncollectible accounts. See *allowance for uncollectibles* for further explanation. When the firm uses the allowance method for *sales discounts*, the firm records sales at gross invoice prices (not reduced by the amounts of discounts made available). The firm *debits* an estimate of the amount of discounts to be taken to a revenue contra account and *credits* an allowance account, shown contra to *accounts receivable*.

American Accounting Association (AAA). An organization primarily for academic accountants but open to all interested in accounting. It publishes the *Accounting Review* and several other journals.

American Institute of Certified Public Accountants. See *AICPA*.

American Stock Exchange (AMEX) (ASE).

A public market where various corporate *securities* are traded.

AMEX. *American Stock Exchange*.

amortization. Strictly speaking, the process of liquidating or extinguishing ("bringing to death") a *debt* with a series of payments to the *creditor* (or to a *sinking fund*). From that usage has evolved a related use involving the accounting for the payments themselves: "amortization schedule" for a mortgage, which is a table showing the allocation between *interest* and *principal*. The term has come to mean writing off ("liquidating") the cost of an asset. In this context it means the general process of *allocating* the *acquisition cost* of an asset either to the periods of benefit as an *expense* or to *inventory* accounts as a *product cost*. This is called *depreciation* for *plant assets*, *depletion* for *wasting assets* (natural resources), and "amortization" for *intangibles*. *SFAC No. 6* refers to amortization as "the accounting process of reducing an amount by periodic

payments or write-downs." The expressions "unamortized debt discount or premium" and "to amortize debt discount or premium" relate to *accruals*, not to *deferrals*. The expressions "amortization of long-term assets" and "to amortize long-term assets" refer to *deferrals*, not *accruals*. Contrast with *accretion*.

amortized cost. A measure required by *SFAS No. 115* for *held-to-maturity securities*. This amount results from applying the method described at *effective interest method*. The firm records the security at its initial cost and computes the *effective interest rate* for the security. Whenever the firm receives cash from the issuer of the security or whenever the firm reaches the end of one of its own *accounting periods* (that is, reaches the time for its own *adjusting entries*), it takes the following steps. It multiplies the amount currently recorded on the books by the effective interest rate (which remains constant over the time the firm holds the security). It debits that amount to the Debt Security account and credits the amount to Interest Revenue. If the firm receives cash, it debits Cash and credits the debt security account. The firm recomputes the book value of the Debt Security as the book value before these entries plus the increase for the interest revenue less the decrease for the cash received. The resulting amount is the amortized cost for the end of that period.

analysis of variances. See *variance analysis*.

annual report. A report prepared once a year for shareholders and other interested parties. It includes a *balance sheet*, an *income statement*, a *statement of cash flows*, a reconciliation of changes in *owners' equity* accounts, a *summary of significant accounting principles*, other explanatory *notes*, the *auditor's report*, and comments from management about the year's events. See *10-K* and *financial statements*.

annuitant. One who receives an *annuity*.

annuity — approximate net realizable value method

annuity. A series of payments of equal amount, usually made at equally spaced time intervals.

annuity certain. An *annuity* payable for a definite number of periods. Contrast with *contingent annuity*.

annuity due. An *annuity* whose first payment occurs at the start of period 1 (or at the end of period 0). Contrast with *annuity in arrears*.

annuity in advance. An *annuity due*.

annuity in arrears. An *ordinary annuity* whose first payment occurs at the end of the first period.

annuity method of depreciation. See *compound interest depreciation*.

antidilutive. Said of a *potentially dilutive* security that will increase *earnings per share* if its holder *exercises* it or *converts* it into common stock. In computing *primary* and *fully diluted earnings per share*, the firm must assume that holders of antidilutive securities will not exercise their options or convert securities into common shares. The opposite assumption would lead to increased reported earnings per share in a given period.

APB. Accounting Principles Board of the AICPA. It set *accounting principles* from 1959 through 1973, issuing 31 *APB Opinions* and 4 *APB Statements*. The FASB superseded it.

APB Opinion. The name for the APB pronouncements that compose much of *generally accepted accounting principles*; the APB issued 31 *APB Opinions* from 1962 through 1973.

APB Statement. The APB issued four *APB Statements* between 1962 and 1970. The *Statements* were approved by at least two-thirds of the board, but they state recommendations, not requirements. For example, *Statement No. 3* (1969) suggested the publication of *constant-dollar* financial statements but did not require them.

APBs. An abbreviation used for *APB Opinions*.

applied cost. A *cost* that a firm has *allocated* to a department, product, or activity; not necessarily based on actual costs incurred.

applied overhead. *Overhead costs* charged to departments, products, or activities. Also called *absorbed overhead*.

appraisal. In valuing an *asset* or *liability*, a process that involves expert opinion rather than evaluation of explicit market transactions.

appraisal costs. *Costs* incurred to detect individual units of products that do not conform to specifications, including end-process sampling and field-testing. Also called “detection costs.”

appraisal method of depreciation. The periodic *depreciation* charge that equals the difference between the beginning-of-period and the end-of-period appraised values of the *asset*. If that difference is positive. If negative, there is no charge. Not based on *historical cost*, this method is thus not generally accepted.

appreciation. An increase in economic value caused by rising market prices for an *asset*. Contrast with *accretion*.

appropriated retained earnings. See *retained earnings, appropriated*.

appropriation. In governmental accounting, an *expenditure* authorized for a specified amount, purpose, and time.

appropriation account. In governmental accounting, an account set up to record specific authorizations to spend. The governmental unit credits this account with appropriation amounts. At the end of the period, the unit closes to (debits) this account all *expenditures* during the period and all *encumbrances* outstanding at the end of the period.

approximate net realizable value method. A method of assigning joint costs to *joint products* based on revenues minus *additional processing costs* of the end products.

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ARB. *Accounting Research Bulletin.*

arbitrage. Strictly speaking, the simultaneous purchase in one market and sale in another of a *security* or commodity in hope of making a *profit* on price differences in the different markets. Often, writers use this term loosely when a trader sells an item that is somewhat different from the item purchased; for example, the sale of shares of common stock and the simultaneous purchase of a *convertible bond* that is convertible into identical common shares. The trader hopes that the market will soon see that the similarities of the items should make them have equal market values. When the market values converge, the trader closes the positions and profits from the original difference in prices, less trading costs.

arbitrary. Having no causation basis. Accounting theorists and practitioners often, properly, say, "Some cost allocations are arbitrary." In that sense, the accountant does not mean that the allocations are capricious or haphazard but does mean that theory suggests no unique solution to the allocation problem at hand. Accountants require that arbitrary allocations be systematic, rational, and consistently followed over time.

arm's length. A transaction negotiated by unrelated parties, both acting in their own self-interests; the basis for a *fair market value* estimation or computation.

arrears. *Cumulative dividends* that the firm has not yet declared. See *annuity in arrears* for another context.

ARS. *Accounting Research Study.*

articles of incorporation. Document filed with state authorities by persons forming a corporation. When the state returns the document with a certificate of incorporation, the document becomes the corporation's *charter*.

articulate. The relation between any operating statement (for example, *income statement* or *statement of cash flows*) and comparative

ARB — asset depreciation range (ADR)

balance sheets, where the operating statement explains (or reconciles) the change in some major balance sheet category (for example, *retained earnings* or *working capital*).

ASE. *American Stock Exchange.*

ASR. *Accounting Series Release.*

assess. To value property for the purpose of property taxation; to levy a charge on the owner of property for improvements thereto, such as for sewers or sidewalks. The taxing authority computes the assessment.

assessed valuation. For real estate or other property, a dollar amount that a government uses as a basis for levying taxes. The amount need not have some relation to *market value*.

asset. *SFAC No. 5* defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions. . . . An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." A footnote points out that "probable" means that which we can reasonably expect or believe but that is not certain or proved. You may understand condition (c) better if you think of it as requiring that a future benefit cannot be an asset if it arises from an *executory contract*, a mere exchange of promises. Receiving a purchase order from a customer provides a future benefit, but it is an *executory contract*, so the order cannot be an asset. An asset may be *tangible* or *intangible*, short-term (current) or long-term (noncurrent).

asset depreciation range (ADR). The range of *depreciable lives* allowed by the *Internal*

asset securitization — audit program

Revenue Service for a specific depreciable *asset*.

asset securitization. *Securitization*.

asset turnover. Net sales divided by average assets. See *ratio*.

assignment of accounts receivable. Transfer of the legal ownership of an account receivable through its sale. Contrast with *pledging* accounts receivable, where the receivables serve as *collateral* for a *loan*.

ATB. *Accounting Terminology Bulletin*.

at par. A *bond* or *preferred shares* issued (or selling) at *face amount*.

attachment. The laying claim to the *assets* of a borrower (or debtor) by a lender (or creditor) when the borrower has failed to pay debts on time.

attest. An auditor's rendering of an *opinion* that the *financial statements* are fair. Common usage calls this procedure the "attest function" of the CPA. See *fair presentation*.

attestor. Typically independent CPAs, who *audit financial statements* prepared by management for the benefit of users. The FASB describes accounting's constituency as comprising preparers, attestors, and users.

attribute measured. The particular *cost* reported in the balance sheet. When making physical measurements, such as of a person, one needs to decide the units with which to measure, such as inches or centimeters or pounds or grams. One chooses the attribute height or weight independently of the measuring unit, English or metric. Conventional accounting uses *historical cost* as the attribute measured and *nominal dollars* as the measuring unit. Some theorists argue that accounting would better serve readers if it used *current cost* as the attribute measured. Others argue that accounting would better serve readers if it used *constant dollars* as the measuring unit. Some, including us, think

accounting should change both the measuring unit and the attribute measured. One can measure the attribute historical cost in nominal dollars or in constant dollars. One can also measure the attribute current cost in nominal dollars or constant dollars. Choosing between the two attributes and the two measuring units implies four different accounting systems. Each of these four has its uses.

attribute(s) sampling. The use of sampling technique in which the observer assesses each item selected on the basis of whether it has a particular qualitative characteristic in order to ascertain the rate of occurrence of this characteristic in the population. See also *estimation sampling*. Compare *variables sampling*. Example of attributes sampling: take a sample population of people, note the fraction that is male (say, 40 percent), and then infer that the entire population contains 40 percent males. Example of variables sampling: take a sample population of people, observe the weight of each sample point, compute the mean of those sampled people's weights (say, 160 pounds), and then infer that the mean weight of the entire population equals 160 pounds.

audit. Systematic inspection of accounting records involving analyses, tests, and *confirmations*. See *internal audit*.

audit committee. A committee of the board of directors of a *corporation*, usually comprising outside directors, who nominate the independent auditors and discuss the auditors' work with them. If the auditors believe the shareholders should know about certain matters, the auditors, in principle, first bring these matters to the attention of the audit committee; in practice, the auditors may notify management before they notify the audit committee.

Audit Guides. See *Industry Audit Guides*.

audit program. The procedures followed by the *auditor* in carrying out the *audit*.

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audit trail. A reference accompanying an entry, or *post*, to an underlying source record or document. Efficiently checking the accuracy of accounting entries requires an audit trail. See *cross-reference*.

Auditing Research Monograph. Publication series of the *AICPA*.

auditing standards. Standards promulgated by the *PCAOB* for auditors to follow in carrying out their *attest* functions. The *PCAOB* began operations in earnest in 2003, and initially has said that it would use the standards originally promulgated by the *AICPA*, including general standards, standards of field work, and standards of reporting. According to the *AICPA*, these standards “deal with the measures of the quality of the performance and the objectives to be attained” rather than with specific auditing procedures. As time passes, the *PCAOB* will substitute its rules for those of the *AICPA*.

Auditing Standards Board. *AICPA* operating committee that promulgates auditing rules. The new operations of the *PCAOB*, after 2003, render uncertain what this Board will do.

auditor. Without a modifying adjective, usually refers to an external auditor—one who checks the accuracy, fairness, and general acceptability of accounting records and statements and then *attests* to them. See *internal auditor*.

auditor’s opinion. *Auditor’s report*.

auditor’s report. The auditor’s statement of the work done and an opinion of the *financial statements*. The auditor usually gives unqualified (“clean”) opinions but may qualify them, or the auditor may disclaim an opinion in the report. Often called the “accountant’s report.” See *adverse opinion*.

AudSEC. The former Auditing Standards Executive Committee of the *AICPA*, now functioning as the *Auditing Standards Board*.

audit trail — avoidable cost

authorized capital stock. The number of *shares* of stock that a corporation can issue; specified by the *articles of incorporation*.

available for sale, securities. *Marketable securities* a firm holds that are classified as neither *trading securities* nor *held-to-maturity (debt) securities*. This classification is important in *SFAS No. 115*, which requires the owner to carry marketable equity securities on the balance sheet at market value, not at cost. Under *SFAS No. 115*, the income statement reports *holding gains and losses* on trading securities but not on securities available for sale. The required accounting *credits (debits)* holding gains (losses) on securities available for sale directly to an *owners’ equity* account. On sale, the firm reports realized gain or loss as the difference between the selling price and the original cost, for trading securities, and as the difference between the selling price and the book value at the beginning of the period of sale, for securities available for sale and for debt securities held to maturity. By their nature, however, the firm will only rarely sell debt securities “held to maturity.”

average. The arithmetic mean of a set of numbers; obtained by summing the items and dividing by the number of items.

average collection period of receivables. See *ratio*.

average-cost flow assumption. An *inventory flow assumption* in which the cost of units equals the *weighted average* cost of the *beginning inventory* and purchases. See *inventory equation*.

average tax rate. The rate found by dividing *income tax* expense by *net income* before taxes. Contrast with *marginal tax rate* and *statutory tax rate*.

avoidable cost. A *cost* that ceases if a firm discontinues an activity; an *incremental* or *variable cost*. See *programmed cost*.

B

backflush costing. A method of *allocating indirect costs* and *overhead*; used by companies that hope to have zero or small *work-in-process inventory* at the end of the period. The method *debits* all *product costs* to *cost of goods sold* (or *finished goods inventory*) during the period. To the extent that work in process actually exists at the end of the period, the method then debits work-in-process and *credits* cost of goods sold (or finished goods inventory). This method is “back-flush” in the sense that costing systems ordinarily, but not in this case, allocate first to work-in-process and then forward to cost of goods sold or to finished goods. Here, the process allocates first to cost of goods sold (or finished goods) and then, later if necessary, to work-in-process.

backlog. Orders for which a firm has insufficient *inventory* on hand for current delivery and will fill in a later period.

backlog depreciation. In *current cost accounting*, a problem arising for the *accumulated depreciation* on *plant assets*. Consider an asset costing \$10,000 with a 10-year life depreciated with the straight-line method. Assume that a similar asset has a current cost of \$10,000 at the end of the first year but \$12,000 at the end of the second year. Assume that the firm bases the depreciation charge on the average current cost during the year, \$10,000 for the first year and \$11,000 for the second. The depreciation charge for the first year is \$1,000 and for the second is \$1,100 ($= .10 \times \$11,000$), so the *accumulated depreciation account* is \$2,100 after two years. Note that at the end of the second year, the firm has used 20 percent of the asset’s future benefits, so the accounting records based on current costs must show a *net book value* of \$9,600 ($= .80 \times \$12,000$),

which results only if accumulated depreciation equals \$2,400, so that book value equals \$9,600 ($= \$12,000 - \$2,400$). But the sum of the depreciation charges equals only \$2,100 ($= \$1,000 + \$1,100$). The *journal entry* to increase the accumulated depreciation account requires a *credit* to that account of \$300. The backlog depreciation question arises: What account do we debit? Some theorists would *debit* an *income* account, and others would *debit* a *balance sheet owners’ equity* account without reducing current-period earnings. The answer to the question of what to debit interrelates with how the firm records the *holding gains* on the asset. When the firm debits the asset account for \$2,000 to increase the recorded amount from \$10,000 to \$12,000, it records a holding gain of \$2,000 with a credit. Many theorists believe that whatever account the firm credits for the holding gain is the same account that the firm should debit for backlog depreciation. This is sometimes called “catch-up depreciation.”

bad debt. An *uncollectible account*; see *bad debt expense* and *sales contra, estimated uncollectibles*.

bad debt expense. The name for an *account debited* in both the *allowance method* for *uncollectible accounts* and the *direct write-off method*. Under the allowance method, some prefer to treat the account as a revenue contra, not as an expense, and give it an account title such as Uncollectible Accounts Adjustment.

bad debt recovery. Collection, perhaps partial, of a specific account receivable previously written off as uncollectible. If a firm uses the *allowance method*, it will usually *credit* the *allowance* account, assuming that it has correctly assessed the amount of bad

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debts but has merely misjudged the identity of one of the nonpaying customers. If the firm decides that its charges for bad debts have been too large, it will credit the Bad Debt Expense account. If the firm uses the *direct write-off* method, it will credit a *revenue account*.

bailout period. In a *capital budgeting* context, the total time that elapses before accumulated cash inflows from a project, including the potential *salvage value* of assets at various times, equal or exceed the accumulated cash outflows. Contrast with *payback period*, which assumes completion of the project and uses terminal salvage value. Bailout, in contrast with payback, takes into account, at least to some degree, the *present value* of the cash flows after the termination date that the analyst is considering. The potential salvage value at any time includes some estimate of the flows that can occur after that time.

balance. As a noun, the opening balance in an *account* plus the amounts of increases less the amounts of decreases. (In the absence of a modifying adjective, the term means closing balance, in contrast to opening balance. The closing balance for a period becomes the opening balance for the next period.) As a verb, “balance” means to find the value of the arithmetic expression described above.

balance sheet. Statement of financial position that shows $\text{Total assets} = \text{Total liabilities} + \text{Owners' equity}$. The *balance sheet* usually classifies Total Assets as (1) *current assets*, (2) *investments*, (3) *property, plant, and equipment*, or (4) *intangible assets*. The balance sheet accounts composing Total Liabilities usually appear under the headings Current Liabilities and Long-term Liabilities.

balance sheet account. An account that can appear on a balance sheet; a *permanent account*. Contrast with *temporary account*.

balanced scorecard. A set of performance targets, not all expressed in dollar amounts, for

bailout period — base stock method

setting an organization’s goals for its individual employees or groups or divisions. A community relations employee might, for example, set targets in terms of number of employee hours devoted to local charitable purposes.

balloon. Most *mortgage* and *installment loans* require relatively equal periodic payments. Sometimes the loan requires relatively equal periodic payments with a large final payment. Usage calls the large final payment a “balloon” payment and the loan, a “balloon” loan. Although a coupon bond meets this definition, usage seldom, if ever, applies this term to bond loans.

bank balance. The amount of the balance in a checking account shown on the *bank statement*. Compare with *adjusted bank balance of cash*, and see *bank reconciliation schedule*.

bank prime rate. See *prime rate*.

bank reconciliation schedule. A schedule that explains the difference between the book balance of the cash in a bank account and the bank’s statement of that amount; takes into account the amount of items such as checks that have not cleared or deposits that have not been recorded by the bank, as well as errors made by the bank or the firm.

bank statement. A statement sent by the bank to a checking account customer showing deposits, checks cleared, and service charges for a period, usually one month.

bankrupt. Occurs when a company’s *liabilities* exceed its *assets* and the firm or one of its creditors has filed a legal petition that the bankruptcy court has accepted under the bankruptcy law. A bankrupt firm is usually, but need not be, *insolvent*.

base stock method. A method of inventory valuation that assumes that a firm must keep on hand at all times a minimum normal, or base stock, of goods for effective continuity of operations. The firm values this base

basic accounting equation — Big N

quantity at *acquisition cost* of the inventory on hand in the earliest period when inventory was on hand. Firms may not use this method, either for financial reporting or for tax reporting, but most theorists consider it to be the forerunner of the *LIFO* cost flow assumption.

basic accounting equation. *Accounting equation.*

basic cost-flow equation. *Cost-flow equation.*

basic earnings per share (BEPS). *Net income to common shareholders*, divided by the weighted average number of common shares *outstanding* during the period. Required by *SFAS No. 128* and by *IASB*. See *primary earnings per share (PEPS)* for contrast. Because BEPS does not deal with *common-stock equivalents*, it will almost always give a larger earnings-per-share figure than PEPS.

basis. *Acquisition cost*, or some substitute therefor, of an *asset* or *liability* used in computing gain or loss on disposition or retirement; *attribute measured*. This term appears in both *financial* and *tax reporting*, but the basis of a given item need not be the same for both purposes.

basis point. One one-hundredth ($=1/100$). Terminology usually quotes *interest rates* in percentage terms, such as “5.60 percent” or “5.67 percent.” The difference between those two interest rates is described as “7 basis points” or seven one-hundredths of one percent. Financial writers often extend this usage to other contexts involving decimals. For example, if the mean grade point average in the class is 3.25 and a given student scores 3.30, we might say that the student scored “5 basis points” above the class average.

basket purchase. Purchase of a group of *assets* (and *liabilities*) for a single price; the acquiring firm must assign *costs* to each item so that it can record the individual items with their separate amounts in the *accounts*.

batch-level activities. Work required to ready equipment or people for a production run.

bear. One who believes that security prices will fall. A “bear market” refers to a time when stock prices are generally declining. Contrast with *bull*.

bearer bond. See *registered bond* for contrast and definition.

beginning inventory. Valuation of *inventory* on hand at the beginning of the *accounting period*, equals *ending inventory* from the preceding period.

behavioral congruence. *Goal congruence.*

benchmarking. Process of measuring a firm’s performance, products, and services against standards based on best levels of performance achievable or, sometimes, achieved by other firms.

BEPS. *Basic earnings per share.*

betterment. An *improvement*, usually *capitalized*, not *expensed*.

bid. An offer to purchase, or the amount of the offer.

big bath. A *write-off* of a substantial amount of costs previously treated as *assets*; usually occurs when a corporation drops a business line that earlier required a large investment but that proved to be unprofitable. The term is sometimes used to describe a situation in which a corporation takes a large write-off in one period in order to free later periods of gradual write-offs of those amounts. In this sense it frequently occurs when the top management of the firm changes.

Big 4, Final 4. The four largest U.S. *public accounting* partnerships; in alphabetical order: Deloitte & Touche; Ernst & Young; KPMG Peat Marwick; and PricewaterhouseCoopers. See *Big N*.

Big N. The largest U.S. *public accounting* partnerships. When we first prepared this glossary, there were eight such partnerships,

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referred to as the “Big 8.” See *Big 4*. The term “Big N” came into use when various of the *Big 8* proposed to merge with each other and the ultimate number of large partnerships was in doubt, which it still is, although we don’t expect the number to change before 2010.

bill. An *invoice* of charges and *terms of sale* for goods and services; also, a piece of currency.

bill of materials. A specification of the quantities of *direct materials* that a firm expects to use to produce a given job or quantity of output.

blocked currency. Currency that the holder, by law, cannot withdraw from the issuing country or exchange for the currency of another country.

board. *Board of directors.*

board of directors. The governing body of a corporation; elected by the shareholders.

bond. A certificate to show evidence of debt. The *par value* is the *principal* or face amount of the bond payable at maturity. The *coupon rate* is the amount of the yearly payments divided by the principal amount. Coupon bonds have attached coupons that the holder can redeem at stated dates. Increasingly, firms issue not coupon bonds but registered bonds; the firm or its agent keeps track of the owners of registered bonds. Normally, bonds call for semiannual payments.

bond conversion. The act of exchanging *convertible bonds* for *preferred* or *common shares*.

bond discount. From the standpoint of the issuer of a *bond* at the issue date, the excess of the *par value* of a bond over its initial sales price and, at later dates, the excess of par over the sum of the following two amounts: initial issue price and the portion of discount already *amortized*; from the standpoint of a bondholder, the difference between par value

bill — bonus method

and selling price when the bond sells below par.

bond indenture. The contract between an issuer of *bonds* and the bondholders.

bond premium. Exactly parallel to *bond discount* except that the issue price (or current selling price) exceeds *par value*.

bond ratings. Corporate and *municipal bond* issue ratings, based on the issuer’s existing *debt* level, its previous record of payment, the *coupon rate* on the bonds, and the safety of the *assets* or *revenues* that are committed to paying off *principal* and *interest*. Moody’s Investors Service and Standard & Poor’s Corporation publish bond ratings: Moody’s top rating is Aaa; Standard & Poor’s is AAA.

bond redemption. Retirement of *bonds*.

bond refunding. To incur *debt*, usually through the issue of new *bonds*, intending to use the proceeds to retire an *outstanding* bond issue.

bond sinking fund. See *sinking fund*.

bond table. A table showing the current price of a *bond* as a function of the *coupon rate*, current (remaining) term *maturity*, and effective *yield to maturity* (or *effective rate*).

bonus. Premium over normal *wage* or *salary*, paid usually for meritorious performance.

bonus method. One of two methods to recognize an excess, say \$10,000, when a *partnership* admits a new partner and when the new partner’s capital account is to show an amount larger than the amount of *tangible* assets that he or she contributes. First, the old partners may transfer \$10,000 from themselves to the new partner. This is the bonus method. Second, the partnership may recognize goodwill in the amount of \$10,000, with the credit to the new partner’s capital account. This is the *goodwill method*. (Notice that the new partner’s percentage of total ownership differs under the two methods.) If the new partner’s capital account is to show an amount smaller

book — breakeven chart

than the tangible assets that he or she contributed, then the old partners will receive bonus or goodwill, depending on the method.

book. As a verb, to record a transaction; as a noun, usually plural, the *journals* and *ledgers*; as an adjective, see *book value*.

book cost. *Book value.*

book inventory. An *inventory* amount that results not from physical count but from the amount of beginning inventory plus *invoice* amounts of net purchases less invoice amounts of *requisitions* or withdrawals; implies a *perpetual inventory* method.

book of original entry. *Journal.*

book value. The amount shown in the books or in the *accounts* for an *asset*, *liability*, or *owners' equity* item. The term is generally used to refer to the *net* amount of an *asset* or group of assets shown in the account that records the asset and reductions, such as for *amortization*, in its cost. Of a firm, it refers to the excess of total assets over total liabilities; *net assets*.

book value per share of common stock. Common *shareholders' equity* divided by the number of shares of common stock outstanding. See *ratio*.

bookkeeping. The process of analyzing and recording transactions in the accounting records.

boot. The additional cash paid (or received) along with a used item in a trade-in or exchange transaction for another item. See *trade-in*.

borrower. See *loan*.

bottleneck. An operation in which the work to be performed equals or exceeds the available capacity, thus holding up further operations.

branch. A sales office or other unit of an enterprise physically separated from the home office of the enterprise but not organized as a legally separate *subsidiary*. Writers seldom use this term to refer to manufacturing units.

branch accounting. An accounting procedure that enables the firm to report the financial position and operations of each *branch* separately but later combine them for published statements.

brand, brand name. See *trademark* and *trademark right*.

breakeven analysis. See *breakeven chart*.

breakeven chart. Two kinds of breakeven charts appear here. The charts use the following information for one month. Revenue is \$30 per unit.

Cost Classification	Variable Cost, Per Unit	Fixed Cost, Per Month
Manufacturing Costs		
Direct Material	\$ 4	
Direct Labor	9	
Overhead	4	\$ 3,060
Total manufacturing Costs	\$ 17	\$ 3,060
Selling, general, and administrative costs	5	1,740
Total costs	<u>\$ 22</u>	<u>\$ 4,800</u>

The cost-volume-profit graph presents the relation between changes in volume to the amount of *profit*, or *income*. Such a graph shows total *revenue* and total *costs* for each volume level, and the user reads profit or loss at any volume directly from the chart. The profit-volume graph does not show revenues and costs but more readily indicates profit (or loss) at various output levels. Keep in mind two caveats about these graphs:

1. Although the curve depicting *variable cost* and total cost appears as a straight line for its entire length, at low or high levels of output, variable cost will probably differ from \$22 per unit. The variable cost figure usually results from studies of operations at some broad central area of production, called the *relevant range*. The chart will not usually provide accurate results for low (or high) levels of activity. For this reason, the total cost and the profit-loss curves sometimes

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appear as dotted lines at lower (or higher) volume levels.

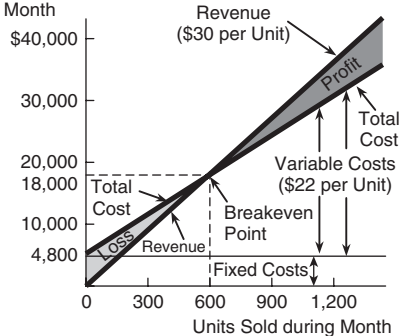
- This chart, simplistically, assumes a single-product firm. For a multiproduct firm, the horizontal axis would have to be stated in dollars rather than in physical

breakeven point — business combination

units of output. Breakeven charts for multiproduct firms necessarily assume that the firm sells constant proportions of the several products, so that changes in this mixture, as well as in costs or selling prices, invalidate such a chart.

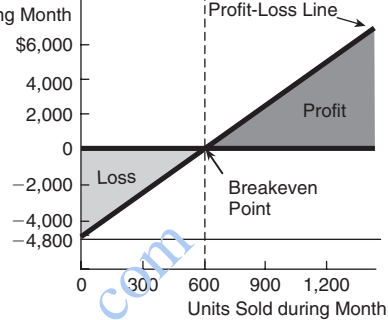
(a) Cost-Volume-Profit Graph

Revenue and Costs during Month



(b) Profit-Volume Graph

Profit or Loss during Month



breakeven point. The volume of sales required so that total revenues equals total costs; may be expressed in units ($\text{Fixed costs} \div \text{Contribution per unit}$) or in sales dollars [$\text{Selling price per unit} \times (\text{Fixed costs} \div \text{Contribution per unit})$].

break-even time. Time required before the firm recovers the amounts it invested in developing a new product.

budget. A financial plan that a firm uses to estimate the results of future operations; frequently used to help control future operations. In governmental operations, budgets often become the law. See *standard costs* for further elaboration and contrast.

budgetary accounts. In governmental accounting, the accounts that reflect estimated operations and financial condition, as affected by estimated revenues, appropriations, and encumbrances. Contrast with *proprietary accounts*, which record the transactions.

budgetary control. Management of governmental (nongovernmental) unit in accordance with an official (approved) budget in

order to keep total expenditures within authorized (planned) limits.

budgeted cost. See *standard costs* for definition and contrast.

budgeted statements. *Pro forma statements* prepared before the event or period occurs.

bull. One who believes that security prices will rise. A “bull market” refers to a time when stock prices are generally rising. Contrast with *bear*.

burden. See *overhead costs*.

burn rate. A new business usually begins life with cash-absorbing operating losses but with a limited amount of cash. The “burn rate” measures how long the new business can survive before operating losses must stop or the firm must receive a new infusion of cash. Writers usually express the burn rate in months.

business combination. As defined in *APB Opinion No. 16*, the bringing together into a single accounting entity of two or more incorporated or unincorporated businesses. The new

business entity — capital

entity will account for the *merger* either with the *purchase method* or, outside the United States, with the *pooling-of-interests method*. See *conglomerate*.

business entity. *Entity; accounting entity.*

BV (*besloten vennootschap*). Netherlands: a private limited-liability company.

bylaws. The rules adopted by the shareholders of a corporation; specify the general methods for carrying out the functions of the corporation.

byproduct. A *joint product* whose sales value is so small relative to the sales value of the other joint product(s) that it does not receive normal accounting treatment. The costs assigned to byproducts reduce the costs of the main product(s). Accounting allocates byproducts a share of joint costs such that the expected gain or loss at their sale is zero. Thus, byproducts appear in the *accounts at net realizable value*.

C

C corporation. In tax terminology, a corporation paying its own income taxes. Contrast with *S corporation*.

CA. *Chartered accountant.*

call. An option to buy *shares* of a publicly traded corporation at a fixed price during a fixed time span. Contrast with *put*.

call premium. See *callable bond*.

call price. See *callable bond*.

callable bond. A *bond* for which the issuer reserves the right to pay a specific amount, the call price, to retire the obligation before its *maturity date*. If the issuer agrees to pay more than the *face amount* of the bond when called, the excess of the payment over the face amount is the “call premium.”

called-up share capital. United Kingdom: *common stock at par value*.

Canadian Institute of Chartered Accountants
The national organization that represents *chartered accountants* in Canada. Web Site: www.cica.ca.

cancelable lease. See *lease*.

CAP. *Committee on Accounting Procedure.*

capacity. Stated in units of product, the amount that a firm can produce per unit of time; stated in units of input, such as *direct labor-hours*,

the amount of input that a firm can use in production per unit of time. A firm uses this measure of output or input in allocating *fixed costs* if the amounts producible are normal, rather than maximum, amounts.

capacity cost. A *fixed cost* incurred to provide a firm with the capacity to produce or to sell. Consists of *standby costs* and *enabling costs*. Contrast with *programmed costs*.

capacity variance. *Production volume variance.*

capital. *Owners' equity* in a business; often used, equally correctly, to mean the total assets of a business; sometimes used to mean *long-term assets*. Sometimes used to mean *funds raised* or all assets or long-term financing. This word causes confusion in accounting and finance. Uninformed users mix up the funds (and their uses) with the sources of the funds. Consider the following transactions. A firm raises \$100 cash by issuing shares and uses the \$100 to acquire *inventory* and *plant assets*. Did the investor “invest capital” of \$100 or did the firm “invest capital” of \$100 or both? You will hear “invest capital” used for both sides of that transaction. Now focus on the firm that issued the shares and received the cash. Some would say the first transaction, the issue of shares, “raised capital.” (If you ask of a person who

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answers this way, “What is the *capital*, the increase in owners’ equity or the increased cash?” you will not get a clear answer, consistent across all such people.) Others would say only the second transaction, spending the cash, raised capital and only then for the plant assets, not the inventory. When a regulator focuses on a bank’s capital ratios, it looks to the right-hand side of the balance sheet, not to how the firm has invested its funds. Sometimes bank regulators will take the owners’ equity total and subtract from that amount the amount of intangible assets, resulting in a total with no clear conception, which they call “tangible capital.” See *cost of capital* for further discussion of the confusion between the cost of raising funds and the return to, or *opportunity cost* of, investing funds. The confusion is so prevalent that we tend to avoid using the word, except to mean *shareholders’ equity*.

capital asset. Properly used, a designation, for income tax purposes, that describes property held by a taxpayer except *cash*, *inventoriable assets*, goods held primarily for sale, most depreciable property, *real estate*, *receivables*, certain *intangibles*, and a few other items. Sometimes writers use this term imprecisely to describe *plant* and *equipment*, which are clearly not capital assets under the income-tax definition. Writers often use the term to refer to an *investment in securities*.

capital budget. Plan of proposed outlays for acquiring long-term *assets* and the means of *financing* the acquisition.

capital budgeting. The process of choosing *investment* projects for an enterprise by considering the *present value* of cash flows and deciding how to raise the funds the investment requires.

capital consumption allowance. The term used for *depreciation expense* in national income accounting and the reporting of funds in the economy.

capital asset — capitalization of a corporation

capital contributed in excess of par (or stated) value. A preferred title for the account that shows the amount received by the issuer for *capital stock* in excess of *par (or stated) value*.

capital expenditure (outlay). An *expenditure* to acquire long-term *assets*.

capital gain. The excess of proceeds over *cost*, or other *basis*, from the sale of a *capital asset* as defined by the Internal Revenue Code. If the taxpayer has held the capital asset for a sufficiently long time before sale, then the gain is taxed at a rate lower than that used for other gains and ordinary income.

capital lease. A *lease* treated by the *lessee* as both the borrowing of funds and the acquisition of an *asset* to be *amortized*. The lessee (tenant) recognizes both the *liability* and the asset on its balance sheet. Expenses consist of *interest* on the *debt* and *amortization* of the asset. The *lessor* (landlord) treats the lease as the sale of the asset in return for a series of future cash receipts. Contrast with *operating lease*.

capital loss. A negative capital gain; see *capital gain*.

capital rationing. In a *capital budgeting* context, the imposition of constraints on the amounts of total capital expenditures in each period.

capital stock. The ownership shares of a corporation. Consists of all classes of *common* and *preferred shares*.

capital structure. The composition of a corporation’s equities; the relative proportions of short-term debt, long-term debt, and *owners’ equity*.

capital surplus. An inferior term for *capital contributed in excess of par (or stated) value*.

capitalization of a corporation. A term used by investment analysts to indicate *shareholders’ equity* plus bonds outstanding.

capitalization of earnings — cash equivalent

capitalization of earnings. The process of estimating the *fair value* of a firm by computing the *net present value* of the predicted *net income* (not *cash flows*) of the firm for the future.

capitalization rate. An *interest rate* used to convert a series of payments or receipts or earnings into a single *present value*.

capitalize. To record an *expenditure* that may benefit a future period as an *asset* rather than to treat the expenditure as an *expense* of the period of its occurrence. Whether expenditures for advertising or for research and development should be capitalized is controversial, but *SFAS No. 2* forbids capitalizing R&D costs. We believe GAAP should allow firms to capitalize expenditures when they lead to future benefits and thus meet the criterion to be an asset.

carryback, carryforward, carryover. The use of losses or tax credits in one period to reduce income taxes payable in other periods. Two common kinds of carrybacks exist: for net operating losses and for *capital losses*. They apply against taxable income. In general, carrybacks are for three years, with the earliest year first. The taxpayer can carry forward operating losses for fifteen years. Corporate capital loss carryforwards are for five years. Individuals can carry forward capital losses indefinitely.

carrying cost. Costs (such as property taxes and insurance) of holding, or storing, *inventory* from the time of purchase until the time of sale or use.

carrying value (amount). *Book value*.

CASB (Cost Accounting Standards Board).

A board authorized by the U.S. Congress to “promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost-accounting principles followed by defense contractors and subcontractors under federal contracts.” The *principles* the CASB

promulgated since 1970 have considerable weight in practice wherever the *FASB* has not established a standard. Congress allowed the CASB to go out of existence in 1980 but reinstated it in 1990.

cash. Currency and coins, negotiable checks, and balances in bank accounts. For the *statement of cash flows*, “cash” also includes *marketable securities* held as *current assets*.

cash basis of accounting. In contrast to the *accrual basis of accounting*, a system of accounting in which a firm recognizes *revenues* when it receives *cash* and recognizes *expenses* as it makes *disbursements*. The firm makes no attempt to match *revenues* and *expenses* in measuring *income*. See *modified cash basis*.

cash budget. A schedule of expected cash receipts and disbursements.

cash change equation. For any *period*, the change in *cash* equals the change in *liabilities* plus the change in *owners' equity* minus the change in noncash *assets*.

cash collection basis. The *installment method* for recognizing *revenue*. Do not confuse with the *cash basis of accounting*.

cash conversion cycle. *Cash cycle*.

cash cycle. The period of time during which a firm converts *cash* into *inventories*, *inventories* into *accounts receivable*, and *receivables* back into cash. Sometimes called *earnings cycle*.

cash disbursements journal. A specialized *journal* used to record *expenditures by cash* and by *check*. If a *check register* is also used, a cash disbursements journal records only expenditures of currency and coins.

cash discount. A sales or purchase price reduction allowed for prompt payment.

cash dividend. See *dividend*.

cash equivalent. According to *SFAS No. 95*, “short-term, highly liquid investments that

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cash equivalent value — central corporate expenses

are both readily convertible to known amounts of cash [and] so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. . . . Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, [and] money market funds.”

cash equivalent value. A term used to describe the amount for which an *asset* could be sold. Sometimes called *market value* or *fair market price (value)*.

cash flow. Cash *receipts* minus *disbursements* from a given *asset*, or group of assets, for a given period. Financial analysts sometimes use this term to mean *net income + depreciation + depletion + amortization*. See also *operating cash flow* and *free cash flow*.

cash flow from operations. Receipts from customers and from investments less expenditures for inventory, labor, and services used in the usual activities of the firm, less interest expenditures. See *statement of cash flows and operations*. Same as *cash provided by operations*.

cash-flow hedge. A hedge of an exposure to variability in the cash flows of a recognized *asset* or *liability* or of a forecasted transaction, such as expected future foreign sales. The cash flows hedged do not themselves appear on the *balance sheet*. The hedging instrument itself is a *marketable security* and appears on the balance sheet at market value. If the firm uses hedge accounting and the hedging instrument is highly effective, then it will be able to report in *other comprehensive income* the *gains* and *losses*, so these amounts will not appear in periodic net income.

cash flow statement. *Statement of cash flows*.

cash provided by operations. An important subtotal in the *statement of cash flows*. This amount equals the total of revenues producing *cash* less *expenses* requiring cash. Often,

the amount appears as *net income* plus expenses not requiring cash (such as depreciation charges) minus revenues not producing cash (such as revenues recognized under the *equity method* of accounting for a long-term investment). The statement of cash flows maintains the same distinctions between *continuing operations*, *discontinued operations*, and *income* or *loss* from *extraordinary items* as does the *income statement*.

cash receipts journal. A specialized *journal* used to record all *receipts* of *cash*.

cash (surrender) value of life insurance. An amount equal not to the face value of the policy to be paid in the event of death but to the amount that the owner could realize by immediately canceling the policy and returning it to the insurance company for cash. A firm owning a life insurance policy reports it as an *asset* at an amount equal to this value.

cash yield. See *yield*.

cashier's check. A bank's own *check* drawn on itself and signed by the cashier or other authorized official. It is a direct obligation of the bank. Compare with *certified check*.

catch-up depreciation. *Backlog depreciation*.

cause-and-effect analysis. An identification of potential causes of defects and taking actions to cure the problem found. To use this analysis, first define the effect and then identify the causes of the problem. The potential causes fall into four categories: human factors, methods and design factors, machine-related factors, and materials or components factors. As management identifies the prevailing causes, it develops and implements corrective measures.

CCA. *Current cost accounting; current value accounting*.

central corporate expenses. General *overhead expenses* incurred in running the corporate headquarters and related supporting activities

central processing unit (CPU) — channel stuffing

of a corporation. Accounting treats these expenses as *period expenses*. Contrast with *manufacturing overhead*. *Line of business reporting* must decide how to treat these expenses—whether to allocate them to the individual segments and, if so, how to allocate them.

central processing unit (CPU). The computer system component that carries out the arithmetic, logic, and data transfer.

certificate. The document that is the physical embodiment of a *bond* or a *share of stock*; a term sometimes used for the *auditor's report*.

certificate of deposit. A form of *deposit* in a bank or thrift institution. Federal law constrains the rate of interest that banks can pay to their depositors. Current law allows banks to pay a rate higher than the one allowed on a *time deposit* if the depositor promises to leave funds on deposit for several months or more. When the bank receives such funds, it issues a certificate of deposit. The depositor can withdraw the funds before maturity by paying a penalty.

certified check. The *check* of a depositor drawn on a bank. The bank inserts the words “accepted” or “certified” on the face of the check, with the date and a signature of a bank official. The check then becomes an obligation of the bank. Compare with *cashier's check*.

certified financial statement. A financial statement attested to by an independent *auditor* who is a *CPA*.

certified internal auditor. See *CIA*.

certified management accountant. *CMA*.

certified public accountant (CPA). An accountant who has satisfied the statutory and administrative requirements of his or her jurisdiction to be registered or licensed as a public accountant. In addition to passing the Uniform CPA Examination administered by

the *AICPA*, the CPA must meet certain educational, experience, and moral requirements that differ from jurisdiction to jurisdiction. The jurisdictions are the 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

CFA. *Chartered Financial Analyst*.

CGA (Certified General Accountant). Canada: an accountant who has satisfied the experience, education, and examination requirements of the Certified General Accountants' Association.

chain discount. A series of *discount* percentages. For example, if a chain discount of 10 and 5 percent is quoted, then the actual, or *invoice*, price is the nominal, or list, price times .90 times .95, or 85.5, percent of invoice price.

change fund. Coins and currency issued to cashiers, delivery drivers, and so on.

changes, accounting. See *accounting changes*.

changes in financial position. See *statement of cash flows*.

channel stuffing. Assume a company's ordinary practices record *revenue* when it ships to customers goods previously ordered. A company engaging in channel-stuffing will ship goods not yet ordered but record them as *sales*, as though a real customer had ordered them. It might even get permission from the customer to ship, saying it will not bill the customer until next period and that the customer will get its usual grace period to pay the bill starting from that later date, next period. Often, sales staff eager to boost their own sales commissions will send a letter to the customer laying out the agreement: the customer will accept the shipment and if asked, confirm that it ordered the goods, but the seller will not send an invoice until later, and the customer need not pay until later or can return the goods. Such a letter is called a “side letter” and even honest managements

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have a hard time locating these. All a management can do is to be diligent and deal severely with employees found issuing side letters.

charge. As a noun, a *debit* to an account; as a verb, to debit.

charge off. To treat as a *loss* or *expense* an amount originally recorded as an *asset*; use of this term implies that the charge is not in accord with original expectations.

chart of accounts. A list of names and numbers, systematically organized, of *accounts*.

charter. Document issued by a state government authorizing the creation of a corporation.

chartered accountant(s) (CA). The title used in British Commonwealth countries, such as Australia, Canada, India, Scotland and New Zealand, for an accountant who has satisfied the requirements of the institute of his or her jurisdiction to be qualified to serve as a *public accountant*. In the United Kingdom other than Scotland, members use the initials ACA or FCA: *A* means Associate and *F* means Fellow; the Associate has less experience than does the Fellow. A partnership of chartered accountants signs its firm name with the letters *CA*. In Canada, each provincial institute or order has the right to administer the examination and set the standards of performance and ethics for Chartered Accountants in its province. For a number of years, however, the provincial organizations have pooled their rights to qualify new members through the Inter-provincial Education Committee, and the result is that there are nationally set and graded examinations given in English and French. Deviation from the pass/fail grade awarded by the Board of Examiners (a subcommittee of the Inter-provincial Education Committee) is rare.

Chartered Financial Analyst (CFA). A person who has passed three examinations, over

charge — clean opinion

at least an 18-month period, covering topics in accounting, economics, financial economics, portfolio management, and security analysis. The Association for Investment Management and Research (AIMR) administers the program through its Institute of Chartered Financial Analysts. Beyond passing examinations, the person needs to have approved working experience and satisfy standards of professional conduct.

check. The Federal Reserve Board defines a check as “a *draft* or order upon a bank or banking house purporting to be drawn upon a deposit of funds for the payment at all events of a certain sum of money to a certain person therein named or to him or his order or to bearer and payable instantly on demand.” It must contain the phrase “pay to the order of.” The amount shown on the check must be clearly readable, and the check must have the signature of the drawer. The drawer need not date the check. In the accounts, the drawer usually reduces the *balance* in the *cash account* when it issues the check, not later when the check clears the bank. See *remittance advice*.

check register. A *journal* to record *checks* issued.

CIA (Certified Internal Auditor). One who has satisfied certain requirements of the *Institute of Internal Auditors* including experience, ethics, education, and passing examinations.

CICA. *Canadian Institute of Chartered Accountants*.

CIF (cost, insurance, and freight). In contracts, a term used along with the name of a given port, such as New Orleans, to indicate that the quoted price includes insurance, handling, and freight charges up to delivery by the seller at the given port.

circulating capital. *Working capital*.

clean opinion. See *auditor's report*.

clean surplus concept — common cost

clean surplus concept. The notion that all entries to the *retained earnings* account must record *net income* and *dividends*. See *comprehensive income*. Contrast with *current operating performance concept*. This concept, with minor exceptions, now controls *GAAP*. (See *APB Opinions No. 9* and *No. 30*.)

clearing account. An account containing amounts to be transferred to another account(s) before the end of the *accounting period*. Examples are the *income summary* account (whose balance transfers to *retained earnings*) and the *purchases* account (whose balance transfers to *inventory* or to *cost of goods sold*).

close. As a verb, to transfer the *balance* of a *temporary* or *contra* or *adjunct account* to the main account to which it relates; for example, to transfer *revenue* and *expense* accounts directly, or through the *income summary* account, to an *owners' equity* account or to transfer *purchase discounts* to *purchases*.

closed account. An *account* with equal *debits* and *credits*, usually as a result of a *closing entry*.

closing entries. The *entries* that accomplish the transfer of balances in *temporary accounts* to the related *balance sheet accounts*. See *work sheet*.

closing inventory. *Ending inventory*.

CMA (Certified Management Accountant)

certificate. Awarded by the *Institute of Certified Management Accountants* of the *Institute of Management Accountants* to those who pass a set of examinations and meet certain experience and continuing-education requirements.

CoCoA. *Continuously Contemporary Accounting*.

coding of accounts. The numbering of *accounts*, as for a *chart of accounts*, that is necessary for computerized accounting.

coinsurance. Common condition of insurance policies that protect against hazards such as fire or water damage. These often specify that the owner of the property may not collect the full amount of insurance for a loss unless the insurance policy covers at least some specified “coinsurance” percentage, usually about 80 percent, of the *replacement cost* of the property. Coinsurance clauses induce the owner to carry full, or nearly full, coverage.

COLA. Cost-of-living adjustment. See *indexation*.

collateral. *Assets* pledged by a *borrower* who will surrender those assets if he or she fails to repay a *loan*.

collectible. Capable of being converted into *cash*—now if due, later otherwise.

collusion. Cooperative effort by employees to commit fraud or another unethical act.

combination. See *business combination*.

comfort letter. A letter in which an auditor conveys negative assurances as to unaudited financial statements in a prospectus or draft financial statements included in a preliminary prospectus.

commercial paper. Short-term notes issued by corporate borrowers.

commission. Employee remuneration, usually expressed as a percentage, based on an activity rate, such as sales.

committed costs. *Capacity costs*.

Committee on Accounting Procedure (CAP).

Predecessor of the *APB*. The *AICPA*'s principles-promulgating body from 1939 through 1959. Its 51 pronouncements are *Accounting Research Bulletins*.

common cost. *Cost* resulting from the use of *raw materials*, a facility (e.g., plant or machines), or a service (e.g., fire insurance) that benefits several products or departments. A

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firm must allocate this cost to those products or departments. Common costs result when two or more departments produce multiple products together even though the departments could produce them separately; *joint costs* occur when two or more departments must produce multiple products together. Many writers use “common costs” and “joint costs” synonymously. See *joint cost*, *indirect costs*, *overhead*; and *sterilized allocation*.

common-dollar accounting. *Constant-dollar accounting.*

common monetary measuring unit. For U.S. corporations, the dollar. See also *stable monetary unit assumption* and *constant-dollar accounting*.

common shares. *Shares* representing the class of owners who have residual claims on the *assets* and *earnings* of a corporation after the firm meets all *debt* and *preferred shareholders'* claims.

common-size statement. A *percentage statement* usually based on total *assets* or *net sales* or *revenues*.

common-stock equivalent. A *security* whose primary value arises from its holder's ability to exchange it for *common shares*; includes *stock options*, *warrants*, and also *convertible bonds* or *convertible preferred stock* whose *effective interest rate* at the time of issue is less than two-thirds the average Aa corporate bond yield. See *bond ratings*.

company-wide control. See *control system*.

comparative (financial) statements. *Financial statements* showing information for the same company for different times, usually two successive years for balance sheets and three for *income* and *cash flow statements*. Nearly all published financial statements are in this form. Contrast with *historical summary*.

compensating balance. The amount required to be left on deposit for a loan. When a bank

common-dollar accounting — compound entry

lends funds to customers, it often requires that the customers keep on deposit in their checking accounts an amount equal to some percentage—say, 20 percent—of the loan. Such amounts effectively increase the *interest rate*. The borrower must disclose the amounts of such balances in *notes* to the *financial statements*.

completed contract method. Recognizing *revenues* and *expenses* for a job or order only when the firm finishes it, except that when the firm expects a loss on the contract, the firm must recognize all revenues and expenses in the period when the firm first foresees a loss. Accountants generally use this term only for long-term contracts. This method is otherwise equivalent to the *sales basis of revenue recognition*.

complete sales basis. See *sales basis of revenue recognition*.

compliance audit. Objectively obtaining and evaluating evidence regarding assertions, actions, and events to ascertain the degree of correspondence between them and established performance criteria.

compliance procedure. An *audit* procedure used to gain evidence as to whether the prescribed internal controls are operating effectively.

composite cost of capital. See *cost of capital*.

composite depreciation or composite life method. *Group depreciation* when the items are of unlike kind. The term also applies when the firm depreciates as a whole a single item (e.g., a crane, which consists of separate units with differing service lives, such as the chassis, the motor, the lifting mechanism, and so on), rather than treating each of its components separately.

compound entry. A *journal entry* with more than one *debit* or more than one *credit* or both. See *trade-in transaction* for an example.

compound interest — comprehensive income

compound interest. *Interest* calculated on *principal* plus previously undistributed interest.

compound interest depreciation. A method designed to hold the *rate of return* on an asset constant. First find the *internal rate of return* on the cash inflows and outflows of the asset. The periodic depreciation charge equals the cash flow for the period less the internal rate of return multiplied by the asset's book value at the beginning of the period. When the cash flows from the asset are constant over time, usage sometimes refers to the method as the "annuity method" of depreciation.

compounding period. The time period, usually a year or a portion of a year, for which a firm calculates *interest*. At the end of the period, the borrower may pay interest to the lender or may add the interest (that is, convert it) to the principal for the next interest-earning period.

comprehensive budget. *Master budget*.

comprehensive income. Defined in *SFAC No. 3* as "the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from

nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners." In this definition, "equity" means *owners' equity* or *shareholders' equity*. *SFAS No. 130* requires firms to report comprehensive income as part of a statement showing *earnings* (primarily from realized transactions), comprehensive income (with additions for all other changes in owners' equity, primarily *holding gains and losses* and *foreign exchange gains and losses*), and comprehensive income plus *accounting adjustments*. The *FASB* encourages the discontinuation of the term "net income." The terms "earnings" and "comprehensive income" denote different concepts, with totals different from that of the old "net income." *SFAS No. 130* requires that the firm report comprehensive income in a format having the same prominence as other *financial statements*. We cannot predict which "income total"—earnings or comprehensive income—users of financial statements will focus on. See Exhibit 1.1 for two formats the *FASB* suggests firms use. General Electric uses a different one, harder to follow.

ONE-STATEMENT APPROACH	
Statement of Net Income and Comprehensive Income	
Revenues	\$100,000
Expenses	(25,000)
Gain on Sale of Securities	2,000
Other Gains and Losses	<u>8,000</u>
Earnings from Continuing Operations before Income Tax	\$ 85,000
Income Tax Expense	<u>(21,250)</u>
Earnings before Discontinued Operations and Extraordinary Items	\$ 63,750
Discontinued Operations, Net of Tax	30,000
Extraordinary Items, Net of Tax	<u>(28,000)</u>
Income before Cumulative Effect of Accounting Change	\$ 65,750
Cumulative Effect of Accounting Change, Net of Tax	<u>(2,500)</u>
Net Income (or, as preferred by the FASB, Earnings)	<u>\$ 63,250</u>

EXHIBIT 1.1 REPORTING COMPREHENSIVE INCOME, TWO ALLOWED FORMATS

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ONE-STATEMENT APPROACH (continued)		
Other Comprehensive Income, Net of Tax:		
Foreign Currency Translation Adjustments		\$ 7,000
Unrealized Gains and Losses on Securities:		
Unrealized Holding Gains Arising during Period	\$13,000	
Less: Reclassification Adjustment for Gain Included in Net Income (Earnings)	(1,500)	11,500
Minimum Pension Liability Adjustment		(2,500)
Other Comprehensive Income (Loss)		<u>\$ 16,000</u>
Comprehensive Income (Loss)		<u>\$ 79,250</u>
TWO-STATEMENT APPROACH		
Statement of Net Income		
Revenues		\$100,000
Expenses		(25,000)
Gain on Sale of Securities		2,000
Other Gains and Losses		8,000
Earnings from Continuing Operations before Income Tax		<u>\$ 85,000</u>
Income Tax Expense		(21,250)
Earnings before Discontinued Operations and Extraordinary Items		<u>\$ 63,750</u>
Discontinued Operations, Net of Tax		30,000
Extraordinary Items, Net of Tax		(28,000)
Income before Cumulative Effect of Accounting Change		\$ 65,750
Cumulative Effect of Accounting Change, Net of Tax		(2,500)
Net Income (or, as preferred by the FASB, Earnings)		<u>\$ 63,250</u>
Statement of Comprehensive Income		
Net Income (or, as preferred by the FASB, Earnings)		<u>\$ 63,250</u>
Other Comprehensive Income, Net of Tax:		
Foreign Currency Translation Adjustments		\$ 7,000
Unrealized Gains and Losses on Securities:		
Unrealized Holding Gains Arising during Period	\$13,000	
Less: Reclassification Adjustment for Gain Included in Net Income (Earnings)	(1,500)	11,500
Minimum Pension Liability Adjustment		(2,500)
Other Comprehensive Income (Loss)		<u>\$ 16,000</u>
Comprehensive Income (Loss)		<u>\$ 79,250</u>

EXHIBIT 1.1 REPORTING COMPREHENSIVE INCOME, TWO ALLOWED FORMATS (CONTINUED)

comptroller. Same meaning and pronunciation as *controller*. Modern users, however, tend to use this form for government and not-for-profit entities and *controller* for profit-seeking ones.

conceptual framework. A coherent system of interrelated objectives and fundamentals, promulgated by the *FASB* primarily through its *SFAC* publications, expected to lead to consistent standards for *financial accounting* and reporting.

confidence level. The measure of probability that the actual characteristics of the population lie within the stated precision of the estimate derived from a sampling process. A sample estimate may be expressed in the following terms: “Based on the sample, we are 95 percent sure [confidence level] that the true population value is within the range of X to Y [precision].” See *precision*.

confirmation. A formal memorandum delivered by the customers or suppliers of a company

conglomerate — constructive receipt

to its independent *auditor* verifying the amounts shown as receivable or payable. The auditor originally sends the confirmation document to the customer. If the auditor asks that the customer return the document whether the *balance* is correct or incorrect, usage calls it a “positive confirmation.” If the auditor asks that the customer return the document only if it contains an error, usage calls it a “negative confirmation.”

conglomerate. *Holding company.* This term implies that the owned companies operate in dissimilar lines of business.

conservatism. A *reporting objective* that calls for anticipation of all *losses* and *expenses* but defers recognition of *gains* or *profits* until they are *realized* in *arm's-length* transactions. In the absence of certainty, report events to minimize cumulative income. Conservatism does not mean reporting low income in every *accounting period*. Over long-enough time spans, income is cash-in less cash-out. If a (conservative) reporting method shows low income in early periods, it must show higher income in some later period.

consignee. See *on consignment*.

consignment. See *on consignment*.

consignor. See *on consignment*.

consistency. Treatment of like *transactions* in the same way in consecutive periods so that financial statements will be more comparable than otherwise; the reporting policy implying that a reporting *entity*, once it adopts specified procedures, should follow them from period to period. See *accounting changes* for the treatment of inconsistencies.

consol. A *bond* that never matures; a *perpetuity* in the form of a bond; originally issued by Great Britain after the Napoleonic wars to consolidate debt issues of that period. The term arose as an abbreviation for “consolidated annuities.”

consolidated financial statements. Statements that are issued by legally separate companies and that show financial position and income as they would appear if the companies were one economic *entity*.

constant dollar. A hypothetical unit of *general purchasing power*, denoted “C\$” by the *FASB*.

constant-dollar accounting. Accounting that measures items in *constant dollars*. See *historical cost/constant-dollar accounting* and *current cost/nominal-dollar accounting*. Sometimes called “general price level-adjusted accounting” or “general purchasing-power accounting.”

constant-dollar date. The time at which the *general purchasing power* of one *constant dollar* exactly equals the *general purchasing power* of one *nominal dollar*; that is, the date when C\$1 = \$1. When the constant-dollar date is midperiod, the nominal amounts of *revenues* and *expenses* spread evenly throughout the period equal their constant-dollar amounts but end-of-period *balance sheet* amounts measured in constant midperiod dollars differ from their nominal-dollar amounts. When the constant-dollar date is at the end of the period, the constant-dollar amounts equal the nominal-dollar amounts on a balance sheet for that date.

constrained share company. Canada: a public company whose *charter* specifies that people who are Canadian citizens or who are corporations resident in Canada must own a prescribed percentage of the shares.

constructive liability. *FASB's* term for an item recorded as an accounting *liability*, which the firm has no obligation to pay but intends to pay. An example is the liability with related *expense* that management establishes for future cash payments for severance payments for employees it intends to discharge in a restructuring.

constructive receipt. An item included in taxable income when the taxpayer can control

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funds whether or not it has received cash. For example, *interest* added to *principal* in a savings account is constructively received.

Consumer Price Index (CPI). A *price index* computed and issued monthly by the Bureau of Labor Statistics of the U.S. Department of Labor. The index attempts to track the price level of a group of goods and services purchased by the average consumer. The CPI is used in *constant-dollar accounting*.

contingency. A potential *liability*. If a specified event occurs, such as a firm's losing a lawsuit, it would recognize a liability. The notes disclose the contingency, but so long as it remains contingent, it does not appear in the balance sheet. *SFAS No. 5* requires treatment as a contingency until the outcome is "probable" and the amount of payment can be reasonably estimated, perhaps within a range. When the outcome becomes probable (the future event is "likely" to occur) and the firm can reasonably estimate the amount (using the lower end of a range if it can estimate only a range), then the firm recognizes a liability in the accounts, rather than just disclosing it. A *material* contingency may lead to a qualified, "subject to" auditor's opinion. Firms do not record *gain* contingencies in the accounts but merely disclose them in notes.

contingent annuity. An *annuity* whose number of payments depends on the outcome of an event whose timing is uncertain at the time the annuity begins; for example, an annuity payable until death of the *annuitant*. Contrast with *annuity certain*.

contingent issue (securities). Securities issuable to specific individuals at the occurrence of some event, such as the firm's attaining a specified level of earnings.

contingent liability. *Contingency*. Avoid this term because it refers to something not (yet) a *liability* on the *balance sheet*.

continuing appropriation. A governmental *appropriation* automatically renewed without

Consumer Price Index (CPI) — contributed capital

further legislative action until altered or revoked or expended.

continuing operations. See *income from continuing operations*.

continuity of operations. The assumption in accounting that the business *entity* will continue to operate long enough to carry out its current plans. The *going-concern assumption*.

continuous budget. A *budget* that adds a future period as the current period ends. This budget, then, always reports on the same number of periods.

continuous compounding. *Compound interest* in which the *compounding period* is every instant of time. See *e* for the computation of the equivalent annual or periodic rate.

continuous flow processing. Mass production of homogeneous products in a continuous flow. Companies manufacturing with continuous flow processes use *process costing* to account for product costs.

continuous improvement. Modern *total quality management (TQM)* practitioners believe that the process of seeking quality is never complete. This attitude reflects that assumption, seeking always to improve activities.

continuous inventory method. The *perpetual inventory method*.

Continuously Contemporary Accounting (CoCoA). A name coined by the Australian theorist Raymond J. Chambers to indicate a combination of *current value accounting* in which the *measuring unit* is *constant dollars* and the *attribute measured* is *exit value*.

contra account. An *account*, such as *accumulated depreciation*, that accumulates subtractions from another account, such as machinery. Contrast with *adjunct account*.

contributed capital. Name for the *owners' equity* account that represents amounts paid in, usually in *cash*, by owners; the sum of the balances in *capital stock* accounts plus *capital*

contributed surplus — conversion cost

contributed in excess of par (or stated) value accounts. Contrast with *donated capital*.

contributed surplus. An inferior term for *capital contributed in excess of par value*.

contribution approach. *Income statement* preparation method that reports *contribution margin*, by separating *variable costs* from *fixed costs*, in order to emphasize the importance of cost-behavior patterns for purposes of planning and control.

contribution margin. *Revenue* from *sales* less all *variable expenses*. Contrast with *gross margin*.

contribution margin ratio. *Contribution margin* divided by *net sales*; usually measured from the price and cost of a single unit; sometimes measured in total for companies with multiple products.

contribution per unit. Selling price less *variable costs* per unit.

contributory. Said of a *pension plan* in which employees, as well as employers, make payments to a *pension fund*. Note that the provisions for *vesting* apply only to the employer's payments. Whatever the degree of vesting of the employer's payments, employees typically gets back all their payments, with interest, in case of death or other cessation of employment before retirement.

control (controlling) account. A summary *account* with totals equal to those of entries and balances that appear in individual accounts in a *subsidiary ledger*. Accounts Receivable is a control account backed up with an account for each customer. Do not change the balance in a control account unless you make a corresponding change in one of the subsidiary accounts.

control charts. Presentations of warning signals that help management distinguish between random or routine variations in quality and variations that it should investigate. The presentations show the results of statistical

process-control measures for a sample, batch or some other unit. These presentations depict variation in a process and its behavior over time. Management specifies an acceptable level of variation and plans to investigate the causes of deviations beyond that level.

control system. A device used by top management to ensure that lower-level management carries out its plans or to safeguard assets. Control designed for a single function within the firm is "operational control"; control designed for autonomous segments that generally have responsibility for both revenues and costs is "divisional control"; control designed for activities of the firm as a whole is "company-wide control." Systems designed for safeguarding assets are "internal control" systems.

controllable cost. A *cost* influenced by the way a firm carries out operations. For example, marketing executives control advertising costs. These costs can be *fixed* or *variable*. See *programmed costs* and *managed costs*.

controlled company. A company in which an individual or corporation holds a majority of the voting shares. An owner can sometimes exercise effective control even though it owns less than 50 percent of the shares.

controller. A title for the chief accountant of an organization; often spelled *comptroller* when used to identify that person in a government or not-for-profit entity.

conversion. The act of exchanging a convertible security for another security.

conversion audit. An examination of change-over procedures, and new accounting procedures and files, that takes place when a significant change in the accounting system (e.g., a change from a manual to a computerized system or a change of computers) occurs.

conversion cost. *Direct labor* costs plus *factory overhead* costs incurred in producing a product; that is, the cost to convert raw materials to finished products. *Manufacturing cost*.

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conversion period. *Compounding period*; also, period during which the holder of a *convertible bond* or *convertible preferred stock* can convert it into *common shares*.

convertible bond. A *bond* whose owner may convert it into a specified number of shares of *capital stock* during the *conversion period*.

convertible preferred stock. *Preferred shares* whose owner may convert them into a specified number of *common shares*.

cookie-jar accounting. A name, most prominently used by a chairman of the *SEC*, to indicate the practice of reporting lower *income* in an early period, so that management, at its discretion, can report higher income in a later period. Consider, for example, the entry to estimate *warranty costs* for products sold. The *journal entry debits an expense account*, reducing income, and *credits a liability account*. In some later period, the firm can debit a warranty cost to the liability account, not to an expense account, relieving that later period of the income reduction that an expense would have caused. See *quality of earnings*. Often, users refer to the excess liability amount, the amount in the cookie jar, later available for income enhancement, as a “reserve.” See *reserve* for our warnings about using that word in any context.

cooperative. An incorporated organization formed for the benefit of its members (owners), who are either producers or consumers, in order to acquire for them profits or savings that otherwise accrue to middlemen. Members exercise control on the basis of one vote per member.

coproduct. A product that shares production facilities with another product. For example, if an apparel manufacturer produces shirts and jeans on the same line, these are coproducts. Distinguish coproducts from *joint products* and *byproducts* that, by their very nature, a firm must produce together, such as

conversion period — core deposit intangible

the various grades of wood a lumber factory produces.

copyright. Exclusive right granted by the government to an individual author, composer, playwright, or the like for the life of the individual plus 50 years. If a firm receives the copyright, then the right extends 75 years after the original publication. The *economic life* of a copyright can be less than the legal life, such as, for example, the copyright of this book.

core deposit intangible. A bank borrows funds from its customers, called “depositors,” who open checking and savings accounts. Those depositors can take out their funds at any time, but usually don’t. The amount that depositors leave on deposit for long periods of time are called “core deposits.” The bank lends those funds to other customers, called “borrowers,” at *interest rates* larger than the amount it pays the depositors for the funds. (For checking accounts, the rate the bank pays depositors is often zero.) The fact that the depositors can remove their funds at any time, but, on average, leave amounts on deposit relatively permanently means that the bank can lend those funds for relatively long periods of time, usually at higher interest rates, than it can charge for shorter-term loans. (See *yield curve*.) The bank’s ability to borrow from some customers at a low rate and lend to other customers at a high rate creates wealth for the bank. Bankers and banking analysts call this wealth the “core deposit intangible.” It represents an *asset* not recognized in the financial statements by the bank that created with wealth, although some *SEC* commissioners have expressed the thought that accounting should recognize such items as assets. When one bank buys another in a *purchase*, however, it will pay for this asset and will record it as an asset. Usually, the acquiring bank does not

corner — cost method (for investments)

use the specific account title “Core Deposit Intangible,” but instead uses the account title *Goodwill*.

corner. The control, of a quantity of shares or a commodity, sufficiently large that the holder can control the market price.

corporation. A legal entity authorized by a state to operate under the rules of the entity’s *charter*.

correcting entry. An *adjusting entry* that properly records a previously, improperly recorded *transaction*. Do not confuse with entries that correct *accounting errors*.

correction of errors. See *accounting errors*.

cost. The sacrifice, measured by the *price* paid or to be paid, to acquire *goods* or *services*. See *acquisition cost* and *replacement cost*. Terminology often uses “cost” when referring to the valuation of a good or service acquired. When writers use the word in this sense, a cost is an *asset*. When the benefits of the acquisition (the goods or services acquired) expire, the cost becomes an *expense* or *loss*. Some writers, however, use “cost” and “expense” as synonyms. Contrast with *expense*. The word “cost” appears in more than 50 accounting terms, each with sometimes subtle distinctions in meaning. See *cost terminology* for elaboration. Clarity requires that the user include with the word “cost” an adjective or phrase to be clear about intended meaning.

cost accounting. Classifying, summarizing, recording, reporting, and allocating current or predicted *costs*; a subset of *managerial accounting*.

Cost Accounting Standards Board. See *CASB*.

cost accumulation. Bringing together, usually in a single *account*, all *costs* of a specified activity. Contrast with *cost allocation*.

cost allocation. Assigning *costs* to individual products or time periods. Contrast with *cost accumulation*.

cost-based transfer price. A *transfer price* based on *historical costs*.

cost behavior. The functional relation between changes in activity and changes in *cost*; for example: *fixed* versus *variable costs*; *linear* versus *curvilinear cost*.

cost–benefit criterion. Some measure of *costs* compared with some measure of *benefits* for a proposed undertaking. If the costs exceed the benefits, then the analyst judges the undertaking not worthwhile. This criterion will not yield good decisions unless the analyst estimates all costs and benefits flowing from the undertaking.

cost center. A unit of activity for which a firm accumulates *expenditures* and *expenses*.

cost driver. A factor that causes an activity’s costs. See *driver* and *activity basis*.

cost driver rate. Rate at which the *cost driver* causes *costs*.

cost-effective. Among alternatives, the one whose benefit, or payoff, per unit of cost is highest; sometimes said of an action whose expected benefits exceed expected costs whether or not other alternatives exist with larger cost–benefit ratios.

cost estimation. The process of measuring the functional relation between changes in activity levels and changes in cost.

cost flow assumption. See *flow assumption*.

cost-flow equation. Beginning balance + Transfers in = Transfers out + Ending balance

$$BB + TI = TO + EB.$$

cost flows. Costs passing through various classifications within an entity. See *flow of costs* for a diagram.

cost hierarchy. Categorizes costs according to whether they are *capacity*, *product*, *customer*, *batch* or *unit costs*.

cost method (for investments). In accounting for an investment in the *capital stock* or

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cost method (for treasury stock) — cost-recovery-first method

bonds of another company, method in which the firm shows the investment at *acquisition cost* and treats only *dividends* declared or *interest receivable* as *revenue*; not allowed by *GAAP*.

cost method (for treasury stock). The method of showing *treasury stock* in a *contra account* to all other items of *shareholders' equity* in an amount equal to that paid to reacquire the stock.

cost object(ive). Any activity for which management desires a separate measurement of *costs*. Examples include departments, products, and territories.

cost of capital. *Opportunity cost* of funds invested in a business; the rate of return that rational owners require an asset to earn before they will devote that asset to a particular purpose; sometimes measured as the average annual rate that a company must pay for its *equities*. In *efficient capital markets*, this cost is the *discount rate* that equates the expected *present value* of all future cash flows to common shareholders with the market value of common stock at a given time. Analysts often measure the cost of capital by taking a *weighted average* of the firm's *debt* and various *equity securities*. We sometimes call the measurement so derived the "composite cost of capital," and some analysts confuse this measurement of the cost of capital with the cost of capital itself. For example, if the equities of a firm include substantial amounts for the *deferred income tax liability*, the composite cost of capital will underestimate the true cost of capital, the required rate of return on a firm's assets, because the deferred income tax liability has no explicit cost.

cost of goods manufactured. The sum of all costs allocated to products completed during a period, including materials, labor, and *overhead*.

cost of goods purchased. Net purchase price of goods acquired plus costs of storage and

delivery to the place where the owner can productively use the items.

cost of goods sold. Inventoriable *costs* that firms *expense* because they sold the units; equals *beginning inventory* plus *cost of goods purchased* or *manufactured* minus *ending inventory*.

cost of sales. Generally refers to *cost of goods sold*, occasionally to *selling expenses*.

cost or market, whichever is lower. See *lower of cost or market*.

cost percentage. One less *markup percentage*; *cost of goods available for sale* divided by selling prices of goods available for sale (when FIFO is used), *cost of purchases* divided by selling prices of purchases (when LIFO is used). See *markup* for further detail on inclusion in the calculation of cost percentage.

cost-plus transfer pricing. *Transfer price* equal to the *cost* of the transferred product plus a *markup*.

cost pool. *Indirect cost pool*; groupings or aggregations of costs, usually for subsequent analysis.

cost principle. The *principle* that requires reporting *assets* at *historical* or *acquisition cost*, less accumulated *amortization*. This principle relies on the assumption that cost equals *fair market value* at the date of acquisition and that subsequent changes are not likely to be significant.

cost-recovery-first method. A method of *revenue* recognition that *credits inventory* as the firm receives cash collections and continues until the firm has collected cash equal to the sum of all costs. Only after the firm has collected cash equal to costs does it recognize *income*. A firm may not use this method in financial reporting unless the total amount of collections is highly uncertain. It is never allowed for income tax reporting. Contrast with the *installment method*, allowed for

cost sheet — cost terminology

both book and tax, in which the firm credits *constant* proportions of each cash collection both to cost and to income.

cost sheet. Statement that shows all the elements composing the total cost of an item.

cost structure. For a given set of total costs, the percentages of fixed and variable costs, typically two percentages adding to 100 percent.

cost terminology. The word “cost” appears in many accounting terms. Exhibit 1-2 classifies some of these terms according to the distinctions between the terms in accounting usage. Joel Dean was, to our knowledge, the first to attempt such distinctions; we have used some of his ideas here. We discuss some of the terms in more detail under their own listings.

TERMS (SYNONYMS GIVEN IN PARENTHESES)		DISTINCTIONS AND COMMENTS
1. The following pairs of terms distinguish the basis measured in accounting.		
Historical Cost (Acquisition Cost)	vs. Current Cost	A distinction used in financial accounting. Current cost can be used more specifically to mean replacement cost, net realizable value, or present value of cash flows. “Current cost” is often used narrowly to mean replacement cost.
Historical Cost (Actual Cost)	vs. Standard Cost	The distinction between historical and standard costs arises in product costing for inventory valuation. Some systems record actual costs while others record the standard costs.
2. The following pairs of terms denote various distinctions among historical costs. For each pair of terms, the sum of the two kinds of costs equals total historical cost used in financial reporting.		
Variable Cost	vs. Fixed Cost (Constant Cost)	Distinction used in breakeven analysis and in designing cost accounting systems, particularly for product costing. See (4), below, for a further subdivision of fixed costs and (5), below, for the economic distinction between marginal and average cost closely paralleling this one.
Traceable Cost	vs. Common Cost (Joint Cost)	Distinction arises in allocating manufacturing costs to product. Common costs are allocated to product, but the allocations are more-or-less arbitrary. The distinction also arises in segment reporting and in separating manufacturing from nonmanufacturing costs.
Direct Cost	vs. Indirect Cost	Distinction arises in designing cost accounting systems and in product costing. Direct costs can be traced directly to a cost object (e.g., a product, a responsibility center), whereas indirect costs cannot.
Out-of-Pocket Cost (Outlay Cost; Cash Cost)	vs. Book Cost	Virtually all costs recorded in financial statements require a cash outlay at one time or another. The distinction here separates expenditures to occur in the future from those already made and is used in making decisions. Book costs, such as for depreciation, reduce income without requiring a future outlay of cash. The cash has already been spent. See future v. past costs in (5), below.

EXHIBIT 1.2 COST TERMINOLOGY: DISTINCTIONS AMONG TERMS CONTAINING THE WORD “COST”

TERMS (SYNONYMS GIVEN IN PARENTHESES)		DISTINCTIONS AND COMMENTS
Incremental Cost (Marginal Cost; Differential Cost)	vs. Unavoidable Cost (Inescapable Cost; Sunk Cost)	Distinction used in making decisions. Incremental costs will be incurred (or saved) if a decision is made to go ahead (or to stop) some activity, but not otherwise. Unavoidable costs will be reported in financial statements whether the decision is made to go ahead or not, because cash has already been spent or committed. Not all unavoidable costs are book costs, as, for example, a salary promised but not yet earned, that will be paid even if a no-go decision is made. The economist restricts the term <i>marginal cost</i> to the cost of producing one more unit. Thus the next unit has a marginal cost; the next week's output has an incremental cost. If a firm produces and sells a new product, the related new costs would properly be called incremental, not marginal. If a factory is closed, the costs saved are incremental, not marginal.
Escapable Cost	vs. Inescapable Cost (Unavoidable Cost)	Same distinction as incremental v. sunk costs, but this pair is used only when the decision maker is considering stopping something—ceasing to produce a product, closing a factory, or the like. See next pair.
Avoidable Cost	vs. Unavoidable Cost	A distinction sometimes used in discussing the merits of variable and absorption costing. Avoidable costs are treated as product cost and unavoidable costs are treated as period expenses under variable costing.
Controllable Cost	vs. Uncontrollable Cost	The distinction here is used in assigning responsibility and in setting bonus or incentive plans. All costs can be affected by someone in the entity; those who design incentive schemes attempt to hold a person responsible for a cost only if that person can influence the amount of the cost.
3. In each of the following pairs, used in historical cost accounting, the word "cost" appears in one of the terms where "expense" is meant.		
Expired Cost	vs. Unexpired Cost	The distinction is between <i>expense</i> and <i>asset</i> .
Product Cost	vs. Period Cost	The terms distinguish product cost from period expense. When a given asset is used, is its cost converted into work in process and then finished goods on the balance sheet until the goods are sold or is it an expense shown on this period's income statement? Product costs appear on the income statement as part of cost of goods sold in the period when the goods are sold. Period expenses appear on the income statement with an appropriate caption for the item in the period when the cost is incurred or recognized.

EXHIBIT 1.2 COST TERMINOLOGY: DISTINCTIONS AMONG TERMS CONTAINING THE WORD "COST" (CONTINUED)

TERMS (SYNONYMS GIVEN IN PARENTHESES)		DISTINCTIONS AND COMMENTS	
<p>4. The following subdivisions of fixed (historical) costs are used in analyzing operations. The relation between the components of fixed costs is:</p>			
$\begin{array}{c} \text{Fixed} \\ \text{Costs} \end{array} = \begin{array}{c} \text{Capacity} \\ \text{Costs} \end{array} + \begin{array}{c} \text{Programmed} \\ \text{Costs} \end{array}$			
$\begin{array}{c} \text{Semifixed} \\ \text{Costs} \end{array} + \begin{array}{c} \text{Fixed} \\ \text{Portions} \end{array} + \begin{array}{c} \text{of} \\ \text{"Pure"} \\ \text{Fixed Costs} \end{array} = \begin{array}{c} \text{Standby} \\ \text{Costs} \end{array} + \begin{array}{c} \text{Enabling} \\ \text{Costs} \end{array} + \begin{array}{c} \text{Semi-variable} \\ \text{Costs} \end{array}$			
Capacity Cost (Committed Cost)	vs. Programmed Cost (Managed Cost; Discretionary Cost)	Capacity costs give a firm the capability to produce or to sell. Programmed costs, such as for advertising or research and development, may not be essential, but once a decision to incur them is made, they become fixed costs.	
Standby Cost	vs. Enabling Cost	Standby costs will be incurred whether capacity, once acquired, is used or not, such as property taxes and depreciation on a factory. Enabling costs, such as for a security force, can be avoided if the capacity is unused.	
Semifixed Cost	vs. Semivariable Cost	A cost fixed over a wide range but that can change at various levels is a semifixed cost or "step cost." An example is the cost of rail lines from the factory to the main rail line where fixed cost depends on whether there are one or two parallel lines, but are independent of the number of trains run per day. Semivariable costs combine a strictly fixed component cost plus a variable component. Telephone charges usually have a fixed monthly component plus a charge related to usage.	
<p>5. The following pairs of terms distinguish among economic uses or decision-making uses or regulatory uses of cost terms.</p>			
Fully Absorbed Cost	vs. Variable Cost (Direct Cost)	Fully absorbed costs refer to costs where fixed costs have been allocated to units or departments as required by generally accepted accounting principles. Variable costs, in contrast, may be more relevant for making decisions, such as in setting prices.	
Fully Absorbed Cost	vs. Full Cost	In full costing, all costs, manufacturing costs as well as central corporate expenses (including financing expenses) are allocated to product or divisions. In full absorption costing, only manufacturing costs are allocated to product. Only in full costing will revenues, expenses, and income summed over all products or divisions equal corporate revenues, expenses, and income.	

EXHIBIT 1.2 COST TERMINOLOGY: DISTINCTIONS AMONG TERMS CONTAINING THE WORD "COST" (CONTINUED)

TERMS (SYNONYMS GIVEN IN PARENTHESES)		DISTINCTIONS AND COMMENTS
Opportunity Cost	vs. Outlay Cost (Out-of-Pocket Cost)	Opportunity cost refers to the economic benefit foregone by using a resource for one purpose instead of for another. The outlay cost of the resource will be recorded in financial records. The distinction arises because a resource is already in the possession of the entity with a recorded historical cost. Its economic value to the firm, opportunity cost, generally differs from the historical cost; it can be either larger or smaller.
Future Cost	vs. Past Cost	Effective decision making analyzes only present and future outlay costs, or out-of-pocket costs. Opportunity costs are relevant for profit maximizing; past costs are used in financial reporting.
Short-Run Cost	vs. Long-Run Cost	Short-run costs vary as output is varied for a given configuration of plant and equipment. Long-run costs can be incurred to change that configuration. This pair of terms is the economic analog of the accounting pair, see (2) above, variable and fixed costs. The analogy is not perfect because some short-run costs are fixed, such as property taxes on the factory, from the point of view of breakeven analysis.
Imputed Cost	vs. Book Cost	In a regulatory setting some costs, for example the cost of owners' equity capital, are calculated and used for various purposes; these are imputed costs. Imputed costs are not recorded in the historical costs accounting records for financial reporting. Book costs are recorded.
Average Cost	vs. Marginal Cost	The economic distinction equivalent to fully absorbed cost of product and variable cost of product. Average cost is total cost divided by number of units. Marginal cost is the cost to produce the next unit (or the last unit).
Differential Cost (Incremental Cost)	vs. Variable Cost	Whether a cost changes or remains fixed depends on the activity basis being considered. Typically, but not invariably, costs are said to be variable or fixed with respect to an activity basis such as changes in production levels. Typically, but not invariably, costs are said to be incremental or not with respect to an activity basis such as the undertaking of some new venture. For example, consider the decision to undertake the production of food processors, rather than food blenders, which the manufacturer has been making. To produce processors requires the acquisition of a new machine tool. The cost of the new machine tool is incremental with respect to a decision to produce food processors instead of food blenders, but, once acquired, becomes a fixed cost of producing food processors. If costs of direct labor hours are going

EXHIBIT 1.2 COST TERMINOLOGY: DISTINCTIONS AMONG TERMS CONTAINING THE WORD "COST" (CONTINUED)

TERMS (SYNONYMS GIVEN IN PARENTHESES)	DISTINCTIONS AND COMMENTS
	to be incurred for the production of food processors or food blenders, whichever is produced (in a scenario when not both are to be produced), such costs are variable with respect to production measured in units, but not incremental with respect to the decision to produce processors rather than blenders. This distinction is often blurred in practice, so a careful understanding of the activity basis being considered is necessary for understanding of the concepts being used in a particular application.

EXHIBIT 1.2 COST TERMINOLOGY: DISTINCTIONS AMONG TERMS CONTAINING THE WORD "COST" (CONTINUED)

cost-to-cost. The *percentage-of-completion method* in which the firm estimates the fraction of completion as the ratio of costs incurred to date divided by the total costs the firm expects to incur for the entire project.

cost-volume-profit analysis. A study of the sensitivity of *profits* to changes in units sold (or produced) or costs or prices.

cost-volume-profit graph (chart). A graph that shows the relation between *fixed costs, contribution per unit, breakeven point, and sales*. See *breakeven chart*.

costing. The process of calculating the cost of activities, products, or services; the British word for *cost accounting*.

counterparty. The term refers to the opposite party in a legal contract. In accounting and finance, a frequent usage arises when an entity purchases (or sells) a *derivative* financial contract, such as an *option, forward contract, and futures contract*.

coupon. That portion of a *bond* document redeemable at a specified date for payments. Its physical form resembles a series of tickets; each coupon has a date, and the holder either deposits it at a bank, just like a check, for collection or mails it to the issuer's agent for collection.

coupon rate. Of a *bond*, the total dollar amount of coupons paid in any one year divided by par value. Contrast with *effective rate*.

covenant. A promise with legal validity. A loan covenant specifies the terms under which the lender can force the borrower to repay funds otherwise not yet due. For example, a *bond* covenant might say that the *principal* of a bond issue falls due on December 31, 2010, unless the firm's *debt-equity ratio* falls below 40 percent, in which case the amount becomes due immediately.

CPA. See *certified public accountant*. The AICPA suggests that no periods appear in the abbreviation.

CPI. *Consumer price index*.

CPP. Current purchasing power; usually used, primarily in the United Kingdom, as an adjective modifying the word "accounting" to mean the accounting that produces *constant-dollar financial statements*.

Cr. Abbreviation for *credit*, always with initial capital letter. Quiz: What do you suppose *Cr.* stands for? For the answer, see *Dr.*

creative accounting. Selection of *accounting principles* and interpretation of transactions or events designed to manipulate, typically to increase but sometimes merely to smooth, reported *income from continuing operations*; one form of *fraudulent financial reporting*. Many attempts at creative accounting involve premature *revenue recognition*.

credit. As a noun, an entry on the right-hand side of an *account*; as a verb, to make an

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entry on the right-hand side of an account; records increases in *liabilities*, *owners' equity*, *revenues*, and *gains*; records decreases in *assets* and *expenses*. See *debit and credit conventions*. This term also refers to the ability or right to buy or borrow in return for a promise to pay later.

credit bureau. An organization that gathers and evaluates data on the ability of a person to meet financial obligations and sells this information to its clients.

credit loss. The amount of accounts receivable that the firm finds, or expects to find, *uncollectible*.

credit memorandum. A document used by a seller to inform a buyer that the seller is crediting (reducing) the buyer's account receivable because of *errors*, *returns*, or *allowances*; also, the document provided by a bank to a depositor to indicate that the bank is increasing the depositor's balance because of some event other than a deposit, such as the collection by the bank of the depositor's *note receivable*.

creditor. One who lends. In the United Kingdom, *accounts payables*. See *Dr.*

critical accounting judgments. All numbers on a *balance sheet*, except the date, require some judgment or estimate. (The previous sentence passes for a joke in accounting.) The SEC requires that management in its annual report to shareholders identify the accounting issues whose judgments and estimates have potential for significant effect on *earnings* and *financial position*. Examples include *inventory valuation*, *measurement of goodwill impairment*, accounting for *hedges*, and *revenue recognition*.

critical path method (CPM). A method of *network analysis* in which the analyst estimates normal duration time for each activity within a project. The critical path identifies the shortest completion period based on the

credit bureau — current assets

most time-consuming sequence of activities from the beginning to the end of the network. Compare *PERT*.

critical success factors. The important things a company must do to be successful; may vary from one company to another.

cross-reference (index). A number placed beside each *account* in a *journal entry* indicating the *ledger* account to which the record keeper posted the entry and placing in the ledger the page number of the journal where the record keeper first recorded the journal entry; used to link the *debit* and *credit* parts of an entry in the ledger accounts back to the original entry in the journal. See *audit trail*.

cross-section analysis. Analysis of *financial statements* of various firms for a single period of time; contrast with *time-series analysis*, in which analysts examine statements of a given firm for several periods of time.

Crown corporation. Canada and United Kingdom: a corporation that is ultimately accountable, through a minister of the Crown, to Parliament or a legislature for the conduct of its affairs.

cum div, (dividend). The condition of shares whose quoted market price includes a declared but unpaid dividend. This condition pertains between the declaration date of the dividend and the record date. Compare *ex div. (dividend)*.

cum rights. The condition of securities whose quoted market price includes the right to purchase new securities. Compare *ex rights*.

cumulative dividend. Preferred stock *dividends* that, if not paid, accrue as a commitment that the firm must pay before it can declare dividends to common shareholders.

cumulative preferred shares. Preferred shares with *cumulative dividend* rights.

current assets. *Cash* and other *assets* that a firm expects to turn into cash, sell, or exchange within the normal operating cycle of the firm

current cost — customer-level activities

or one year, whichever is longer. One year is the usual period for classifying asset balances on the balance sheet. Current assets include *cash, marketable securities, receivables, inventory, and current prepayments.*

current cost. *Cost* stated in terms of current values (of *productive capacity*) rather than in terms of *acquisition cost*. See *net realizable value* and *current selling price*.

current cost accounting. The *FASB's* term for *financial statements* in which the *attribute measured* is *current cost*.

current cost/nominal-dollar accounting. Accounting based on *current cost* valuations measured in *nominal dollars*. Components of *income* include an *operating margin* and *holding gains and losses*.

current exchange rate. The rate at which the holder of one unit of currency can convert it into another at the end of the *accounting period* being reported on or, for *revenues, expenses, gains, and losses*, the date of recognition of the transaction.

current exit value. *Exit value*.

current fund. In governmental accounting, a synonym for *general fund*.

current funds. *Cash* and other assets readily convertible into cash; in governmental accounting, funds spent for operating purposes during the current period; includes *general, special revenue, debt service, and enterprise funds*.

current (gross) margin. See *operating margin based on current costs*.

current liability. A debt or other obligation that a firm must discharge within a short time, usually the *earnings cycle* or one year, normally by expending *current assets*.

current operating performance concept. The notion that reported *income* for a period ought to reflect only ordinary, normal, and recurring operations of that period. A consequence is that *extraordinary* and nonrecurring items are

entered directly in the Retained Earnings account. Contrast with *clean surplus concept*. This concept is no longer acceptable. (See *APB Opinion No. 9* and *No. 30*.)

current ratio. Sum of *current assets* divided by sum of *current liabilities*. See *ratio*.

current realizable value. *Realizable value*.

current replacement cost. Of an *asset*, the amount currently required to acquire an identical asset (in the same condition and with the same service potential) or an asset capable of rendering the same service at a current *fair market price*. If these two amounts differ, use the lower. Contrast with *reproduction cost*.

current selling price. The amount for which an *asset* could be sold as of a given time in an *arm's-length* transaction rather than in a forced sale.

current service costs. *Service costs* of a *pension plan*.

current value accounting. The form of accounting in which all assets appear at *current replacement cost (entry value)* or *current selling price* or *net realizable value (exit value)* and all *liabilities* appear at *present value*. Entry and exit values may differ from each other, so theorists have not agreed on the precise meaning of "current value accounting."

current yield. Of a *bond*, the annual amount of *coupons* divided by the current market price of the bond. Contrast with *yield to maturity*.

currently attainable standard cost. *Normal standard cost*.

curvilinear (variable) cost. A continuous, but not necessarily linear (straight-line), functional relation between activity levels and *costs*.

customer-level activities. Work performed to meet the needs of a specific customer, aggregated over all customers.

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customer response time — debit and credit conventions

customer response time. Period that elapses from the moment a customer places an order for a product or requests service to the moment the firm delivers the product or service to the customer.

customers' ledger. The *ledger* that shows *accounts receivable* of individual customers. It is the *subsidiary ledger* for the *control account* Accounts Receivable.

cutoff rate. *Hurdle rate.*

D

data bank. An organized file of information, such as a customer name and address file, used in and kept up-to-date by a processing system.

database. A comprehensive collection of inter-related information stored together in computerized form to serve several applications.

database management system. Generalized software programs used to handle physical storage and manipulation of databases.

days of average inventory on hand. See *ratio*.

days of grace. The days allowed by law or contract for payment of a debt after its due date.

DCF. *Discounted cash flow.*

DDB. *Double declining-balance depreciation.*

debenture bond. A *bond* not secured with *collateral*.

debit. As a noun, an entry on the left-hand side of an *account*; as a verb, to make an entry on the left-hand side of an account; records increases in *assets* and *expenses*; records decreases in *liabilities*, *owners' equity*, and *revenues*. See *debit and credit conventions*.

debit and credit conventions. The conventional use of the *T-account* form and the rules for debit and credit in *balance sheet accounts* (see below). The equality of the two sides of the *accounting equation* results from recording equal amounts of *debits* and *credits* for each *transaction*.

Typical Asset Account	
Opening Balance	
Increase	Decrease
+	-
Dr.	Cr.
Ending Balance	
Typical Liability Account	
	Opening Balance
Decrease	Increase
-	+
Dr.	Cr.
	Ending Balance
Typical Owners' Equity Account	
	Opening Balance
Decrease	Increase
-	+
Dr.	Cr.
	Ending Balance

Revenue and expense accounts belong to the owners' equity group. The relation and the rules for debit and credit in these accounts take the following form:

Owners' Equity			
Decrease		Increase	
-		+	
Dr.		Cr.	
Expenses		Revenues	
Dr.	Cr.	Dr.	Cr.
+	-	-	+
*			*

*Normal balance before closing

debit memorandum — defeasance

debit memorandum. A document used by a seller to inform a buyer that the seller is debiting (increasing) the amount of the buyer's *accounts receivable*. Also, the document provided by a bank to a depositor to indicate that the bank is decreasing the depositor's *balance* because of some event other than payment for a *check*, such as monthly service charges or the printing of checks.

debt. An amount owed. The general name for *notes*, *bonds*, *mortgages*, and the like that provide evidence of amounts owed and have definite payment dates.

debt capital. *Noncurrent liabilities*. See *debt financing*, and contrast with *equity financing*.

debt-equity ratio. Total *liabilities* divided by total equities. See *ratio*. Some analysts put only total shareholders' equity in the denominator. Some analysts restrict the numerator to *long-term debt*.

debt financing. *Leverage*. Raising *funds* by issuing *bonds*, *mortgages*, or *notes*. Contrast with *equity financing*.

debt guarantee. See *guarantee*.

debt ratio. *Debt-equity ratio*.

debt service fund. In governmental accounting, a *fund* established to account for payment of *interest* and *principal* on all general-obligation *debt* other than that payable from special *assessments*.

debt service payment. The payment required by a lending agreement, such as periodic coupon payment on a bond or installment payment on a loan or a lease payment. It is sometimes called "interest payment," but this term will mislead the unwary. Only rarely will the amount of a debt service payment equal the interest expense for the period preceding the payment. A debt service payment will always include some amount for interest, but the payment will usually differ from the interest expense.

debt service requirement. The amount of cash required for payments of *interest*, current maturities of *principal* on outstanding *debt*, and payments to *sinking funds* (corporations) or to the debt service fund (governmental).

debtor. One who borrows; in the United Kingdom, *accounts receivable*.

decentralized decision making. Management practice in which a firm gives a manager of a business unit responsibility for that unit's *revenues* and *costs*, freeing the manager to make decisions about prices, sources of supply, and the like, as though the unit were a separate business that the manager owns. See *responsibility accounting* and *transfer price*.

declaration date. Time when the *board of directors* declares a *dividend*.

declining-balance depreciation. The method of calculating the periodic *depreciation* charge by multiplying the *book value* at the start of the period by a constant percentage. In pure declining-balance depreciation, the constant percentage is $1 - ns/c$, where n is the *depreciable life*, s is *salvage value*, and c is *acquisition cost*. See *double declining-balance depreciation*.

deep discount bonds. Said of *bonds* selling much below (exactly how much is not clear) *par value*.

defalcation. Embezzlement.

default. Failure to pay *interest* or *principal* on a *debt* when due.

defeasance. Transaction with the economic effect of *debt retirement* that does not retire the debt. When *interest rates* increase, many firms find that the *market value* of their outstanding *debt* has dropped substantially below its *book value*. In *historical cost accounting* for debt retirements, retiring debt with a *cash* payment less than the book value of the debt results in a gain (generally, an *extraordinary item*). Many firms would like to

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retire the outstanding debt issues and report the gain. Two factors impede doing so: (1) the gain can be a taxable event generating adverse *income tax* consequences; and (2) the transaction costs in retiring all the debt can be large, in part because the firm cannot easily locate all the debt holders or persuade them to sell back their bonds to the issuer. The process of “defeasance” serves as the economic equivalent to retiring a debt issue while it saves the issuer from experiencing adverse tax consequences and from actually having to locate and retire the bonds. The process works as follows. The debt-issuing firm turns over to an independent trustee, such as a bank, amounts of cash or low-risk government bonds sufficient to make all debt service payments on the outstanding debt, including bond retirements, in return for the trustee’s commitment to make all debt service payments. The debt issuer effectively retires the outstanding debt. It debits the liability account, credits Cash or Marketable Securities as appropriate, and credits Extraordinary Gain on Debt Retirement. The trustee can retire debt or make debt service payments, whichever it chooses. For income tax purposes, however, the firm’s debt remains outstanding. The firm will have taxable interest *deductions* for its still-outstanding debt and taxable interest *revenue* on the investments held by the trustee for debt service. In law, the term “defeasance” means “a rendering null and void.” This process renders the outstanding debt economically null and void, without causing a taxable event.

defensive interval. A financial *ratio* equal to the number of days of normal cash *expenditures* covered by *quick assets*. It is defined as follows:

$$\frac{\text{Quick Assets}}{(\text{All Expenses Except Amortization and Others Not Using Funds} \div 365)}$$

defensive interval — deferred income tax (liability)

The denominator of the ratio is the cash expenditure per day. Analysts have found this ratio useful in predicting *bankruptcy*.

deferral. The accounting process concerned with past *cash receipts* and *payments*; in contrast to *accrual*; recognizing a liability resulting from a current cash receipt (as for magazines to be delivered) or recognizing an asset from a current cash payment (as for prepaid insurance or a long-term depreciable asset).

deferral method. See *flow-through method* (of accounting for the *investment credit*) for definition and contrast.

deferred annuity. An *annuity* whose first payment occurs sometime after the end of the first period.

deferred asset. *Deferred charge*.

deferred charge. *Expenditure* not recognized as an *expense* of the period when made but carried forward as an *asset* to be *written off* in future periods, such as for advance rent payments or insurance premiums. See *deferral*.

deferred cost. *Deferred charge*.

deferred credit. Sometimes used to indicate *advances from customers*.

deferred debit. *Deferred charge*.

deferred expense. *Deferred charge*.

deferred gross margin. *Unrealized gross margin*.

deferred income. *Advances from customers*.

deferred income tax (liability). An *indeterminate-term liability* that arises when the pre-tax income shown on the tax return is less than what it would have been had the firm used the same *accounting principles* and *cost basis* for *assets* and *liabilities* in tax returns as it used for financial reporting. *SFAS No. 109* requires that the firm debit income tax *expense* and credit deferred income tax

deferred revenue — deposit method (of revenue recognition)

with the amount of the taxes delayed by using accounting principles in tax returns different from those used in financial reports. See *temporary difference*, *timing difference*, *permanent difference*, and *installment sales*. If, as a result of temporary differences, cumulative taxable income exceeds cumulative reported income before taxes, the deferred income tax account will have a *debit* balance, which the firm will report as a *deferred charge*.

deferred revenue. Sometimes used to indicate *advances from customers*.

deferred tax. See *deferred income tax*.

deficit. A *debit balance* in the Retained Earnings account; presented on the balance sheet in a *contra account* to *shareholders' equity*; sometimes used to mean negative *net income* for a period.

defined-benefit plan. A *pension plan* in which the employer promises specific dollar amounts to each eligible employee; the amounts usually depend on a formula that takes into account such things as the employee's earnings, years of employment, and age. The employer adjusts its cash contributions and pension expense to *actuarial* experience in the eligible employee group and investment performance of the pension *fund*. This is sometimes called a "fixed-benefit" pension plan. Contrast with *money purchase plan*.

defined-contribution plan. A *money purchase (pension) plan* or other arrangement, based on formula or discretion, in which the employer makes cash contributions to eligible individual employee *accounts* under the terms of a written plan document. The trustee of the funds in the account manages the funds, and the employee-beneficiary receives at retirement (or at some other agreed time) the amount in the fund. The employer makes no promise about that amount. Profit-sharing pension plans are of this type.

deflation. A period of declining *general price-level changes*.

Delphi technique. Forecasting method in which members of the forecasting group prepare individual forecasts, share them anonymously with the rest of the group, and only then compare forecasts and resolve differences.

demand deposit. *Funds* in a *checking account* at a bank.

demand loan. See *term loan* for definition and contrast.

denial of opinion. Canada: the statement that an *auditor*, for reasons arising in the *audit*, is unable to express an opinion on whether the *financial statements* provide *fair presentation*.

denominator volume. Capacity measured in the number of units the firm expects to produce this period; when divided into *budgeted fixed costs*, results in fixed costs applied per unit of product.

department(al) allocation. Obtained by first accumulating *costs* in *cost pools* for each department and then, using separate rates, or sets of rates, for each department, allocating from each cost pool to products produced in that department.

dependent variable. See *regression analysis*.

depletion. Exhaustion or *amortization* of a *wasting asset* or *natural resource*. Also see *percentage depletion*.

depletion allowance. See *percentage depletion*.

deposit intangible. See *core deposit intangible*.

deposit, sinking fund. Payments made to a *sinking fund*.

deposit method (of revenue recognition). A method of *revenue* recognition that is the same as the *completed sale* or *completed contract method*. In some contexts, such as when the customer has the right to return goods for a full refund or in retail land sales, the customer must make substantial payments while still having the right to back out

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of the deal and receive a refund. When the seller cannot predict with reasonable precision the amount of cash it will ultimately collect and when it will receive cash, the seller must *credit* Deposits, a *liability account*, rather than *revenue*. (In this regard, the accounting differs from that in the completed contract method, in which the account credited offsets the *Work-in-Process* inventory account.) When the *sale* becomes complete, the firm credits a revenue account and *debits* the Deposits account.

deposits (by customers). A *liability* that the firm *credits* when receiving *cash* (as in a bank, or in a grocery store when the customer pays for soda-pop bottles with cash to be repaid when the customer returns the bottles) and when the firm intends to discharge the liability by returning the cash. Contrast with the liability account *Advances from Customers*, which the firm credits on receipt of cash, expecting later to discharge the liability by delivering goods or services. When the firm delivers the goods or services, it credits a *revenue* account.

deposits in transit. Deposits made by a firm but not yet reflected on the *bank statement*.

depreciable cost. That part of the *cost* of an asset, usually *acquisition cost* less *salvage value*, that the firm will charge off over the life of the asset through the process of *depreciation*.

depreciable life. For an *asset*, the time period or units of activity (such as miles driven for a truck) over which the firm allocates the *depreciable cost*. For tax returns, depreciable life may be shorter than estimated *service life*.

depreciation. *Amortization of plant assets*; the process of allocating the cost of an asset to the periods of benefit—the *depreciable life*; classified as a *production cost* or a *period expense*, depending on the asset and whether the firm uses *full absorption* or *variable*

deposits (by customers) — Descartes' rule of signs

costing. Depreciation methods described in this glossary include the *annuity method*, *appraisal method*, *composite method*, *compound interest method*, *declining-balance method*, *production method*, *replacement method*, *retirement method*, *straight-line method*, *sinking fund method*, and *sum-of-the-years'-digits method*.

depreciation reserve. An inferior term for *accumulated depreciation*. See *reserve*. Do not confuse with a replacement *fund*.

derivative (financial instrument). A financial instrument, such as an option to purchase a share of stock, created from another, such as a share of stock; an instrument, such as a *swap*, whose value depends on the value of another asset called the “underlying”—for example, the right to receive the difference between the interest payments on a fixed-rate five-year loan for \$1 million and the interest payments on a floating-rate five-year loan for \$1 million. To qualify as a derivative under FASB rules, SFAS No. 133, the instrument has one or more underlyings, and one or more notional amounts or payment provisions or both, it either does not require an initial net investment or it requires one smaller than would be required for other types of contracts expected to have a similar response to changes in market factors, and its terms permit settlement for cash in lieu of physical delivery or the instrument itself trades on an exchange. See also *forward contract* and *futures contract*.

Descartes' rule of signs. In a *capital budgeting* context, a rule that says a series of cash flows will have a nonnegative number of *internal rates of return*. The number equals the number of variations in the sign of the cash flow series or is less than that number by an even integer. Consider the following series of cash flows, the first occurring now and the others at subsequent yearly intervals: -100, -100, +50, +175, -50, +100. The internal rates of

detection costs — differentiable cost

return are the numbers for r that satisfy the following equation:

$$-100 - \frac{100}{(1+r)} + \frac{50}{(1+r)^2} + \frac{175}{(1+r)^3} - \frac{50}{(1+r)^4} + \frac{100}{(1+r)^5} = 0.$$

The series of cash flows has three variations in sign: a change from minus to plus, a change from plus to minus, and a change from minus to plus. The rule says that this series must have either one or three internal rates of return; in fact, it has only one, about 12 percent. But also see *reinvestment rate*.

detection costs. See *appraisal costs*.

detective controls. *Internal controls* designed to detect, or maximize the chance of detection of, errors and other irregularities.

determination. See *determine*.

determine. A term often used (in our opinion, overused) by accountants and those who describe the accounting process. A leading dictionary associates the following meanings with the verb “determine”: settle, decide, conclude, ascertain, cause, affect, control, impel, terminate, and decide upon. In addition, accounting writers can mean any one of the following: measure, allocate, report, calculate, compute, observe, choose, and legislate. In accounting, there are two distinct sets of meanings: those encompassed by the synonym “cause or legislate” and those encompassed by the synonym “measure.” The first set of uses conveys the active notion of causing something to happen, and the second set of uses conveys the more passive notion of observing something that someone else has caused to happen. An accountant who speaks of cost or income “determination” generally means measurement or observation, not causation; management and economic conditions cause costs and income to be what they are. One who speaks of accounting principles

“determination” can mean choosing or applying (as in “determining depreciation charges” from an allowable set) or causing to be acceptable (as in the FASB’s “determining” the accounting for *leases*). In the long run, income is cash-in less cash-out, so management and economic conditions “determine” (cause) income to be what it is. In the short run, reported income is a function of accounting principles chosen and applied, so the accountant “determines” (measures) income. A question such as “Who determines income?” has, therefore, no unambiguous answer. The meaning of “an accountant determining acceptable accounting principles” is also vague. Does the clause mean merely choosing one principle from the set of generally acceptable principles, or does it mean using professional judgment to decide that some of the generally accepted principles are not correct under the current circumstances? We try never to use “determine” unless we mean “cause.” Otherwise we use “measure,” “report,” “calculate,” “compute,” or whatever specific verb seems appropriate. We suggest that careful writers will always “determine” to use the most specific verb to convey meaning. “Determine” seldom best describes a process in which those who make decisions often differ from those who apply technique. The term *predetermined (factory) overhead rate* contains an appropriate use of the word.

development stage enterprise. As defined in *SFAS No. 7*, a firm whose planned principal operations have not commenced or, having commenced, have not generated significant revenue. The financial statements should identify such enterprises, but no special *accounting principles* apply to them.

diagnostic signal. See *warning signal* for definition and contrast.

differentiable cost. The cost increments associated with infinitesimal changes in volume. If a total cost curve is smooth (in mathematical

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differential — discount

terms, differentiable), then we say that the curve graphing the derivative of the total cost curve shows differentiable costs.

differential. An adjective used to describe the change (increase or decrease) in a *cost, expense, investment, cash flow, revenue, profit*, and the like as the firm produces or sells one or more additional (or fewer) units or undertakes (or ceases) an activity. This term has virtually the same meaning as *incremental*, but if the item declines, “decremental” better describes the change. Contrast with *marginal*, which means the change in cost or other item for a small (one unit or even less) change in number of units produced or sold.

differential analysis. Analysis of *differential costs, revenues, profits, investment, cash flow*, and the like.

differential cost. See *differential*.

differential cost analysis. See *relevant cost analysis*.

dilution. A potential reduction in *earnings per share* or *book value* per share by the potential *conversion* of securities or by the potential exercise of *warrants* or *options*.

dilutive. Said of a *security* that will reduce *earnings per share* if it is exchanged for *common shares*.

dip(ping) into LIFO layers. See *LIFO inventory layer*.

direct access. Access to computer storage where information can be located directly, regardless of its position in the storage file. Compare *sequential access*.

direct cost. Cost of *direct material* and *direct labor* incurred in producing a product. See *prime cost*. In some accounting literature, writers use this term to mean the same thing as *variable cost*.

direct costing. Another, less-preferred, term for *variable costing*.

direct-financing (capital) lease. See *sales-type (capital) lease* for definition and contrast.

direct labor (material) cost. Cost of labor (material) applied and assigned directly to a product; contrast with *indirect labor (material)*.

direct labor variance. Difference between actual and *standard direct labor* allowed.

direct method. See *statement of cash flows*.

direct posting. A method of bookkeeping in which the firm makes *entries* directly in *ledger accounts*, without using a *journal*.

direct write-off method. See *write-off method*.

disbursement. Payment by *cash* or by *check*. See *expenditure*.

DISC (domestic international sales corporation).

A U.S. *corporation*, usually a *subsidiary*, whose *income* results primarily from exports. The parent firm usually defers paying *income tax* on 50 percent of a DISC's income for a long period. Generally, this results in a lower overall corporate tax for the *parent* than would otherwise be incurred.

disclaimer of opinion. An *auditor's report* stating that the auditor cannot give an opinion on the *financial statements*. Usually results from *material* restrictions on the scope of the audit or from material uncertainties, which the firm has been unable to resolve by the time of the audit, about the accounts.

disclosure. The showing of facts in *financial statements, notes* thereto, or the *auditor's report*.

discontinued operations. See *income from discontinued operations*.

discount. In the context of *compound interest, bonds* and *notes*, the difference between *face amount* (or *future value*) and *present value* of a payment; in the context of *sales* and *purchases*, a reduction in price granted for prompt payment. See also *chain discount, quantity discount*, and *trade discount*.

discount factor — disintermediation

discount factor. The reciprocal of one plus the *discount rate*. If the discount rate is 10 percent per period, the discount factor for three periods is $1/(1.10)^3 = (1.10)^{-3} = 0.75131$.

discount rate. *Interest rate* used to convert future payments to *present values*.

discounted bailout period. In a *capital budgeting* context, the total time that must elapse before discounted value of net accumulated cash flows from a project, including potential *salvage value* at various times of assets, equals or exceeds the *present value* of net accumulated cash outflows. Contrast with *discounted payback period*.

discounted cash flow (DCF). Using either the *net present value* or the *internal rate of return* in an analysis to measure the value of future expected cash *expenditures* and *receipts* at a common date. In discounted cash flow analysis, choosing the alternative with the largest *internal rate of return* may yield wrong answers given *mutually exclusive projects* with differing amounts of initial investment for two of the projects. Consider, to take an unrealistic example, a project involving an initial investment of \$1, with an *IRR* of 60 percent, and another project involving an initial investment of \$1 million, with an *IRR* of 40 percent. Under most conditions, most firms will prefer the second project to the first, but choosing the project with the larger *IRR* will lead to undertaking the first, not the second. Usage calls this shortcoming of choosing between alternatives based on the magnitude of the internal rate of return, rather than based on the magnitude of the *net present value* of the cash flows, the “scale effect.”

discounted payback period. The shortest amount of time that must elapse before the discounted *present value* of cash inflows from a project, excluding potential *salvage value*, equals the discounted present value of the cash outflows.

discounting a note. See *note receivable discounted* and *factoring*.

discounts lapsed (lost). The sum of *discounts* offered for prompt payment that the purchaser did not take because the discount period expired. See *terms of sale*.

discovery sampling. Acceptance sampling in which the analyst accepts an entire population if and only if the sample contains no disparities.

discovery value accounting. See *reserve recognition accounting*.

discretionary cost center. See *engineered cost center* for definition and contrast.

discretionary costs. *Programmed costs*.

Discussion Memorandum. A neutral discussion of all the issues concerning an accounting problem of current concern to the *FASB*. The publication of such a document usually signals that the *FASB* will consider issuing an *SFAS* or *SFAC* on this particular problem. The discussion memorandum brings together material about the particular problem to facilitate interaction and comment by those interested in the matter. A public hearing follows before the *FASB* will issue an *Exposure Draft*.

dishonored note. A *promissory note* whose maker does not repay the loan at *maturity*, for a *term loan*, or on demand, for a *demand loan*.

disintermediation. Moving funds from one interest-earning account to another, typically one promising a higher rate. Federal law regulates the maximum *interest rate* that both banks and savings-and-loan associations can pay for *time deposits*. When free-market interest rates exceed the regulated interest ceiling for such time deposits, some depositors withdraw their funds and invest them elsewhere at a higher interest rate. This process is known as “disintermediation.”

distributable income. The portion of conventional accounting net income that the firm can distribute to owners (usually in the form of *dividends*) without impairing the physical capacity of the firm to continue operations at current levels. Pretax distributable income is conventional pretax income less the excess of *current cost* of goods sold and *depreciation* charges based on the replacement cost of *productive capacity* over cost of goods sold and depreciation on an *acquisition cost basis*. Contrast with *sustainable income*. See *inventory profit*.

distributable surplus. Canada and United Kingdom: the statutory designation to describe the portion of the proceeds of the issue of shares without *par value* not allocated to share capital.

distributed processing. Processing in a computer information network in which an individual location processes data relevant to it while the operating system transmits information required elsewhere, either to the central computer or to another local computer for further processing.

distribution expense. *Expense* of selling, advertising, and delivery activities.

dividend. A distribution of assets generated from *earnings* to owners of a corporation. The firm may distribute cash (cash dividend), stock (stock dividend), property, or other securities (dividend in kind). Dividends, except stock dividends, become a legal liability of the corporation when the corporation's board declares them. Hence, the owner of stock ordinarily recognizes *revenue* when the board of the corporation declares the dividend, except for stock dividends. See also *liquidating dividend* and *stock dividend*.

dividend yield. *Dividends* declared for the year divided by market price of the stock as of the time for which the analyst computes the yield.

dividends in arrears. Dividends on *cumulative preferred stock* that the corporation's board has not yet declared in accordance with the preferred stock contract. The corporation must usually clear such arrearages before it can declare dividends on *common shares*.

dividends in kind. See *dividend*.

division. A more or less self-contained business unit that is part of a larger family of business units under common control.

divisional control. See *control system*.

divisional reporting. See *segment reporting*.

division return on investment (ROI). Equals the *division profit* divided by the investment in the division.

dollar sign rules. In accounting statements or schedules, place a dollar sign beside the first figure in each column and beside any figure below a horizontal line drawn under the preceding figure.

dollar-value LIFO method. A form of *LIFO* inventory accounting with inventory quantities (*layers*) measured in dollar, rather than physical, terms. The method adjusts for changing prices by using specific price indexes appropriate for the kinds of items in the inventory.

domestic international sales corporation. See *DISC*.

donated capital. A *shareholders' equity* account credited when the company receives gifts, such as land or buildings, without issuing shares or other owners' equity interest in return. A city might donate a plant site hoping the firm will build a factory and employ local residents. Do not confuse with *contributed capital*.

double declining-balance depreciation (DDB). *Declining-balance depreciation* in which the constant percentage used to multiply by book value in computing the depreciation charge for the year is $2/n$, where n is the *depreciable life* in periods. Omit *salvage value* from the

double entry — dual transfer prices

depreciable amount. Thus, if the asset cost \$100 and has a depreciable life of five years, the depreciation in the first year would be $\$40 = 2/5 \times \100 , in the second year would be $\$24 = 2/5 \times (\$100 - \$40)$, and in the third year would be $\$14.40 = 2/5 \times (\$100 - \$40 - \$24)$. By the fourth year, the remaining undepreciated cost could be depreciated under the straight-line method at $\$10.80 = 1/2 \times (\$100 - \$40 - \$24 - \$14.40)$ per year for tax purposes. Note that salvage value does not affect these computations except that the method will not depreciate the book value below salvage value.

double entry. In recording transactions, a system that maintains the equality of the accounting equation or the balance sheet. Each entry results in recording equal amounts of *debits* and *credits*.

double taxation. Occurs when the taxing authority (U.S. or state) taxes corporate income as earned (first tax) and then the same taxing authority taxes the after-tax income, distributed to owners as dividends, again as personal income tax (second tax).

doubtful accounts. *Accounts receivable* that the firm estimates to be *uncollectible*.

Dr. The abbreviation for *debit*, always with the initial capital letter. *Dr.* is a shortened form of the word *debtor*, and *Cr.* comes from the word *creditor*. In the early days of double-entry record-keeping in the United Kingdom, the major asset was accounts receivable, called *creditors*, and the major liability was accounts payable, called *debtors*. Thus the *r* in *Cr.* does not refer to the *r* in *credit* but to the second *r* in *creditor*.

draft. A written order by the first party, called the drawer, instructing a second party, called the drawee (such as a bank) to pay a third party, called the payee. See also *check*, *cashier's check*, *certified check*, *NOW account*, *sight draft*, and *trade acceptance*.

drawee. See *draft*.

drawer. See *draft*.

drawing account. A *temporary account* used in *sole proprietorships* and *partnerships* to record payments to owners or partners during a period. At the end of the period, the firm closes the drawing account by crediting it and debiting the owner's or partner's share of income or, perhaps, his or her capital account.

drawings. Payments made to a *sole proprietor* or to a *partner* during a period. See *drawing account*.

driver, cost driver. A cause of costs incurred. Examples include processing orders, issuing an engineering change order, changing the production schedule, and stopping production to change machine settings. The notion arises primarily in product costing, particularly *activity-based costing*.

drop ship(ment). Occurs when a distributor asks a manufacturer to send an order directly to the customer (ordinarily a manufacturer sends goods to a distributor, who sends the goods to its customer). Usage calls the shipment a "drop shipment" and refers to the goods as "drop shipped."

dry-hole accounting. See *reserve recognition accounting* for definition and contrast.

dual-transactions assumption (fiction). Occurs when an analyst, in understanding cash flows, views transactions not involving *cash* as though the firm first generated cash and then used it. For example, the analyst might view the issue of *capital stock* in return for the *asset* land as though the firm issued stock for *cash* and then used cash to acquire the land. Other examples of transactions that could involve the dual-transaction assumption are the issue of a *mortgage* in return for a noncurrent asset and the issue of stock to bondholders on *conversion* of their *convertible bonds*.

dual transfer prices. Occurs when the *transfer price* charged to the buying *division* differs

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duality — EBITDA

from that *credited* to the selling division. Such prices make sense when the selling division has excess capacity and, as usual, the *fair market value* exceeds the *incremental cost* to produce the goods or services being transferred.

duality. The *double-entry* record-keeping axiom that every *transaction* must result in equal *debit* and *credit* amounts.

dumping. A foreign firm's selling a good or service in the United States at a price below market price at home or, in some contexts, below some measure of cost (which concept is not clearly defined). The practice is illegal in the United States if it harms (or threatens to harm) a U.S. industry.

E

e. The base of natural logarithms; 2.71828. . . . If *interest* compounds continuously during a period at stated rate of r per period, then the effective *interest rate* is equivalent to interest compounded once per period at rate i where $i = e^r - 1$. Tables of e^r are widely available. If 12 percent annual interest compounds continuously, the effective annual rate is $e^{.12} - 1 = 12.75$ percent. Interest compounded continuously at rate r for d days is $e^{rd/365} - 1$. For example, interest compounded for 92 days at 12 percent is $e^{.12 \times 92/365} - 1 = 3.07$ percent.

earn-out. For two merging firms, an agreement in which the amount paid by the acquiring firm to the acquired firm's shareholders depends on the future earnings of the acquired firm or, perhaps, of the *consolidated entity*.

earned surplus. A term that writers once used, but no longer use, for *retained earnings*.

earnings. A term with no precise meaning but used to mean *income* or sometimes *profit*. The *FASB*, in requiring that firms report *comprehensive income*, encouraged firms to use the term "earnings" for the total formerly reported as *net income*. Firms will likely only slowly change from using the term "net income" to the term "earnings."

earnings, retained. See *retained earnings*.

earnings cycle. The period of time, or the series of transactions, during which a given

firm converts *cash* into *goods* and *services*, then sells goods and services to customers, and finally collects cash from customers. *Cash cycle*.

earnings per share (of common stock). *Net income* to common shareholders (net income minus *preferred dividends*) divided by the average number of *common shares* outstanding; see also *primary earnings per share* and *fully diluted earnings per share*. See *ratio*.

earnings per share (of preferred stock). *Net income* divided by the average number of *preferred shares* outstanding during the period. This ratio indicates how well income covers (or protects) the preferred dividends; it does not indicate a legal share of *earnings*. See *ratio*.

earnings statement. *Income statement*.

easement. The acquired right or privilege of one person to use, or have access to, certain property of another. For example, a public utility's right to lay pipes or lines under the property of another and to service those facilities.

EBIT. *Earnings before interest and (income) taxes*; acronym used by analysts.

EBITDA. *Earnings before interest, (income) taxes, depreciation, and amortization*; acronym used by analysts to focus on a particular

economic consequences — effective (interest) rate

measure of *cash flow* used in valuation. This is not the same as, but is similar in concept to, *cash flow from operations*. Some analysts exclude *nonrecurring* items from this total.

economic consequences. The *FASB* says that in setting *accounting principles*, it should take into account the real effects on various participants in the business world. It calls these effects “economic consequences.”

economic depreciation. Decline in *current cost* (or *fair value*) of an *asset* during a period.

economic entity. See *entity*.

economic life. The time span over which the firm expects to receive the benefits of an *asset*. The economic life of a *patent*, *copyright*, or *franchise* may be less than the legal life. *Service life*.

economic order quantity (EOQ). In mathematical *inventory* analysis, the optimal amount of stock to order when demand reduces inventory to a level called the “reorder point.” If *A* represents the *incremental cost* of placing a single order, *D* represents the total demand for a period of time in units, and *H* represents the incremental holding cost during the period per unit of inventory, then the economic order quantity is:

$$EOQ = \sqrt{2AD/H}$$

Usage sometimes calls *EOQ* the “optimal lot size.”

economic transfer pricing rule. Transfer at the *differential outlay cost* to the selling division (typically *variable costs*), plus the *opportunity cost* to the company of making the internal transfers (\$0 if the seller has idle capacity, or selling price minus variable costs if the seller is operating at capacity).

economic value added (EVA®). The amount of earnings generated above the cost of funds

invested to generate those earnings. To calculate economic value added, find the difference between (the net after-tax operating profit) and (the product of the weighted-average cost of capital multiplied by the investment in the economic unit).

ED. *Exposure Draft*.

EDGAR. Electronic Data, Gathering, Analysis, and Retrieval system; rules and systems adopted by the *SEC* in 1993 to ensure that all the paperwork involved in the filings submitted by more than 15,000 public companies are electronically submitted.

EDP. *Electronic data processing*.

effective interest method. In computing *interest expense* (or *revenue*), a systematic method that makes the interest expense (revenue) for each period divided by the amount of the net *liability (asset)* at the beginning of the period equal to the *yield rate* on the liability (asset) at the time of issue (acquisition). Interest for a period is the yield rate (at time of issue) multiplied by the net liability (asset) at the start of the period. The *amortization* of discount or premium is the *plug* to give equal *debits* and *credits*. (Interest expense is a debit, and the amount of debt service payment is a credit.)

effective (interest) rate. Of a liability such as a bond, the *internal rate of return* or *yield to maturity* at the time of issue. Contrast with *coupon rate*. If the borrower issues the bond for a price below *par*, the effective rate is higher than the coupon rate; if it issues the bond for a price greater than *par*, the effective rate is lower than the coupon rate. In the context of *compound interest*, the effective rate occurs when the *compounding period* on a *loan* differs from one year, such as a nominal interest rate of 12 percent compounded monthly. The effective interest is the single rate that one could use at the end of the year to multiply the

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principal at the beginning of the year and give the same amount as results from compounding interest each period during the year. For example, if 12 percent per year compounds monthly, the effective annual interest rate is 12.683 percent. That is, if you compound \$100 each month at 1 percent per month, the \$100 will grow to \$112.68 at the end of the year. In general, if the nominal rate of r percent per year compounds m times per year, then the effective rate is $(1 + r/m)^m - 1$.

efficiency variance. A term used for the *quantity variance* for materials or labor or *variable overhead* in a *standard costing system*.

efficient capital market. A market in which security prices reflect all available information and react nearly instantaneously and in an unbiased fashion to new information.

efficient market hypothesis. The finance supposition that security prices trade in *efficient capital markets*.

EITF. *Emerging Issues Task Force*.

electronic data processing. Performing computations and other data-organizing steps in a computer, in contrast to doing these steps by hand or with mechanical calculators.

eligible. Under income tax legislation, a term that restricts or otherwise alters the meaning of another tax or accounting term, generally to signify that the related assets or operations may receive a specified tax treatment.

eliminations. In preparing *consolidated statements*, *work sheet* entries made to avoid duplicating the amounts of *assets*, *liabilities*, *owners' equity*, *revenues*, and *expenses* of the consolidated *entity* when the firm sums the accounts of the *parent* and *subsidiaries*.

Emerging Issues Task Force (EITF). A group convened by the *FASB* to deal more rapidly with accounting issues than the *FASB's*

efficiency variance — endorsement

due-process procedures can allow. The task force comprises about 20 members from public accounting, industry, and several trade associations. It meets every six weeks. Several *FASB* board members usually attend and participate. The chief accountant of the *SEC* has indicated that the *SEC* will require that published financial statements follow guidelines set by a consensus of the *EITF*. The *EITF* requires that nearly all its members agree on a position before that position receives the label of "consensus." Such positions appear in *Abstracts of the EITF*, published by the *FASB*. Since 1984, the *EITF* has become one of the promulgators of *GAAP*.

employee stock option. See *stock option*.

Employee Stock Ownership Trust (or Plan). See *ESOT*.

employer, employee payroll taxes. See *payroll taxes*.

enabling costs. A type of *capacity cost* that a firm will stop incurring if it shuts down operations completely but will incur in full if it carries out operations at any level. Examples include costs of a security force or of a quality-control inspector for an assembly line. Contrast with *standby costs*.

encumbrance. In governmental accounting, an anticipated *expenditure* or *funds* restricted for an anticipated expenditure, such as for outstanding purchase orders. *Appropriations* less expenditures less outstanding encumbrances yields unencumbered balance.

ending inventory. The *cost of inventory* on hand at the end of the *accounting period*; often called "closing inventory." Ending inventory from the end of one period becomes the *beginning inventory* for the next period.

endorsee. See *endorser*.

endorsement. See *draft*. The *payee* signs the draft and transfers it to a fourth party, such as the payee's bank.

endorser — equity financing

endorser. A *note* or *draft payee*, who signs the note after writing “Pay to the order of X,” transfers the note to person X, and presumably receives some benefit, such as cash, in return. Usage refers to person X as the “endorsee.” The endorsee then has the rights of the payee and may in turn become an endorser by endorsing the note to another endorsee.

engineered cost center. Responsibility center with sufficiently well-established relations between inputs and outputs that the analyst, given data on inputs, can predict the outputs or, conversely, given the outputs, can estimate the amounts of inputs that the process should have used. Consider the relation between pounds of flour (input) and loaves of bread (output). Contrast discretionary cost center, where such relations are so imprecise that analysts have no reliable way to relate inputs to outputs. Consider the relation between advertising the corporate logo or trademark (input) and future revenues (output).

engineering method (of cost estimation). To estimate unit cost of product from study of the materials, labor, and *overhead* components of the production process.

enterprise. Any business organization, usually defining the accounting *entity*.

enterprise fund. A *fund* that a governmental unit establishes to account for acquisition, operation, and maintenance of governmental services that the government intends to be self-supporting from user charges, such as for water or airports and some toll roads.

entity. A person, *partnership*, *corporation*, or other organization. The *accounting entity* that issues accounting statements may not be the same as the entity defined by law. For example, a *sole proprietorship* is an accounting entity, but the individual’s combined business and personal assets are the legal entity in most jurisdictions. Several affiliated corporations may be separate legal entities but issue *consolidated financial statements* for

the group of companies operating as a single economic entity.

entity theory. The corporation view that emphasizes the form of the *accounting equation* that says *assets = equities*. Contrast with *proprietorship theory*. The entity theory focuses less on the distinction between *liabilities* and *shareholders’ equity* than does the proprietorship theory. The entity theory views all equities as coming to the corporation from outsiders who have claims of differing legal standings. The entity theory implies using a *multiple-step* income statement.

entry value. The *current cost* of acquiring an asset or service at a *fair market price*. *Replacement cost*.

EOQ. *Economic order quantity*.

EPS. *Earnings per share*.

EPVI. *Excess present value index*.

equalization reserve. An inferior title for the allowance or *estimated liability* account when the firm uses the *allowance method* for such things as maintenance expenses. Periodically, the accountant will debit maintenance *expense* and credit the allowance. As the firm makes *expenditures* for maintenance, it will debit the allowance and credit cash or the other asset used in maintenance.

equities. *Liabilities plus owners’ equity*. See *equity*.

equity. A claim to *assets*; a source of assets. *SFAC No. 3* defines equity as “the residual interest in the assets of an entity that remains after deducting its liabilities.” Thus, many knowledgeable people use “equity” to exclude liabilities and count only owners’ equities. We prefer to use the term to mean all liabilities plus all owners’ equity because there is no other single word that serves this useful purpose. We fight a losing battle.

equity financing. Raising *funds* by issuing *capital stock*. Contrast with *debt financing*.

equity method. In accounting for an *investment* in the stock of another company, a method that debits the proportionate share of the earnings of the other company to the investment account and credits that amount to a *revenue* account as earned. When the investor receives *dividends*, it debits *cash* and credits the investment account. An investor who owns sufficient shares of stock of an unconsolidated company to exercise significant control over the actions of that company must use the equity method. It is one of the few instances in which the firm recognizes revenue without an increase in *working capital*.

equity ratio. *Shareholders' equity* divided by total *assets*. See *ratio*.

equivalent production. *Equivalent units*.

equivalent units (of work). The number of units of completed output that would require the same costs that a firm would actually incur for the production of completed and partially completed units during a period. For example, if at the beginning of a period the firm starts 100 units and by the end of the period has incurred costs for each of these equal to 75 percent of total costs to complete the units, then the equivalent units of work for the period would be 75. This is used primarily in *process costing* calculations to measure in uniform terms the output of a continuous process.

ERISA (Employee Retirement Income Security Act of 1974). The federal law that sets most *pension plan* requirements.

error accounting. See *accounting errors*.

escalator clause. Inserted in a purchase or rental contract, a clause that permits, under specified conditions, upward adjustments of price.

escapable cost. *Avoidable cost*.

ESOP (Employee Stock Ownership Plan). See *ESOT*.

ESOT (Employee Stock Ownership Trust).

A trust *fund* that is created by a corporate employer and that can provide certain tax benefits to the corporation while providing for employee stock ownership. The corporate employer can contribute up to 25 percent of its payroll per year to the trust. The corporation may deduct the amount of the contribution from otherwise taxable income for federal *income tax* purposes. The trustee of the assets must use them for the benefit of employees—for example, to fund death or retirement benefits. The assets of the trust are usually the *common shares*, sometimes nonvoting, of the corporate employer. For an example of the potential *tax shelter*, consider the case of a corporation with \$1 million of *debt* outstanding, which it wants to retire, and an annual payroll of \$2 million. The corporation sells \$1 million of common stock to the ESOT. The ESOT borrows \$1 million with the loan guaranteed by, and therefore a *contingency* of, the corporation. The corporation uses the \$1 million proceeds of the stock issue to retire its outstanding debt. (The debt of the corporation has been replaced with the debt of the ESOT.) The corporation can contribute \$500,000 ($= .25 \times \2 million payroll) to the ESOT each year and treat the contribution as a deduction for tax purposes. After a little more than two years, the ESOT has received sufficient funds to retire its loan. The corporation has effectively repaid its original \$1 million debt with pretax dollars. Assuming an income tax rate of 40 percent, it has saved \$400,000 ($= .40 \times \1 million) of after-tax dollars if the \$500,000 expense for the contribution to the ESOT for the pension benefits of employees would have been made, in one form or another, anyway. Observe that the corporation could use the proceeds (\$1 million in the example) of the stock issued to the ESOT for any of several different purposes: financing expansion, replacing plant assets, or acquiring another

company. Basically this same form of pre-tax-dollar financing through pensions is available with almost any corporate pension plan, with one important exception. The trustees of an ordinary pension trust must invest the assets prudently, and if they do not, they are personally liable to the employees. Current judgment about prudent investment requires diversification—trustees should invest pension trust assets in a wide variety of investment opportunities. (The trustee may not ordinarily invest more than 10 percent of a pension trust's assets in the parent's common stock.) Thus, the ordinary pension trust cannot, in practice, invest all, or even most, of its assets in the parent corporation's stock. This constraint does not apply to the investments of an ESOT. The trustee may invest all ESOT assets in the parent company's stock. The ESOT also provides a means for closely held corporations to achieve wider ownership of shares without *going public*. The laws enabling ESOTs provide for the independent professional appraisal of shares not traded in public markets and for transactions between the corporation and the ESOT or between the ESOT and the employees to be based on the appraised values of the shares.

estate planning. The arrangement of an individual's affairs to facilitate the passage of assets to beneficiaries and to minimize taxes at death.

estimated expenses. See *after cost*.

estimated liability. The preferred terminology for estimated costs the firm will incur for such uncertain things as repairs under *warranty*. An estimated liability appears on the *balance sheet*. Contrast with *contingency*.

estimated revenue. A term used in governmental accounting to designate revenue expected to accrue during a period independent of whether the government will collect it during the period. The governmental unit

usually establishes a *budgetary account* at the beginning of the budget period.

estimated salvage value. Synonymous with *salvage value* of an *asset* before its retirement.

estimates, changes in. See *accounting changes*.

estimation sampling. The use of sampling technique in which the sampler infers a qualitative (e.g., fraction female) or quantitative (e.g., mean weight) characteristic of the population from the occurrence of that characteristic in the sample drawn. See *attribute(s) sampling*; *variables sampling*.

EURL (entreprise unipersonnelle à responsabilité limitée). France: similar to *SARL* but having only one shareholder.

ex div (dividend). Said of *shares* whose market price quoted in the market has been reduced by a *dividend* already declared but not yet paid. The *corporation* will send the dividend to the person who owned the share on the *record date*. One who buys the share ex dividend will not receive the dividend even though the corporation has not yet paid it.

ex rights. The condition of securities whose quoted market price no longer includes the right to purchase new securities, such rights having expired or been retained by the seller. Compare *cum rights*.

except for. Qualification in *auditor's report*, usually caused by a change, approved by the auditor, from one acceptable accounting principle or procedure to another.

excess present value. In a *capital budgeting* context, *present value* (of anticipated net cash inflows minus cash outflows including initial cash outflow) for a project. The analyst uses the *cost of capital* as the *discount rate*.

excess present value index. *Present value* of future *cash* inflows divided by initial cash outlay.

exchange. The generic term for a transaction (or, more technically, a reciprocal transfer)

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between one entity and another; in another context, the name for a market, such as the New York Stock Exchange.

exchange gain or loss. The phrase used by the *FASB* for *foreign exchange gain or loss*.

exchange rate. The *price* of one country's currency in terms of another country's currency. For example, the British pound sterling might be worth U.S.\$1.60 at a given time. The exchange rate would be stated as "one pound is worth one dollar and sixty cents" or "one dollar is worth £.625" (= £1/\$1.60).

excise tax. Tax on the manufacture, sale, or consumption of a commodity.

executory contract. A mere exchange of promises; an agreement providing for payment by a payor to a payee on the performance of an act or service by the payee, such as a labor contract. Accounting does not recognize benefits arising from executory contracts as *assets*, nor does it recognize obligations arising from such contracts as *liabilities*. See *partially executory contract*.

exemption. A term used for various amounts subtracted from gross income in computing taxable income. Usage does not call all such subtractions "exemptions." See *tax deduction*.

exercise. Occurs when owners of an *option* or *warrant* purchase the security that the option entitles them to purchase.

exercise price. See *option*.

exit value. The proceeds that would be received if assets were disposed of in an *arm's-length transaction*. *Current selling price*; *net realizable value*.

expectancy theory. The notion that people act in ways to obtain rewards and prevent penalties.

expected value. The mean or arithmetic *average* of a statistical distribution or series of numbers.

expected value of (perfect) information. Expected *net benefits* from an undertaking with

exchange gain or loss — Exposure Draft (ED)

(perfect) information minus expected net benefits of the undertaking without (perfect) information.

expendable fund. In governmental accounting, a *fund* whose resources, *principal*, and earnings the governmental unit may distribute.

expenditure. Payment of *cash* for goods or services received. Payment may occur at the time the purchaser receives the goods or services or at a later time. Virtually synonymous with *disbursement* except that disbursement is a broader term and includes all payments for goods or services. Contrast with *expense*.

expense. As a noun, a decrease in *owners' equity* accompanying the decrease in *net assets* caused by selling goods or rendering services or by the passage of time; a "gone" (net) asset; an expired cost. Measure expense as the *cost* of the (net) assets used. Do not confuse with *expenditure* or *disbursement*, which may occur before, when, or after the firm recognizes the related expense. Use the word "cost" to refer to an item that still has service potential and is an asset. Use the word "expense" after the firm has used the asset's service potential. As a verb, "expense" means to designate an expenditure—past, current, or future—as a current expense.

expense account. An *account* to accumulate *expenses*; *closed* to *retained earnings* at the end of the accounting period; a *temporary owners' equity* account; also used to describe a listing of expenses that an employee submits to the employer for reimbursement.

experience rating. A term used in insurance, particularly unemployment insurance, to denote changes from ordinary rates to reflect extraordinarily large or small amounts of claims over time by the insured.

expired cost. An *expense* or a *loss*.

Exposure Draft (ED). A preliminary statement of the *FASB* (or the *APB* between 1962 and 1973) showing the contents of a

pronouncement being considered for enactment by the board.

external failure costs. *Costs that a firm incurs when it detects nonconforming products and services after delivering them to customers, including warranty repairs, product liability, marketing costs, and sales allowances.*

external reporting. Reporting to shareholders and the public, as opposed to internal reporting for management's benefit. See *financial accounting*, and contrast with *managerial accounting*.

extraordinary item. *A material expense or revenue item characterized both by its unusual*

nature and by its infrequency of occurrence; appears along with its income tax effects separately from ordinary income and income from discontinued operations on the income statement. Accountants would probably classify a loss from an earthquake as an extraordinary item. Accountants treat gain (or loss) on the retirement of bonds as an extraordinary item under the terms of SFAS No. 4.

extrinsic rewards. Rewards that come from outside the individual, such as rewards from a teacher, a parent, an organization, and a spouse; they include grades, money, praise, and prizes. Contrast with *intrinsic rewards*.

F

face amount (value). The nominal amount due at maturity from a bond or note not including the contractual periodic payment that may also come due on the same date. Good usage calls the corresponding amount of a stock certificate the *par* or *stated value*, whichever applies.

facility-level activities. Work that supports the entire organization. Examples include top management, human resources, and research and development.

factoring. The process of buying notes or accounts receivable at a discount from the holder owed the debt; from the holder's point of view, the selling of such notes or accounts. When the transaction involves a single note, usage calls the process "discounting a note."

factory. Used synonymously with *manufacturing* as an adjective.

factory burden. *Manufacturing overhead.*

factory cost. *Manufacturing cost.*

factory expense. *Manufacturing overhead. Expense is a poor term in this context because the item is a product cost.*

factory overhead. Usually an item of *manufacturing cost* other than *direct labor* or *direct materials*.

fair market price (value). See *fair value*.

fair presentation (fairness). One of the qualitative standards of financial reporting. When the auditor's report says that the *financial statements* "present fairly . . .," the auditor means that the accounting alternatives used by the entity all comply with GAAP. In recent years, however, courts have ruled that conformity with *generally accepted accounting principles* may be insufficient grounds for an opinion that the statements are fair. SAS No. 5 requires that the auditor judge the accounting principles used in the statements to be "appropriate in the circumstances" before attesting to fair presentation.

fair value, fair market price (value). Price (value) negotiated at *arm's length* between a willing buyer and a willing seller, each acting rationally in his or her own self-interest. The accountant may estimate this amount in the absence of a monetary transaction. This is sometimes measured as the present value of expected cash flows.

62 Glossary fair-value hedge — Financial Accounting Standards Advisory Council (FASAC)

fair-value hedge. A hedge of an exposure to changes in the *fair value* of a recognized *asset* or *liability* or of an unrecognized firm commitment. If the firm uses *hedge accounting*, it will report both the hedged item and the hedging instrument at fair value, with *gains* and *losses* reported in *net income*. If the hedge is effective, the gains and losses on these items will offset each other, although both will appear in net income.

FASAC. Financial Accounting Standards Advisory Council. FASB (Financial Accounting Standards Board). An independent board responsible, since 1973, for establishing *generally accepted accounting principles*. Its official pronouncements are *Statements of Financial Accounting Concepts (SFAC)*, *Statements of Financial Accounting Standards (SFAS)*, and *FASB Interpretations*. See also *Discussion Memorandum* and *Technical Bulletin*. Web site: www.fasb.org.

FASB Interpretation FIN. An official *FASB* statement interpreting the meaning of *Accounting Research Bulletins*, *APB Opinions*, and *Statements of Financial Accounting Standards*. *FIN 46*, for example, has curtailed the use of *off-balance-sheet financings*.

FASB Technical Bulletin. See *Technical Bulletin*.

favorable variance. An excess of actual *revenues* over expected revenues; an excess of *standard cost* over actual cost.

federal income tax. *Income tax* levied by the U.S. government on individuals and corporations.

Federal Insurance Contributions Act. See *FICA*.

Federal Unemployment Tax Act. See *FUTA*.

feedback. The process of informing employees about how their actual performance compares with the expected or desired level of

performance, in the hope that the information will reinforce desired behavior and reduce unproductive behavior.

FEI. Financial Executives Institute.

FICA (Federal Insurance Contributions Act). The law that sets *Social Security taxes* and benefits.

fiduciary. Someone responsible for the custody or administration of property belonging to another; for example, an executor (of an estate), agent, receiver (in *bankruptcy*), or trustee (of a trust).

FIFO (first-in, first-out). The *inventory flow assumption* that firms use to compute *ending inventory cost* from most recent purchases and *cost of goods sold* from oldest purchases including beginning inventory. FIFO describes cost flow from the viewpoint of the income statement. From the balance sheet perspective, *LISH* (last-in, still-here) describes this same cost flow. Contrast with *LIFO*.

finance. As a verb, to supply with *funds* through the *issue* of stocks, bonds, notes, or mortgages or through the retention of earnings.

financial accounting. The accounting for *assets*, *equities*, *revenues*, and *expenses* of a business; primarily concerned with the historical reporting, to external users, of the *financial position* and operations of an *entity* on a regular, periodic basis. Contrast with *managerial accounting*.

Financial Accounting Foundation. The independent foundation (committee), governed by a board of trustees, that raises funds to support the *FASB* and *GASB*.

Financial Accounting Standards Advisory Council (FASAC). A committee of academics, preparers, attestors, and users giving advice to the *FASB* on matters of strategy and emerging issues. The council spends much of each meeting learning about current

developments in standard-setting from the FASB staff.

Financial Accounting Standards Board. *FASB.*

Financial Executives Institute (FEI). An organization of financial executives, such as chief accountants, *controllers*, and treasurers, of large businesses. In recent years, the FEI has been a critic of the FASB because it views many of the FASB requirements as burdensome while not *cost-effective*.

financial expense. An *expense* incurred in raising or managing *funds*.

financial flexibility. As defined by *SFAC No. 5*, “the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.”

financial forecast. See *financial projection* for definition and contrast.

financial instrument. The *FASB* defines this term as follows.

Cash, evidence of an ownership interest in an entity, or a contract that both:

[a] imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity, and

[b] conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

financial leverage. See *leverage*.

financial literacy. The *NYSE* and the *NASDAQ* have required that companies who list their shares with these groups have an audit committee comprising at least three independent board members who are financially literate. The organizations mention the ability to understand the *financial statements*, but leave

the definition of financial literacy to the individual boards to define. We think financial literacy in this sense requires the ability to understand the transactions requiring critical accounting judgments or estimates; the accounting issues and choices for those judgments; what management chose, and why; and what opportunities management’s choices provide for earnings management. See *critical accounting judgments*.

financial model. Model, typically expressed with arithmetic relations, that allows an organization to test the interaction of economic variables in a variety of settings.

financial position (condition). Statement of the *assets* and *equities* of a firm; displayed as a *balance sheet*.

financial projection. An estimate of *financial position*, results of *operations*, and changes in cash flows for one or more future periods based on a set of assumptions. If the assumptions do not represent the most likely outcomes, then auditors call the estimate a “projection.” If the assumptions represent the most probable outcomes, then auditors call the estimate a “forecast.” “Most probable” means that management has evaluated the assumptions and that they are management’s judgment of the most likely set of conditions and most likely outcomes.

financial ratio. See *ratio*.

financial reporting objectives. Broad objectives that are intended to guide the development of specific *accounting standards*; set out by *FASB SFAC No. 1*.

Financial Reporting Release. Series of releases, issued by the SEC since 1982; replaces the *Accounting Series Release*. See *SEC*.

financial statements. The *balance sheet*, *income statement*, *statement of retained earnings*, *statement of cash flows*, statement of changes in *owners’ equity accounts*, statement of *comprehensive income*, and *notes thereto*.

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financial structure — fixed manufacturing overhead applied

financial structure. *Capital structure.*

financial vice-president. Person in charge of the entire accounting and finance function; typically one of the three most influential people in the company.

financial year. Australia and United Kingdom: term for *fiscal year*.

financing activities. Obtaining resources from (a) owners and providing them with a return on and a return of their *investment* and (b) *creditors* and repaying amounts borrowed (or otherwise settling the obligation). See *statement of cash flows*.

financing lease. *Capital lease.*

finished goods (inventory account). Manufactured product ready for sale; a *current asset* (inventory) account.

firm. Informally, any business entity. (Strictly speaking, a firm is a *partnership*.)

firm commitment. The FASB, in SFAS No. 133, defines this as “an agreement with an unrelated party, binding on both parties and usually legally enforceable,” which requires that the firm promise to pay a specified amount of a currency and that the firm has sufficient disincentives for nonpayment that the firm will probably make the payment. A firm commitment resembles a *liability*, but it is an *executory contract*, so is not a liability. SFAS No. 133 allows the firm to recognize certain financial *hedges* in the balance sheet if they hedge firm commitments. The FASB first used the term in SFAS No. 52 and No. 80 but made the term more definite and more important in SFAS No. 133. This is an early, perhaps the first, step in changing the recognition criteria for assets and liabilities to exclude the test that the future benefit (asset) or obligation (liability) not arise from an *executory contract*.

first-in, first-out. See *FIFO*.

fiscal year. A period of 12 consecutive months chosen by a business as the *accounting*

period for *annual reports*, not necessarily a *natural business year* or a calendar year.

FISH. An acronym, conceived by George H. Sorter, for *first-in, still-here*. FISH is the same cost flow assumption as *LIFO*. Many readers of accounting statements find it easier to think about inventory questions in terms of items still on hand. Think of LIFO in connection with *cost of goods sold* but of FISH in connection with *ending inventory*. See *LISH*.

fixed assets. *Plant assets.*

fixed assets turnover. *Sales* divided by average total *fixed assets*.

fixed benefit plan. A *defined-benefit plan*.

fixed budget. A plan that provides for specified amounts of *expenditures* and *receipts* that do not vary with activity levels; sometimes called a “static budget.” Contrast with *flexible budget*.

fixed charges earned (coverage) ratio. *Income* before *interest expense* and *income tax expense* divided by *interest expense*.

fixed cost (expense). An *expenditure* or *expense* that does not vary with volume of activity, at least in the short run. See *capacity costs*, which include *enabling costs* and *standby costs*, and *programmed costs* for various subdivisions of fixed costs. See *cost terminology*.

fixed cost price variance (spending variance). The difference between actual and *budgeted fixed costs*.

fixed interval sampling. A method of choosing a sample: the analyst selects the first item from the population randomly, drawing the remaining sample items at equally spaced intervals.

fixed liability. *Long-term liability.*

fixed manufacturing overhead applied. The portion of *fixed manufacturing overhead cost* allocated to units produced during a period.

fixed overhead variance — flow-through method

fixed overhead variance. Difference between *actual fixed manufacturing costs* and fixed manufacturing costs applied to production in a *standard costing system*.

flexible budget. Budget that projects receipts and expenditures as a function of activity levels. Contrast with *fixed budget*.

flexible budget allowance. With respect to manufacturing overhead, the total cost that a firm should have incurred at the level of activity actually experienced during the period.

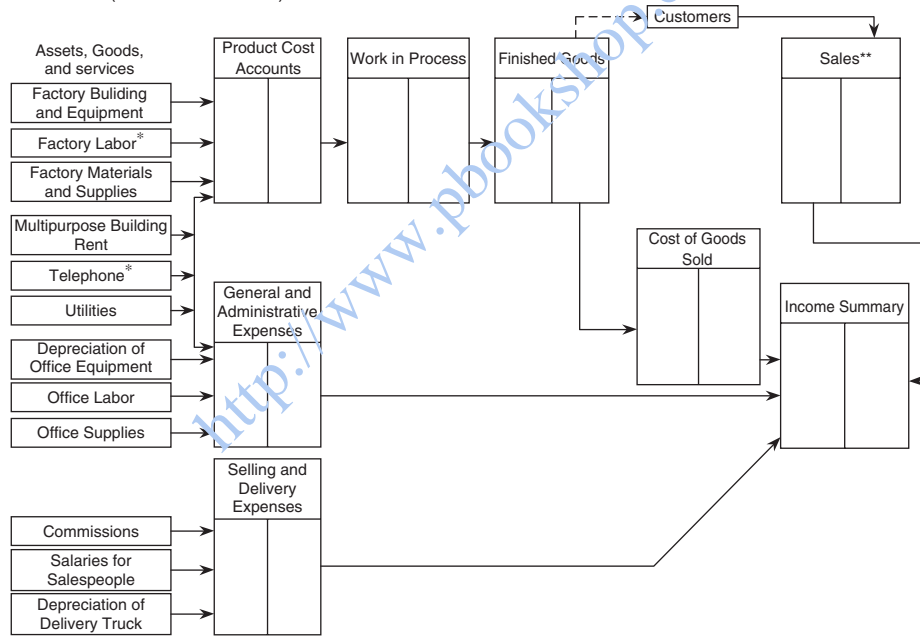
float. Checks whose amounts the bank has added to the depositor's bank account but whose amounts the bank has not yet reduced from the drawer's bank account.

flow. The change in the amount of an item over time. Contrast with *stock*.

flow assumption. An assumption used when the firm makes a *withdrawal* from *inventory*. The firm must compute the cost of the withdrawal by a flow assumption if the firm does not use the *specific identification* method. The usual flow assumptions are *FIFO*, *LIFO*, and *weighted average*.

flow of costs. Costs passing through various classifications within an *entity* engaging, at least in part, in manufacturing activities. See the accompanying diagram for a summary of *product* and *period cost* flows.

Flow of Costs (and Sales Revenue)



* The credit in the entry to record these items is usually to a payable; for all others, the credit is usually to an asset, or to an asset contra account.

** When the firm records sales to customers, it credits the Sales account. The debit is usually to Cash or Accounts Receivable.

flow-through method. Accounting for the *investment credit* to show all income statement benefits of the credit in the year of acquisition rather than spreading them over the life of the asset acquired (called the “deferral method”). The *APB* preferred the deferral

method in *Opinion No. 2* (1962) but accepted the flow-through method in *Opinion No. 4* (1964). The term also applies to *depreciation* accounting in which the firm uses the *straight-line method* for financial reporting and an *accelerated depreciation* method for

66 Glossary

tax reporting. Followers of the flow-through method would not recognize a *deferred tax liability*. *APB Opinion No. 11* prohibits the use of the flow-through approach in financial reporting, although some regulatory commissions have used it.

FOB. Free on board some location (for example, FOB shipping point, FOB destination). The *invoice price* includes delivery at seller's expense to that location. Title to goods usually passes from seller to buyer at the FOB location.

folio. A page number or other identifying reference used in posting to indicate the source of entry.

footing. Adding a column of figures.

footnotes. More detailed information than that provided in the *income statement*, *balance sheet*, *statement of retained earnings*, and *statement of cash flows*. These are an integral part of the statements, and the *auditor's report* covers them. They are sometimes called "notes."

forecast. See *financial projection* for definition and contrast.

foreclosure. Occurs when a lender takes possession of property for his or her own use or sale after the borrower fails to make a required payment on a *mortgage*. Assume that the lender sells the property but that the proceeds of the sale are too small to cover the outstanding balance on the loan at the time of foreclosure. Under the terms of most mortgages, the lender becomes an unsecured creditor of the borrower for the still-unrecovered balance of the loan.

foreign currency. For *financial statements* prepared in a given currency, any other currency.

foreign currency translation. Reporting in the currency used in financial statements the amounts denominated or measured in a different currency.

FOB — fraudulent conveyance

foreign exchange gain or loss. Gain or loss from holding *net foreign monetary items* during a period when the *exchange rate* changes.

foreign sales corporation. See *FSC*.

forfeited share. A share to which a subscriber has lost title because of nonpayment of a *call*.

Form 10-K. See *10-K*.

Form 20-F. See *20-F*.

forward contract. An agreement to purchase or sell a specific commodity or financial instrument for a specified price, the *forward price*, at a specified date. Contrast with *futures contract*. Typically, forward contracts are not traded on organized exchanges (unlike *futures contract*), so the parties to the agreement sacrifice liquidity but gain flexibility in setting contract quantities, qualities, and settlement dates.

forward-exchange contract. An agreement to exchange at a specified future date currencies of different countries at a specified rate called the "forward rate."

forward price. The price of a commodity for delivery at a specified future date; in contrast to the "spot price," the price of that commodity on the day of the price quotation.

franchise. A privilege granted or sold, such as to use a name or to sell products or services.

fraudulent conveyance. A transfer of goods or cash that a court finds illegal. *Creditors* of a *bankrupt* firm usually receive less than the firm owed them. For example, a creditor of a bankrupt firm might collect from the trustee of the bankrupt firm only \$.60 for every dollar the bankrupt firm owed. Creditors, anticipating bankruptcy, sometimes attempt to persuade the firm to pay the debt in full before the firm declares bankruptcy, reducing the net assets available to other creditors. Bankruptcy laws have rules forbidding such transfers from a near-bankrupt firm to some of its creditors. Such a transfer is called a

fraudulent financial reporting — function

“fraudulent conveyance.” Courts sometimes ask accountants to judge whether a firm had liabilities exceeding assets even before the firm went into bankruptcy. When the court can find that economic bankruptcy occurred before legal bankruptcy, it will declare transfers of assets to creditors after economic bankruptcy to be fraudulent conveyances and have the assets returned to the trustees (or to a legal entity called the “bankrupt’s estate”) for redistribution to all creditors.

fraudulent financial reporting. Intentional or reckless conduct that results in materially misleading *financial statements*. See *creative accounting*.

free cash flow. This term has no standard meaning. Some financial statement analysts use it to mean *Cash flow from operations + Interest expense + Income tax expense*. Others mean the excess of cash flow from operations over cash flow for investing. Usage varies so much that you should ascertain the meaning intended in context by this phrase.

free on board. *FOB*.

freight-in. The *cost* of freight or shipping incurred in acquiring *inventory*, preferably treated as a part of the cost of *inventory*; often shown temporarily in an *adjunct account* that the acquirer closes at the end of the period with other purchase accounts to the inventory account.

freight-out. The *cost* of freight or shipping incurred in selling *inventory*, treated by the seller as a selling *expense* in the period of sale.

FSC (foreign sales corporation). A foreign corporation engaging in certain export activities, some of whose *income* the United States exempts from federal *income tax*. A U.S. corporation need pay no income taxes on *dividends* distributed by an FSC out of *earnings* attributable to certain foreign income.

full absorption costing. The *costing* method that assigns all types of manufacturing costs (*direct material, direct labor, fixed and variable overhead*) to units produced; required by *GAAP*; also called “absorption costing.” Contrast with *variable costing*.

full costing, full costs. The total cost of producing and selling a unit; often used in *long-term* profitability and pricing decisions. Full cost per unit equals *full absorption cost* per unit plus *marketing, administrative, interest, and other central corporate expenses*, per unit. The sum of full costs for all units equals total costs of the firm.

full disclosure. The reporting policy requiring that all significant or *material* information appear in the financial statements. See *fair presentation*.

fully diluted earnings per share. For *common stock* smallest *earnings per share* figure that one can obtain by computing an earnings per share for all possible combinations of assumed *exercise* or *conversion* of *potentially dilutive securities*. This figure must appear on the *income statement* if it is less than 97 percent of earnings available to common shareholders divided by the average number of common shares outstanding during the period.

fully vested. Said of a *pension plan* when an employee (or his or her estate) has rights to all the benefits purchased with the employer’s contributions to the plan even if the employee does not work for this employer at the time of death or retirement.

function. In governmental accounting, said of a group of related activities for accomplishing a service or regulatory program for which the governmental unit has responsibility; in mathematics, a rule for associating a number, called the dependent variable, with another number (or numbers), called independent variable(s).

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functional classification — GAAP

functional classification. *Income statement* reporting form that classifies *expenses* by function, that is, cost of goods sold, administrative expenses, financing expenses, selling expenses. Contrast with *natural classification*.

functional currency. Currency in which an entity carries out its principal economic activity.

fund. An *asset* or group of assets set aside for a specific purpose. See also *fund accounting*.

fund accounting. The accounting for resources, obligations, and *capital* balances, usually of a not-for-profit or governmental *entity*, which the entity has segregated into *accounts* representing logical groupings based on legal, donor, or administrative restrictions or requirements. The groupings are “funds.” The accounts of each fund are *self-balancing*, and from them one can prepare a *balance sheet* and an operating statement for each fund. See *fund* and *fund balance*.

fund balance. In governmental accounting, the excess of assets of a *fund* over its liabilities and reserves; the not-for-profit equivalent of *owners' equity*.

funded. Said of a *pension plan* or other obligation when the firm has set aside *funds* for meeting the obligation when it comes due. The federal law for pension plans requires that the firm fund all *normal costs* when it recognizes them as expenses. In addition, the firm must fund *prior service cost* of pension plans over 30 or over 40 years, depending on the circumstances.

funding. Replacing *short-term* liabilities with *long-term* debt.

funds. Generally *working capital*; current assets less current liabilities; sometimes used

to refer to *cash* or to cash and *marketable securities*.

funds provided by operations. See *cash provided by operations*.

funds statement. An informal name often used for the *statement of cash flows*.

funny money. Said of securities, such as *convertible preferred stock*, *convertible bonds*, *options*, and *warrants*, that have aspects of *common shares* but that did not reduce reported *earnings per share* before the issuance of *APB Opinion No. 9* in 1966 and *No. 15* in 1969.

FUTA (Federal Unemployment Tax Act).

Provides for taxes to be collected at the federal level, to help subsidize the individual states' administration of their unemployment compensation programs.

future value. Value at a specified future date of a sum increased at a specified *interest rate*.

futures contract. An agreement to purchase or sell a specific commodity or financial instrument for a specified price, at a specific future time or during a specified future period. Contrast with *forward contract*. When traded on an organized exchange, the exchange sets the minimum contract size and expiration date(s). The exchange requires that the holder of the contract settle in cash each day the fluctuations in the value of the contract. That is, each day, the exchange marks the contract to market value, called the “(daily) settlement price.” A contract holder who has lost during the day must put up more cash, and a holder who has gained receives cash.

G

GAAP. *Generally accepted accounting principles*; a plural noun. In the United Kingdom

and elsewhere, this means “generally accepted accounting practices.”

GAAS — general expenses

GAAS. *Generally accepted auditing standards;* a plural noun. Do not confuse with *GAS*.

gain. In *financial accounting* contexts, the increase in *owners' equity* caused by a transaction that is not part of a firm's typical, day-to-day operations and not part of owners' *investment* or *withdrawals*. Accounting distinguishes the meaning of the term "gain" (or *loss*) from that of related terms. First, gains (and losses) generally refer to nonoperating, incidental, peripheral, or nonroutine transactions: gain on sale of land in contrast to *gross margin on sale of inventory*. Second, gains and losses are *net* concepts, not gross concepts: gain or loss results from subtracting some measure of *cost* from the measure of inflow. *Revenues* and *expenses*, on the other hand, are gross concepts; their difference is a net concept. Gain is nonroutine and net, *profit* or *margin* is routine and net; revenue from *continuing operations* is routine and gross; revenue from *discontinued operations* is nonroutine and gross. Loss is net but can be either routine ("loss on sale of inventory") or not ("loss on disposal of segment of business").

In *managerial accounting* and lay contexts, the difference between some measure of *revenue* or *receipts* or *proceeds* and some measure of costs, such as direct costs or variable costs or fully absorbed costs or full costs (see *cost terminology*). Because the word can have so many different meanings, careful writers should be explicit to designate one.

gain contingency. See *contingency*.

GAS. *Goods available for sale.* Do not confuse with *GAAS*.

GASB (Governmental Accounting Standards Board). An independent body responsible, since 1984, for establishing accounting standards for state and local government units. It is part of the *Financial Accounting Foundation*,

parallel to the *FASB*, and currently consists of five members.

GbR (Gesellschaft des bürgerlichen Rechtes). Germany: a *partnership* whose members agree to share in specific aspects of their own separate business pursuits, such as an office. This partnership has no legal form and is not a separate accounting *entity*.

GDP Implicit Price Deflator (index). A *price index* issued quarterly by the Office of Business Economics of the U.S. Department of Commerce. This index attempts to trace the price level of all *goods and services* composing the *gross domestic product*. Contrast with *Consumer Price Index*.

gearing. United Kingdom: *financial leverage*.

gearing adjustment. A *revenue* representing part of a *holding gain*. Consider a firm that has part of its assets financed by *noncurrent liabilities* and that has experienced *holding gains* on its *assets* during a period. All the increase in wealth caused by the holding gains belongs to the owners; none typically belongs to the lenders. Some British accounting authorities believe that published *income statements* should show part of the holding gain in *income* for the period. The part they would report in income is the fraction of the gain equal to the fraction that debt composes of total financing; for example, if debt equals 40 percent of total equities and the holding gain equals \$100 for the period, the amount to appear in income for the period would be \$40. Usage calls that part the "gearing adjustment."

general debt. A governmental unit's debt legally payable from general revenues and backed by the full faith and credit of the governmental unit.

general expenses. *Operating expenses* other than those specifically identified as cost of goods sold, selling, and administration.

70 Glossary **general fixed asset (group of accounts) — generally accepted auditing standards**

general fixed asset (group of accounts). Accounts showing a governmental unit's long-term assets that are not accounted for in *enterprise, trust*, or intragovernmental service funds.

general fund. A nonprofit entity's assets and liabilities not specifically earmarked for other purposes; the primary operating fund of a governmental unit.

general journal. The formal record in which the firm records transactions, or summaries of similar transactions, in *journal entry* form as they occur. Use of the adjective "general" usually implies that the journal has only two columns for cash amounts or that the firm also uses various *special journals*, such as a *check register* or *sales journal*.

general ledger. The name for the formal *ledger* containing all the financial statement accounts. It has equal debits and credits, as evidenced by the *trial balance*. Some of the accounts in the general ledger may be *control accounts*, supported by details contained in *subsidiary ledgers*.

general partner. *Partnership* member who is personally liable for all debts of the partnership; contrast with *limited partner*.

general price index. A measure of the aggregate prices of a wide range of goods and services in the economy at one time relative to the prices during a base period. See *Consumer Price Index* and *GDP Implicit Price Deflator*. Contrast with *specific price index*.

general price level-adjusted statements. See *constant-dollar accounting*

general price-level changes. Changes in the aggregate prices of a wide range of goods and services in the economy. These price measurements result from using a *general price index*. Contrast with *specific price changes*.

general purchasing power. The command of the dollar over a wide range of goods and services in the economy. The general

purchasing power of the dollar is inversely related to changes in a general price index. See *general price index*.

general purchasing-power accounting. See *constant-dollar accounting*.

generally accepted accounting principles (GAAP). As previously defined by the *CAP, APB*, and now the *FASB*, the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time; includes both broad guidelines and relatively detailed practices and procedures. In the United States, the *FASB* defines GAAP to include accounting pronouncements of the *SEC* and other government agencies as well as a variety of authoritative sources, such as this book.

generally accepted auditing standards (GAAS). The *PCAOB* has explicitly stated that it began compiling its auditing promulgations with GAAS, as issued by the *AICPA*, but "a reference to generally accepted auditing standards in auditors' reports is no longer appropriate or necessary." The phrase has referred to the standards, as opposed to particular procedures, that the *AICPA* promulgated (in *Statements on Auditing Standards*) and that concern "the auditor's professional quantities" and "the judgment exercised by him in the performance of his examination and in his report." Currently, there have been 10 such standards: 3 general ones (concerned with proficiency, independence, and degree of care to be exercised), 3 standards of field work, and 4 standards of reporting. The first standard of reporting requires that the *auditor's report* state whether the firm prepared the *financial statements* in accordance with *generally accepted accounting principles*. Thus, before the *PCAOB* became the auditing rulemaker, the typical auditor's report says that the auditor conducted the examination in accordance with generally accepted auditing standards and that the firm prepared

geographic segment — GLA (general price level–adjusted accounting)

the statements in accordance with generally accepted accounting principles. The report will not refer to the standards of the Public Company Accounting Oversight Board (United States). See *auditor's report*.

geographic segment. A single operation or a group of operations that are located in a particular geographic area and that generate revenue, incur costs, and have assets used in or associated with generating such revenue.

GIE (groupement d'intérêt économique). France: a joint venture, normally used for exports and research-and-development pooling.

GmbH (Gesellschaft mit beschränkter Haftung). Germany: a private company with an unlimited number of shareholders. Transfer of ownership can take place only with the consent of other shareholders. Contrast with *AG*.

goal congruence. The idea that all members of an organization have incentives to perform for a common interest, such as *shareholder wealth maximization* for a *corporation*.

going-concern assumption. For accounting purposes, accountants' assumption that a business will remain in operation long enough to carry out all its current plans. This assumption partially justifies the *acquisition cost* basis, rather than a *liquidation* or *exit value* basis, of accounting.

going public. Said of a business when its *shares* become widely traded rather than being closely held by relatively few shareholders; issuing shares to the general investing public.

goods. Items of merchandise, supplies, raw materials, or finished goods. Sometimes the meaning of "goods" is extended to include all *tangible* items, as in the phrase "goods and services."

goods available for sale. The sum of *beginning inventory* plus all acquisitions of merchandise or finished goods during an *accounting period*.

goods-in-process. *Work-in-process*.

goodwill. The excess of cost of an acquired firm (or operating unit) over the current *fair market value* of the separately identifiable *net assets* of the acquired unit. Before the acquiring firm can recognize goodwill, it must assign a *fair market value* to all identifiable assets, even when not recorded on the books of the acquired unit. For example, if a firm has developed a *patent* that does not appear on its books because of *SFAS No. 2*, if another company acquires the firm, the acquirer will recognize the patent at an amount equal to its estimated fair market value. The acquirer will compute the amount of goodwill only after assigning values to all assets it can identify. Informally, the term indicates the value of good customer relations, high employee morale, a well-respected business name, and so on, all of which the firm or analyst expects to result in greater-than-normal earning power.

goodwill method. A method of accounting for the *admission* of a new partner to a *partnership* when the new partner will receive a portion of capital different from the value of the *tangible* assets contributed as a fraction of tangible assets of the partnership. See *bonus method* for a description and contrast.

Governmental Accounting Standards Advisory Council. A group that consults with the *GASB* on agenda, technical issues, and the assignment of priorities to projects. It comprises more than a dozen members representing various areas of expertise.

Governmental Accounting Standards Board
GASB.

GPL (general price level). Usually used as an adjective modifying the word "accounting" to mean *constant-dollar accounting*.

GLA (general price level–adjusted accounting). *Constant-dollar accounting*.

72 Glossary

GPP (general purchasing power). Usually used as an adjective modifying the word “accounting” to mean *constant-dollar accounting*.

graded vesting. Said of a *pension plan* in which not all employees currently have fully *vested* benefits. By law, the benefits must vest according to one of several formulas as time passes.

grandfather clause. An exemption in new accounting *pronouncements* exempting transactions that occurred before a given date from the new accounting treatment. For example, *APB Opinion No. 17*, adopted in 1970, exempted *goodwill* acquired before 1970 from required *amortization*. The term “grandfather” appears in the title to *SFAS No. 10*.

gross. Not adjusted or reduced by deductions or subtractions. Contrast with *net*, and see *gain* for a description of how the difference between net and gross affects usage of the terms *revenue*, *gain*, *expense*, and *loss*.

gross domestic product (GDP). The market value of all goods and services produced by capital or labor within a country, regardless of who owns the capital or of the nationality of the labor; most widely used measure of production within a country. Contrast with gross national product (GNP), which measures the market value of all goods and services produced with capital owned by, and labor services supplied by, the residents of that country regardless of where they work or where they own capital. In the United States in recent years, the difference between GDP and GNP equals about two-tenths of 1 percent of GDP.

gross margin. *Net sales* minus *Cost of goods sold*.

gross margin percent. $100 \times (1 - \text{Cost of goods sold/net sales}) = 100 \times (\text{Gross margin/Net sales})$.

GPP (general purchasing power) — guarantee

gross national product (GNP). See *gross domestic product* for definition and contrast.

gross price method (of recording purchase or sales discounts). The firm records the *purchase* (or *sale*) at the *invoice price*, not deducting the amounts of *discounts* available. Later, it uses a *contra* account to purchases (or sales) to record the amounts of discounts taken. Since information on discounts lapsed will not emerge from this system, most firms should prefer the *net price method* of recording purchase discounts.

gross profit. *Gross margin*.

gross profit method. A method of estimating *ending inventory* amounts. First, the firm measures *cost of goods sold* as some fraction of sales; then, it uses the *inventory equation* to value *ending inventory*.

gross profit ratio. *Gross margin* divided by *net sales*.

gross sales. All *sales* at *invoice* prices, not reduced by *discounts*, *allowances*, *returns*, or other adjustments.

group depreciation. In calculating *depreciation* charges, a method that combines similar assets rather than depreciating them separately. It does not recognize gain or loss on retirement of items from the group until the firm sells or retires the last item in the group. See *composite life method*.

guarantee. A promise to answer for payment of debt or performance of some obligation if the person liable for the debt or obligation fails to perform. A guarantee is a *contingency* of the *entity* making the promise. Often, writers use the words “guarantee” and “warranty” to mean the same thing. In precise usage, however, “guarantee” means some person’s promise to perform a contractual obligation such as to pay a sum of cash, whereas “warranty” refers to promises about pieces of machinery or other products. See *warranty*.

H

half-year convention. In *tax accounting* under *ACRS*, and sometimes in *financial accounting*, an assumption that the firm acquired *depreciable assets* at midyear of the year of acquisition. When the firm uses this convention, it computes the *depreciation charge* for the year as one-half the charge that it would have used if it had acquired the assets at the beginning of the year.

hardware. The physical equipment or devices forming a computer and peripheral equipment.

hash total. Used to establish accuracy of data processing; a control that takes the sum of data items not normally added together (e.g., the sum of a list of part numbers) and subsequently compares that sum with a computer-generated total of the same values. If the two sums are identical, then the analyst takes some comfort that the two lists are identical.

Hasselback. An annual directory of accounting faculty at colleges and universities; gives information about the faculty's training and fields of specialization. James R. Hasselback, of Florida State University, has compiled the directory since the 1970s; Prentice-Hall distributes it. On-line, you can find it at the Rutgers University accounting Web site: <http://www.rutgers.edu/Accounting/>.

health-care benefits obligation. At any time, the present value of the nonpension benefits promised by an employer to employees during their retirement years.

hedge. To reduce, perhaps cancel altogether, one risk the entity already bears, by purchasing a security or other financial instrument. For example, a farmer growing corn runs the risk that corn prices may decline before the corn matures and can be brought to market. Such a farmer can arrange to sell the corn now for future delivery, hedging the risk of corn price changes. A firm may have a

receivable denominated in euros due in six months. It runs the risk that the exchange rate between the dollar and the euro will change and the firm will receive a smaller number of dollars in the future than it would receive from the same number of marks received today. Such a firm may hedge its exposure to risk of changes in the exchange rate between dollars and euros in a variety of ways. See *cash-flow hedge* and *fair-value hedge*. Do not confuse with *hedge accounting*.

hedge accounting. Firms may, but need not, use hedge accounting. If the firm elects hedge accounting and if its hedging instrument is highly effective, it will report *gains* and *losses* on hedging instruments for *cash-flow hedges* in *other comprehensive income*, rather than in *net income*. For *fair-value hedges*, the firm using hedge accounting will report the hedged *asset* or *liability* at *fair value*; it reports the hedging instrument at fair value in any event.

held-to-maturity securities. *Marketable debt securities* that a firm expects to, and has the ability to, hold to *maturity*; a classification important in *SFAS No. 115*, which generally requires the owner to carry marketable securities on the balance sheet at market value, not at cost. Under *SFAS No. 115*, the firm may show held-to-maturity debt securities at *amortized cost*. If the firm lacks either the expectation or the intent to hold the debt security to its maturity, then the firm will show that security at market value as a security *available for sale*.

hidden reserve. An amount by which a firm has understated *owners' equity*, perhaps deliberately. The understatement arises from an undervaluation of *assets* or overvaluation of *liabilities*. By undervaluing assets on this period's *balance sheet*, the firm can overstate *net income* in some future period by

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hire-purchase agreement (contract) — hypothecation

disposing of the asset: actual *revenues* less artificially low cost of assets sold yields artificially high net income. No *account* in the *ledger* has this title.

hire-purchase agreement (contract). United Kingdom: a *lease* containing a purchase *option*.

historical cost. *Acquisition cost; original cost; a sunk cost.*

historical cost/constant-dollar accounting. Accounting based on *historical cost* valuations measured in *constant dollars*. The method restates *nonmonetary items* to reflect changes in the *general purchasing power* of the dollar since the time the firm acquired specific *assets* or incurred specific *liabilities*. The method recognizes a *gain* or *loss* on *monetary items* as the firm holds them over time periods when the general purchasing power of the dollar changes.

historical exchange rate. The rate at which one currency converts into another at the date a transaction took place. Contrast with *current exchange rate*.

historical summary. A part of the *annual report* that shows items, such as *net income*, *revenues*, *expenses*, *asset* and *equity* totals, *earnings per share*, and the like, for 5 or 10 periods including the current one. Usually not as much detail appears in the historical summary as in *comparative statements*, which typically report as much detail for the two preceding years as for the current year. Annual reports may contain both comparative statements and a historical summary.

holdback. Under the terms of a contract, a portion of the progress payments that the customer need not pay until the contractor has fulfilled the contract or satisfied financial obligations to subcontractors.

holding company. A company that confines its activities to owning *stock* in, and supervising management of, other companies. A holding

company usually owns a controlling interest in—that is, more than 50 percent of the voting stock of—the companies whose stock it holds. Contrast with *mutual fund*. See *conglomerate*. In British usage, the term refers to any company with controlling interest in another company.

holding gain or loss. Difference between end-of-period price and beginning-of-period price of an asset held during the period. The financial statements ordinarily do not separately report realized holding gains and losses. Income does not usually report unrealized gains at all, except on *trading securities*. See *lower of cost or market*. See *inventory profit* for further refinement, including *gains* on *assets* sold during the period.

holding gain or loss net of inflation. Increase or decrease in the *current cost* of an asset while it is held; measured in units of *constant dollars*.

horizontal analysis. *Time-series analysis*.

horizontal integration. An organization's extension of activity in the same general line of business or its expansion into supplementary, complementary, or compatible products. Compare *vertical integration*.

house account. An account with a customer who does not pay sales commissions.

human resource accounting. A term used to describe a variety of proposals that seek to report the importance of human resources—knowledgeable, trained, and loyal employees—in a company's earning process and total assets.

hurdle rate. Required rate of return in a *discounted cash flow* analysis.

hybrid security. *Security*, such as a *convertible bond*, containing elements of both *debt* and *owners' equity*.

hypothecation. The *pledging* of property, without transfer of title or possession, to secure a loan.

I

IAA. *Interamerican Accounting Association.*

IASB. *International Accounting Standards Board.*

ICMA (Institute of Certified Management Accountants). See *CMA* and *Institute of Management Accountants.*

ideal standard costs. *Standard costs* set equal to those that a firm would incur under the best-possible conditions.

IFRS. International Financial Reporting Standard(s). Refers broadly to all the pronouncements of the *IASB* and, with numbers after the letters, to specific reporting standards issued by the *IASB*.

IIA. *Institute of Internal Auditors.*

IMA. *Institute of Management Accountants.*

impairment. Reduction in *market value* of an *asset*. When the firm has information indicating that its long-lived *assets*, such as *plant*, identifiable *intangibles*, and *goodwill*, have declined in *market value* or will provide a smaller future benefit than originally anticipated, it tests to see if the decline in value is so drastic that the expected future cash flows from the asset have declined below *book value*. If then-current book value exceeds the sum of expected cash flows, an asset impairment has occurred. At the time the firm judges that an impairment has occurred, the firm writes down the book value of the asset to its then-current *fair value*, which is the market value of the asset or, if the firm cannot assess the market value, the expected *net present value* of the future cash flows.

implicit interest. *Interest* not paid or received. See *interest, imputed*. All transactions involving the deferred payment or receipt of cash involve interest, whether explicitly stated or not. The implicit interest on a single-payment

note equals the difference between the amount collected at maturity and the amount lent at the start of the loan. One can compute the implicit *interest rate* per year for loans with a single cash inflow and a single cash outflow from the following equation:

$$\left[\frac{\text{Cash Received at Maturity}}{\text{Cash Lent}} \right]^{(1/t)} - 1$$

where t is the term of the loan in years; t need not be an integer.

imprest fund. *Petty cash fund.*

improvement. An *expenditure* to extend the useful life of an *asset* or to improve its performance (rate of output, cost) over that of the original asset; sometimes called “betterment.” The firm capitalizes such expenditures as part of the asset’s cost. Contrast with *maintenance* and *repair*.

imputed cost. A cost that does not appear in accounting records, such as the *interest* that a firm could earn on cash spent to acquire inventories rather than, say, government bonds. Or, consider a firm that owns the buildings it occupies. This firm has an imputed cost for rent in an amount equal to what it would have to pay to use similar buildings owned by another or equal to the amount it could collect from someone renting the premises from the firm. *Opportunity cost*.

imputed interest. See *interest, imputed*.

in the black (red). Operating at a profit (loss).

in-process R&D. When one firm acquires another, the acquired firm will often have *research and development* activities under way that, following *GAAP*, it has *expensed*. The acquiring firm will pay for these activities to the extent they have value and will then, following *GAAP*, write off the activities. For

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incentive compatible compensation — income summary

each dollar of in-process R&D that the acquiring firm identifies and immediately *expenses*, it will have one less dollar of *goodwill* or other assets to *amortize*. Some acquirers have overstated the valuations of acquired in-process R&D in order to increase immediate *write-offs* and subsequent, recurring *income*.

incentive compatible compensation. Said of a compensation plan that induces managers to act for the interests of owners while acting also in their own interests. For example, consider that a time of rising prices and increasing inventories when using a *LIFO* cost flow assumption implies paying lower *income taxes* than using *FIFO*. A bonus scheme for managers based on accounting *net income* is not incentive-compatible because owners likely benefit more under *LIFO*, whereas managers benefit more if they report using *FIFO*. See *LIFO conformity rule* and *goal congruence*.

income. *Excess of revenues and gains over expenses and losses* for a period; *net income*. The term is sometimes used with an appropriate modifier to refer to the various intermediate amounts shown in a *multiple-step income statement* or to refer to revenues, as in “rental income.” See *comprehensive income*.

income accounts. *Revenue and expense accounts*.

income before taxes. On the *income statement*, the difference between all *revenues and expenses* except *income tax expense*. Contrast with *net income*.

income determination. See *determine*.

income distribution account. *Temporary account* sometimes debited when the firm declares *dividends*; closed to *retained earnings*.

income from continuing operations. As defined by *APB Opinion No. 30*, all *revenues* less all *expenses* except for the following: results of operations (including *income tax effects*) that a firm has discontinued or will

discontinue; *gains or losses*, including *income tax effects*, on disposal of segments of the business; *gains or losses*, including *income tax effects*, from *extraordinary items*; and the cumulative effect of *accounting changes*.

income from discontinued operations. *Income*, net of tax effects, from parts of the business that the firm has discontinued during the period or will discontinue in the near future. Accountants report such items on separate lines of the *income statement*, after *income from continuing operations* but before *extraordinary items*.

income (revenue) bond. See *special revenue debt*.

income smoothing. A method of timing business *transactions* or choosing *accounting principles* so that the firm reports smaller variations in *income* from year to year than it otherwise would. Although some managements set income smoothing as an objective, no standard-setter does.

income statement. The statement of *revenues, expenses, gains, and losses* for the period, ending with *net income* for the period. Accountants usually show the *earnings-per-share* amount on the income statement; the *reconciliation* of beginning and ending balances of *retained earnings* may also appear in a combined statement of income and retained earnings. See *income from continuing operations, income from discontinued operations, extraordinary items, multiple-step, and single-step*.

income summary. In problem solving, an *account* that serves as a surrogate for the *income statement*. In using an income summary, close all *revenue accounts* to the Income Summary as *credits* and all *expense accounts* as *debits*. The *balance* in the account, after you make all these *closing entries*, represents income or loss for the period. Then,

income tax — inflation accounting

close the income summary balance to retained earnings.

income tax. An annual tax levied by the federal and other governments on the income of an entity.

income tax allocation. See *deferred income tax (liability)* and *tax allocation: intra-statement*.

incremental. An adjective used to describe the increase in *cost, expense, investment, cash flow, revenue, profit*, and the like if the firm produces or sells one or more units or if it undertakes an activity. See *differential*.

incremental cost. See *incremental*.

incur. Said of an obligation of a firm, whether or not that obligation is *accrued*. For example, a firm incurs interest expense on a loan as time passes but accrues that interest only on payment dates or when it makes an *adjusting entry*.

indenture. See *bond indenture*.

independence. The mental attitude required of the CPA in performing the *attest* function. It implies that the CPA is impartial and that the members of the auditing CPA firm own no stock in the corporation being audited.

independent accountant. The CPA who performs the *attest* function for a firm.

independent variable. See *regression analysis*.

indeterminate-term liability. A *liability* lacking the criterion of being due at a definite time. This term is our own coinage to encompass the *minority interest*.

indexation. An attempt by lawmakers or parties to a contract to cope with the effects of *inflation*. Amounts fixed in law or contracts are “indexed” when these amounts change as a given measure of price changes. For example, a so-called escalator clause (COLA—cost of living allowance or adjustment) in a labor contract might provide that hourly wages will be increased as the *Consumer Price Index* increases. Many economists

have suggested the indexation of numbers be fixed in the *income tax* laws. If, for example, the personal *exemption* is \$2,500 at the start of the period, if prices rise by 10 percent during the period, and if the personal exemption is indexed, then the personal exemption would automatically rise to \$2,750 ($= \$2,500 + .10 \times \$2,500$) at the end of the period.

indirect cost pool. Any grouping of individual costs that a firm does not identify with a *cost objective*.

indirect costs. Production costs not easily associated with the production of specific goods and services; *overhead costs*. Accountants may *allocate* them on some *arbitrary* basis to specific products or departments.

indirect labor (material) cost. An *indirect cost* for labor (material), such as for supervisors (supplies).

indirect method. See *statement of cash flows*.

individual proprietorship. *Sole proprietorship*.

Industry Audit Guides. A series of AICPA publications providing specific accounting and *auditing principles* for specialized situations. Audit guides have been issued covering government contractors, state and local government units, investment companies, finance companies, brokers and dealers in securities, and many other subjects.

inescapable cost. A *cost* that the firm or manager cannot avoid (see *avoidable*) because of an action. For example, if management shuts down two operating rooms in a hospital but still must employ security guards in unreduced numbers, the security costs are “inescapable” with respect to the decision to close the operating rooms.

inflation. A time of generally rising prices.

inflation accounting. Strictly speaking, *constant-dollar accounting*. Some writers incorrectly use the term to mean *current cost accounting*.

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information circular. Canada: a document, accompanying the notice of a shareholders' meeting, prepared in connection with the solicitation of proxies by or on behalf of the management of the corporation. It contains information concerning the people making the solicitation, election of directors, appointment of auditors, and other matters to be acted on at the meeting.

information system. A system, sometimes formal and sometimes informal, for collecting, processing, and communicating data that are useful for the managerial functions of decision making, planning, and control and for financial reporting under the *attest* requirement.

inherent interest rate. *Implicit interest rate.*

initial cash flows. *Cash flows* associated with the beginning of an investment project. Often include *asset cost*, freight and installation costs, reduced by cash proceeds from disposing of existing assets made redundant or unnecessary by the new project, and *income tax effect of gain (loss)* on disposal of existing assets.

insolvent. Unable to pay debts when due; said of a company even though *assets* exceed *liabilities*.

installment. Partial payment of a debt or partial collection of a receivable, usually according to a contract.

installment contracts receivable. The name used for *accounts receivable* when the firm uses the *installment method* of recognizing revenue. Its *contra account*, *unrealized gross margin*, appears on the balance sheet as a subtraction from the amount receivable.

installment sales. Sales on account when the buyer promises to pay in several separate payments, called *installments*. The seller may, but need not, account for such sales using the *installment method*. If the seller accounts for installment sales with the sales *basis of revenue recognition* for financial

information circular — intangible asset

reporting but with the installment method for income tax returns, then it will have *deferred income tax (liability)*.

installment (sales) method. Recognizing *revenue* and *expense* (or *gross margin*) from a sales transaction in proportion to the fraction of the selling price collected during a period; allowed by the *IRS* for income tax reporting but acceptable in *GAAP (APB Opinion No. 10)* only when the firm cannot estimate cash collections with reasonable precision. See *realized* (and *unrealized*) *gross margin*.

Institute of Certified Management Accountants (ICMA). See *CMA* and *Institute of Management Accountants*.

Institute of Internal Auditors (IIA). The national association of accountants who are engaged in internal auditing and are employed by business firms; administers a comprehensive professional examination. Those who pass the exam qualify to be designated *CIA* (Certified Internal Auditor).

Institute of Management Accountants (IMA). Formerly, the National Association of Accountants, *NAA*; a society open to those engaged in management accounting; parent organization of the *ICMA*, which oversees the *CMA* program.

insurance. A contract for reimbursement of specific losses; purchased with insurance premiums. "Self-insurance" is not insurance but is merely the noninsured's willingness to assume the risk of incurring losses while saving the premium.

intangible asset. A nonphysical right that gives a firm an exclusive or preferred position in the marketplace. Examples are *copyright*, *patent*, *trademark*, *goodwill*, *organization costs*, *capitalized advertising cost*, computer programs, licenses for any of the preceding, government licenses (e.g., broadcasting or the right to sell liquor), *leases*, franchises, mailing lists, exploration permits, import and

export permits, construction permits, and marketing quotas. Invariably, accountants define “intangible” using a “for example” list, as we have just done, because accounting has been unable to devise a definition of “intangible” that will include items such as those listed above but exclude stock and bond certificates. Accountants classify these items as tangibles, even though they give their holders a preferred position in receiving dividends and interest payments.

Interamerican Accounting Association (IAA).

An organization, headquartered in Miami, devoted to facilitating interaction between accounting practitioners in the Americas. intercompany elimination. See *eliminations*.

intercompany profit. Profit within an organization. If one *affiliated company* sells to another, and the goods remain in the second company’s *inventory* at the end of the period, then the first company has not yet realized a *profit* by a sale to an outsider. The profit is “intercompany profit,” and the accountant eliminates it from net *income* when preparing *consolidated income statements* or when the firm uses the *equity method*.

intercompany transaction. *Transaction* between a *parent company* and a *subsidiary* or between subsidiaries in a *consolidated entity*; the accountant must eliminate the effects of such a transaction when preparing *consolidated financial statements*. See *intercompany profit*.

intercorporate investment. Occurs when a given *corporation* owns *shares* or *debt* issued by another.

interdepartment monitoring. An *internal control* device. The advantage of allocating *service department costs* to *production departments* stems from the incentives that this gives those charged with the costs to control the costs incurred in the service department. That process of having one group

monitor the performance of another is interdepartment monitoring.

interest. The charge or cost for using cash, usually borrowed funds. Interest on one’s own cash used is an *opportunity cost*, *imputed interest*. The amount of interest for a loan is the total amount paid by a borrower to a lender less the amount paid by the lender to the borrower. Accounting seeks to allocate that interest over the time of the loan so that the interest rate (= interest charge/amount borrowed) stays constant each period. See *interest rate* for discussion of the quoted amount. See *effective interest rate* and *nominal interest rate*.

interest, imputed. The difference between the face amount and the present value of a promise. If a borrower merely promises to pay a single amount, sometime later than the present, then the face amount the borrower will repay at *maturity* will exceed the present value (computed at a *fair market* interest rate, called the “imputed interest rate”) of the promise. See also *imputed cost*.

interest factor. One plus the *interest rate*.

interest method. See *effective interest method*.

interest rate. A basis used for computing the cost of borrowing funds; usually expressed as a ratio between the number of currency units (e.g., dollars) charged for a period of time and the number of currency units borrowed for that same period of time. When the writers and speakers do not state a period, they almost always mean a period of one year. See *interest*, *simple interest*, *compound interest*, *effective (interest) rate*, and *nominal interest rate*.

interest rate swap. See *swap*.

interfund accounts. In governmental accounting, the accounts that show transactions between funds, especially interfund receivables and payables.

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interim statements. Statements issued for periods less than the regular, annual *accounting period*. The SEC requires most corporations to issue interim statements on a quarterly basis. In preparing interim reports, a problem arises that the accountant can resolve only by understanding whether interim reports should report on the interim period (1) as a self-contained accounting period or (2) as an integral part of the year so that analysts can make forecasts of annual performance. For example, assume that at the end of the first quarter, a retailer has dipped into old LIFO layers, depleting its *inventory*, so that it computes *LIFO cost of goods sold* artificially low and *net income* artificially high, relative to the amounts the firm would have computed if it had made the “normal” purchases, equal to or greater than sales. The retailer expects to purchase inventory sufficiently large so that when it computes cost of goods sold for the year, there will be no *dips into old LIFO layers* and income will not be artificially high. The first approach will compute the quarterly income from low cost of goods sold using data for the dips that have actually occurred by the end of the quarter. The second approach will compute quarterly income from cost of goods sold, assuming that purchases were equal to “normal” amounts and that the firm did not dip into old LIFO layers. *APB Opinion No. 28* and the SEC require that interim reports be constructed largely to satisfy the second purpose.

internal audit, internal auditor. An *audit* conducted by the firm’s own employees, called “internal auditors,” to ascertain whether the firm’s *internal control* procedures work as planned. Contrast with an external audit conducted by a *CPA*.

internal controls. Policies and procedures designed to provide management with reasonable assurances that employees behave in a way that enables the firm to meet its organizational goals. See *control system*.

interim statements — intrinsic rewards

internal failure costs. *Costs incurred* when a firm detects nonconforming products and services before delivering them to customers; these include scrap, rework, and retesting.

internal rate of return (IRR). The discount rate that equates the net *present value* of a stream of cash outflows and inflows to zero.

internal reporting. Reporting for management’s use in planning and control. Contrast with *external reporting* for financial statement users.

Internal Revenue Service (IRS). Agency of the U.S. Treasury Department responsible for administering the Internal Revenue Code and collecting income and certain other taxes.

International Accounting Standards Board (IASB). An organization that promotes the international convergence of accounting standards. Web site: <http://www.iasb.org>. Successor to the International Accounting Standards Committee, IASC, which it superceded in 2001. A good site for tracing developments in international accounting is <http://www.iasplus.com>, maintained by the worldwide Deloitte Touche Tohmatsu firm, and recommended by the renowned expert on international accounting, Professor Stephen A. Zeff of Rice University.

International Organization of Securities Commissions. *IOSCO*.

interperiod tax allocation. See *deferred income tax (liability)*.

interpolation. The estimation of an unknown number intermediate between two (or more) known numbers.

Interpretations. See *FASB Interpretation*.

intrastatement tax allocation. See *tax allocation: intrastatement*.

intrinsic rewards. Rewards that come from within the individual, such as the satisfaction from studying hard, providing help to

inventoriable costs — inventory profit

someone in need, or doing a good job. Contrast with *extrinsic rewards*.

inventoriable costs. *Costs* incurred that the firm adds to the cost of manufactured products; *product costs (assets)* as opposed to *period expenses*.

inventory. As a noun, the *balance* in an asset *account*, such as raw materials, supplies, work-in-process, and finished goods; as a verb, to calculate the *cost* of goods on hand at a given time or to count items on hand physically.

inventory equation. *Beginning inventory* + Net additions – Withdrawals = *Ending inventory*. Ordinarily, additions are net purchases, and withdrawals are *cost of goods sold*. Notice that ending inventory, appearing on the balance sheet, and cost of goods sold, appearing on the income statement, must add to a fixed sum. The larger is one; the smaller must be the other. In valuing inventories, the firm usually knows beginning inventory and net purchases. Some inventory methods (for example, some applications of the *retail inventory method*) measure costs of goods sold and use the equation to find the cost of ending inventory. Most methods measure cost of ending inventory and use the equation to find the cost of goods sold (withdrawals). In *current cost* (in contrast to *historical cost*) *accounting*, additions (in the equation) include holding gains, whether realized or not. Thus the current cost inventory equation is as follows: Beginning inventory (at Current cost) + Purchases (where Current cost is Historical cost) + Holding gains (whether realized or not) – Ending inventory (at Current cost) = Cost of goods sold (Current cost).

inventory holding gains. See *inventory profit*.

inventory layer. See *LIFO inventory layer*.

inventory profit. A term with several possible meanings. Consider the data in the accompanying illustration. The firm uses a *FIFO cost*

flow assumption and derives its *historical cost* data. The assumed *current cost* data resemble those that the FASB suggested in *SFAS No. 89*. The term *income from continuing operations* refers to revenues less expenses based on current, rather than historical, costs. To that subtotal, add realized holding gains to arrive at realized (conventional) income. To that, add unrealized holding gains to arrive at economic income. The term “inventory profit” often refers (for example in some *SEC* releases) to the realized holding gain, \$110 in the illustration. The amount of inventory profit will usually be material when the firm uses FIFO and when prices rise. Other analysts, including us, prefer to use the term “inventory profit” to refer to the total *holding gain*, \$300 (= \$110 + \$190, both realized and unrealized), but writers use this meaning less often. In periods of rising prices and increasing inventories, the realized holding gains under a FIFO cost flow assumption will exceed those under LIFO. In the illustration, for example, assume under LIFO that the historical cost of goods sold is \$4,800, that historical LIFO cost of beginning inventory is \$600, and that historical LIFO cost of ending inventory is \$800. Then income from continuing operations, based on current costs, remains \$350 (= \$5,200 – \$4,850), realized holding gains are \$50 (= \$4,850 – \$4,800), realized income is \$400 (= \$350 + \$50), the unrealized holding gain for the year is \$250 [= (\$1,550 – \$800) – (\$1,100 – \$600)], and economic income is \$650 (= \$350 + \$50 + \$250). The cost flow assumption has only one real effect on this series of calculations: the split of the total holding gain into realized and unrealized portions. Thus, economic income does not depend on the cost flow assumption. Holding gains total \$300 in the illustration. The choice of cost flow assumption determines the portion reported as realized.

Inventory Profit Illustration

	(Historical) Acquisition Cost	
	Assuming FIFO	Current Cost
ASSUMED DATA		
Inventory, 1/1	\$ 900	\$1,100
Inventory, 12/31	1,160	1,550
Cost of Goods Sold for the Year	4,740	4,850
Sales for the Year	\$5,200	\$5,200
INCOME STATEMENT FOR THE YEAR		
Sales	\$5,200	\$5,200
Cost of Goods Sold	<u>4,740</u>	<u>4,850</u>
(1) Income from Continuing Operations		\$ 350
Realized Holding Gains		<u>110^a</u>
(2) Realized Income = Conventional Net Income (under FIFO)	<u>\$ 460</u>	\$ 460
Unrealized Holding Gain		190 ^b
(3) Economic Income		<u>\$ 650</u>

^aRealized holding gain during a period is current cost of goods sold less historical cost of goods sold; for the year the realized holding gain under FIFO is \$110 = \$4,850 - \$4,740. Some refer to this as "Inventory profit."

^bThe total unrealized holding gain at any time is current cost of inventory on hand at that time less historical cost of that inventory. The unrealized holding gain during a period is unrealized holding gain at the end of the period less the unrealized holding gain prior to this year is: \$200 = \$1,100 - \$900.

inventory turnover. Number of times the firm sells the average *inventory* during a period; *cost of goods sold* for a period divided by average inventory for the period. See *ratio*.

invested capital. *Contributed capital*.

investee. A company in which another entity, the "investor," owns stock.

investing activities. Acquiring and selling *securities* or productive *assets* expected to produce *revenue* over several *periods*.

investment. An *expenditure* to acquire property or other *assets* in order to produce *revenue*; the asset so acquired; hence a *current* expenditure made in anticipation of future income; said of other companies' *securities* held for the long term and appearing in a separate section of the *balance sheet*; in this context, contrast with *marketable securities*.

investment center. A *responsibility center*, with control over *revenues*, *costs*, and *assets*.

investment credit. A reduction in income tax liability sometimes granted by the federal government to firms that buy new equipment. This item is a credit in that the taxpayer deducts it from the tax bill, not from pretax income. The tax credit has been a given percentage of the purchase price of the assets purchased. The government has changed the actual rates and rates over the years. As of 1999, there is no investment credit. See *flow-through method* and *carryforward*.

investment decision. The decision whether to undertake an action involving production of goods or services; contrast with financing decision.

investment tax credit. *Investment credit*.

investment turnover ratio. A term that means the same thing as *total assets turnover ratio*.

investments. A balance sheet heading for tangible assets held for periods longer than the operating cycle and not used in revenue production (assets not meeting the definitions of *current assets* or *property, plant, and equipment*).

invoice. A document showing the details of a sale or purchase *transaction*.

IOSCO (International Organization of Securities Commissions). The name, since 1983, of a confederation of regulators of securities and futures markets. Members come from over 80 countries. The IOSCO encourages the *IASB* to eliminate accounting alternatives and to ensure that accounting standards are detailed

I.O.U — *Journal of Accounting Research*

and complete, with adequate disclosure requirements, and that financial statements are user-friendly.

I.O.U. An informal document acknowledging a debt, setting out the amount of the debt and signed by the debtor.

IRR. *Internal rate of return.*

IRS. *Internal Revenue Service.*

isoprofit line. On a graph showing feasible production possibilities of two products that require the use of the same, limited resources, a line showing all feasible production possibility combinations with the same *profit* or, perhaps, *contribution margin*.

issue. A corporation exchange of its stock (or *bonds*) for cash or other *assets*. Terminology says the corporation “issues,” not “sells,” that stock (or bonds). Also used in the context of withdrawing supplies or materials from inventory for use in operations and of drawing a *check*.

issued shares. Those shares of *authorized capital stock* that a *corporation* has distributed to the shareholders. See *issue*. Shares of *treasury stock* are legally issued but are not *outstanding* for the purpose of voting, *dividend declarations*, and *earnings-per-share* calculations.

J

JIT. See *just-in-time inventory*.

job cost sheet. A schedule showing actual or budgeted inputs for a special order.

job development credit. The name used for the *investment credit* in the 1971 tax law, since repealed, on this subject.

job (-order) costing. Accumulation of *costs* for a particular identifiable batch of product, known as a *job*, as it moves through production.

jobs. Customized products.

joint cost. Cost of simultaneously producing or otherwise acquiring two or more products, called *joint products*, that a firm must, by the nature of the process, produce or acquire together, such as the cost of beef and hides of cattle. Generally, accounting allocates the joint costs of production to the individual products in proportion to their respective sales value (or, sometimes and usually not preferred, their respective physical quantities) at the *split-off* point. Other examples include *central corporate expenses* and *overhead* of a department when it manufactures several

products. See *common cost* and *sterilized allocation*.

joint cost allocation. See *joint cost*.

joint process. A process that converts a common input into several outputs.

joint product. One of two or more outputs with significant value that a firm must produce or acquire simultaneously. See *byproduct* and *joint cost*.

journal. The place where the firm records transactions as they occur; the book of original entry.

journal entry. A dated *journal* recording, showing the accounts affected, of equal *debits* and *credits*, with an explanation of the *transaction*, if necessary.

Journal of Accountancy. A monthly publication of the *AICPA*.

Journal of Accounting and Economics. Scholarly journal published by the William E. Simon Graduate School of Business Administration of the University of Rochester.

Journal of Accounting Research. Scholarly journal containing articles on theoretical and

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empirical aspects of accounting; published by the Graduate School of Business of the University of Chicago.

journal voucher. A *voucher* documenting (and sometimes authorizing) a *transaction*, leading to an entry in the *journal*.

journalize. To make an entry in a *journal*.

judgment(al) sampling. A method of choosing a sample in which the analyst subjectively selects items for examination, in contrast to selecting them by statistical methods. Compare *random sampling*.

junk bond. A low-rated *bond* that lacks the merit and characteristics of an investment-

journal voucher — know-how

grade bond. It offers high yields, typically in excess of 15 percent per year, but also possesses high risk of default. Sometimes writers, less pejoratively, call these “high-yield bonds.” No clear line separates junk from nonjunk bonds.

just-in-time inventory (production) (JIT). In managing *inventory* for manufacturing, system in which a firm purchases or manufactures each component just before the firm uses it. Contrast with systems in which firms acquire or manufacture many parts in advance of needs. JIT systems have much smaller carrying costs for inventory, ideally none, but run higher risks of incurring *stockout* costs.

K

k. Two to the tenth power (2^{10} or 1,024), when referring to computer storage capacity. The one-letter abbreviation derives from the first letter of the prefix “kilo-” (which means 1,000 in decimal notation).

Kaizen costing. A management concept that seeks continuous improvements, likely occurring in small incremental amounts, by refinements of all components of a production process.

KG (Kommanditgesellschaft). Germany: similar to a general partnership (*OHG*) except that some of its members may limit their liability. One of the partners must be a *general partner* with unlimited liability.

kiting. A term with slightly different meanings in banking and auditing contexts. In both, however, it refers to the wrongful practice of taking advantage of the *float*, the time that elapses between the deposit of a *check* in one bank and its collection at another. In the banking context, an individual deposits in Bank A a check written on Bank

B. He (or she) then writes checks against the deposit created in Bank A. Several days later, he deposits in Bank B a check written on Bank A, to cover the original check written on Bank B. Still later, he deposits in Bank A a check written on Bank B. The process of covering the deposit in Bank A with a check written on Bank B and vice versa continues until the person can arrange an actual deposit of cash. In the auditing context, kiting refers to a form of *window dressing* in which the firm makes the amount of the account Cash in Bank appear larger than it actually is by depositing in Bank A a check written on Bank B without recording the check written on Bank B in the *check register* until after the close of the *accounting period*.

know-how. Technical or business information that is of the type defined under *trade secret* but that a firm does not maintain as a secret. The rules of accounting for this *asset* are the same as for other *intangibles*.

L

labor efficiency variance. Measures labor productivity by multiplying the *standard* labor price times the difference between the standard labor hours and the actual labor hours.

labor price (or wage) variance. Measures the difference between the actual and *standard* labor prices (wage rates).

labor variances. The *price* (or *rate*) and *quantity* (or *usage*) *variances* for *direct labor* inputs in a *standard costing system*.

laid-down cost. Canada and UK: the sum of all direct costs incurred for procurement of goods up to the time of physical receipt, such as invoice cost plus customs and excise duties, freight and cartage.

land. An *asset* shown at *acquisition cost* plus the *cost* of any nondepreciable *improvements*; in accounting, implies use as a plant or office site rather than as a *natural resource*, such as timberland or farmland.

lapping (accounts receivable). The theft, by an employee, of cash sent in by a customer to discharge the latter's *payable*. The employee conceals the theft from the first customer by using cash received from a second customer. The employee conceals the theft from the second customer by using cash received from a third customer, and so on. The process continues until the thief returns the funds or can make the theft permanent by creating a fictitious *expense* or receivable write-off or until someone discovers the fraud.

lapse. To expire; said of, for example, an insurance policy or discounts that are made available for prompt payment and that the purchaser does not take.

last-in, first-out. See *LIFO*.

layer. See *LIFO inventory layer*.

lead time. The time that elapses between placing an order and receiving the *goods* or *services* ordered.

learning curve. A mathematical expression of the phenomenon that incremental unit costs to produce decrease as managers and labor gain experience from practice.

lease. A contract calling for the lessee (user) to pay the lessor (owner) for the use of an asset. A cancelable lease allows the lessee to cancel at any time. A noncancelable lease requires payments from the lessee for the life of the lease and usually shares many of the economic characteristics of *debt financing*. Most long-term noncancelable leases meet the usual criteria for classifying them as *liabilities*, and GAAP require the firm to show them as liabilities. *SFAS No. 13* and the *SEC* require disclosure, in notes to the financial statements, of the commitments for long-term noncancelable leases. See *capital lease* and *operating lease*.

leasehold. The *asset* representing the right of the lessee to use leased property. See *lease* and *leasehold improvement*.

leasehold improvement. An *improvement* to leased property. The firm should *amortize* it over the *service life* or the life of the lease, whichever is shorter.

least and latest rule. Paying the least amount of taxes as late as possible within the law to minimize the *present value* of tax payments for a given set of operations. Sensible taxpayers will follow this rule. When a taxpayer knows that tax rates will increase later, the taxpayer may reduce the present value of the tax burden by paying smaller taxes sooner. Each set of circumstances requires its own computations.

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ledger — lien

ledger. A book of accounts; book of final entry.

See *general ledger* and *subsidiary ledger*.
Contrast with *journal*.

legal capital. The amount of *contributed capital* that, according to state law, the firm must keep permanently in the firm as protection for creditors.

legal entity. See *entity*.

lender. See *loan*.

lessee. See *lease*.

lessor. See *lease*.

letter stock. Privately placed *common shares*; so called because the SEC requires the purchaser to sign a letter of intent not to resell the shares.

leverage. More than proportional result from extra effort or financing. Some measure of output increases faster than the measure of input. “Operating leverage” refers to the tendency of *net income* to rise at a faster rate than sales in the presence of *fixed costs*. A doubling of sales, for example, usually implies a more than doubling of net income. “Financial leverage” (or “capital leverage”) refers to an increase in rate of return larger than the increase in explicit financing costs—the increased rate of return on *owners’ equity* (see *ratio*), when an *investment* earns a return larger than the after-tax *interest rate* paid for *debt* financing. Because the interest charges on debt usually do not change, any *incremental* income benefits owners and none benefits debtors. When writers use the term “leverage” without a qualifying adjective, the term usually refers to financial leverage, the use of *long-term* debt in securing *funds* for the *entity*.

leveraged lease. A special form of lease involving three parties: a *lender*, a *lessor*, and a *lessee*. The lender, such as a bank or insurance company, lends a portion, say 80 percent, of the cash required for acquiring the *asset*. The lessor puts up the remainder, 20

percent, of the cash required. The lessor acquires the asset with the cash, using the asset as security for the loan, and leases it to the lessee on a *noncancelable* basis. The lessee makes periodic lease payments to the lessor, who in turn makes payments on the loan to the lender. Typically, the lessor has no obligation for the debt to the lender other than transferring a portion of the receipts from the lessee. If the lessee should default on the required lease payments, then the lender can repossess the leased asset. The lessor usually has the right to benefit from the tax deductions for *depreciation* on the asset, for *interest expense* on the loan from the lender, and for any *investment credit*. The lease is leveraged in the sense that the lessor, who takes most of the risks and enjoys most of the rewards of ownership, usually borrows most of the funds needed to acquire the asset. See *leverage*.

liability. An obligation to pay a definite (or reasonably definite) amount at a definite (or reasonably definite) time in return for a past or current benefit (that is, the obligation arises from a transaction that is not an *executory contract*); a probable future sacrifice of economic benefits arising from present obligations of a particular *entity* to *transfer assets* or to provide services to other entities in the future as a result of past *transactions* or events. SFAC No. 6 says that “probable” refers to that which we can reasonably expect or believe but that is neither certain nor proved. A liability has three essential characteristics: (1) the obligation to transfer assets or services has a specified or knowable date, (2) the entity has little or no discretion to avoid the transfer, and (3) the event causing the obligation has already happened, that is, it is not executory.

lien. The right of person A to satisfy a claim against person B by holding B’s property as security or by seizing B’s property.

life annuity — liquidation value per share

life annuity. A *contingent annuity* in which payments cease at the death of a specified person(s), usually the *annuitant(s)*.

LIFO (last-in, first-out). An *inventory* flow assumption in which the *cost of goods sold* equals the cost of the most recently acquired units and a firm computes the *ending inventory cost* from the costs of the oldest units. In periods of rising prices and increasing inventories, LIFO leads to higher reported expenses and therefore lower reported income and lower balance sheet inventories than does FIFO. Contrast with *FIFO*. See *FISH* and *inventory profit*.

LIFO conformity rule. The *IRS* rule requiring that companies that use a *LIFO cost flow assumption* for *income taxes* must also use LIFO in computing *income* reported in *financial statements* and forbidding the disclosure of *pro forma* results from using any other cost flow assumption.

LIFO, dollar-value method. See *dollar-value LIFO method*.

LIFO inventory layer. A portion of LIFO inventory cost on the *balance sheet*. The *ending inventory* in physical quantity will usually exceed the *beginning inventory*. The *LIFO cost flow assumption* assigns to this increase in physical quantities a cost computed from the prices of the earliest purchases during the year. The LIFO inventory then consists of layers, sometimes called “slices,” which typically consist of relatively small amounts of physical quantities from each of the past years when purchases in physical units exceeded sales in units. Each layer carries the prices from near the beginning of the period when the firm acquired it. The earliest layers will typically (in periods of rising prices) have prices much less than current prices. If inventory quantities should decline in a subsequent period—a “dip into old LIFO layers”—the latest layers enter cost of goods sold first.

LIFO reserve. *Unrealized holding gain* in *ending inventory*: current or *FIFO historical cost* of ending inventory less *LIFO historical cost*. A better term for this concept is “excess of current cost over LIFO historical cost.” See *reserve*.

limited liability. The legal concept that shareholders of corporations are not personally liable for debts of the company.

limited partner. A *partnership* member who is not personally liable for debts of the partnership. Every partnership must have at least one *general partner*, who is fully liable.

line-of-business reporting. See *segment reporting*.

line of credit. An agreement with a bank or set of banks for short-term borrowings on demand.

linear programming. A mathematical tool for finding profit-maximizing (or cost-minimizing) combinations of products to produce when a firm has several products that it can produce but faces linear constraints on the resources available in the production processes or on maximum and minimum production requirements.

liquid. Said of a business with a substantial amount (the amount is unspecified) of *working capital*, especially *quick assets*.

liquid assets. *Cash*, *current marketable securities*, and sometimes, *current receivables*.

liquidating dividend. A *dividend* that a firm declares in the winding up of a business to distribute its assets to the shareholders. Usually the recipient treats this as a return of *investment*, not as *revenue*.

liquidation. Payment of a debt; sale of assets in closing down a business or a segment thereof.

liquidation value per share. The amount each *share* of stock will receive if the *board* dissolves a corporation; for *preferred stock* with

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a liquidation preference, a stated amount per share.

liquidity. Refers to the availability of *cash*, or near-cash resources, for meeting a firm's obligations.

LISH. An acronym, conceived by George H. Sorter, for *last-in, still-here*. LISH is the same cost flow assumption as *FIFO*. Many readers of accounting statements find it easier to think about inventory questions in terms of items still on hand. Think of *FIFO* in connection with *cost of goods sold* but of *LISH* in connection with *ending inventory*. See *FISH*.

list price. The published or nominally quoted price for goods.

list price method. See *trade-in transaction*.

loan. An arrangement in which the owner of property, called the lender, allows someone else, called the borrower, the use of the property for a period of time, which the agreement setting up the loan usually specifies. The borrower promises to return the property to the lender and, often, to make a payment for the use of the property. This term is generally used when the property is *cash* and the payment for its use is *interest*.

LOCOM. *Lower of cost or market*.

long-lived (term) asset. An asset whose benefits the firm expects to receive over several years; a *noncurrent* asset, usually includes *investments*, *plant assets*, and *intangibles*.

long run, long term. A term denoting a time or time periods in the future. How far in the future depends on context. For some securities traders, "long-term" can mean anything beyond the next hour or two. For most managers, it means the period of time long enough to allow change in total productive capacity. For government policymakers, it can mean anything beyond the next decade or two. For geologists, it can mean millions of years. In contrast to the *short run*. Use a hyphen when

liquidity — lower of cost or market (LOCOM)

the phrase is an adjective, but no hyphen when it is a noun.

long-term (construction) contract accounting.

The *percentage-of-completion method* of *revenue* recognition; sometimes used to mean the *completed contract method*.

long-term debt ratio. *Noncurrent liabilities* divided by total *assets*.

long-term liability (debt). *Noncurrent liability*.

long term. See *long run*.

long-term solvency risk. The risk that a firm will not have sufficient *cash* to pay its *debts* sometime in the *long run*.

loophole. Imprecise term meaning a technicality allowing a taxpayer (or *financial statements*) to circumvent the intent, without violating the letter, of the law (or *GAAP*).

loss. Excess of *cost* over net proceeds for a single transaction; negative *income* for a period; a cost expiration that produced no *revenue*. See *gain* for a discussion of related and contrasting terms and how to distinguish loss from *expense*.

loss contingency. See *contingency*.

lower of cost or market (LOCOM). A basis for valuation of *inventory* and, formerly in the United States, of *marketable securities*. This basis sets inventory value at the lower of *acquisition cost* or *current replacement cost* (market), subject to the following constraints. First, the market value of an item used in the computation cannot exceed its *net realizable value*—an amount equal to selling price less reasonable costs to complete production and to sell the item. Second, the market value of an item used in the computation cannot be less than the net realizable value minus the normal *profit* ordinarily realized on disposition of completed items of this type. The basis chooses the lower-of-cost-or-market valuation as the lower of *acquisition cost* or *replacement cost* (market) subject to

Ltd, Limited — make-or-buy decision

the upper and lower bounds on replacement cost established in the first two steps. Thus,

Market Value = Midvalue of (Replacement Cost, Net Realizable Value, Net Realizable Value Less Normal Profit Margin)

Lower of Cost = Minimum (Acquisition Cost, or Market Valuation)

The accompanying exhibit illustrates the calculation of the lower-of-cost-or-market valuation for four inventory items. Notice that each of the four possible outcomes occurs once in measuring lower of cost or market. Item 1 uses acquisition cost; item 2 uses net realizable value; item 3 uses replacement cost; and item 4 uses net realizable value less normal profit margin.

	Item			
	1	2	3	4
Calculation of Market Value				
(a) Replacement Cost . . .	\$92	\$96	\$92	\$96
(b) Net Realizable Value . .	95	95	95	95
(c) Net Realizable Value Less				
Normal Profit Margin				
[= (b) - \$9]	36	86	86	86
(d) Market = Midvalue [(a), (b), (c)]	92	95	92	95

Calculation of Lower of Cost or Market

(e) Acquisition Cost	\$90	\$97	\$96	\$90
(f) Market [= (d)]	92	95	92	95
(g) Lower of Cost or Market = Minimum [(e), (f)]	90	95	92	90

A taxpayer may not use the lower-of-cost-or-market basis for inventory on tax returns in combination with a *LIFO cost flow assumption*. In the context of inventory, once the firm writes down the asset, it establishes a new “original cost” basis and ignores subsequent increases in market value in the accounts.

The firm may apply lower of cost or market to individual items of inventory or to groups (usually called *pools*) of items. The smaller the group, the more *conservative* the resulting valuation.

Omit hyphens when you use the term as a noun, but use them when you use the term as an adjectival phrase.

Ltd, Limited. United Kingdom: a private limited corporation. The name of a private limited company must include the word “Limited” or its abbreviation “Ltd.”

lump-sum acquisition. *Basket purchase.*

M

MACRS. *Modified Accelerated Cost Recovery System.* See *Accelerated Cost Recovery System*. Since 1986, MACRS has been the accelerated depreciation method required for U.S. income tax purposes.

maintenance. *Expenditures* undertaken to preserve an *asset’s* service potential for its originally intended life. These expenditures are *period expenses* or *product costs*. Contrast with *improvement*, and see *repair*.

make money, making money. Users of these words can mean any of the following: earn *income*; earn *other comprehensive income*; save *opportunity costs*; earn *revenues*; earn *gross margin*; sell for *cash*; and maybe others, as well. You can see that you should avoid these words in clear communications. See *money*.

make-or-buy decision. A managerial decision about whether the firm should produce a

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product internally or purchase it from others. Proper make-or-buy decisions in the short run result only when a firm considers *incremental costs* in the analysis.

maker (of note) (of check). One who signs a *note* to borrow; one who signs a *check*; in the latter context, synonymous with “drawer.” See *draft*.

management. Executive authority that operates a business.

management accounting. See *managerial accounting*.

Management Accounting. Monthly publication of the *IMA*.

management audit. An audit conducted to ascertain whether a firm or one of its operating units properly carries out its objectives, policies, and procedures; generally applies only to activities for which accountants can specify qualitative standards. See *audit* and *internal audit*.

management by exception. A principle of management in which managers focus attention on performance only if it differs significantly from that expected.

management by objective (MBO). A management approach designed to focus on the definition and attainment of overall and individual objectives with the participation of all levels of management.

management information system (MIS). A system designed to provide all levels of management with timely and reliable information required for planning, control, and evaluation of performance.

management’s discussion and analysis (MD&A). A discussion of management’s views of the company’s performance; required by the *SEC* to be included in the *10-K* and in the *annual report* to shareholders. The information typically contains discussion of such items as liquidity, results of *operations*, *segments*, and the effects of *inflation*.

maker (of note) (of check) — markdown

managerial (management) accounting. Reporting designed to enhance the ability of management to do its job of decision making, planning, and control. Contrast with *financial accounting*.

manufacturing cost. Cost of producing goods, usually in a factory.

manufacturing expense. An imprecise, and generally incorrect, alternative title for *manufacturing overhead*. The term is generally incorrect because these costs are usually *product costs*, not expenses.

manufacturing overhead. General manufacturing *costs* that are not directly associated with identifiable units of product and that the firm incurs in providing a capacity to carry on productive activities. Accounting treats *fixed* manufacturing overhead cost as a *product cost* under *full absorption costing* but as an *expense* of the period under *variable costing*.

margin. *Revenue* less specified expenses. See *contribution margin*, *gross margin*, and *current margin*.

margin of safety. Excess of actual, or budgeted, sales over *breakeven* sales; usually expressed in dollars but may be expressed in units of product.

marginal cost. The *incremental cost* or *differential cost* of the last unit added to production or the first unit subtracted from production. See *cost terminology* and *differential* for contrast.

marginal costing. *Variable costing*.

marginal revenue. The increment in *revenue* from the sale of one additional unit of product.

marginal tax rate. The amount, expressed as a percentage, by which income taxes increase when taxable income increases by one dollar. Contrast with *average tax rate*.

markdown. See *markup* for definition and contrast.

markdown cancellation — markup percentage

markdown cancellation. See *markup* for definition and contrast.

market-based transfer price. A *transfer price* based on external market data rather than internal company data.

market price. See *fair value*.

market rate. The rate of *interest* a company must pay to borrow *funds* currently. See *effective rate*.

market value. *Fair market value*.

marketable equity securities. *Marketable securities* representing *owners' equity* interest in other companies, rather than *loans* to them.

marketable securities. Other companies' *stocks* and *bonds* held that can be readily sold on stock exchanges or over-the-counter markets and that the company plans to sell as cash is needed; classified as *current assets* and as part of "cash" in preparing the *statement of cash flows*. If the firm holds these same securities for *long-term* purposes, it will classify them as *noncurrent assets*. *SFAS No. 115* requires that all marketable equity and all debt securities (except those debt securities the holder has the ability and intent to hold to maturity) appear at market value on the balance sheet. The firm reports changes in market value in income for *trading securities* but debits holding losses (or credits holding gains) directly to owners' equity accounts for *securities available for sale*.

marketing costs. Costs incurred to sell; includes locating customers, persuading them to buy, delivering the goods or services, and collecting the sales proceeds.

mark to market. As a verb, to record an item in the books at *current fair market value*. When used as an adjective, hyphenate the phrase.

markon. See *markup* for definition and contrast.

markup. The difference between the original selling price of items acquired for *inventory*

and the cost. Precise usage calls this "markon," although many businesspeople use the term "markup." Because of confusion of this use of "markup" with its precise definition (see below), terminology sometimes uses "original markup." If the originally established retail price increases, the precise term for the amount of price increase is "markon," although terminology sometimes uses "additional markup." If a firm reduces selling price, terminology uses the terms "markdown" and "markup cancellation." "Markup cancellation" refers to reduction in price following "additional markups" and can, by definition, be no more than the amount of the additional markup; "cancellation of additional markup," although not used, is descriptive. "Markdown" refers to price reductions from the original retail price. A price increase after a markdown is a "markdown cancellation." If original cost is \$12 and original selling price is \$20, then markon (original markup) is \$8; if the firm later increases the price to \$24, the \$4 increase is markup (additional markup); if the firm later lowers the price to \$21, the \$3 reduction is markup cancellation; if the firm further lowers the price to \$17, the \$4 reduction comprises \$1 markup cancellation and \$3 markdown; if the firm later increases the price to \$22, the \$5 increase comprises \$3 of markdown cancellation and \$2 of markup (additional markup). Accountants track markup cancellations and markdowns separately because they deduct the former (but not the latter) in computing the selling prices of goods available for sale for the denominator of the *cost percentage* used in the conventional *retail inventory method*.

markup cancellation. See *markup* for definition and contrast.

markup percentage. *Markup* divided by (acquisition cost plus *markup*).

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master budget. A budget projecting all *financial statements* and their components.

matching convention. The concept of recognizing cost expirations (*expenses*) in the same accounting period during which the firm recognizes related *revenues*; combining or simultaneously recognizing the revenues and expenses that jointly result from the same *transactions* or other events.

material. As an adjective, it means relatively important, capable of influencing a decision (see *materiality*); as a noun, *raw material*.

materiality. The concept that accounting should disclose separately only those events that are relatively important (no operable definition yet exists) for the business or for understanding its statements. *SFAC No. 2* suggests that accounting information is material if “the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

materials efficiency variance. Measures materials waste by multiplying the *standard* materials price times the difference between the standard materials quantity used and the actual materials quantity used.

materials price variance. Measures the difference between the actual and *standard* materials prices.

materials variances. *Price* and *quantity variances* for *direct materials* in *standard costing systems*; difference between actual cost and standard cost.

matrix. A rectangular array of numbers or mathematical symbols.

matrix inverse. For a given square *matrix* A , the matrix, A^{-1} such that $AA^{-1} = A^{-1}A = I$, the identity matrix. Not all square matrices have inverses. Those that do not are “singular”; those that do are “nonsingular.”

master budget — minority investment

maturity. The date at which an obligation, such as the *principal* of a *bond* or a *note*, becomes due.

maturity value. The amount expected to be collected when a loan reaches *maturity*. Depending on the context, the amount may be *principal* or principal and *interest*.

MBO. *Management by objective.*

MD&A. *Management’s discussion and analysis* section of the *annual report*.

measuring unit. See *attribute measured* for definition and contrast.

merchandise. *Finished goods* bought by a retailer or wholesaler for resale; contrast with finished goods of a manufacturing business.

merchandise costs. Costs incurred to sell a product, such as commissions and advertising.

merchandise turnover. *Inventory turnover* for merchandise. See *ratio*.

merchandising business. As opposed to a manufacturing or service business, one that purchases (rather than manufactures) *finished goods* for resale.

merger. The joining of two or more businesses into a single *economic entity*. See *holding company*.

minority interest. A *balance sheet account* on *consolidated statements* showing the *equity* in a less-than-100-percent-owned *subsidiary* company; equity allocable to those who are not part of the controlling (majority) interest; may be classified either as shareholders’ equity or as a liability of *indeterminate term* on the consolidated balance sheet. The *income statement* must subtract the minority interest in the current period’s income of the less-than-100-percent-owned subsidiary to arrive at consolidated *net income* for the period.

minority investment. A holding of less than 50 percent of the *voting stock* in another corporation; accounted for with the *equity method*

when the investor owns sufficient shares that it can exercise “significant influence” and as *marketable securities* otherwise. See *mutual fund*.

minutes book. A record of all actions authorized at corporate *board of directors* or shareholders’ meetings.

MIS. *Management information system.*

mix variance. One of the *manufacturing variances*. Many *standard cost* systems specify combinations of inputs—for example, labor of a certain skill and materials of a certain quality grade. Sometimes combinations of inputs used differ from those contemplated by the standard. The mix variance attempts to report the cost difference caused by those changes in the combination of inputs.

mixed cost. A *semi-fixed* or a *semi-variable* cost.

Modified Accelerated Cost Recovery System (MACRS). Name used for the *Accelerated Cost Recovery System*, originally passed by Congress in 1981 and amended by Congress in 1986.

modified cash basis. The *cash basis of accounting* with long-term assets accounted for using the *accrual basis of accounting*. Most users of the term “cash basis of accounting” actually mean “modified cash basis.”

monetary assets and liabilities. See *monetary items*.

monetary gain or loss. The firm’s *gain* or *loss* in *general purchasing power* as a result of its holding *monetary assets* or liabilities during a period when the *general purchasing power of the dollar* changes; explicitly reported in *constant-dollar accounting*. During periods of *inflation*, holders of net monetary assets lose, and holders of net monetary liabilities gain, general purchasing power. During periods of *deflation*, holders of net monetary assets gain, and holders of net monetary liabilities lose, general purchasing power.

monetary items. Amounts fixed in terms of dollars by statute or contract; *cash*, *accounts receivable*, *accounts payable*, and *debt*. The distinction between monetary and nonmonetary items is important for *constant-dollar accounting* and for *foreign exchange gain or loss* computations. In the foreign exchange context, account amounts denominated in dollars are not monetary items, whereas amounts denominated in any other currency are monetary.

monetary-nonmonetary method. *Foreign currency translation* that translates all *monetary items* at the *current exchange rate* and translates all *nonmonetary items* at the *historical rate*.

money. A word seldom used with precision in accounting, at least in part because economists have not yet agreed on its definition. Economists use the term to refer to both a medium of exchange and a store of value. See *cash* and *monetary items*. Consider a different set of issues concerning the phrase, “making money.” Lay terminology uses this to mean “earning *income*” whether, as a result, the firm increased its *cash* balances or other *net assets*. The user does not typically mean that the firm has increased cash equal to the amount of net income, although the unaware listeners often think the phrase means this. Given that usage equates “making money” with “earning income,” in this sense “money” has a credit balance not a debit balance. Since cash typically has a debit balance, the phrase “making money” is even more troublesome. Consider the following language from the U.S. statutes on forfeitures required of some who commit illegal acts: “... the amount of money acquired through illegal transactions ...” Does the law mean the cash left over after the lawbreaker has completed the illegal transactions, the income earned from the transactions, or something else?

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Focus on the following four sets of questions and see how much difficulty you have in answering the questions associated with 3 and 4.

1. I took a cab and it cost \$10; I spent money. Did the cabbie earn money? If so, how much?
2. I asked Jerry to give me a ride and he did, so I didn't spend \$10. Did I earn money? If so, how much?
3. I decided to walk, so I didn't spend \$10. Did I earn money? If so, how much?
4. I canceled the trip, so I didn't spend \$10. Did I earn money? If so, how much?

Now, you can better appreciate why careful writers avoid using the word.

Consider a different set of issues concerning the phrase, "making money." Lay terminology uses this to mean "earning income" whether, as a result, the firm increased its *cash* balances or other *net assets*. The user does not typically mean that the firm has increased cash equal to the amount of net income, although the unaware listeners often think the phrase means this. Given that usage equates "making money" with "earning income," in this sense "money" has a credit balance not a debit balance. Since cash typically has a debit balance, the phrase "making money" is even more troublesome. Consider the following language from the U.S. statutes on forfeitures required of some who commit illegal acts: "... the amount of money acquired through illegal transactions" Does the law mean the cash left over after the lawbreaker has completed the illegal transactions, the income earned from the transactions, or something else? Sometimes "making money" means avoiding a cost that financial accounting does not recognize.

Consider the following sets of questions and see how you have to think to decide whether, in a given question, "money" refers to a debit or a credit. Assume I start with \$10 in cash.

money purchase plan — moving average method

1. I took a cab and it cost \$10; I spent money. Did the cabbie make money? Does the cabbie have money?
2. I decided to walk, so I didn't spend \$10. Did I make money?
3. I canceled the trip. Did I make money?

"Money" sometimes refers to debits and sometimes to credits; "making money" sometimes means earning accounting income and sometimes avoiding a cost, not reported in accounting, so careful writing about accounting avoids the word.

money purchase plan. A *pension plan* in which the employer contributes a specified amount of cash each year to each employee's pension fund; sometimes called a *defined-contribution plan*; contrast with *defined-benefit plan*. The plan does not specify the benefits ultimately received by the employee, since these benefits depend on the rate of return on the cash invested. As of the mid-1990s, most corporate pension plans were defined-benefit plans because both the law and *generally accepted accounting principles* for pensions made defined-benefit plans more attractive than money purchase plans. *ERISA* makes money purchase plans relatively more attractive than they had been. We expect the relative number of money purchase plans to continue to increase.

mortality table. Data of life expectancies or probabilities of death for persons of specified age and sex.

mortgage. A claim given by the borrower (mortgagor) to the lender (mortgagee) against the borrower's property in return for a loan.

moving average. An *average* computed on observations over time. As a new observation becomes available, analysts drop the oldest one so that they always compute the average for the same number of observations and use only the most recent ones.

moving average method. *Weighted-average inventory method.*

multiple-step — negative goodwill

multiple-step. Said of an *income statement* that shows various subtotals of *expenses* and *losses* subtracted from *revenues* to show intermediate items such as *operating income*, income of the enterprise (operating income plus *interest* income), income to investors (income of the enterprise less *income taxes*), net income to shareholders (income to investors less interest charges), and income retained (net income to shareholders less dividends). See *entity theory*.

municipal bond. A *bond* issued by a village, town, or city. *Interest* on such bonds is generally exempt from federal *income taxes* and from some state income taxes. Because bonds issued by state and county governments often

have these characteristics, terminology often calls such bonds “municipals” as well. These are also sometimes called “tax-exempts.”

mutual fund. An investment company that issues its own stock to the public and uses the proceeds to invest in securities of other companies. A mutual fund usually owns less than 5 or 10 percent of the stock of any one company and accounts for its investments using current *market values*. Contrast with *holding company*.

mutually exclusive (investment) projects. Competing investment projects in which accepting one project eliminates the possibility of undertaking the remaining projects.

 N

NAARS. *National Automated Accounting Research System*.

NASDAQ (National Association of Securities Dealers Automated Quotation System).

A computerized system to provide brokers and dealers with price quotations for securities traded *over the counter* as well as for some *NYSE* securities.

National Association of Accountants (NAA).

Former name for the *Institute of Management Accountants (IMA)*.

National Automated Accounting Research System (NAARS).

A computer-based information-retrieval system containing, among other things, the complete text of most public corporate annual reports and *Forms 10-K*. Users may access the system through the *AICPA*.

natural business year. A 12-month period chosen as the reporting period so that the end of the period coincides with a low point in activity or inventories. See *ratio* for a discussion of analyses of financial statements of companies using a natural business year.

natural classification. *Income statement* reporting form that classifies *expenses* by nature of items acquired, such as materials, wages, salaries, insurance, and taxes, as well as depreciation. Contrast with *functional classification*.

natural resources. Timber, oil and gas, ore deposits, and other products of nature that have economic value. Terminology uses the term *depletion* to refer to the process of *amortizing* the cost of natural resources. Natural resources are “nonrenewable” (for example, oil, coal, gas, ore deposits) or “renewable” (timber, sod fields); terminology often calls the former “wasting assets.” See also *reserve recognition accounting* and *percentage depletion*.

negative confirmation. See *confirmation*.

negative goodwill. See *goodwill*. When a firm acquires another company, and the *fair market value* of the *net assets* acquired exceeds the purchase price, *APB Opinion No. 16* requires that the acquiring company reduce the valuation of noncurrent assets (except

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investments in marketable securities) until the purchase price equals the adjusted valuation of the fair market value of net assets acquired. If, after the acquiring company reduces the valuation of noncurrent assets to zero, the valuation of the remaining net assets acquired still exceeds the purchase price, then the difference appears as a credit balance on the balance sheet as negative goodwill. For negative goodwill to exist, someone must be willing to sell a company for less than the fair market value of net current assets and marketable securities. Because such bargain purchases are rare, one seldom sees negative goodwill in the financial statements. When it does appear, it generally signals unrecorded obligations, such as a contingency related to a pending lawsuit.

negotiable. Legally capable of being transferred by *endorsement*. Usually said of *checks* and *notes* and sometimes of *stocks* and *bearer bonds*.

negotiated transfer price. A *transfer price* set jointly by the buying and the selling divisions.

net. Reduced by all relevant deduction.

net assets. Total *assets* minus total *liabilities*; equals the amount of *owners' equity*. Often, we find it useful to split the balance sheet into two parts: *owners' equity* and all the rest. The "rest" is total assets less total liabilities. To take an example, consider one definition of *revenue*: the increase in *owners' equity* accompanying the net assets increase caused by selling goods or rendering services. An alternative, more cumbersome way to say the same thing is: the increase in *owners' equity* accompanying the assets increase or the liabilities decrease, or both, caused by selling goods or rendering services. Consider the definition of *goodwill*: the excess of purchase price over the fair market value of identifiable net assets acquired in a purchase transaction. Without the phrase "net assets," the definition might be as follows: the excess

negotiable — net of tax method

of purchase price over the fair market value of identifiable assets reduced by the fair market value of identifiable liabilities acquired in a purchase transaction.

net bank position. From a firm's point of view, *cash* in a specific bank less *loans payable* to that bank.

net book value. *Book value*.

net current asset value (per share). *Working capital* divided by the number of common shares outstanding. Some analysts think that when a common share trades in the market for an amount less than net current asset value, the shares are undervalued and investors should purchase them. We find this view naive because it ignores, generally, the efficiency of capital markets and, specifically, unrecorded obligations, such as for executory contracts and contingencies, not currently reported as *liabilities* in the *balance sheet* under GAAP.

net current assets.

Working capital = *Current assets* – *Current liabilities*.

net income. The excess of all *revenues* and *gains* for a period over all *expenses* and *losses* of the period. The FASB is proposing to discontinue use of this term and substitute *earnings*. See *comprehensive income*.

net loss. The excess of all *expenses* and *losses* for a period over all *revenues* and *gains* of the period; negative *net income*.

net markup. In the context of *retail inventory methods*, *markups* less markup cancellations; a figure that usually ignores *markdowns* and *markdown cancellations*.

net of tax method. A nonsanctioned method for dealing with the problem of *income tax allocation*; described in *APB Opinion No. 11*. The method subtracts deferred tax items from specific *asset* amounts rather than showing them as a deferred credit or *liability*.

net of tax reporting — nominal amount (value)

net of tax reporting. Reporting, such as for *income from discontinued operations*, *extraordinary items*, and *prior-period adjustments*, in which the firm adjusts the amounts presented in the *financial statements* for all income tax effects. For example, if an extraordinary loss amounted to \$10,000, and the marginal tax rate was 40 percent, then the extraordinary item would appear “net of taxes” as a \$6,000 loss. Hence, not all a firm’s income taxes necessarily appear on one line of the income statement. The reporting allocates the total taxes among *income from continuing operations*, *income from discontinued operations*, *extraordinary items*, cumulative effects of *accounting changes*, and *prior-period adjustments*.

net operating profit. *Income from continuing operations*.

net present value. Discounted or *present value* of all cash inflows and outflows of a project or of an *investment* at a given *discount rate*.

net price method (of recording purchase or sales discounts). Method that records a *purchase* (or *sale*) at its *invoice* price less all *discounts* made available, under the assumption that the firm will take nearly all discounts offered. The purchaser debits, to an *expense* account, discounts lapsed through failure to pay promptly. For purchases, management usually prefers to know about the amount of discounts lost because of inefficient operations, not the amounts taken, so that most managers prefer the net price method to the *gross price method*.

net realizable (sales) value. Current selling price less reasonable costs to complete production and to sell the item. Also, a method for *allocating joint costs* in proportion to *realizable values* of the joint products. For example, joint products A and B together cost \$100; A sells for \$60, whereas B sells for \$90. Then a firm would allocate to A $(\$60/\$150) \times \$100 = .40 \times \$100 = \$40$ of cost

while it would allocate to B $(\$90/\$150) \times \$100 = \60 of cost.

net sales. Sales (at gross invoice amount) less *returns*, *allowances*, freight paid for customers, and *discounts* taken.

net working capital. *Working capital*; the term “net” is redundant in accounting. Financial analysts sometimes mean *current assets* when they speak of working capital, so for them the “net” is not redundant.

net worth. A misleading term with the same meaning as *owners’ equity*. Avoid using this term; accounting valuations at historical cost do not show economic worth.

network analysis. A project planning and scheduling method, usually displayed in a diagram, that enables management to identify the interrelated sequences that it must accomplish to complete the project.

new product development time. The period between a firm’s first consideration of a product and delivery of it to the customer.

New York Stock Exchange (NYSE). A public market in which those who own seats (a seat is the right to participate) trade various corporate *securities*.

next-in, first-out. See *NIFO*.

NIFO (next-in, first-out). A *cost flow assumption*, one not allowed by GAAP. In making decisions, many managers consider *replacement costs* (rather than *historical costs*) and refer to them as NIFO costs.

no par. Said of *stock* without a *par value*.

nominal accounts. *Temporary accounts*, such as *revenue* and *expense* accounts; contrast with *balance sheet accounts*. The firm closes all nominal accounts at the end of each *accounting period*.

nominal amount (value). An amount stated in dollars, in contrast to an amount stated in *constant dollars*. Contrast with *real amount (value)*.

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nominal dollars. The measuring unit giving no consideration to differences in the *general purchasing power of the dollar* over time. The face amount of currency or coin, a *bond*, an *invoice*, or a *receivable* is a nominal-dollar amount. When the analyst adjusts that amount for changes in *general purchasing power*, it becomes a *constant-dollar* amount.

nominal interest rate. A rate specified on a *debt* instrument; usually differs from the market or *effective rate*; also, a rate of *interest* quoted for a year. If the interest compounds more often than annually, then the *effective interest rate* exceeds the nominal rate.

noncancelable. See *lease*.

nonconsolidated subsidiary. An *intercorporate investment* in which the parent owns more than 50 percent of the shares of the *subsidiary* but accounts for the investment with the *cost method*.

noncontributory. Said of a *pension plan* in which only the employer makes payments to a *pension fund*. Contrast with *contributory*.

noncontrollable cost. A cost that a particular manager cannot *control*.

noncurrent. Of a *liability*, due in more than one year (or more than one *operating cycle*); of an *asset*, the firm will enjoy the future benefit in more than one year (or more than one operating cycle).

nonexpendable fund. A governmental fund whose *principal*, and sometimes earnings, the entity may not spend.

noninterest-bearing note. A *note* that does not specify explicit interest. The *face value* of such a note will exceed its *present value* at any time before *maturity* value so long as *interest rates* are positive. *APB Opinion No. 21* requires that firms report the present value, not face value, of long-term noninterest-bearing notes as the *asset* or *liability* amount in financial statements. For this purpose, the

nominal dollars — normal costing system

firm uses the *historical interest rate*. See *interest, imputed*.

nonmanufacturing costs. All *costs* incurred other than those necessary to produce goods. Typically, only manufacturing firms use this designation.

nonmonetary items. All items that are not monetary. See *monetary items*.

nonoperating. In the *income statement* context, said of *revenues* and *expenses* arising from *transactions* incidental to the company's main line(s) of business; in the *statement of cash flows* context, said of all financing and investing sources or uses of cash in contrast to cash provided by operations. See *operations*.

nonprofit corporation. An incorporated *entity*, such as a hospital, with owners who do not share in the earnings. It usually emphasizes providing services rather than maximizing income.

nonrecurring. Said of an event that is not expected to happen often for a given firm. *APB Opinion No. 30* requires firms to disclose separately the effects of such events as part of *ordinary* items unless the event is also unusual. See *extraordinary* item.

non-value-added activity. An activity that causes costs without increasing a product's or service's value to the customer.

normal cost. Former name for *service cost* in accounting for pensions and other postemployment benefits.

normal costing. Method of charging costs to products using actual *direct materials*, actual *direct labor*, and predetermined *factory overhead* rates.

normal costing system. *Costing* based on *actual material* and *labor* costs but using *predetermined overhead* rates per unit of some *activity* basis (such as *direct labor-hours* or *machine-hours*) to apply overhead to production. Management decides the rate to charge

normal spoilage — off-balance-sheet financing

to production for overhead at the start of the period. At the end of the period the accounting multiplies this rate by the actual number of units of the base activity (such as actual direct labor-hours worked or actual machine-hours used during the period) to apply overhead to production.

normal spoilage. Costs incurred because of ordinary amounts of spoilage. Accounting prorates such costs to units produced as *product costs*. Contrast with *abnormal spoilage*.

normal standard cost, normal standards.

The *cost* a firm expects to incur under reasonably efficient operating conditions with adequate provision for an average amount of rework, spoilage, and the like.

normal volume. The level of production that will, over a time span, usually one year, satisfy purchasers' demands and provide for reasonable *inventory* levels.

note. An unconditional written promise by the maker (borrower) to pay a certain amount on demand or at a certain future time.

note receivable discounted. A *note* assigned by the holder to another. The new holder of

the note typically pays the old holder an amount less than the *face value* of the note, hence the word "discounted." If the old holder assigns the note to the new holder with recourse, the old holder has a *contingent liability* until the maker of the note pays the debt. See *factoring*.

notes. Some use this word instead of *footnotes* when referring to the detailed information included by management as an integral part of the *financial statements* and covered by the *auditor's report*.

NOW (negotiable order of withdrawal) account.

Negotiable order of withdrawal. A *savings account* whose owner can draw an order to pay, much like a *check*, but technically not a check, and give it to others, who can redeem the order at the savings institution.

number of days sales in inventory (or receivables).

Days of average inventory on hand (or average collection period for receivables). See *ratio*.

NV (naamloze vennootschap). Netherlands: a public limited liability company.

NYSE. *New York Stock Exchange*.

O

OASDHI. *Old Age, Survivors, Disability, and Health Insurance*.

objective. See *reporting objectives* and *objectivity*.

objective function. In *linear programming*, the name of the profit (or cost) criterion the analyst wants to maximize (or minimize).

objectivity. The reporting policy implying that the firm will not give formal recognition to an event in financial statements until the firm can measure the magnitude of the events with reasonable accuracy and check that amount with independent verification.

obsolescence. An asset's *market value* decline caused by improved alternatives becoming available that will be more *cost-effective*. The decline in market value does not relate to physical changes in the asset itself. For example, computers become obsolete long before they wear out. See *partial obsolescence*.

Occupational Safety and Health Act. *OSHA*.

off-balance-sheet financing. A description often used for an obligation that meets all the tests to be classified a liability except that the obligation arises from an *executory contract* and, hence, is not a *liability*. Consider the

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following example. Miller Corporation desires to acquire land costing \$25 million, on which it will build a shopping center. It could borrow the \$25 million from its bank, paying interest at 12 percent, and buy the land outright from the seller. If so, both an asset and a liability will appear on the balance sheet. Instead, it borrows \$5 million and purchases for \$5 million from the seller an *option* to buy the land from the seller at any time within the next six years for a price of \$20 million. The option costs Miller Corporation \$5 million immediately and provides for continuing "option" payments of \$2.4 million per year, which precisely equal Miller Corporation's borrowing rate multiplied by the remaining purchase price of the land: $\$2.4 \text{ million} = .12 \times \20 million . Although Miller Corporation need not continue payments and can let the option lapse at any time, it also has an obligation to begin developing on the site immediately. Because Miller Corporation has invested a substantial sum in the option, will invest more, and will begin immediately developing the land, Miller Corporation will almost certainly exercise its option before expiration. The seller of the land can take the option contract to the bank and borrow \$20 million, paying interest at Miller Corporation's borrowing rate, 12 percent per year. The continuing option payments from Miller Corporation will be sufficient to enable the seller to make its payments to the bank. *Generally accepted accounting principles* view Miller Corporation as having acquired an option for \$5 million rather than having acquired land costing \$25 million in return for \$25 million of debt. The firm will likely be able to structure this transaction so that it need not recognize debt on the balance sheet until it borrows more funds to exercise the option.

The *FASB* has curtailed the use of such financings with *FIN 46*. See also *variable interest entity*.

off-balance-sheet risk — on consignment

off-balance-sheet risk. A contract that exposes an entity to the possibility of loss but that does not appear in the financial statements. For example, a *forward-exchange contract* generally does not appear on the balance sheet because it is an *executory contract*. The contract may reduce or increase the entity's exposure to foreign-exchange risk (the chance of loss due to unfavorable changes in the foreign-exchange rate). It may also expose the entity to credit risk (the chance of loss that occurs when the *counterparty* to the contract cannot fulfill the contract terms). *SFAS No. 105* requires entities to describe contracts with off-balance-sheet risk.

OHG (Offene Handelsgesellschaft). Germany: a general *partnership*. The partners have unlimited *liability*.

Old Age, Survivors, Disability, and Health Insurance, or OASDHI. The technical name for Social Security under the Federal Insurance Contributions Act (*FICA*).

on consignment. Said of goods delivered by the owner (the consignor) to another (the consignee) to be sold by the consignee. On delivery of the goods from the consignor to the consignee, the consignor can, but need not, make an entry transferring the goods at cost from Finished Goods Inventory to another inventory account, such as Goods out on Consignment. The consignor recognizes revenue only when the consignee has sold the goods to customers. Under such an arrangement, the owner of the goods bears the inventory holding costs until the ultimate seller (consignee) sells them. The owner also bears the risk that the items will never sell to final customers, but manufacturers or distributors who provide generous return options to their customers can achieve this aspect of consignment sales in an outright sale. The consignment protects the consignor from the consignee's bankruptcy, as the arrangement entitles the owner either to

on (open) account — operating leverage

the return of the property or to payment of a specified amount. The goods are assets of the consignor. Such arrangements provide the consignor with better protection than an outright sale on account to the consignee in bankruptcy. In event of bankruptcy, the ordinary seller, holding an account receivable, has no special claim to the return of the goods, whereas a consignor can reclaim the goods without going through bankruptcy proceedings, from which the consignor might recover only a fraction of the amounts owed to it.

on (open) account. Said of a *purchase* (or *sale*) when the seller expects payment sometime after delivery and the purchaser does not give a *note* evidencing the *debt*. The purchaser has generally signed an agreement sometime in the past promising to pay for such purchases according to an agreed time schedule. When the firm sells (purchases) on open account, it *debits* (*credits*) *Accounts Receivable* (*Payable*).

one-line consolidation. Said of an *intercorporate investment* accounted for with the *equity method*. With this method, the *income* and *balance sheet* total *assets* and *equities* amounts are identical to those that would appear if the parent consolidated the investee firm, even though the income from the investment appears on a single line of the income statement and the net investment appears on a single line in the Assets section of the balance sheet.

one-write system. A system of bookkeeping that produces several records, including original documents, in one operation by the use of reproductive paper and equipment that provides for the proper alignment of the documents.

on-time performance. The firm delivers the product or service at the time scheduled for delivery.

open account. Any *account* with a nonzero *debit* or *credit balance*. See *on (open) account*.

operating. An adjective used to refer to *revenue* and *expense* items relating to the company's main line(s) of business. See *operations*.

operating accounts. *Revenue*, *expense*, and *production cost accounts*. Contrast with *balance sheet accounts*.

operating activities. For purposes of the *statement of cash flows*, all *transactions* and *events* that are neither *financing activities* nor *investing activities*. See *operations*.

operating budget. A formal *budget* for the *operating cycle* or for a year.

operating cash flow. *Cash flow from operations*. Financial statement analysts sometimes use this term to mean

Cash flow from operations –
Capital expenditures – *dividends*.

This usage leads to such ambiguity that the reader should always confirm the definition that the writer uses before drawing inferences from the reported data.

operating cycle. *Earnings cycle*.

operating expenses. *Expenses* incurred in the course of *ordinary* activities of an *entity*; frequently, a classification including only *selling*, *general*, and *administrative expenses*, thereby excluding *cost of goods sold*, *interest*, and *income tax* expenses. See *operations*.

operating lease. A *lease* accounted for by the *lessee* without showing an *asset* for the lease rights (*leasehold*) or a *liability* for the lease payment obligations. The lessee reports only rental payments during the period, as *expenses* of the period. The asset remains on the lessor's *books*, where rental collections appear as *revenues*. Contrast with *capital lease*.

operating leverage. Usually said of a firm with a large proportion of *fixed costs* in its *total costs*. Consider a book publisher or a railroad:

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such a firm has large costs to produce the first unit of service; then, the *incremental costs* of producing another book or transporting another freight car are much less than the *average cost*, so the *gross margin* on the sale of the subsequent units is relatively large. Contrast this situation with that, for example, of a grocery store, where the *contribution margin* equals less than 5 percent of the selling price. For firms with equal profitability, however defined, we say that the one with the larger percentage increase in income from a given percentage increase in dollar sales has the larger operating leverage. See *leverage* for contrast of this term with “financial leverage.” See *cost terminology* for definitions of terms involving the word “cost.”

operating margin. *Revenues from sales minus cost of goods sold and operating expenses.*

operating margin based on current costs. *Revenues from sales minus current cost of goods sold; a measure of operating efficiency that does not depend on the cost flow assumption for inventory; sometimes called “current (gross) margin.” See inventory profit for illustrative computations.*

operating ratio. See *ratio*.

operational control. See *control system*.

operational measures of time. Indicators of the speed and reliability with which organizations supply products and services to customer. Companies generally use two operational measures of time: *customer response time* and *on-time performance*.

operations. A word not precisely defined in *accounting*. Generally, analysts distinguish operating activities (producing and selling *goods or services*) from financing activities (raising funds) and *investing activities*. Acquiring goods on account and then paying for them one month later, though generally classified as an operating activity, has the characteristics of a financing activity. Or

operating margin — organization costs

consider the transaction of selling plant assets for a price in excess of book value. On the *income statement*, the gain appears as part of income from operations (“continuing operations” or “discontinued” operations, depending on the circumstances), but the *statement of cash flows* reports all the funds received below the Cash from Operations section, as a nonoperating source of cash, “disposition of noncurrent assets.” In income tax accounting, an “operating loss” results whenever deductions exceed taxable revenues.

opinion. The *auditor’s report* containing an attestation or lack thereof; also, *APB Opinion*.

opinion paragraph. Section of *auditor’s report*, generally following the *scope paragraph* and giving the auditor’s conclusion that the *financial statements* are (rarely, are not) in accordance with GAAP and present fairly the *financial position*, changes in financial position, and the results of *operations*.

opportunity cost. The *present value* of the *income* (or *costs*) that a firm could earn (or save) from using an *asset* in its best alternative use to the one under consideration.

opportunity cost of capital. *Cost of capital*.

option. The legal right to buy or sell something during a specified period at a specified price, called the *exercise price*. If the right exists during a specified time interval, it is known as an “American option.” If it exists for only one specific day, it is known as a “European option.” Do not confuse employee *stock options* with *put* and *call* options, traded in various public markets.

ordinary annuity. An *annuity in arrears*.

ordinary income. For income tax purposes, reportable *income* not qualifying as *capital gains*.

organization costs. The *costs* incurred in planning and establishing an *entity*; example of

organization goals — over-the-counter

an *intangible* asset. The firm must treat these costs as *expenses* of the period, even though the *expenditures* clearly provide future benefits and meet the test to be *assets*.

organization goals. Broad objectives for an organization established by management.

original cost. *Acquisition cost*; in public utility accounting, the acquisition cost of the *entity* first devoting the *asset* to public use. See *aboriginal cost*.

original entry. Entry in a *journal*.

OSHA (Occupational Safety and Health Act).

The federal law that governs working conditions in commerce and industry.

other comprehensive income. According to the FASB, *comprehensive income* items that are not themselves part of earnings. See *comprehensive income*. To define comprehensive income does not convey its essence. To understand comprehensive income, you need to understand how it differs from *earnings* (or *net income*), the concept measured in the *earnings (income) statement*. The term *earnings* (or *net income*) refers to the sum of all components of comprehensive income minus the components of other comprehensive income.

outlay. The amount of an *expenditure*.

outlier. Said of an observation (or data point) that appears to differ significantly in some regard from other observations (or data points) of supposedly the same phenomenon; in a *regression analysis*, often used to describe an observation that falls far from the fitted regression equation (in two dimensions, line).

out-of-pocket. Said of an *expenditure* usually paid for with cash; an *incremental* cost.

out-of-stock cost. The estimated decrease in future *profit* as a result of losing customers because a firm has insufficient quantities of

inventory currently on hand to meet customers' demands.

output. Physical quantity or monetary measurement of *goods* and *services* produced.

outside director. A corporate board of directors member who is not a company officer and does not participate in the corporation's day-to-day management.

outstanding. Unpaid or uncollected; when said of *stock*, refers to the shares issued less *treasury stock*; when said of *checks*, refers to a check issued that did not clear the *drawer's* bank prior to the *bank statement* date.

over-and-short. Title for an *expense account* used to account for small differences between book balances of cash and actual cash and vouchers or receipts in *petty cash* or *change funds*.

overapplied (overabsorbed) overhead. Costs applied, or *charged*, to product and exceeding actual *overhead costs* during the period; a *credit balance* in an overhead account after overhead is assigned to product.

overdraft. A *check* written on a checking account that contains funds less than the amount of the check.

overhead costs. Any *cost* not directly associated with the production or sale of identifiable goods and services; sometimes called "burden" or "indirect costs" and, in the United Kingdom, "oncosts"; frequently limited to manufacturing overhead. See *central corporate expenses* and *manufacturing overhead*.

overhead rate. Standard, or other predetermined rate, at which a firm applies *overhead costs* to products or to services.

over-the-counter. Said of a *security* traded in a negotiated transaction, as on *NASDAQ*, rather than in an auctioned one on an organized stock exchange, such as the *New York Stock Exchange*.

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owners' equity. *Proprietorship; assets minus liabilities; paid-in capital plus retained earnings* of a corporation; partners' capital

owners' equity — partially executory contract

accounts in a *partnership*; owner's capital account in a *sole proprietorship*.

P

paid-in capital. Sum of balances in *capital stock* and *capital contributed in excess of par (or stated) value* accounts; same as *contributed capital* (minus *donated capital*). Some use the term to mean only *capital contributed in excess of par (or stated value)*.

paid-in surplus. See *surplus*.

P&L. Profit-and-loss statement; *income statement*.

paper profit. A *gain* not yet realized through a *transaction*; an *unrealized holding gain*.

par. See *at par* and *face amount*.

par value. *Face amount* of a *security*.

par value method. In accounting for *treasury stock*, method that *debits* a common stock account with the *par value* of the shares required and allocates the remaining debits between the *Additional Paid-in Capital* and *Retained Earnings* accounts. Contrast with *cost method*.

parent company. Company owning more than 50 percent of the voting shares of another company, called the *subsidiary*.

Pareto chart. A graph of a skewed statistical distribution. In many business settings, a relatively small percentage of the potential population causes a relatively large percentage of the business activity. For example, some businesses find that the top 20 percent of the customers buy 80 percent of the goods sold. Or, the top 10 percent of products account for 60 percent of the revenues or 70 percent of the profits. The statistical distribution known as the Pareto distribution has this property of skewness, so a graph of a phenomenon with such skewness has come to be

known as a Pareto chart, even if the underlying data do not actually well fit the Pareto distribution. Practitioners of *total quality management* find that in many businesses, a small number of processes account for a large fraction of the quality problems, so they advocate charting potential problems and actual occurrences of problems to identify the relatively small number of sources of trouble. They call such a chart a "Pareto chart."

partial obsolescence. One cause of decline in *market value* of an *asset*. As technology improves, the economic value of existing *assets* declines. In many cases, however, it will not pay a firm to replace the existing asset with a new one, even though it would acquire the new type rather than the old if it did make a new acquisition currently. In these cases, the accountant should theoretically recognize a loss from partial obsolescence from the firm's owning an old, out-of-date asset, but *GAAP* do not permit recognition of partial obsolescence until the sum of future cash flows from the asset total less than book value; see *impairment*. The firm will carry the old asset at *cost* less *accumulated depreciation* until the firm retires it from service so long as the *undiscounted future cash flows* from the asset exceed its book value. Thus management that uses an asset subject to partial obsolescence reports results inferior to those reported by a similar management that uses a new asset. See *obsolescence*.

partially executory contract. *Executory contract* in which one or both parties have done something other than merely promise.

partially funded — payroll taxes

partially funded. Said of a *pension plan* in which the firm has not funded all earned benefits. See *funded* for funding requirements.

partially vested. Said of a *pension plan* in which not all employee benefits have *vested*. See *graded vesting*.

participating dividend. *Dividend* paid to preferred shareholders in addition to the minimum preferred dividends when the *preferred stock* contract provides for such sharing in earnings. Usually the contract specifies that dividends on *common shares* must reach a specified level before the preferred shares receive the participating dividend.

participating preferred stock. *Preferred stock* with rights to *participating dividends*.

participative budgeting. Using input from lower- and middle-management employees in setting goals.

partner's drawing. A payment made to a partner and debited against his or her share of income or capital. The name of a *temporary account*, closed to the partner's capital account, to record the debits when the partner receives such payments.

partnership. Contractual arrangement between individuals to share resources and operations in a jointly run business. See *general* and *limited partner* and *Uniform Partnership Act*.

patent. A right granted for up to 20 years by the federal government to exclude others from manufacturing, using, or selling a claimed design, product, or plant (e.g., a new breed of rose) or from using a claimed process or method of manufacture; an *asset* if the firm acquires it by purchase. If the firm develops it internally, current *GAAP* require the firm to *expense* the development costs when incurred.

payable. Unpaid but not necessarily due or past due.

pay-as-you-go. Said of an *income tax* scheme in which the taxpayer makes periodic payments of income taxes during the period when it earns the income to be taxed; in contrast to a scheme in which the taxpayer owes no payments until the end of, or after, the period when it earned the income being taxed (called *PAYE*—pay-as-you-earn—in the United Kingdom). The phrase is sometimes used to describe an *unfunded pension plan*, or retirement benefit plan, in which the firm makes payments to pension plan beneficiaries from general corporate funds, not from cash previously contributed to a fund. Under this method, the firm debits expense as it makes payments, not as it incurs the obligations. This is not acceptable as a method of accounting for pension plans, under *SFAS No. 87*, or as a method of *funding*, under *ERISA*.

payback period. Amount of time that must elapse before the cash inflows from a project equal the cash outflows.

payback reciprocal. One divided by the *payback period*. This number approximates the *internal rate of return* on a project when the project life exceeds twice the payback period and the cash inflows are identical in every period after the initial period.

PAYE (pay-as-you-earn). See *pay-as-you-go* for contrast.

payee. The person or entity who receives a cash payment or who will receive the stated amount of cash on a *check*. See *draft*.

payout ratio. *Common stock dividends* declared for a year divided by net *income* to common stock for the year; a term used by financial analysts. Contrast with *dividend yield*.

payroll taxes. Taxes levied because the taxpayer pays salaries or wages; for example, *FICA* and unemployment compensation insurance taxes. Typically, the employer pays

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a portion and withholds part of the employee's wages.

PCAOB. *Public Company Accounting Oversight Board.*

P/E ratio. *Price-earnings ratio.*

Pension Benefit Guarantee Corporation (PBGC). A federal corporation established under *ERISA* to guarantee basic pension benefits in covered pension plans by administering terminated pension plans and placing *liens* on corporate assets for certain unfunded pension liabilities.

pension fund. *Fund*, the assets of which the trustee will pay to retired ex-employees, usually as a *life annuity*; generally held by an independent trustee and thus not an *asset* of the employer.

pension plan. Details or provisions of employer's contract with employees for paying retirement *annuities* or other benefits. See *funded*, *vested*, *service cost*, *prior service cost*, *money purchase plan*, and *defined-benefit plan*.

per books. An expression used to refer to the *book value* of an item at a specific time.

percent. Any number, expressed as a decimal, multiplied by 100.

percentage depletion (allowance). Deductible *expense* allowed in some cases by the federal *income tax* regulations; computed as a percentage of gross income from a *natural resource* independent of the unamortized cost of the *asset*. Because the amount of the total deductions for tax purposes usually exceeds the cost of the asset being *depleted*, many people think the deduction is an unfair tax advantage or *loophole*.

percentage-of-completion method. Recognizing *revenues* and *expenses* on a job, order, or contract (1) in proportion to the *costs* incurred for the period divided by total costs expected to be incurred for the job or order

PCAOB — permanent difference

("cost to cost") or (2) in proportion to engineers' or architects' estimates of the incremental degree of completion of the job, order, or contract during the period. Contrast with *completed contract method*.

percentage statement. A statement containing, in addition to (or instead of) dollar amounts, ratios of dollar amounts to some base. In a percentage *income statement*, the base is usually either *net sales* or *total revenues*, and in a percentage *balance sheet*, the base is usually *total assets*.

period. *Accounting period.*

period cost. An inferior term for *period expense*.

period expense (charge). *Expenditure*, usually based on the passage of time, charged to operations of the accounting period rather than *capitalized* as an asset. Contrast with *product cost*.

periodic cash flows. *Cash flows* that occur during the life of an investment project. Often include *receipts* from *sales*, *expenditures* for *fixed* and *variable production costs*, and savings of *fixed* and *variable production costs*, to name a few. They do not include noncash items, such as *financial accounting depreciation charges* or *allocated items of overhead* not requiring *differential cash expenditures*.

periodic inventory. In recording *inventory*, a method that uses data on beginning inventory, additions to inventories, and ending inventory to find the cost of withdrawals from inventory. Contrast with *perpetual inventory*.

periodic procedures. The process of making *adjusting entries* and *closing entries* and preparing the *financial statements*, usually by use of *trial balances* and *work sheets*.

permanent account. An account that appears on the *balance sheet*. Contrast with *temporary account*.

permanent difference. Difference between reported income and taxable income that will

permanent file — plant assets

never reverse and, hence, requires no entry in the *deferred income tax (liability)* account; for example, nontaxable state and municipal *bond* interest that will appear on the financial statements. Contrast with *temporary difference*. See *deferred income tax liability*.

permanent file. The file of working papers that are prepared by a public accountant and that contain the information required for reference in successive professional engagements for a particular organization, as distinguished from working papers applicable only to a particular engagement.

perpetual annuity. *Perpetuity*.

perpetual inventory. *Inventory* quantity and amount records that the firm changes and makes current with each physical addition to or withdrawal from the stock of goods; an inventory so recorded. The records will show the physical quantities and, frequently, the dollar valuations that should be on hand at any time. Because the firm explicitly computes *cost of goods sold*, it can use the *inventory equation* to compute an amount for what *ending inventory* should be. It can then compare the computed amount of ending inventory with the actual amount of ending inventory as a *control* device to measure the amount of *shrinkages*. Contrast with *periodic inventory*.

perpetuity. An *annuity* whose payments continue forever. The *present value* of a perpetuity in *arrears* is p/r where p is the periodic payment and r is the *interest rate* per period. If a perpetuity promises \$100 each year, in arrears, forever, and the interest rate is 8 percent per year, then the perpetuity has a value of $\$1,250 = \$100/.08$.

perpetuity growth model. See *perpetuity*. A *perpetuity* whose cash flows grow at the rate g per period and thus has *present value* of $1/(r - g)$. Some call this the “Gordon Growth Model” because Myron Gordon wrote about applications of this formula and its variants

in the 1950s. John Burr Williams wrote about them in the 1930s.

personal account. *Drawing account*.

PERT (Program Evaluation and Review Technique). A method of *network analysis* in which the analyst makes three time estimates for each activity—the optimistic time, the most likely time, and the pessimistic time—and gives an expected completion date for the project within a probability range.

petty cash fund. Currency and coins maintained for expenditures that the firm makes with cash on hand.

physical units method. A method of allocating a *joint cost* to the *joint products* based on a physical measure of the joint products; for example, allocating the cost of a cow to sirloin steak and to hamburger, based on the weight of the meat. This method usually provides nonsensical (see *sterilized allocation*) results unless the physical units of the joint products tend to have the same value.

physical verification. *Verification*, by an *auditor*, performed by actually inspecting items in *inventory*, *plant assets*, and the like, in contrast to merely checking the written records. The auditor may use statistical sampling procedures.

planning and control process. General name for the management techniques comprising the setting of organizational goals and *strategic plans*, *capital budgeting*, *operations budgeting*, comparison of plans with actual results, performance evaluation and corrective action, and revisions of goals, plans, and budgets.

plant. *Plant assets*.

plant asset turnover. Number of dollars of *sales* generated per dollar of *plant assets*; equal to sales divided by average *plant assets*.

plant assets. *Assets* used in the revenue-production process. Plant assets include buildings, machinery, equipment, land, and natural

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resources. The phrase “property, plant, and equipment” (though often appearing on balance sheets) is therefore a redundancy. In this context, “plant” used alone means buildings.

plantwide allocation method. A method for allocating overhead costs to product. First, use one *cost pool* for the entire plant. Then, allocate all costs from that pool to products using a single overhead *allocation rate*, or one set of rates, for all the products of the plant, independent of the number of departments in the plant.

PLC (public limited company). United Kingdom: a publicly held *corporation*. Contrast with *Ltd*.

pledging. The borrower assigns *assets* as security or *collateral* for repayment of a loan.

pledging of receivables. The process of using expected collections on *accounts receivable* as *collateral* for a loan. The borrower remains responsible for collecting the receivable but promises to use the proceeds for repaying the debt.

plow back. To retain *assets* generated by earnings for continued investment in the business.

plug. Process for finding an unknown amount. For any *account*, Beginning balance + Additions – Deductions = Ending balance; if you know any three of the four items, you can find the fourth with simple arithmetic, called “plugging.” In making a *journal entry*, often you know all *debits* and all but one of the *credits* (or vice versa). Because *double-entry bookkeeping* requires equal debits and credits, you can compute the unknown quantity by subtracting the sum of the known credits from the sum of all the debits (or vice versa), also called “plugging.” Accountants often call the unknown the “plug.” For example, in amortizing a *discount* on *bonds payable* with the *straight-line depreciation method*, *interest expense* is a plug: Interest expense =

plantwide allocation method — post

Interest payable + *Discount amortization*. See *trade-in transaction* for an example. The term sometimes has a bad connotation for accountants because plugging can occur in a slightly different context. During the process of preparing a *preclosing trial balance* (or *balance sheet*), often the sum of the debits does not equal the sum of the credits. Rather than find the error, some accountants are tempted to force equality by changing one of the amounts, with a plugged debit or credit to an account such as Other Expenses. No harm results from this procedure if the amount of the error is small compared with asset totals, since spending tens or hundreds of dollars in a bookkeeper’s or accountant’s time to find an error of a few dollars will not be *cost-effective*. Still, most accounting teachers rightly disallow this use of plugging because exercises and problems set for students provide enough information not to require it.

point of sale. The time, not the location, at which a *sale* occurs.

pooling-of-interests method. Accounting for a *business combination* by adding together the *book value* of the *assets* and *equities* of the combined firms; generally leads to a higher reported *net income* for the combined firms than results when the firm accounts for the business combination as a purchase because the *market values* of the merged assets generally exceed their book values. US GAAP do not allow this method, although it previously did, so financial statements still reflect the effects of pooling accounting. Contrast with *purchase method*. Called *uniting-of-interests method* by the IASB.

population. The entire set of numbers or items from which the analyst samples or performs some other analysis.

positive confirmation. See *confirmation*.

post. To record entries in an *account* to a *ledger*, usually as transfers from a *journal*.

post-closing trial balance — prepaid expense

post-closing trial balance. *Trial balance* taken after the accountant has *closed* all *temporary accounts*.

post-statement events. Events that have *material* impact and that occur between the end of the *accounting period* and the formal publication of the *financial statements*. Even though the events occur after the end of the period being reported on, the firm must disclose such events in notes if the auditor is to give a *clean opinion*.

potentially dilutive security. A *security* that its holder may convert into, or exchange for, common stock and thereby reduce reported *earnings per share*; *options*, *warrants*, *convertible bonds*, and *convertible preferred stock*.

PPB. *Program budgeting*. The second “P” stands for “plan.”

practical capacity. Maximum level at which a plant or department can operate efficiently.

precision. The degree of accuracy for an estimate derived from a sampling process, usually expressed as a range of values around the estimate. The analyst might express a sample estimate in the following terms: “Based on the sample, we are 95 percent sure [confidence level] that the true population value is within the range of X to Y [precision].” See *confidence level*.

preclosing trial balance. *Trial balance* taken at the end of the period before *closing entries*; in this sense, an *adjusted trial balance*; sometimes taken before *adjusting entries* and then synonymous with *unadjusted trial balance*.

predatory prices. Setting prices below some measure of cost in an effort to drive out competitors with the hope of recouping losses later by charging monopoly prices. Illegal in the United States if the prices set are below long-run variable costs. We know of no

empirical evidence that firms are successful at recoupment.

predetermined (factory) overhead rate. Rate used in applying *overhead costs* to products or departments developed at the start of a period. Compute the rate as estimated overhead cost divided by the estimated number of units of the overhead allocation base (or *denominator volume*) activity. See *normal costing*.

preemptive right. The privilege of a *shareholder* to maintain a proportionate share of ownership by purchasing a proportionate share of any new stock issues. Most state corporation laws allow corporations to pay shareholders to waive their preemptive rights or state that preemptive rights exist only if the *corporation charter* explicitly grants them. In practice, then, preemptive rights are the exception rather than the rule.

preference as to assets. The rights of *preferred shareholders* to receive certain payments before common shareholders receive payments in case the board dissolves the corporation.

preferred shares. *Capital stock* with a claim to *income* or *assets* after *bondholders* but before *common shares*. *Dividends* on preferred shares are *income distributions*, not *expenses*. See *cumulative preferred stock*.

premium. The excess of issue (or market) price over *par value*. For a different context, see *insurance*.

premium on capital stock. Alternative but inferior title for *capital contributed in excess of par (or stated) value*.

prepaid expense. An *expenditure* that leads to a *deferred charge* or *prepayment*. Strictly speaking, this is a contradiction in terms because an *expense* is a gone asset, and this title refers to past *expenditures*, such as for rent or insurance premiums, that still have future benefits and thus are *assets*. We try to avoid this term and use “prepayment” instead.

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prepaid income. An inferior alternative title for *advances from customers*. Do not call an item *revenue* or *income* until the firm earns it by delivering goods or rendering services.

prepayments. *Deferred charges; assets* representing *expenditures* for future benefits. Rent and insurance premiums paid in advance are usually current prepayments.

present value. Value today (or at some specific date) of an amount or amounts to be paid or received later (or at other, different dates), discounted at some *interest* or *discount rate*; an amount that, if invested today at the specified rate, will grow to the amount to be paid or received in the future.

prevention costs. *Costs incurred* to prevent defects in the products or services they produce, including procurement inspection, processing control (inspection), design, quality training and machine inspection.

price. The quantity of one *good* or *service*, usually *cash*, asked in return for a unit of another good or service. See *fair value*.

price-earnings (P/E) ratio. At a given time, the market value of a company's *common share*, per share, divided by the *earnings per common share* for the past year. The analyst usually bases the denominator on *income from continuing operations* or, if the analyst thinks the current figure for that amount does not represent a usual situation—such as when the number is negative or, if positive, close to zero—on some estimate of the number. See *ratio*.

price index. A series of numbers, one for each period, that purports to represent some *average* of prices for a series of periods, relative to a base period.

price level. The number from a *price index* series for a given period or date.

price level-adjusted statements. *Financial statements* expressed in terms of dollars of uniform purchasing power. The statements

prepaid income — prior-period adjustment

restate *nonmonetary* items to reflect changes in general *price levels* since the time the firm acquired specific *assets* and incurred *liabilities*. The statements recognize a *gain* or *loss* on *monetary items* as the firm holds them over time periods when the general *price level changes*. Conventional financial statements show *historical costs* and ignore differences in purchasing power in different periods.

price variance. In accounting for *standard costs*, an amount equal to (Actual cost per unit – Standard cost per unit) × Actual quantity.

primary earnings per share (PEPS). Net *income* to common shareholders plus *interest* (net of tax effects) or *dividends* paid on *common-stock equivalents* divided by (weighted average of common shares outstanding plus the net increase in the number of common shares that would become *outstanding* if the holders of all common stock equivalents were to exchange them for common shares with cash proceeds, if any, used to retire common shares). As of 1997 and *SFAS No. 128*, replaced with *basic earnings per share*.

prime cost. Sum of *direct materials* plus *direct labor* costs assigned to product.

prime rate. The loan rate charged by commercial banks to their creditworthy customers. Some customers pay even less than the prime rate and others, more. The *Federal Reserve Bulletin* is the authoritative source of information about historical prime rates.

principal. An amount on which *interest* accrues, either as *expense* (for the borrower) or as *revenue* (for the lender); the *face amount* of a *loan*; also, the absent owner (principal) who hires the manager (agent) in a “principal-agent” relation.

principle. See *generally accepted accounting principles*.

prior-period adjustment. A *debit* or *credit* that is made directly to *retained earnings*

prior service cost — production method (depreciation)

(and that does not affect *income* for the period) to adjust earnings as calculated for prior periods. Such adjustments are now rare. Theory suggests that accounting should correct for errors in accounting estimates (such as the *depreciable life* or *salvage value* of an asset) by adjusting retained earnings so that statements for future periods will show correct amounts. But *GAAP* require that corrections of such estimates flow through current, and perhaps future, *income statements*. See *accounting changes* and *accounting errors*.

prior service cost. *Present value* at a given time of a *pension plan's* retroactive *benefits*. "Unrecognized prior service cost" refers to that portion of prior service cost not yet *debited to expense*. See *actuarial accrued liability* and *funded*. Contrast with *normal cost*.

pro forma income. See *pro forma statements*.

pro forma statements. Hypothetical statements; financial statements as they would appear if some event, such as a *merger* or increased production and sales, had occurred or were to occur; sometimes spelled as one word, "proforma." The phrase "pro forma income" has come to disrepute, as some companies have published pro forma income statements showing their good news, their recurring income, and omitting the bad news, as non-recurring. They have attempted to focus the investment community on their own presentation of this good news, de-emphasizing *GAAP* net income. The *SEC* and others have attempted to make these disclosures less misleading.

probable. In many of its definitions, the *FASB* uses the term "probable." See, for example, *asset*, *firm commitment*, *liability*. A survey of practicing accountants revealed that the average of the probabilities that those surveyed had in mind when they used the term "probable" was 85 percent. Some accountants think that any event whose outcome is

greater than 50 percent should be called "probable." The *FASB* uses the phrase "more likely than not" when it means greater than 50 percent.

proceeds. The *funds* received from the disposition of assets or from the issue of securities.

process costing. A method of *cost accounting* based on average costs (total cost divided by the *equivalent units* of work done in a period); typically used for assembly lines or for products that the firm produces in a series of steps that are more continuous than discrete.

product. *Goods* or *services* produced.

product cost. Any *manufacturing cost* that the firm can—or, in some contexts, should—debit to an *inventory* account. See *flow of costs*, for example. Contrast with *period expenses*.

product life cycle. Time span between initial concept (typically starting with research and development) of a good or service and the time when the firm ceases to support customers who have purchased the good or service.

production cost. *Manufacturing cost*.

production cost account. A *temporary account* for accumulating *manufacturing costs* during a period.

production department. A department producing salable *goods* or *services*; contrast with *service department*.

production method (depreciation). One form of *straight-line depreciation*. The firm assigns to the depreciable asset (e.g., a truck) a *depreciable life* measured not in elapsed time but in units of output (e.g., miles) or perhaps in units of time of expected use. Then the *depreciation* charge for a period is a portion of depreciable cost equal to a fraction computed as the actual output produced during the period divided by the expected total output to be produced over the life of the asset. This method is sometimes called the "units-of-production (or output) method."

production method (revenue recognition).

Percentage-of-completion method for recognizing revenue.

production volume variance. Standard fixed overhead rate per unit of normal capacity (or base activity) times (units of base activity budgeted or planned for a period minus actual units of base activity worked or assigned to product during the period); often called a “volume variance.”

productive capacity. One attribute measured for assets. The current cost of long-term assets means the cost of reproducing the productive capacity (e.g., the ability to manufacture one million units a year), not the cost of reproducing the actual physical assets currently used (see *reproduction cost*). Replacement cost of productive capacity will be the same as reproduction cost of assets only in the unusual case when no technological improvement in production processes has occurred and the relative prices of goods and services used in production have remained approximately the same as when the firm acquired the currently used goods and services.

product-level activities. Work that supports a particular product or service line. Examples include design work, supervision, and advertising that are specific to each type of product or service.

production cycle efficiency. Measures the efficiency of the production cycle by computing the ratio of the time spent processing a unit divided by the *production cycle time*. The higher the percentage, the less the time and costs spent on *non-value-added activities*, such as moving and storage.

production cycle time. The total time to produce a unit. Includes processing, moving, storing, and inspecting.

profit. Excess of revenues over expenses for a transaction; sometimes used synonymously with *net income* for the period.

profit-and-loss account. United Kingdom: *retained earnings*.

profit-and-loss sharing ratio. The fraction of *net income* or loss allocable to a partner in a *partnership*. Need not be the same fraction as the partner’s share of capital.

profit-and-loss statement. *Income statement*.

profit center. A *responsibility center* for which a firm accumulates both revenues and expenses. Contrast with *cost center*.

profit margin. Sales minus all expenses.

profit margin percentage. Profit margin divided by *net sales*.

profit maximization. The doctrine that the firm should account for a given set of operations so as to make reported *net income* as large as possible; contrast with *conservatism*. This concept in accounting differs from the profit-maximizing concept in economics, which states that the firm should manage operations to maximize the present value of the firm’s wealth, generally by equating *marginal costs* and *marginal revenues*.

profit plan. The *income statement* portion of a *master budget*.

profit-sharing plan. A *defined-contribution plan* in which the employer contributes amounts based on *net income*.

profit variance analysis. Analysis of the causes of the difference between budgeted profit in the *master budget* and the profits earned.

profit-volume analysis (equation). Analysis of effects, on profits, caused by changes in volume or *contribution margin* per unit or *fixed costs*. See *breakeven chart*.

profit-volume graph. See *breakeven chart*.

profit-volume ratio. *Net income* divided by net sales in dollars.

profitability accounting. *Responsibility accounting*.

program budgeting (PPB) — prorated

program budgeting (PPB). Specification and analysis of inputs, outputs, costs, and alternatives that link plans to *budgets*.

programmed cost. A *fixed cost* not essential for carrying out operations. For example, a firm can control costs for research and development and advertising designed to generate new business, but once it commits to incur them, they become fixed costs. These costs are sometimes called managed costs or *discretionary costs*. Contrast with *capacity costs*.

progressive tax. Tax for which the rate increases as the taxed base, such as income, increases. Contrast with *regressive tax*.

project financing arrangement. As defined by *SFAS No. 47*, the financing of an investment project in which the lender looks principally to the *cash flows* and *earnings* of the project as the source of funds for repayment and to the *assets* of the project as *collateral* for the loan. The general *credit* of the project entity usually does not affect the terms of the financing either because the borrowing entity is a *corporation* without other assets, or because the financing provides that the lender has no direct *recourse* to the entity's owners.

projected benefit obligation. The *actuarial present value* at a given date of all pension benefits attributed by a *defined-benefit pension* formula to employee service rendered before that date. The analyst measures the obligation using assumptions as to future compensation levels if the formula incorporates future compensation, as happens, for example, when the plan bases the eventual pension benefit on wages of the last several years of employees' work lives. Contrast to "accumulated benefit obligation," where the analyst measures the obligation using employee compensation levels at the time of the measurement date.

projected financial statement. *Pro forma* financial statement.

projection. See *financial projection* for definition and contrast.

promissory note. An unconditional written promise to pay a specified sum of cash on demand or at a specified date.

proof of journal. The process of checking the arithmetic accuracy of *journal entries* by testing for the equality of all *debits* and all *credits* since the last previous proof.

property dividend. A *dividend in kind*.

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

proportionate consolidation. Canada: a presentation of the *financial statements* of any investor-investment relationship, whereby the investor's pro rata share of each *asset*, *liability*, *income* item, and *expense* item appears in the *financial statements* of the investor under the various *balance sheet* and *income statement* headings.

proprietary accounts. See *budgetary accounts* for definition and contrast in the context of governmental accounting.

proprietorship. *Assets* minus *liabilities* of an *entity*; equals *contributed capital* plus *retained earnings*.

proprietorship theory. The corporation view that emphasizes the form of the *accounting equation* that says *assets* – *liabilities* = *owners' equity*; contrast with *entity theory*. The major implication of a choice between these theories deals with the treatment of *subsidiaries*. For example, the proprietorship theory views *minority interest* as an *indeterminate-term liability*. The proprietorship theory implies using a *single-step income statement*.

prorate. To *allocate* in proportion to some base; for example, to allocate *service department* costs in proportion to hours of service used by the benefited department or to allocate *manufacturing variances* to product sold and to product added to *ending inventory*.

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prorating variances. See *prorate*.

prospectus. Formal written document describing *securities* a firm will issue. See *proxy*.

protest fee. Fee charged by banks or other financial agencies when the bank cannot collect items (such as *checks*) presented for collection.

provision. Part of an *account* title. Often the firm must recognize an *expense* even though it cannot be sure of the exact amount. The entry for the estimated expense, such as for *income taxes* or expected costs under *warranty*, is as follows:

Retained Earnings (Estimated)	X
Liability Increase (Estimated)	X

American terminology often uses “provision” in the expense account title of the above entry. Thus, Provision for Income Taxes means the estimate of income tax expense. (British terminology uses “provision” in the title for the estimated liability of the above entry, so that Provision for Income Taxes is a balance sheet account.)

proxy. Written authorization given by one person to another so that the second person can act for the first, such as to vote shares of stock; of particular significance to accountants because the *SEC* presumes that management distributes financial information along with its proxy solicitations.

public accountant. Generally, this term is synonymous with *certified public accountant*. Some jurisdictions, however, license individuals who are not CPAs as public accountants.

public accounting. That portion of accounting primarily involving the *attest* function, culminating in the *auditor’s report*.

prorating variances — purchase order

Public Company Accounting Oversight Board, PCAOB. A board established by the Sarbanes-Oxley Act of 2002 which regulates the auditing profession and sets standards for audits of public companies. The *SEC* appoints its members.

PuPU. Acronym for *purchasing power unit*; conceived by John C. Burton, former chief accountant of the *SEC*. Those who think that *constant-dollar accounting* is not particularly useful poke fun at it by calling it “PuPU accounting.”

purchase allowance. A reduction in sales *invoice price* usually granted because the purchaser received *goods* not exactly as ordered. The purchaser does not return the goods but agrees to keep them for a price lower than originally agreed upon.

purchase discount. A reduction in purchase *invoice price* granted for prompt payment. See *sales discount* and *terms of sale*.

purchase investigation. An investigation of the financial affairs of a company for the purpose of disclosing matters that may influence the terms or conclusion of a potential acquisition.

purchase method. Accounting for a *business combination* by adding the acquired company’s assets at the price paid for them to the acquiring company’s assets. Contrast with *pooling-of-interests method*. The firm adds the acquired assets to the books at current values rather than original costs; the subsequent *amortization expenses* usually exceed those (and reported income is smaller than that) for the same business combination accounted for as a pooling of interests. US *GAAP* now require that the acquirer use the purchase method, but other countries still allow poolings.

purchase order. Document issued by a buyer authorizing a seller to deliver goods, with the buyer to make payment later.

purchasing power gain or loss — quality of earnings

purchasing power gain or loss. *Monetary gain or loss.*

push-down accounting. An accounting method used in some *purchase transactions*. Assume that Company A purchases substantially all the *common shares* of Company B but that Company B must still issue its own *financial statements*. The question arises, shall Company B change the *basis* for its *assets* and *equities* on its own books to the same updated amounts at which they appear on Company A's *consolidated financial statements*?

Company B uses "push-down accounting" when it shows the new asset and equity bases reflecting Company A's purchase, because the method "pushes down" the new bases from Company A (where *GAAP* require them) to Company B (where the new bases would not appear in *historical cost accounting*). Since 1983, the *SEC* has required push-down accounting under some circumstances.

put. An option to sell *shares* of a publicly traded corporation at a fixed price during a fixed time span. Contrast with *call*.

Q

qualified report (opinion). *Auditor's report* containing a statement that the auditor was unable to complete a satisfactory examination of all things considered relevant or that the auditor has doubts about the financial impact of some *material* item reported in the financial statements. See *except for* and *subject to*.

quality. In modern usage, a product or service has quality to the extent it conforms to specifications or provides customers the characteristics promised them.

quality of earnings. A phrase with no single, agreed-upon meaning. Some who use the phrase use it with different meanings on different occasions. "Quality of earnings" has an accounting aspect and a business cycle aspect.

In its accounting aspect, managers have choices in measuring and reporting *earnings*. This discretion can involve any of the following: selecting *accounting principles* or standards when *GAAP* allow a choice; making estimates in the application of accounting principles; and timing transactions to allow recognizing *nonrecurring* items in earnings. In some instances the range of choices has a

large impact on reported earnings and in others, small. (1) Some use the phrase "quality of earnings" to mean the degree to which management can affect reported income by its choices of accounting estimates even though the choices recur every period. These users judge, for example, insurance companies to have low-quality earnings. Insurance company management must reestimate its liabilities for future payments to the insured each period, thereby having an opportunity to report periodic earnings within a wide range. (2) Others use the phrase to mean the degree to which management actually takes advantage of its flexibility. For them, an insurance company that does not vary its methods and estimating techniques, even though it has the opportunity to do so, has high-quality earnings. (3) Some have in mind the proximity in time between *revenue* recognition and cash collection. For them, the smaller the time delay, the higher will be the quality. (4) Still others use the phrase to mean the degree to which managers who have a choice among the items with large influence on earnings choose the ones that result in income measures that are more likely to recur. For them, the more likely an item of

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earnings is to recur, the higher will be its quality. Often these last two groups trade off with each other. Consider a dealer leasing a car on a long-term *lease*, receiving monthly collections. The dealer who uses *sales-type lease* accounting scores low on proximity of revenue recognition (all at the time of signing the lease) to cash collection but highlights the nonrepetitive nature of the transaction. The leasing dealer who uses *operating lease* accounting has perfectly matching revenue recognition and cash collection, but the *recurring* nature of the revenue gives a misleading picture of a repetitive transaction. The phrase “item of earnings” in (4) is ambiguous. The writer could mean the underlying economic event (which occurs when the lease for the car is signed) or the revenue recognition (which occurs every time the dealer using operating lease accounting receives cash). Hence, you should try to understand what other speakers and writers mean by “quality of earnings” when you interpret what they say and write. Some who refer to “earnings quality” suspect that managers will usually make choices that enhance current earnings and present the firm in the best light, independent of the ability of the firm to generate similar earnings in the future.

In the business cycle aspect, management’s action often has no impact on the stability and recurrence of earnings. Compare a company that sells consumer products and likely has sales repeating every week with a construction company that builds to order. Companies in noncyclical businesses, such as some public utilities, likely have more stable earnings than ones in cyclical businesses, such as steel. Some use “quality of earnings” to refer to the stability and recurrence of basic revenue-generating activities. Those who use the phrase this way rarely

quality of financial position — quick ratio

associate earnings quality with accounting issues.

quality of financial position. Because of the *articulation* of the *income statement* with the *balance sheet*, the factors that imply a high (or low) *quality of earnings* also affect the balance sheet. Users of this phrase have in mind the same accounting issues as they have in mind when they use the phrase “quality of earnings.”

quantitative performance measure. A measure of output based on an objectively observable quantity, such as units produced or *direct costs* incurred, rather than on an unobservable quantity or a quantity observable only nonobjectively, like quality of service provided.

quantity discount. A reduction in purchase price as quantity purchased increases. The Robinson-Patman Act constrains the amount of the discount. Do not confuse with *purchase discount*.

quantity variance. *Efficiency variance*; in *standard cost* systems, the standard price per unit times (actual quantity used minus standard quantity that should be used).

quasi-reorganization. A *reorganization* in which no new company emerges or no court has intervened, as would happen in *bankruptcy*. The primary purpose is to rid the balance sheet of a *deficit* (negative *retained earnings*) and give the firm a “fresh start.”

quick assets. *Assets* readily convertible into *cash*; includes cash, current marketable securities, and current receivables.

quick ratio. Sum of (cash, current marketable securities, and current receivables) divided by *current liabilities*; often called the “acid test ratio.” The analyst may exclude some nonliquid receivables from the numerator. See *ratio*.

R

R². The proportion of the statistical variance of a *dependent variable* explained by the equation fit to *independent variable(s)* in a *regression analysis*.

Railroad Accounting Principles Board (RAPB). A board brought into existence by the Staggers Rail Act of 1980 to advise the Interstate Commerce Commission on accounting matters affecting railroads. The RAPB was the only cost-accounting body authorized by the government during the decade of the 1980s (because Congress ceased funding the CASB during the 1980s). The RAPB incorporated the pronouncements of the CASB and became the government's authority on cost accounting principles.

R&D. See *research and development*.

random number sampling. For choosing a sample, a method in which the analyst selects items from the *population* by using a random number table or generator.

random sampling. For choosing a sample, a method in which all items in the population have an equal chance of being selected. Compare *judgment(al) sampling*.

RAPB. *Railroad Accounting Principles Board*.

rate of return on assets. *Return on assets*.

rate of return on common stock equity. See *ratio*.

rate of return on shareholders' (owners') equity. See *ratio*.

rate of return (on total capital). See *ratio* and *return on assets*.

rate variance. *Price variance*, usually for *direct labor costs*.

ratio. The number resulting when one number divides another. Analysts generally use ratios to assess aspects of profitability, solvency, and liquidity. The commonly used financial ratios fall into three categories: (1) those that summarize some aspect of *operations* for a period, usually a year, (2) those that summarize some aspect of *financial position* at a given moment—the moment for which a balance sheet reports, and (3) those that relate some aspect of operations to some aspect of financial position. Exhibit 1-3 lists common financial ratios and shows separately both the numerator and the denominator for each ratio.

Ratio	Numerator	Denominator
Profitability Ratios		
Rate of return on assets	Net income + Interest expense (net of tax effects) ^a	Average total assets during the period
Profit margin for ROA (before interest effects)	Net income + Interest expense (net of tax effects) ^a	Sales
Various expense ratios	Various expenses	Sales
Total assets turnover ratio	Sales	Average total assets during the period
Accounts receivable turnover ratio	Sales	Average accounts receivable during the period
Inventory turnover ratio	Cost of goods sold	Average inventory during the period

EXHIBIT 1.3 SUMMARY OF FINANCIAL STATEMENT RATIOS

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ratio – ratio

Ratio	Numerator	Denominator
Fixed asset turnover ratio	Sales	Average fixed assets during the period
Rate of return on common shareholders' equity	Net income – Preferred stock dividends	Average common shareholders' equity during the period
Profit margin for ROCE (after interest expense and preferred dividends)	Net income – Preferred stock Dividends	Sales
Capital structure leverage ratio	Average total assets during the period	Average common shareholders' equity during the period
Earnings per share of common stock ^b	Net income – Preferred stock dividends	Weighted-average number of common shares outstanding
Short-term Liquidity Ratios		
Current ratio	Current assets	Current liabilities
Quick or acid test ratio	Highly liquid assets (cash, marketable securities, and receivables) ^c	Current liabilities
Cash flow from operations to current liabilities ratio	Cash flow from operations	Average current liabilities during the period
Accounts payable turnover ratio	Purchases ^d	Average accounts payable during the period
Days accounts receivable outstanding	365 days	Accounts receivable turnover ratio
Days inventories held	365 days	Inventory turnover ratio
Days accounts payable outstanding	365 days	Accounts payable turnover ratio
Long-term Liquidity Ratios		
Long-term debt ratio	Total long-term debt	Total long-term debt plus shareholders' equity
Debt–equity ratio	Total liabilities	Total equities (total liabilities + shareholders' equity = total assets)
Cash flow from operations to total liabilities ratio	Cash flow from operations	Average total liabilities during the period
Interest coverage ratio	Income before Interest and income taxes	Interest expense

^a If the parent company does not own all of a consolidated subsidiary, the calculation also adds back to net income the minority interest share of earnings. See Chapter 11 for discussion of minority interest.

^b This calculation is more complicated when there are convertible securities, options, or warrants outstanding.

^c The calculation could conceivably exclude receivables for some firms and include inventories for others.

^d Purchases = Cost of goods sold + Ending inventories – Beginning inventories

EXHIBIT 1.3 SUMMARY OF FINANCIAL STATEMENT RATIOS (CONTINUED)

For all ratios that require an average balance during the period, the analyst often derives the average as one half the sum of the beginning and the ending balances. Sophisticated analysts recognize, however, that

particularly when companies use a fiscal year different from the calendar year, this averaging of beginning and ending balances may mislead. Consider, for example, the rate of *return on assets* of Sears Company,

raw material — recapture

whose fiscal year ends on January 31. Sears chooses a January 31 closing date at least in part because inventories are at a low level and are therefore easy to count—it has sold the Christmas merchandise, and the Easter merchandise has not yet all arrived. Furthermore, by January 31, Sears has collected for most Christmas sales, so receivable amounts are not unusually large. Thus at January 31, the amount of total assets is lower than at many other times during the year. Consequently, the denominator of the rate of return on assets, total assets, for Sears more likely represents the smallest amount of total assets on hand during the year rather than the average amount. The return on assets rate for Sears and other companies that choose a fiscal year-end to coincide with low points in the inventory cycle is likely to exceed the ratio measured with a more accurate estimate of the average amounts of total assets.

raw material. Goods purchased for use in manufacturing a product.

reacquired stock. *Treasury shares.*

real accounts. *Balance sheet accounts*, as opposed to *nominal accounts*. See *permanent accounts*.

real amount (value). An amount stated in *constant dollars*. For example, if the firm sells an investment costing \$100 for \$130 after a period of 10 percent general *inflation*, the *nominal amount of gain* is \$30 (= \$130 – \$100) but the *real amount of gain* is C\$20 (= \$130 – 1.10 × \$100), where “C\$” denotes constant dollars of purchasing power on the date of sale.

real estate. *Land* and its *improvements*, such as landscaping and roads, but not buildings.

real interest rate. Interest rate reflecting the productivity of capital, not including a premium for inflation anticipated over the life of the loan.

realizable value. *Fair value* or, sometimes, *net realizable (sales) value*.

realization convention. The accounting practice of delaying the recognition of *gains* and *losses* from changes in the market price of *assets* until the firm sells the assets. However, the firm recognizes unrealized losses on *inventory* (or *marketable securities* classified as *trading securities*) prior to sale when the firm uses the *lower-of-cost-or-market* valuation basis for inventory (or the *fair value* basis for marketable securities).

realize. To convert into *funds*; when applied to a *gain* or *loss*, implies that an *arm's-length transaction* has taken place. Contrast with *recognize*; the firm may recognize a loss (as, for example, on *marketable equity securities*) in the financial statements even though it has not yet realized the loss via a transaction.

realized gain (or loss) on marketable equity securities. An income statement account title for the difference between the proceeds of disposition and the *original cost* of *marketable equity securities*.

realized holding gain. See *inventory profit* for definition and an example.

rearrangement costs. Costs of reinstalling assets, perhaps in a different location. The firm may, but need not, *capitalize* them as part of the assets cost, just as is done with original installation cost. The firm will *expense* these costs if they merely maintain the asset's future benefits at their originally intended level before the relocation.

recapitalization. *Reorganization*.

recapture. Name for one kind of tax payment. Various provisions of the *income tax* rules require a refund by the taxpayer (recapture by the government) of various tax advantages under certain conditions. For example, the taxpayer must repay tax savings provided by *accelerated depreciation* if the taxpayer

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prematurely retires the item providing the tax savings.

receipt. Acquisition of *cash*.

receivable. Any *collectible*, whether or not it is currently due.

receivable turnover. See *ratio*.

reciprocal holdings. Company A owns stock of Company B, and Company B owns stock of Company A; or Company B owns stock of Company C, which owns stock of Company A.

recognize. To enter a transaction in the accounts; not synonymous with *realize*.

reconciliation. A calculation that shows how one balance or figure derives from another, such as a reconciliation of retained earnings or a *bank reconciliation schedule*. See *articulate*.

record date. The date at which the firm pays *dividends* on payment date to those who own the stock.

recourse. The rights of the lender if a borrower does not repay as promised. A recourse loan gives the lender the right to take any of the borrower's assets not exempted from such taking by the contract. See also *note receivable discounted*.

recovery of unrealized loss on trading securities. An *income statement account title* for the *gain* during the current period on *trading securities*.

recurring. Occurring again; occurring repetitively; in accounting, an adjective often used in describing *revenue* or *earnings*. In some contexts, the term "recurring revenue" is ambiguous. Consider a construction contractor who accounts for a single long-term project with the *installment method*, with revenue recognized at the time of each cash collection from the customer. The recognized revenue is recurring, but the transaction leading to the revenue is not. See *quality of earnings*.

receipt — regression analysis

redemption. Retirement by the issuer, usually by a purchase or *call*, of *stocks* or *bonds*.

redemption premium. *Call premium*.

redemption value. The price a corporation will pay to retire *bonds* or *preferred stock* if it calls them before *maturity*.

refinancing. An adjustment in the *capital structure* of a *corporation*, involving changes in the nature and amounts of the various classes of *debt* and, in some cases, *capital* as well as other components of *shareholders' equity*. *Asset* carrying values in the accounts remain unchanged.

refunding bond issue. Said of a *bond* issue whose proceeds the firm uses to retire bonds that are already *outstanding*.

register. A collection of consecutive entries, or other information, in chronological order, such as a check register or an insurance register that lists all insurance policies owned. If the firm records entries in the register, it can serve as a *journal*.

registered bond. A bond for which the issuer will pay the *principal* and *interest*, if registered as to interest, to the owner listed on the books of the issuer; as opposed to a bearer bond, in which the issuer must pay the possessor of the bond.

registrar. An *agent*, usually a bank or trust company, appointed by a corporation to keep track of the names of shareholders and distributions to them.

registration statement. Required by the Securities Act of 1933, statement of most companies that want to have owners of their securities trade the securities in public markets. The statement discloses financial data and other items of interest to potential investors.

regression analysis. A method of *cost estimation* based on statistical techniques for fitting a line (or its equivalent in higher mathematical dimensions) to an observed series of data

regressive tax — rent

points, usually by minimizing the sum of squared deviations of the observed data from the fitted line. Common usage calls the cost that the analysis explains the “dependent variable”; it calls the variable(s) we use to estimate cost behavior “independent variable(s).” If we use more than one independent variable, the term for the analysis is “multiple regression analysis.” See R^2 , *standard error*, and *t-value*.

regressive tax. Tax for which the rate decreases as the taxed base, such as income, increases. Contrast with *progressive tax*.

Regulation S-K. The SEC’s standardization of nonfinancial statement disclosure requirements for documents filed with the SEC.

Regulation S-T. The SEC’s regulations specifying formats for electronic filing and the EDGAR system.

Regulation S-X. The SEC’s principal accounting regulation, which specifies the form and content of financial reports to the SEC.

rehabilitation. The improving of a used asset via an extensive repair. Ordinary repairs and maintenance restore or maintain expected *service potential* of an asset, and the firm treats them as *expenses*. A rehabilitation improves the asset beyond its current service potential, enhancing the service potential to a significantly higher level than before the rehabilitation. Once rehabilitated, the asset may be better, but need not be, than it was when new. The firm will *capitalize expenditures* for rehabilitation, like those for *betterments* and *improvements*.

reinvestment rate. In a *capital budgeting* context, the rate at which the firm invests cash inflows from a project occurring before the project’s completion. Once the analyst assumes such a rate, no project can ever have multiple *internal rates of return*. See *Descartes’ rule of signs*.

relative performance evaluation. Setting performance targets and, sometimes, compensation in relation to the performance of others, perhaps in different firms or divisions, who face a similar environment.

relative sales value method. See *net realizable (sales) value*.

relevant cost. Cost used by an analyst in making a decision. *Incremental cost*; *opportunity cost*.

relevant cost analysis. Identifies the *costs* (or *revenues*) relevant to the decision to be made. A cost or revenue is relevant only if an amount differs between alternatives. Also called *differential cost analysis*.

relevant range. Activity levels over which costs are linear or for which *flexible budget estimates* and *breakeven charts* will remain valid.

remit earnings. An expression likely to confuse a reader without a firm understanding of accounting basics. A firm generates *net assets* by earning *income* and retains net assets if it does not declare *dividends* in the amount of net income. When a firm declares dividends and pays the cash (or other net assets), some writers would say the firm “remit earnings.” We think the student learns better by conceiving earnings as a *credit balance*. When a firm pays dividends it sends net assets, things with debit balances, not something with a credit balance, to the recipient. When writers say firms “remit earnings,” they mean the firms send assets (or net assets) that previous earnings have generated and reduce *retained earnings*.

remittance advice. Information on a *check stub*, or on a document attached to a check by the *drawer*, that tells the *payee* why a payment is being made.

rent. A charge for use of land, buildings, or other assets.

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reorganization — reserve

reorganization. In the *capital structure* of a corporation, a major change that leads to changes in the rights, interests, and implied ownership of the various security owners; usually results from a *merger* or an agreement by senior security holders to take action to forestall *bankruptcy*.

repair. An *expenditure* to restore an *asset's* service potential after damage or after prolonged use. In the second sense, after prolonged use, the difference between repairs and maintenance is one of degree and not of kind. A repair is treated as an *expense* of the period when incurred. Because the firm treats repairs and maintenance similarly in this regard, the distinction is not important. A repair helps to maintain capacity at the levels planned when the firm acquired the *asset*. Contrast with *improvement*.

replacement cost. For an asset, the current fair market price to purchase another, similar asset (with the same future benefit or service potential). *Current cost*. See *reproduction cost* and *productive capacity*. See also *dis-tributable income* and *inventory profit*.

replacement cost method of depreciation. Method in which the analyst augments the original-cost *depreciation* charge with an amount based on a portion of the difference between the *current replacement cost* of the asset and its *original cost*.

replacement system of depreciation. See *retirement method of depreciation* for definition and contrast.

report. *Financial statement; auditor's report*.

report form. *Balance sheet* form that typically shows *assets* minus *liabilities* as one total. Then, below that total appears the components of *owners' equity* summing to the same total. Often, the top section shows *current assets* less current liabilities before *noncurrent assets* less noncurrent liabilities. Contrast with *account form*.

reporting objectives (policies). The general purposes for which the firm prepares *financial statements*. The *FASB* has discussed these in *SFAC No. 1*.

representative item sampling. Sampling in which the analyst believes the sample selected is typical of the entire population from which it comes. Compare *specific item sampling*.

reproduction cost. The *cost* necessary to acquire an *asset* similar in all physical respects to another asset for which the analyst requires a *current value*. See *replacement cost* and *productive capacity* for contrast.

required rate of return (RRR). *Cost of capital*.

requisition. A formal written order or request, such as for withdrawal of supplies from the storeroom.

resale value. *Exit value; net realizable value*.

research and development (R&D). A form of economic activity with special accounting rules. Firms engage in research in hopes of discovering new knowledge that will create a new product, process, or service or of improving a present product, process, or service. Development translates research findings or other knowledge into a new or improved product, process, or service. *SFAS No. 2* requires that firms expense costs of such activities as incurred on the grounds that the future benefits are too uncertain to warrant *capitalization* as an asset. This treatment seems questionable to us because we wonder why firms would continue to undertake R&D if there was no expectation of future benefit; if future benefits exist, then R&D costs should be assets that appear, like other assets, at *historical cost*.

reserve. The worst word in accounting because almost everyone not trained in accounting, and some who are, misunderstand it. The common confusion is that "reserves" represent a pool of *cash* or other *assets* available

when the firm needs them. Wrong. Cash always has a *debit balance*. Reserves always have a *credit balance*. When properly used in accounting, “reserves” refer to an account that appropriates *retained earnings* and restricts dividend declarations. Appropriating retained earnings is itself a poor and vanishing practice, so the word should seldom appear in accounting. In addition, “reserve” was used in the past to indicate an asset *contra account* (e.g., “reserve for depreciation”) or an *estimated liability* (e.g., “reserve for warranty costs”). In any case, reserve accounts have *credit* balances and are not pools of *funds*, as the unwary reader might infer. If a company has set aside a pool of *cash* (or *marketable securities*) to serve some specific purpose such as paying for a new factory, then it will call that cash a *fund*. No other word in accounting causes so much misunderstanding by nonexperts—as well as by “experts”—who should know better. A leading unabridged dictionary defines “reserve” as “cash, or assets readily convertible into cash, held aside, as by a corporation, bank, state or national government, etc. to meet expected or unexpected demands.” This definition is absolutely wrong in accounting. Reserves are not funds. For example, the firm creates a contingency fund of \$10,000 by depositing cash in a fund and makes the following entry:

Contingency Fund	10,000
Cash	10,000

The following entry may accompany the previous entry, if the firm wants to appropriate retained earnings:

Retained Earnings	10,000
Reserve for Contingencies	10,000

The transaction leading to the first entry has economic significance. The second entry has little economic impact for most firms. The problem with the word “reserve” arises because the firm can make the second entry without the first—a company can create a reserve, that is, appropriate retained earnings, without creating a fund. The problem results, at least in part, from the fact that in common usage, “reserve” means a pool of assets, as in the phrase “oil reserves.” The *Internal Revenue Service* does not help in dispelling confusion about the term “reserves.” The federal *income tax* return for corporations uses the title “Reserve for Bad Debts” to mean “Allowance for Uncollectible Accounts” and speaks of the “Reserve Method” in referring to the *allowance method* for estimating *revenue* or *income* reductions from estimated *uncollectibles*.

reserve recognition accounting (RRA). One form of *accounting* for natural resources. In exploration for natural resources, the problem arises of how to treat the expenditures for exploration, both before the firm knows the outcome of the efforts and after it knows the outcome. Suppose that the firm spends \$10 million to drill 10 holes (\$1 million each) and that nine of them are dry whereas one is a gusher containing oil with a *net realizable value* of \$40 million. Dry hole, or *successful efforts*, accounting would expense \$9 million and *capitalize* \$1 million, which the firm will *deplete* as it lifts the oil from the ground. *SFAS No. 19*, now suspended, required *successful efforts costing*. Full costing would expense nothing but would capitalize the \$10 million of drilling costs that the firm will *deplete* as it lifts the oil from the single productive well. Reserve recognition accounting would capitalize \$40 million, which the firm will *deplete* as it lifts the oil, with a \$30 million *credit* to *income* or *contributed capital*. The *balance sheet* shows the *net realizable value* of proven oil and gas

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reserves. The *income statement* has three sorts of items: (1) current income resulting from production or “lifting profit,” which is the *revenue* from sales of oil and gas less the expense based on the current valuation amount at which these items have appeared on the balance sheet, (2) profit or loss from exploration efforts in which the current value of new discoveries is revenue and all the exploration cost is expense, and (3) gain or loss on changes in current value during the year, which accountants in other contexts call a *holding gain or loss*.

reset bond. A bond, typically a *junk bond*, that specifies that periodically the issuer will reset the coupon rate so that the bond sells at *par* in the market. Investment bankers created this type of instrument to help ensure the purchasers of such bonds of getting a fair rate of return, given the riskiness of the issuer. If the issuer gets into financial trouble, its bonds will trade for less than *par* in the market. The issuer of a reset bond promises to raise the interest rate and preserve the value of the bond. Ironically, the reset feature has often had just the opposite effect. The default risk of many issuers of reset bonds has deteriorated so much that the bonds have dropped to less than 50 percent of *par*. To raise the value to *par*, the issuer would have to raise the interest rate to more than 25 percent per year. That rate is so large that issuers have declared bankruptcy rather than attempt to make the new large interest payments; this then reduces the market value of the bonds rather than increases them.

residual income. In an external reporting context, a term that refers to *net income* to *common shares* (= net income less *preferred stock dividends*). In *managerial accounting*, this term refers to the excess of income for a *division* or *segment* of a company over the product of the *cost of capital* for the company multiplied by the average

reset bond — restricted retained earnings

amount of capital invested in the division during the period over which the division earned the income.

residual security. A *potentially dilutive security*. *Options, warrants, convertible bonds, and convertible preferred stock*.

residual value. At any time, the estimated or actual *net realizable value* (that is, proceeds less removal costs) of an *asset*, usually a depreciable *plant asset*. In the context of depreciation accounting, this term is equivalent to *salvage value* and is preferred to *scrap value* because the firm need not scrap the asset. It is sometimes used to mean net *book value*. In the context of a *noncancelable lease*, it is the estimated value of the leased asset at the end of the lease period. See *lease*.

resources supplied. *Expenditures* made for an activity.

resources used. *Cost driver rate times cost driver volume*.

responsibility accounting. Accounting for a business by considering various units as separate entities, or *profit centers*, giving management of each unit responsibility for the unit's *revenues* and *expenses*. See *transfer price*.

responsibility center. An organization part or *segment* that top management holds accountable for a specified set of activities. Also called “accountability center.” See *cost center, investment center, profit center, and revenue center*.

restricted assets. Governmental resources restricted by legal or contractual requirements for specific purpose.

restricted retained earnings. That part of *retained earnings* not legally available for *dividends*. See *retained earnings, appropriated*. Bond indentures and other loan contracts can curtail the legal ability of the corporation to declare dividends without formally requiring

a retained earnings appropriation, but the firm must disclose such restrictions.

retail inventory method. Ascertaining cost amounts of *ending inventory* as follows (assuming *FIFO*): cost of ending inventory = (selling price of *goods available for sale* – sales) × *cost percentage*. The analyst then computes cost of goods sold from the inventory equation; costs of beginning inventory, purchases, and ending inventory are all known. (When the firm uses *LIFO*, the method resembles the *dollar-value LIFO method*.) See *markup*.

retail terminology. See *markup*.

retained earnings. Net *income* over the life of a corporation less all *dividends* (including capitalization through *stock dividends*); *owners' equity* less *contributed capital*.

retained earnings, appropriated. An *account* set up by crediting it and debiting *retained earnings*; used to indicate that a portion of retained earnings is not available for dividends. The practice of appropriating retained earnings is misleading unless the firm marks all capital with its use, which is not practicable, nor sensible, since capital is fungible—all the *equities* jointly fund all the *assets*. The use of formal retained earnings appropriations is declining.

retained earnings statement. A *reconciliation* of the beginning and the ending balances in the *retained earnings account*; required by *generally accepted accounting principles* whenever the firm presents *comparative balance sheets* and an *income statement*. This reconciliation can appear in a separate statement, in a combined statement of income and retained earnings, or in the balance sheet.

retirement method of depreciation. A method in which the firm records no entry for *depreciation expense* until it retires an *asset* from

service. Then, it makes an entry *debiting* depreciation expense and *crediting* the asset account for the cost of the asset retired. If the retired asset has a *salvage value*, the firm reduces the amount of the debit to depreciation expense by the amount of salvage value with a corresponding debit to cash, receivables, or salvaged materials. The “replacement system of depreciation” is similar, except that the debit to depreciation expense equals the cost of the new asset less the salvage value, if any, of the old asset. Some public utilities used these methods. For example, if the firm acquired 10 telephone poles in Year 1 for \$60 each and replaces them in Year 10 for \$100 each when the salvage value of the old poles is \$5 each, the accounting would be as follows:

Retirement Method	
Plant Assets	600
Cash	600
To acquire assets in Year 1.	
Depreciation Expense	550
Salvage Receivable.	50
Plant Assets	600
To record retirement and depreciation in Year 10.	
Plant Assets	1,000
Cash	1,000
To record acquisition of new assets in Year 10.	
Replacement Method	
Plant Assets	600
Cash	600
To acquire assets in Year 1.	
Depreciation Expense	950
Salvage Receivable.	50
Cash	1,000
To record depreciation on old asset in amount quantified by net cost of replacement asset in Year 10.	

The retirement method is like *FIFO* in that it records the cost of the first assets as depreciation and puts the cost of the second

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assets on the balance sheet. The replacement method is like *LIFO* in that it records the cost of the second assets as depreciation expense and leaves the cost of the first assets on the balance sheet.

retirement plan. *Pension plan.*

retroactive benefits. In initiating or amending a *defined-benefit pension plan*, benefits that the benefit formula attributes to employee services rendered in periods prior to the initiation or amendment. See *prior service costs*.

return. A schedule of information required by governmental bodies, such as the tax return required by the *Internal Revenue Service*; also the physical return of merchandise. See also *return on investment*.

return on assets (ROA). *Net income* plus after-tax *interest charges* plus *minority interest* in income divided by average total *assets*; perhaps the single most useful ratio for assessing management's overall operating performance. Most financial economists would subtract average noninterest-bearing *liabilities* from the denominator. Economists realize that when liabilities do not provide for explicit interest charges, the creditor adjusts the terms of contract, such as setting a higher selling price or lower discount, to those who do not pay cash immediately. (To take an extreme example, consider how much higher salary a worker who receives a salary once per year, rather than once per month, would demand.) This ratio requires in the numerator the income amount before the firm accrues any charges to suppliers of funds. We cannot measure the interest charges implicit in the noninterest-bearing liabilities because they cause items such as cost of goods sold and salary expense to be somewhat larger, since the interest is implicit. Subtracting their amounts from the denominator adjusts for their implicit cost. Such subtraction assumes that

retirement plan — reversal (reversing) entry

assets financed with noninterest-bearing liabilities have the same rate of return as all the other assets.

return on investment (ROI), return on capital.

Income (before distributions to suppliers of capital) for a period; as a rate, this amount divided by average total assets. The analyst should add back *interest*, net of tax effects, to *net income* for the numerator. See *ratio*.

revenue. The *owners' equity* increase accompanying the *net assets* increase caused by selling goods or rendering services; in short, a service rendered; *sales* of products, merchandise, and services and earnings from *interest*, *dividends*, *rents*, and the like. Measure revenue as the expected *net present value* of the net assets the firm will receive. Do not confuse with *receipt of funds*, which may occur before, when, or after revenue is recognized. Contrast with *gain* and *income*. See also *holding gain*. Some writers use the term *gross income* synonymously with *revenue*; avoid such usage.

revenue center. Within a firm, a *responsibility center* that has control only over revenues generated. Contrast with *cost center*. See *profit center*.

revenue expenditure. A term sometimes used to mean an *expense*, in contrast to a capital *expenditure* to acquire an *asset* or to discharge a *liability*. Avoid using this term; use *period expense* instead.

revenue received in advance. An inferior term for *advances from customers*.

reversal (reversing) entry. An *entry* in which all *debits* and *credits* are the credits and debits, respectively, of another entry, and in the same amounts. The accountant usually records a reversal entry on the first day of an *accounting period* to reverse a previous *adjusting entry*, usually an *accrual*. The purpose of such entries is to make the bookkeeper's

reverse stock split — reverse stock split

tasks easier. Suppose that the firm pays salaries every other Friday, with paychecks compensating employees for the two weeks just ended. Total salaries accrue at the rate of \$5,000 per five-day workweek. The bookkeeper is accustomed to making the following entry every other Friday:

(1) Salary Expense	10,000
Cash	10,000

To record salary expense and salary payments.

If the firm delivers paychecks to employees on Friday, November 25, then the *adjusting entry* made on November 30 (or perhaps later) to record accrued salaries for November 28, 29, and 30 would be as follows:

(2) Salary Expense	3,000
Salaries Payable	3,000

To charge November operations with all salaries earned in November.

The firm would close the Salary Expense account as part of the November 30 closing entries. On the next payday, December 9, the salary entry would be as follows:

(3) Salary Expense	7,000
Salaries Payable	3,000
Cash	10,000

To record salary payments split between expense for December (seven days) and liability carried over from November.

To make entry (3), the bookkeeper must look back into the records to see how much of the debit is to Salaries Payable accrued from the previous month in order to split the total debits between December expense and the liability carried over from November. Notice that this entry forces the bookkeeper

both (a) to refer to balances in old accounts and (b) to make an entry different from the one customarily made, entry (1). The reversing entry, made just after the books have been closed for the second quarter, makes the salary entry for December 9 the same as that made on all other Friday paydays. The reversing entry merely *reverses* the adjusting entry (2):

(4) Salaries Payable	3,000
Salary Expense	3,000

To reverse the adjusting entry.

This entry results in a zero balance in the Salaries Payable account and a credit balance in the Salary Expense account. If the firm makes entry (4) just after it closes the books for November, then the entry on December 9 will be the customary entry (1). Entries (4) and (1) together have exactly the same effect as entry (3).

The procedure for using reversal entries is as follows: the firm makes the required adjustment to record an accrual (*payable* or *receivable*) at the end of an *accounting period*; it makes the closing entry as usual; as of the first day of the following period, it makes an entry reversing the adjusting entry; when the firm makes (or receives) a payment, it records the entry as though it had not recorded an adjusting entry at the end of the preceding period. Whether a firm uses reversal entries affects the record-keeping procedures but not the financial statements.

This term is also used to describe the entry reversing an incorrect entry before recording the correct entry.

reverse stock split. A stock split in which the firm decreases the number of shares *outstanding*. See *stock split*.

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revolving fund. A fund whose amounts the firm continually spends and replenishes; for example, a *petty cash fund*.

revolving loan. A *loan* that both the borrower and the lender expect to renew at *maturity*.

right. The privilege to subscribe to new *stock* issues or to purchase stock. Usually, securities called *warrants* contain the rights, and the owner of the warrants may sell them. See also *preemptive right*.

risk. A measure of the variability of the *return on investment*. For a given expected amount of return, most people prefer less risk to more risk. Therefore, in rational markets, investments with more risk usually promise, or investors expect to receive, a higher rate of return than investments with lower risk. Most people use “risk” and “uncertainty” as synonyms. In technical language, however, these terms have different meanings. We use “risk” when we know the probabilities attached to the various outcomes, such as the probabilities of heads or tails in the flip of a fair coin. “Uncertainty” refers to an event for which we can only estimate the probabilities of the outcomes, such as winning or losing a lawsuit.

risk-adjusted discount rate. Rate used in discounting cash flows for projects more or less risky than the firm’s average. In a *capital budgeting* context, a decision analyst compares projects by comparing their net *present values* for a given *interest* rate, usually the cost of capital. If the analyst considers a given project’s outcome to be much more or much less risky than the normal undertakings of the company, then the analyst will use a larger interest rate (if the project is riskier) or a smaller interest rate (if less risky) in discounting, and the rate used is “risk-adjusted.”

risk-free rate. An interest rate reflecting only the pure interest rate plus an amount to compensate for inflation anticipated over

revolving fund — rule of 72

the life of a loan, excluding a premium for the risk of default by the borrower. Financial economists usually measure the risk-free rate in the United States from U.S. government securities, such as Treasury bills and notes.

risk premium. Extra compensation paid to employees or extra *interest* paid to lenders, over amounts usually considered normal, in return for their undertaking to engage in activities riskier than normal.

ROA. *Return on assets*.

ROI. *Return on investment*; usually used to refer to a single project and expressed as a ratio: *income* divided by average *cost of assets* devoted to the project.

royalty. Compensation for the use of property, usually a patent, copyrighted material, or natural resources. The amount is often expressed as a percentage of receipts from using the property or as an amount per unit produced.

RRA. *Reserve recognition accounting*.

RRR. Required rate of return. See *cost of capital*.

rule of 69. Rule stating that an amount of cash invested at r percent per period will double in $69/r + .35$ periods. This approximation is accurate to one-tenth of a period for interest rates between 1/4 and 100 percent per period. For example, at 10 percent per period, the rule says that a given sum will double in $69/10 + .35 = 7.25$ periods. At 10 percent per period, a given sum actually doubles in 7.27+ periods.

rule of 72. Rule stating that an amount of cash invested at r percent per period will double in $72/r$ periods. A reasonable approximation for interest rates between 4 and 10 percent but not nearly as accurate as the *rule of 69* for interest rates outside that range. For example, at 10 percent per period, the rule says

that a given sum will double in $72/10 = 7.2$ periods.

rule of 78. The rule followed by many finance companies for allocating earnings on *loans* among the months of a year on the sum-of-the-months'-digits basis when the borrower makes equal monthly payments to the lender. The sum of the digits from 1 through 12 is 78, so the rule allocates $12/78$ of the year's earnings to the first month, $11/78$ to the second month, and so on. This approximation allocates more of the early payments to interest and less to principal than does the correct, compound-interest method. Hence, lenders still use this method even though present-day computers can make the compound-interest computation as easily as they can carry out the approximation. See *sum-of-the-years'-digits depreciation*.

ruling (and balancing) an account. The process of summarizing a series of entries in an *account* by computing a new *balance* and drawing double lines to indicate that the new balance summarizes the information above the double lines. An illustration appears

below. The steps are as follows: (1) Compute the sum of all *debit* entries including opening debit balance, if any—\$1,464.16. (2) Compute the sum of all credit entries including opening credit balance, if any—\$413.57. (3) If the amount in (1) exceeds the amount in (2), then write the excess as a credit with a checkmark—\$1,464.16 – \$413.57 = \$1,050.59. (4) Add both debit and credit columns, which should both now sum to the same amount, and show that identical total at the foot of both columns. (5) Draw double lines under those numbers and write the excess of debits over credits as the new debit balance with a checkmark. (6) If the amount in (2) exceeds the amount in (1), then write the excess as a debit with a checkmark. (7) Do steps (4) and (5) except that the excess becomes the new credit balance. (8) If the amount in (1) equals the amount in (2), then the balance is zero, and only the totals with the double lines beneath them need appear.

Rutgers Accounting Web Site. See <http://www.rutgers.edu/Accounting/> for a useful compendium of accounting information.

AN OPEN ACCOUNT, RULED AND BALANCED

(STEPS INDICATED IN PARENTHESES CORRESPOND TO STEPS DESCRIBED IN "RULING AN ACCOUNT.")

	Date 2004	Explanation	Ref.	Debit (1)	Date 2004	Explanation	Ref.	Credit (2)	
	Jan. 2	Balance	√	100.00					
	Jan. 13		VR	121.37	Sept. 15		J	.42	
	Mar. 20		VR	56.42	Nov. 12		J	413.15	
	June 5		J	1,138.09	Dec. 31	Balance	√	1,050.59	(3)
	Aug. 18		J	1.21					
	Nov. 20		VR	38.43					
	Dec. 7		VR	<u>8.64</u>					
(4)	2005			<u>1,464.16</u>	2005			<u>1,464.16</u>	(4)
(5)	Jan. 1	Balance	√	<u>1,050.59</u>					

S

S corporation. A corporation taxed like a *partnership*. Corporation (or partnership) agreements allocate the periodic *income* to the individual shareholders (or partners) who report these amounts on their individual *income tax* returns. Contrast with *C corporation*.

SA (société anonyme). France: A *corporation*.

SAB. *Staff Accounting Bulletin* of the SEC.

safe-harbor lease. A form of *tax-transfer lease*.

safety stock. Extra items of *inventory* kept on hand to protect against running out.

salary. Compensation earned by managers, administrators, and professionals, not based on an hourly rate. Contrast with *wage*.

sale. A *revenue* transaction in which the firm delivers *goods* or *services* to a customer in return for cash or a contractual obligation to pay.

sale and leaseback. A *financing* transaction in which the firm sells improved property but takes it back for use on a long-term *lease*. Such transactions often have advantageous income-tax effects but usually have no effect on *financial statement income*.

sales activity variance. *Sales volume variance*.

sales allowance. A sales *invoice* price reduction that a seller grants to a buyer because the seller delivered *goods* different from, perhaps because of damage, those the buyer ordered. The seller often accumulates amounts of such adjustments in a temporary *revenue contra account* having this, or a similar, title. See *sales discount*.

sales basis of revenue recognition. Recognition of *revenue* not when a firm produces goods or when it receives orders but only when it has completed the sale by delivering the goods or services and has received cash or a claim to cash. Most firms recognize

revenue on this basis. Compare with the *percentage-of-completion method* and the *installment method*. This is identical with the *completed contract method*, but the latter term ordinarily applies only to *long-term* construction projects.

sales contra, estimated uncollectibles. A title for the contra-revenue account to recognize estimated reductions in income caused by *accounts receivable* that will not be collected. See *bad debt expense*, *allowance for uncollectibles*, and *allowance method*.

sales discount. A sales *invoice* price reduction usually offered for prompt payment. See *terms of sale* and *2/10, n/30*.

sales return. The physical return of merchandise. The seller often accumulates amounts of such returns in a temporary revenue contra account.

sales-type (capital) lease. A form of *lease*. See *capital lease*. When a manufacturer (or other firm) that ordinarily sells goods enters a capital lease as *lessor*, the lease is a “sales-type lease.” When a financial firm, such as a bank or insurance company or leasing company, acquires the asset from the manufacturer and then enters a capital lease as lessor, the lease is a “direct-financing-type lease.” The manufacturer recognizes its ordinary profit (sales price less *cost of goods sold*, where sales price is the *present value* of the contractual lease payments plus any down payment) on executing the sales-type capital lease, but the financial firm does not recognize profit on executing a capital lease of the direct-financing type.

sales value method. *Relative sales value method*. See *net realizable value method*.

sales volume variance. Budgeted *contribution margin* per unit times (planned sales volume minus actual sales volume).

salvage value — segment (of a business)

salvage value. Actual or estimated selling price, net of removal or disposal costs, of a used *plant asset* that the firm expects to sell or otherwise retire. See *residual value*.

SAR. *Summary annual report.*

Sarbanes-Oxley Act. The law, passed in 2002 in the wake of the Enron and related scandals, to stiffen the requirements for corporate governance, including accounting issues. It speaks, among other things, to the regulation of the accounting profession, the standards for audit committees of public companies, the certifications managements must sign, and standards of internal control that companies must meet.

SARL (société à responsabilité limitée). France: a *corporation* with limited liability and a life of no more than 99 years; must have at least two and no more than 50 *shareholders*.

SAS. *Statement on Auditing Standards* of the AICPA.

scale effect. See *discounted cash flow*.

scatter diagram. A graphic representation of the relation between two or more variables within a population.

schedule. A supporting set of calculations, with explanations, that show how to derive figures in a *financial statement* or tax return.

scientific method. *Effective interest method of amortizing bond discount or premium.*

scrap value. *Salvage value* assuming the owner intends to junk the item. A *net realizable value*. *Residual value*.

SEC (Securities and Exchange Commission). An agency authorized by the U.S. Congress to regulate, among other things, the financial reporting practices of most public corporations. The SEC has indicated that it will usually allow the *FASB* to set accounting principles, but it often requires more disclosure than the *FASB* requires. The SEC states

its accounting requirements in its *Accounting Series Releases (ASR)*—replaced in 1982 by the following two), *Financial Reporting Releases*, *Accounting and Auditing Enforcement Releases*, *Staff Accounting Bulletins* (these are, strictly speaking, interpretations by the accounting staff, not rules of the commissioners themselves), and *Regulation S-X and Regulation S-K*. See also *registration statement*, *10-K*, and *20-F*.

secret reserve. *Hidden reserve.*

Securities and Exchange Commission. *SEC.*

securitization. The process of bundling together a group of like *assets*, for example *accounts receivable*, into a single portfolio, then selling that portfolio or partial ownership shares in it. This has roughly the same economic effect as using the assets as *collateral* for a borrowing, but the securitization transaction removes the assets from the *balance sheet*.

security. Document that indicates ownership, such as a *share of stock*, or indebtedness, such as a *bond*, or potential ownership, such as an *option* or *warrant*.

security available for sale. According to *SFAS No. 115* (1993), a *debt* or *equity security* that is not a *trading security*, or a debt security that is not a *security held to maturity*.

security held to maturity. According to *SFAS No. 115* (1993), a *debt security* that the holder has both the ability and the intent to hold to *maturity*; valued in the *balance sheet* at amortized acquisition cost: the book value of the security at the end of each period is the book value at the beginning of the period multiplied by the historical *yield* on the security (measured as of the time of purchase) less any cash the holder receives at the end of this period from the security.

segment (of a business). As defined by *APB Opinion No. 30*, “a component of an *entity* whose activities represent a separate major

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line of business or class of customer. . . [It may be] a *subsidiary*, a division, or a department, . . . provided that its *assets*, results of *operations*, and activities can be clearly distinguished, physically and operationally for financial reporting purposes, from the other assets, results of operations, and activities of the entity.” In *SFAS No. 14*, a segment is defined as a “component of an enterprise engaged in promoting a product or service or a group of related products and services primarily to unaffiliated customers . . . for a profit.” *SFAS No. 131* defines operating segments using the “management approach” as components of the enterprise engaging in revenue- and expense-generating business activities “whose operating results are regularly reviewed by the enterprise’s chief operating decision maker to make decisions about resources . . . and asset performance.”

segment reporting. Reporting of *sales*, *income*, and *assets* by *segments of a business*, usually classified by nature of products sold but sometimes by geographical area where the firm produces or sells goods or by type of customers; sometimes called “line of business reporting.” The accounting for segment income does not allocate *central corporate expenses* to the segments.

self-balancing. A set of records with equal *debits* and *credits* such as the *ledger* (but not individual accounts), the *balance sheet*, and a *fund* in nonprofit accounting.

self-check(ing) digit. A digit forming part of an account or code number, normally the last digit of the number, which is mathematically derived from the other numbers of the code and is used to detect errors in transcribing the code number. For example, assume the last digit of the account number is the remainder after summing the preceding digits and dividing that sum by nine. Suppose the computer encounters the account numbers 7027261-7

segment reporting — serial bonds

and 9445229-7. The program can tell that something has gone wrong with the encoding of the second account number because the sum of the first seven digits is 35, whose remainder on division by 9 is 8, not 7. The first account number does not show such an error because the sum of the first seven digits is 25, whose remainder on division by 9 is, indeed, 7. The first account number may be in error, but the second surely is.

self-insurance. See *insurance*.

self-sustaining foreign operation. A foreign operation both financially and operationally independent of the reporting enterprise (owner) so that the owner’s exposure to exchange-rate changes results only from the owner’s net investment in the foreign entity.

selling and administrative expenses. *Expenses* not specifically identifiable with, or assigned to, production.

semifixed costs. *Costs* that increase with activity as a step function.

semivariable costs. *Costs* that increase strictly linearly with activity but that are positive at zero activity level. Royalty fees of 2 percent of sales are variable; royalty fees of \$1,000 per year plus 2 percent of sales are semivariable.

senior securities. *Bonds* as opposed to *preferred stock*; *preferred stock* as opposed to *common stock*. The firm must meet the senior security claim against *earnings* or *assets* before meeting the claims of less-senior securities.

sensitivity analysis. A study of how the outcome of a decision-making process changes as one or more of the assumptions change.

sequential access. Computer-storage access in which the analyst can locate information only by a sequential search of the storage file. Compare *direct access*.

serial bonds. An *issue* of *bonds* that mature in part at one date, another part on another date,

service basis of depreciation — shrinkage

and so on. The various maturity dates usually occur at equally spaced intervals. Contrast with *term bonds*.

service basis of depreciation. *Production method.*

service bureau. A commercial data-processing center providing service to various customers.

service cost, (current) service cost. *Pension plan expenses incurred during an accounting period for employment services performed during that period. Contrast with prior service cost. See funded.*

service department. A department, such as the personnel or computer department, that provides services to other departments rather than direct work on a salable product. Contrast with *production department*. A firm must allocate costs of service departments whose services benefit manufacturing operations to *product costs* under *full absorption costing*.

service department cost allocation. A procedure in which firms *allocate* the *costs* of operating service departments to other departments.

service life. Period of expected usefulness of an asset; may differ from *depreciable life* for income tax purposes.

service potential. The future benefits that cause an item to be classified as an *asset*. Without service potential, an item has no future benefits, and accounting will not classify the item as an asset. *SFAC No. 6* suggests that the primary characteristic of service potential is the ability to generate future net cash inflows.

services. Useful work done by a person, a machine, or an organization. See *goods*.

setup. The time or costs required to prepare production equipment for doing a job.

SFAC. *Statement of Financial Accounting Concepts* of the *FASB*.

SFAS. *Statement of Financial Accounting Standards*. See *FASB*.

shadow price. An opportunity cost. A *linear programming* analysis provides as one of its outputs the potential value of having available more of the scarce resources that constrain the production process, for example, the value of having more time available on a machine tool critical to the production of two products. Common terminology refers to this value as the “shadow price” or the “dual value” of the scarce resource.

share. A unit of *stock* representing ownership in a corporation.

share premium. United Kingdom: *additional paid-in capital or capital contributed in excess of par value*.

shareholders' equity. *Proprietorship or owners' equity* of a corporation. Because *stock* means inventory in Australia, the United Kingdom, and Canada, their writers use the term “shareholders' equity” rather than the term “stockholders' equity.”

short run. short term. Contrast with *long run*. Managers mean a period of time long enough to allow change the level of production or other activity within the constraints of current total productive capacity. In a *balance sheet* context, it means *current*, ordinarily due within one year. Use a hyphen when the phrase is an adjective, but no hyphen when it is a noun.

short-term liquidity risk. The risk that an *entity* will not have enough *cash* in the *short run* to pay its *debts*.

short-term operating budget. Management's quantitative action plan for the coming year.

shrinkage. An excess of *inventory* shown on the *books* over actual physical quantities on hand; can result from theft or shoplifting as well as from evaporation or general wear and tear. Some accountants, in an attempt to

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downplay their own errors, use the term to mean record-keeping mistakes that they later must correct, with some embarrassment, and that result in material changes in reported income. One should not use the term “shrinkage” for the correction of mistakes because adequate terminology exists for describing mistakes.

shutdown cost. Those fixed costs that the firm continues to incur after it has ceased production; the costs of closing down a particular production facility.

side letter. See *channel stuffing*.

sight draft. A demand for payment drawn by Person A to whom Person B owes cash. Person A presents the *draft* to Person B’s (the debtor’s) bank in expectation that Person B will authorize his or her bank to disburse the funds. Sellers often use such drafts when selling goods to a new customer in a different city. The seller is uncertain whether the buyer will pay the bill. The seller sends the *bill* of lading, or other evidence of ownership of the goods, along with a sight draft to the buyer’s bank. Before the warehouse holding the goods can release them to the buyer, the buyer must instruct its bank to honor the sight draft by withdrawing funds from the buyer’s account. Once the bank honors the sight draft, it hands to the buyer the bill of lading or other document evidencing ownership, and the goods become the property of the buyer.

simple interest. *Interest* calculated on *principal* where interest earned during periods before maturity of the loan does not increase the principal amount earning interest for the subsequent periods and the lender cannot withdraw the funds before maturity. Interest = principal \times interest rate \times time, where the rate is a rate per period (typically a year) and time is expressed in units of that period. For example, if the *rate* is annual and the time is two months, then in the formula, use 2/12 for

shutdown cost — slide

time. Simple interest is seldom used in economic calculations except for periods of less than one year and then only for computational convenience. Contrast with *compound interest*.

single-entry accounting. Accounting that is neither *self-balancing* nor *articulated*. That is, it does not rely on equal *debits* and *credits*. The firm makes no *journal entries* and must *plug* to derive *owners’ equity* for the *balance sheet*.

single proprietorship. *Sole proprietorship*.

single-step. Said of an *income statement* in which *ordinary revenue* and *gain* items appear first, with their total. Then come all *ordinary expenses* and *losses*, with their total. The difference between these two totals, plus the effect of *income from discontinued operations* and *extraordinary items*, appears as *net income*. Contrast with *multiple-step* and see *proprietorship theory*.

sinking fund. *Assets* and their earnings earmarked for the retirement of bonds or other long-term obligations. Earnings of sinking fund investments become taxable income of the company.

sinking fund method of depreciation. Method in which the periodic charge is an equal amount each period so that the *future value* of the charges, considered as an *annuity*, will accumulate at the end of the depreciable life to an amount equal to the *acquisition cost* of the asset. The firm does not necessarily, or even usually, accumulate a *fund* of cash. Firms rarely use this method.

skeleton account. *T-account*.

slide. The name of the error made by a bookkeeper in recording the digits of a number correctly with the decimal point misplaced; for example, recording \$123.40 as \$1,234.00 or as \$12.34. If the only errors in a *trial balance* result from one or more slides, then the difference between the sum of the *debits* and the

SMAC — specific identification method

sum of the *credits* will be divisible by nine. Not all such differences divisible by nine result from slides. See *transposition error*.

SMAC (Society of Management Accountants of Canada). The national association of accountants whose provincial associations engage in industrial and governmental accounting. The association undertakes research and administers an educational program and comprehensive examinations; those who pass qualify to be designated CMA (Certified Management Accountants), formerly called RIA (Registered Industrial Accountant).

SNC (société en nom collectif). France: a *partnership*.

soak-up method. The *equity method*.

Social Security taxes. Taxes levied by the federal government on both employers and employees to provide *funds* to pay retired persons (or their survivors) who are entitled to receive such payments, either because they paid Social Security taxes themselves or because Congress has declared them eligible. Unlike a *pension plan*, the Social Security system does not collect funds and invest them for many years. The tax collections in a given year pay primarily for benefits distributed that year. At any given time the system has a multitrillion-dollar unfunded obligation to current workers for their eventual retirement benefits. See *Old Age, Survivors, Disability, and Health Insurance*.

software. The programming aids—such as compilers—sort and report programs, and generators, that extend the capabilities of and simplify the use of the computer, as well as certain operating systems and other control programs. Compare *hardware*.

sole proprietorship. A firm in which all *owners' equity* belongs to one person.

solvent. Able to meet debts when due.

SOP. Statement of Position (of the *AcSEC* of the *AICPA*).

sound value. A phrase used mainly in appraisals of *fixed assets* to mean *fair market price (value)* or *replacement cost* in present condition.

source of funds. Any *transaction* that increases *cash* and *marketable securities* held as *current assets*.

sources and uses statement. *Statement of cash flows*.

SOYD. Sum-of-the-years'-digits depreciation.

SP (société en participation). France: a silent *partnership* in which the managing partner acts for the partnership as an individual in transacting with others who need not know that the person represents a partnership.

special assessment. A compulsory levy made by a governmental unit on property to pay the costs of a specific improvement or service presumed not to benefit the general public but only the owners of the property so assessed; accounted for in a special assessment fund.

special journal. A *journal*, such as a sales journal or cash disbursements journal, to record *transactions* of a similar nature that occur frequently.

special purpose entity. The name for a business now known as a *variable interest entity*. *GAAP* never defined this name, but brought it into existence with an *EITF* consensus in 1990. The Enron financial manipulations depended in part on use of these entities to achieve *off-balance-sheet financing*.

special revenue debt. A governmental unit's debt backed only by revenues from specific sources, such as tolls from a bridge.

specific identification method. Method for valuing *ending inventory* and *cost of goods sold* by identifying actual units sold and remaining in inventory and summing the actual

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costs of those individual units; usually used for items with large unit values, such as precious jewelry, automobiles, and fur coats.

specific item sampling. Sampling in which the analyst selects particular items because of their nature, value, or method of recording. Compare *representative item sampling*.

specific price changes. Changes in the market prices of specific *goods* and *services*. Contrast with *general price-level changes*.

specific price index. A measure of the price of a specific good or service, or a small group of similar goods or services, at one time relative to the price during a base period. Contrast with *general price index*. See *dollar-value LIFO method*.

spending variance. In *standard cost systems*, the *rate* or *price variance* for *overhead costs*.

split. *Stock split*. Sometimes called “split-up.”

split-off point. In accumulating and allocating costs for *joint products*, the point at which all costs are no longer *joint costs* but at which an analyst can identify costs associated with individual products or perhaps with a smaller number of *joint products*.

spoilage. See *abnormal spoilage* and *normal spoilage*.

spot price. The price of a commodity for delivery on the day of the price quotation. See *forward price* for contrast.

spreadsheet. For many years, a term that referred specifically to a *work sheet* organized like a *matrix* that provides a two-way classification of accounting data. The rows and columns both have labels, which are *account* titles. An entry in a row represents a *debit*, whereas an entry in a column represents a *credit*. Thus, the number “100” in the “cash” row and the “accounts receivable” column records an entry debiting cash and crediting accounts receivable for \$100. A given row total indicates all debit entries to the account

specific item sampling — standard cost

represented by that row, and a given column total indicates the sum of all credit entries to the account represented by the column. Since personal-computer software has become widespread, this term has come to refer to any file created by programs such as Lotus 1-2-3® and Microsoft Excel®. Such files have rows and columns, but they need not represent debits and credits. Moreover, they can have more than two dimensions.

squeeze. A term sometimes used for *plug*.

SSARS. *Statement on Standards for Accounting and Review Services*.

stabilized accounting. *Constant-dollar accounting*.

stable monetary unit assumption. In spite of *inflation*, which appears to be a way of life, the assumption that underlies historical cost/nominal-dollar accounting—namely that one can meaningfully add together current dollars and dollars of previous years. The assumption gives no specific recognition to changing values of the dollar in the usual *financial statements*. See *constant-dollar accounting*.

Staff Accounting Bulletin. An interpretation issued by the staff of the Chief Accountant of the SEC “suggesting” how the accountants should apply various *Accounting Series Releases* in practice. The suggestions are part of *GAAP*.

stakeholder. An individual or group, such as employees, suppliers, customers, and shareholders, who have an interest in the corporation’s activities and outcomes.

standard cost. Anticipated *cost* of producing a unit of output; a predetermined cost to be assigned to products produced. Standard cost implies a norm—what costs should be. Budgeted cost implies a forecast—something likely, but not necessarily, a “should,” as implied by a norm. Firms use standard costs as the benchmark for gauging good and bad performance. Although a firm may similarly

use a budget, it need not. A budget may be a planning document, subject to changes whenever plans change, whereas standard costs usually change annually or when technology significantly changes or when costs of labor and materials significantly change.

standard costing. Costing based on *standard costs*.

standard costing system. *Product costing* using *standard costs* rather than actual costs. The firm may use either *full absorption* or *variable costing* principles.

standard error (of regression coefficients). A measure of the uncertainty about the magnitude of the estimated parameters of an equation fit with a *regression analysis*.

standard manufacturing overhead. *Overhead costs* expected to be incurred per unit of time and per unit produced.

standard price (rate). Unit price established for materials or labor used in *standard cost systems*.

standard quantity allowed. The direct material or direct labor (inputs) quantity that production should have used if it had produced the units of output in accordance with preset *standards*.

standby costs. A type of *capacity cost*, such as property taxes, incurred even if a firm shuts down operations completely. Contrast with *enabling costs*.

stated capital. Amount of capital contributed by shareholders; sometimes used to mean *legal capital*.

stated value. A term sometimes used for the *face amount of capital stock*, when the *board* has not designated a *par value*. Where there is stated value per share, capital *contributed in excess of stated value* may come into being.

statement of affairs. A *balance sheet* showing immediate *liquidation* amounts rather than

historical costs, usually prepared when *insolvency* or *bankruptcy* is imminent. Such a statement specifically does not use the *going-concern assumption*.

statement of cash flows. A schedule of *cash receipts* and *payments*, classified by *investing*, *financing*, and *operating activities*; required by the *FASB* for all for-profit companies. Companies may report operating activities with either the direct method (which shows only receipts and payments of cash) or the indirect method (which starts with *net income* and shows adjustments for *revenues* not currently producing cash and for *expenses* not currently using cash). “Cash” includes cash equivalents such as Treasury bills, commercial paper, and *marketable securities* held as *current assets*. This is sometimes called the “funds statement.” Before 1987, the *FASB* required the presentation of a similar statement called the *statement of changes in financial position*, which tended to emphasize *working capital*, not cash.

statement of changes in financial position. As defined by *APB Opinion No. 19*, a statement that explains the changes in *working capital* (or cash) balances during a period and shows the changes in the working capital (or cash) accounts themselves. The *statement of cash flows* has replaced this statement.

statement of charge and discharge. A financial statement, showing *net assets* or *income*, drawn up by an executor or administrator, to account for receipts and dispositions of cash or other assets in an estate or trust.

Statement of Financial Accounting Concepts (SFAC). One of a series of *FASB* publications in its *conceptual framework for financial accounting* and reporting. Such statements set forth objectives and fundamentals to be the basis for specific financial accounting and reporting standards.

Statement of Financial Accounting Standards (SFAS). See *FASB*.

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statement of financial position. *Balance sheet.*

Statement of Position (SOP). A recommendation, on an emerging accounting problem, issued by the AcSEC of the AICPA. The AICPA's Code of Professional Ethics specifically states that CPAs need not treat SOPs as they do rules from the FASB, but a CPA would be wary of departing from the recommendations of an SOP.

statement of retained earnings (income). A statement that reconciles the beginning-of-period and the end-of-period balances in the *retained earnings* account. It shows the effects of *earnings*, *dividend declarations*, and *prior-period adjustments*.

statement of significant accounting policies (principles). A summary of the significant *accounting principles* used in compiling an *annual report*; required by *APB Opinion No. 22*. This summary may be a separate exhibit or the first *note* to the financial statements.

Statement on Auditing Standards (SAS). A series addressing specific auditing standards and procedures. *No. 1* (1973) of this series codifies all statements on auditing standards previously promulgated by the AICPA.

Statement on Standards for Accounting and Review Services (SSARS). Pronouncements issued by the AICPA on unaudited *financial statements* and unaudited financial information of nonpublic entities.

static budget. *Fixed budget.* Budget developed for a set level of the driving variable, such as production or sales, which the analyst does not change if the actual level deviates from the level set at the outset of the analysis.

status quo. Events or cost incurrences that will happen or that a firm expects to happen in the absence of taking some contemplated action.

statutory tax rate. The tax rate specified in the *income tax law* for each type of income (e.g., *ordinary income*, *capital gain or loss*).

statement of financial position — stewardship

step allocation method. *Step-down method.*

step cost. *Semifixed cost.*

step-down method. In *allocating service department costs*, a method that starts by allocating one service department's costs to *production departments* and to all other service departments. Then the firm allocates a second service department's costs, including costs allocated from the first, to production departments and to all other service departments except the first one. In this fashion, a firm may allocate all service departments' costs, including previous allocations, to production departments and to those service departments whose costs it has not yet allocated.

step method. *Step-down method.*

step(ped) cost. *Semifixed cost.*

sterilized allocation. Desirable characteristics of cost allocation methods. Optimal decisions result from considering *incremental costs* only. Optimal decisions never require *allocations of joint or common costs*. A "sterilized allocation" causes the optimal decision choice not to differ from the one that occurs when the accountant does not allocate joint or common costs "sterilized" with respect to that decision. Arthur L. Thomas first used the term in this context. Because *absorption costing* requires that product costs absorb all manufacturing costs and because some allocations can lead to bad decisions, Thomas (and we) advocate that the analyst choose a sterilized allocation scheme that will not alter the otherwise optimal decision. No single allocation scheme is always sterilized with respect to all decisions. Thus, Thomas (and we) advocate that decisions be made on the basis of incremental costs before any allocations.

stewardship. Principle by which management is accountable for an *entity's* resources, for their efficient use, and for protecting them from adverse impact. Some theorists believe that a primary goal of accounting is to

stock — stratified sampling

aid users of *financial statements* in their assessment of management's performance in stewardship.

stock. A measure of the amount of something on hand at a specific time. In this sense, contrast with *flow*. See *inventory* and *capital stock*.

stock appreciation rights. An employer's promise to pay to the employee an amount of *cash* on a certain future date, with the amount of cash being the difference between the *market value* of a specified number of *shares* of *stock* in the employer's company on the given future date and some base price set on the date the rights are granted. Firms sometimes use this form of compensation because changes in tax laws in recent years have made *stock options* relatively less attractive. *GAAP* compute compensation based on the difference between the market value of the shares and the base price set at the time of the grant.

stock dividend. A so-called *dividend* in which the firm distributes additional *shares* of *capital stock* without cash payments to existing shareholders. It results in a *debit* to *retained earnings* in the amount of the market value of the shares issued and a *credit* to *capital stock* accounts. Firms ordinarily use stock dividends to indicate that they have permanently reinvested earnings in the business. Contrast with a *stock split*, which requires no entry in the capital stock accounts other than a notation that the *par* or *stated value* per share has changed.

stock option. The right to purchase or sell a specified number of shares of *stock* for a specified price at specified times. Employee stock options are purchase rights granted by a corporation to employees, a form of compensation. Traded stock options are *derivative securities*, rights created and traded by investors, independent of the corporation whose stock is optioned. Contrast with *warrant*.

stock right. See *right*.

stock split(-up). Increase in the number of common shares outstanding resulting from the issuance of additional shares to existing shareholders without additional capital contributions by them. Does not increase the total *value* (or *stated value*) of *common shares* outstanding because the *board* reduces the par (or stated) value per share in inverse proportion. A three-for-one stock split reduces par (or stated) value per share to one-third of its former amount. A stock split usually implies a distribution that increases the number of shares outstanding by 20 percent or more. Compare with *stock dividend*.

stock subscriptions. See *subscription* and *subscribed stock*.

stock warrant. See *warrant*.

stockholders' equity. See *shareholders' equity*.

stockout. Occurs when a firm needs a unit of *inventory* to use in production or to sell to a customer but has none available.

stockout costs. *Contribution margin* or other measure of *profits* not earned because a seller has run out of *inventory* and cannot fill a customer's order. A firm may incur an extra cost because of delay in filling an order.

stores. *Raw materials*, parts, and supplies.

straight-debt value. An estimate of the *market value* of a *convertible bond* if the bond did not contain a conversion privilege.

straight-line depreciation. Method in which, if the *depreciable life* is n periods, the periodic *depreciation* charge is $1/n$ of the *depreciable cost*; results in equal periodic charges. Accountants sometimes call it "straight-time depreciation."

strategic plan. A statement of the method for achieving an organization's goals.

stratified sampling. In choosing a *sample*, a method in which the investigator first divides the entire *population* into relatively

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street security — sunk cost

homogeneous subgroups (strata) and then selects random samples from these subgroups.

street security. A stock certificate in immediately transferable form, most commonly because the issuing firm has registered it in the name of the broker, who has endorsed it with “payee” left blank.

Subchapter S corporation. A firm legally organized as a *corporation* but taxed as if it were a *partnership*. Tax terminology calls the corporations paying their own income taxes *C corporations*.

subject to. In an *auditor’s report*, qualifications usually caused by a *material* uncertainty in the valuation of an item, such as future promised payments from a foreign government or outcome of pending litigation.

subordinated. *Debt* whose claim on income or assets has lower priority than claims of other debt.

subscribed stock. A *shareholders’ equity* account showing the capital that the firm will receive as soon as the share-purchaser pays the subscription price. A subscription is a legal contract, so once the share-purchaser signs it, the firm makes an entry *debiting* an *owners’ equity contra account* and *crediting* subscribed stock.

subscription. Agreement to buy a *security* or to purchase periodicals, such as magazines.

subsequent events. *Poststatement events*.

subsidiary. A company in which another company owns more than 50 percent of the voting shares.

subsidiary ledger. The *ledger* that contains the detailed accounts whose total appears in a *controlling account* of the *general ledger*.

subsidiary (ledger) accounts. The *accounts* in a *subsidiary ledger*.

successful efforts costing. In petroleum accounting, the *capitalization* of the drilling costs of only those wells that contain gas or

oil. See *reserve recognition accounting* for an example.

summary annual report (SAR). Condensed financial statements distributed in lieu of the usual *annual report*. Since 1987, the *SEC* has allowed firms to include such statements in the annual report to shareholders as long as the firm includes full, detailed statements in SEC filings and in *proxy* materials sent to shareholders.

summary of significant accounting principles *Statement of significant accounting policies (principles)*.

sum-of-the-years’-digits depreciation (SYD, SOYD). An *accelerated depreciation* method for an asset with *depreciable life* of n years where the charge in period i ($i = 1, \dots, n$) is the fraction, $(n + 1 - i)/[n(n + 1)/2]$ of the *depreciable cost*. If an asset has a depreciable cost of \$15,000 and a five-year depreciable life, for example, the depreciation charges would be \$5,000 ($= 5/15 \times \$15,000$) in the first year, \$4,000 in the second, \$3,000 in the third, \$2,000 in the fourth, and \$1,000 in the fifth. The name derives from the fact that the denominator in the fraction is the sum of the digits 1 through n .

sunk cost. Past *costs* that current and future decisions cannot affect and, hence, that are irrelevant for decision making aside from *income tax* effects. Contrast with *incremental costs* and *imputed costs*. For example, the *acquisition cost* of machinery is irrelevant to a decision of whether to scrap the machinery. The current *exit value* of the machinery is the *opportunity cost* of continuing to own it, and the cost of, say, the electricity to run the machinery is an incremental cost of its operation. Sunk costs become relevant for decision making when the analysis requires taking *income taxes* (*gain* or *loss* on disposal of asset) into account, since the cash payment for income taxes depends on the tax basis of the asset.

supplementary statements (schedules) — tangible

Avoid this term in careful writing because it is ambiguous. Consider, for example, a machine costing \$100,000 with current *salvage* value of \$20,000. Some (including us) would say that \$100,000 (the *gross* amount) is “sunk”; others would say that only \$80,000 (the *net* amount) is “sunk.”

supplementary statements (schedules). Statements (schedules) in addition to the four basic *financial statements* (*balance sheet*, *income statement*, *statement of cash flows*, and the *statement of retained earnings*).

surplus. A word once used but now considered poor terminology; prefaced by “earned” to mean *retained earnings* and prefaced by “capital” to mean *capital contributed in excess of par* (or *stated*) value.

surplus reserves. *Appropriated retained earnings*. A phrase with nothing to recommend it: of all the words in accounting, *reserve* is the most objectionable, and *surplus* is the second-most objectionable.

suspense account. A *temporary account* used to record part of a transaction before final analysis of that transaction. For example, if a business regularly classifies all sales into a dozen or more different categories but wants

to deposit the proceeds of cash sales every day, it may credit a sales suspense account pending detailed classification of all sales into Durable Goods Sales, Women’s Clothing Sales, Men’s Clothing Sales, Housewares Sales, and so on.

sustainable income. The part of *distributable income* (computed from *current cost* data) that the firm can expect to earn in the next accounting period if it continues operations at the same levels as were maintained during the current period. *Income from discontinued operations*, for example, may be distributable but not sustainable.

swap. A currency swap is a financial instrument in which the holder promises to pay to (or receive from) the *counterparty* the difference between *debt* denominated in one currency (such as U.S. dollars) and the payments on *debt* denominated in another currency (such as euros). An interest-rate swap typically obligates the party and counterparty to exchange the difference between fixed- and floating-rate interest payments on otherwise similar loans.

S-X. See *Regulation S-X*.

SYD. *Sum-of-the-years'-digits depreciation*.

T

T-account. Account form shaped like the letter T with the title above the horizontal line. *Debits* appear on the left of the vertical line, *credits* on the right.

take-home pay. The amount of a paycheck; earned wages or *salary* reduced by deductions for *income taxes*, *Social Security taxes*, contributions to fringe-benefit plans, union dues, and so on. Take-home pay might be as little as half of earned compensation.

take-or-pay contract. As defined by *SFAS No. 47*, a purchaser-seller agreement that provides

for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services.

taking a bath. To incur a large loss. See *big bath*.

tangible. Having physical form. Accounting has never satisfactorily defined the distinction between tangible and intangible assets. Typically, accountants define intangibles by giving an exhaustive list, and everything not

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on the list is defined as tangible. See *intangible asset* for such a list.

target cost. *Standard cost.* Sometimes, target price less expected profit margin.

target price. Selling price based on customers' value in use of a good or service, constrained by competitors' prices of similar items.

tax. A nonpenal, but compulsory, charge levied by a government on income, consumption, wealth, or other basis, for the benefit of all those governed. The term does not include fines or specific charges for benefits accruing only to those paying the charges, such as licenses, permits, special assessments, admission fees, and tolls.

tax allocation: interperiod. See *deferred income tax liability*.

tax allocation: intrastatement. The showing of income tax effects on *extraordinary items*, *income from discontinued operations*, and *prior-period adjustments*, along with these items, separately from income taxes on other income. See *net-of-tax reporting*.

tax avoidance. See *tax shelter* and *loophole*.

tax basis of assets and liabilities. A concept important for applying SFAS No. 109 on *deferred income taxes*. Two *assets* will generally have different *book values* if the firm paid different amounts for them, *amortizes* them on a different schedule, or both. Similarly, a single asset will generally have a book value different from what it will have for tax purposes if the firm recorded different *acquisition* amounts for the asset for book and for tax purposes, amortizes it differently for book and for tax purposes, or both. The difference between financial book value and income tax basis becomes important in computing deferred income tax amounts. The adjusted cost in the financial records is the "book basis," and the adjusted amount in the tax records is the "tax basis." Differences

target cost — taxable income

between book and tax basis can arise for *liabilities* as well as for assets.

tax credit. A subtraction from taxes otherwise payable. Contrast with *tax deduction*.

tax deduction. A subtraction from *revenues* and *gains* to arrive at taxable income. Tax deductions differ technically from tax *exemptions*, but both reduce gross income in computing taxable income. Both differ from *tax credits*, which reduce the computed tax itself in computing taxes payable. If the tax rate is the fraction t of pretax income, then a *tax credit* of \$1 is worth $\$1/t$ of *tax deductions*.

tax evasion. The fraudulent understatement of taxable revenues or overstatement of deductions and expenses or both. Contrast with *tax shelter* and *loophole*.

tax-exempt. See *municipal bonds*.

tax shelter. The legal avoidance of, or reduction in, *income taxes* resulting from a careful reading of the complex income-tax regulations and the subsequent rearrangement of financial affairs to take advantage of the regulations. Often writers use the term pejoratively, but the courts have long held that a taxpayer has no obligation to pay taxes any larger than the legal minimum. If the public concludes that a given tax shelter is "unfair," then Congress can, and has, changed the laws and regulations. The term is sometimes used to refer to the investment that permits tax avoidance. See *loophole*.

tax shield. The amount of an *expense*, such as *depreciation*, that reduces taxable income but does not require *working capital*. Sometimes this term includes expenses that reduce taxable income and use working capital. A depreciation deduction (or *R&D expense* in the expanded sense) of \$10,000 provides a tax shield of \$3,700 when the marginal tax rate is 37 percent.

taxable income. *Income* computed according to *IRS* regulations and subject to *income*

tax-transfer lease — temporary investments

taxes. Contrast with income, net income, income before taxes (in the *income statement*), and *comprehensive income* (a *financial reporting* concept). Use the term “pretax income” to refer to income before taxes on the income statement in financial reports.

tax-transfer lease. One form of *capital lease*.

Congress has in the past provided business with an incentive to invest in qualifying *plant and equipment* by granting an *investment credit*, which, though it occurs as a reduction in *income taxes* otherwise payable, effectively reduces the purchase price of the assets. Similarly, Congress continues to grant an incentive to acquire such assets by allowing the *Modified Accelerated Cost Recovery System (MACRS)*, form of unusually *accelerated depreciation*. Accelerated depreciation for tax purposes allows a reduction of taxes paid in the early years of an asset’s life, providing the firm with an increased *net present value* of *cash flows*. The *IRS* administers both of these incentives through the income tax laws, rather than paying an outright cash payment. A business with no taxable income in many cases had difficulty reaping the benefits of the investment credit or of accelerated depreciation because Congress had not provided for tax refunds to those who acquire qualifying assets but who have no taxable income. In principle, a company without taxable income could lease from another firm with taxable income an asset that it would otherwise purchase. The second firm acquires the asset, gets the tax-reduction benefits from the acquisition, and becomes a lessor, leasing the asset (presumably at a lower price reflecting its own costs lowered by the tax reductions) to the unprofitable company. Before 1981, tax laws discouraged such leases. That is, although firms could enter into such leases, they could not legally transfer the tax benefits. Under certain restrictive conditions, the tax law now allows a profitable firm to earn

tax credits and take deductions while leasing to the firm without tax liability in such leases. These are sometimes called “safe-harbor leases.”

Technical Bulletin. The *FASB* has authorized its staff to issue bulletins to provide guidance on financial accounting and reporting problems. Although the *FASB* does not formally approve the contents of the bulletins, their contents are part of *GAAP*.

technology. The sum of a firm’s technical *trade secrets* and *know-how*, as distinct from its *patents*.

temporary account. *Account* that does not appear on the *balance sheet*; *revenue* and *expense* accounts, their *adjuncts* and *contras*, *production cost accounts*, *dividend distribution accounts*, and purchases-related accounts (which close to the various inventories); sometimes called a “nominal account.”

temporary difference. According to the *SFAS No. 109* (1992) definition: “A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years.” Temporary differences include *timing differences* and differences between *taxable income* and pretax income caused by different cost bases for assets. For example, a plant asset might have a cost of \$10,000 for financial reporting but a basis of \$7,000 for income tax purposes. This temporary difference might arise because the firm has used an accelerated depreciation method for tax but straight-line for book, or the firm may have purchased the asset in a transaction in which the fair value of the asset exceeded its tax basis. Both situations create a temporary difference.

temporary investments. Investments in *marketable securities* that the owner intends to sell within a short time, usually one year, and hence classifies as *current assets*.

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10-K. The name of the annual report that the SEC requires of nearly all publicly held corporations.

term bonds. A *bond issue* whose component bonds all mature at the same time. Contrast with *serial bonds*.

terminal cash flows. *Cash flows* that occur at the end of an *investment* project. Often include proceeds of *salvage* of equipment and tax on *gain (loss)* on disposal.

term loan. A loan with a *maturity* date, as opposed to a demand loan, which is due whenever the lender requests payment. In practice, bankers and auditors use this phrase only for loans for a year or more.

term structure. A phrase with different meanings in *accounting* and *financial economics*. In accounting, it refers to the pattern of times that must elapse before *assets* turn into, or produce, *cash* and the pattern of times that must elapse before *liabilities* require cash. In financial economics, the phrase refers to the pattern of interest rates as a function of the time that elapses for loans to come due. For example, if six-month loans cost 6 percent per year and 10-year loans cost 9 percent per year, this is called a “normal” term structure because the longer-term loan carries a higher rate. If the six-month loan costs 9 percent per year and the 10-year loan costs 6 percent per year, the term structure is said to be “inverted.” See *yield curve*.

terms of sale. The conditions governing payment for a sale. For example, the terms *2/10, n(et)/30* mean that if the purchaser makes payment within 10 days of the invoice date, it can take a *discount* of 2 percent from *invoice* price; the purchaser must pay the invoice amount, in any event, within 30 days, or it becomes overdue.

theory of constraints (TOC). Concept of improving operations by identifying and reducing bottlenecks in process flows.

10-K — Toronto Stock Exchange (TSX)

thin capitalization. A state of having a high *debt-equity ratio*. Under income tax legislation, the term has a special meaning.

throughput contract. As defined by *SFAS No. 47*, an agreement that is signed by a shipper (processor) and by the owner of a transportation facility (such as an oil or natural gas pipeline or a ship) or a manufacturing facility and that provides for the shipper (processor) to pay specified amounts periodically in return for the transportation (processing) of a product. The shipper (processor) must make cash payments even if it does not ship (process) the contracted quantities.

throughput contribution. Sales dollars minus the sum of all short-run variable costs.

tickler file. A collection of *vouchers* or other memoranda arranged chronologically to remind the person in charge of certain duties to make payments (or to do other tasks) as scheduled.

time-adjusted rate of return. *Internal rate of return*.

time cost. *Period cost*.

time deposit. Cash in bank earning interest. Contrast with *demand deposit*.

time-series analysis. See *cross-section analysis* for definition and contrast.

times-interest (charges) earned. Ratio of pre-tax *income* plus *interest* charges to interest charges. See *ratio*.

timing difference. The major type of *temporary difference* between taxable income and pretax income reported to shareholders; reverses in a subsequent period and requires an entry in the *deferred income tax* account; for example, the use of *accelerated depreciation* for tax returns and *straight-line depreciation* for financial reporting. Contrast with *permanent difference*.

Toronto Stock Exchange (TSX). A public market where various corporate securities trade.

total assets turnover — trade-in transaction

total assets turnover. *Sales* divided by average *total assets*.

total quality management (TQM). Concept of organizing a company to excel in all its activities in order to increase the quality of products and services.

traceable cost. A *cost* that a firm can identify with or assign to a specific product. Contrast with a *joint cost*.

trade acceptance. A *draft* that a seller presents for signature (acceptance) to the buyer at the time it sells goods. The draft then becomes the equivalent of a *note receivable* of the seller and a *note payable* of the buyer.

trade credit. Occurs when one business allows another to buy from it in return for a promise to pay later. Contrast with “consumer credit,” which occurs when a business extends a retail customer the privilege of paying later.

trade discount. A *list price discount* offered to all customers of a given type. Contrast with a *discount* offered for prompt payment and with *quantity discount*.

trade-in. Acquiring a new *asset* in exchange for a used one and perhaps additional cash. See *boot* and *trade-in transaction*.

trade-in transaction. The accounting for a trade-in; depends on whether the firm receives an asset “similar” to (and used in the same line of business as) the asset traded in and whether the accounting is for *financial statements* or for *income tax* returns. Assume that an old asset cost \$5,000, has \$3,000 of *accumulated depreciation* (after recording depreciation to the date of the trade-in), and hence has a *book value* of \$2,000. The old asset appears to have a market value of \$1,500, according to price quotations in used asset markets. The firm trades in the old asset on a new asset with a list price of \$10,000. The firm gives up the old asset and

\$5,500 cash (*boot*) for the new asset. The generic entry for the trade-in transaction is as follows:

New Asset	A		
Accumulated Depreciation (Old Asset)	3,000		
Adjustment on Exchange of Asset		B	or B
Old Asset			5,000
Cash			5,500

1. The *list price* method of accounting for trade-ins rests on the assumption that the list price of the new asset closely approximates its market value. The firm records the new asset at its list price (A = \$10,000 in the example); B is a *plug* (= \$2,500 credit in the example). If B requires a *debit plug*, the Adjustment on Exchange of Asset is a *loss*; if B requires a *credit plug* (as in the example), the adjustment is a *gain*.
2. Another theoretically sound method of accounting for trade-ins rests on the assumption that the price quotation from used-asset markets gives a market value of the old asset that is a more reliable measure than the market value of the new asset determined by list price. This method uses the *fair market price (value)* of the old asset, \$1,500 in the example, to determine B (= \$2,000 book value – \$1,500 assumed proceeds on disposition = \$500 debit or loss). The exchange results in a loss if the book value of the old asset exceeds its market value and in a gain if the market value exceeds the book value. The firm records the new asset on the books by plugging for A (= \$7,000 in the example).
3. For income tax reporting, the taxpayer must recognize neither gain nor loss on the trade-in. Thus the taxpayer records the new asset for tax purposes by assuming B is zero and plugging for A (= \$7,500 in the example). In practice, firms that want to recognize the loss currently will sell the old asset directly, rather than trading it in, and acquire the new asset entirely for cash.

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4. *Generally accepted accounting principles (APB Opinion No. 29)* require a variant of these methods. The basic method is (1) or (2), depending on whether the list price of the new asset (1) or the quotation of the old asset's market value (2) provides the more reliable indication of market value. If the basic method requires a debit entry, or loss, for the Adjustment on Exchange of Asset, then the firm records the trade-in as in (1) or (2) and recognizes the full amount of the loss currently. If, however, the basic method requires a credit entry, or gain, for the Adjustment on Exchange of Asset, then the firm recognizes the gain currently if the old asset and the new asset are not "similar." If the assets are similar

trade payables (receivables) — trademark right

and the party trading in receives no cash, then it recognizes no gain and the treatment resembles that in (3); that is B = 0, plug for A. If the assets are similar and the firm trading in receives cash—a rare case—then it recognizes a portion of the gain currently. The portion of the gain recognized currently is the fraction cash received/fair market value of total consideration received. (When the firm uses the list price method, (1), it assumes that the market value of the old asset is the list price of the new asset plus the amount of cash received by the party trading in.)

A summary of the results of applying GAAP to the example follows.

More Reliable Information as to Fair Market Value	Old Asset Compared with New Asset	
	Similar	Not Similar
New Asset List	A = \$7,500	A = \$10,000
Price	B = 0	B = 2,500 gain
Old Asset Market	A = \$7,000	A = \$ 7,000
Price	B = 500 loss	B = 500 loss

trade payables (receivables). *Payables (receivables)* arising in the ordinary course of business transactions. Most *accounts payable (receivable)* are of this kind.

trade secret. Technical or business information such as formulas, recipes, computer programs, and marketing data not generally known by competitors and maintained by the firm as a secret; theoretically capable of having an indefinite, finite life. A famous example is the secret process for Coca-Cola® (a registered *trademark* of the company). Compare with *know-how*. The firm will capitalize this intangible asset only if purchased. If this *intangible* has a finite, expected useful life, GAAP require amortization over that estimate of its life. If the right has indefinite life, then GAAP require no amortization, but annual tests for *impairment*. If the firm develops the intangible internally, the firm will *expense* the costs as incurred and show no asset.

trademark. A distinctive word or symbol that is affixed to a product, its package, or its

dispenser and that uniquely identifies the firm's products and services. See *trademark right*.

trademark right. The right to exclude competitors in sales or advertising from using words or symbols that are so similar to the firm's *trademarks* as possibly to confuse consumers. Trademark rights last as long as the firm continues to use the trademarks in question. In the United States, trademark rights arise from use and not from government registration. They therefore have a legal life independent of the life of a registration. Registrations last 20 years, and the holder may renew them as long as the holder uses the trademark. If this *intangible* has a finite, expected useful life, GAAP require amortization over that estimate of its life. If the right has indefinite life, then GAAP require no amortization, but annual tests for *impairment*. Under SFAS No. 2, the firm must *expense* internally developed trademark rights.

trading on the equity — treasury shares

trading on the equity. Said of a firm engaging in *debt financing*; frequently said of a firm doing so to a degree considered abnormal for a firm of its kind. *Leverage*.

trading securities. *Marketable securities* that a firm holds and expects to sell within a relatively short time; a classification important in *SFAS No. 115*, which requires the owner to carry marketable equity securities on the balance sheet at market value, not at cost. Contrast with *available for sale, securities* and *held-to-maturity securities*. Under *SFAS No. 115*, the balance sheet reports trading securities at market value on the balance sheet date, and the income statement reports *holding gains and losses* on trading securities. When the firm sells the securities, it reports realized gain or loss as the difference between the selling price and the market value at the last balance sheet date.

transaction. A *transfer* (of more than promises—see *executory contract*) between the accounting *entity* and another party or parties.

transfer. Under *SFAC No. 6*, consists of two types: “reciprocal” and “nonreciprocal.” In a reciprocal transfer, or “exchange,” the entity both receives and sacrifices. In a nonreciprocal transfer, the entity sacrifices but does not receive (examples include gifts, distributions to owners) or receives but does not sacrifice (investment by owner in entity). *SFAC No. 6* suggests that the term “internal transfer” is self-contradictory and that writers should use the term “internal event” instead.

transfer agent. Usually a bank or trust company designated by a corporation to make legal transfers of *stock (bonds)* and, perhaps, to pay *dividends (coupons)*.

transfer price. A substitute for a *market*, or *arm's-length, price* used in *profit*, or *responsibility center, accounting* when one segment of the business “sells” to another segment. Incentives of profit center managers will not coincide with the best interests of the entire

business unless a firm sets transfer prices properly.

transfer-pricing problem. The problem of setting *transfer prices* so that both buyer and seller have *goal congruence* with respect to the parent organization's goals.

translation adjustment. The effect of *exchange-rate* changes caused by converting the value of a net investment denominated in a *foreign currency* to the entity's reporting currency. *SFAS No. 52* requires firms to translate their net investment in relatively self-contained foreign operations at the *balance sheet* date. Year-to-year changes in value caused by exchange-rate changes accumulate in an *owners' equity* account, sometimes called the “cumulative translation adjustment.”

translation gain (or loss). *Foreign exchange gain (or loss)*.

transportation-in. *Freight-in*.

transposition error. An error in recordkeeping resulting from reversing the order of digits in a number, such as recording “32” for “23.” If the only errors in a *trial balance* result from one or more transposition errors, then the difference between the sum of the *debits* and the sum of the *credits* will be divisible by nine. Not all such differences result from transposition errors. See *slide*.

treasurer. The financial officer responsible for managing cash and raising funds.

treasury bond. A bond issued by a corporation and then reacquired. Such bonds are treated as retired when reacquired, and an *extraordinary gain or loss* on reacquisition is recognized. This term also refers to a *bond* issued by the U.S. Treasury Department.

treasury shares. *Capital stock* issued and then reacquired by the corporation. Such reacquisitions result in a reduction of *shareholders' equity* and usually appear on the balance sheet as *contra* to *shareholders' equity*. Accounting

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recognizes neither *gain* nor *loss* on transactions involving treasury stock. The accounting debits (if positive) or credits (if negative) any difference between the amounts paid and received for treasury stock transactions to *additional paid-in capital*. See *cost method* and *par value method*.

treasury stock. *Treasury shares.*

trend analysis. Investigation of sales or other economic trends. Can range from a simple visual extrapolation of points on a graph to a sophisticated computerized time series analysis.

trial balance. A two-column listing of *account balances*. The left-hand column shows all accounts with *debit* balances and their total. The right-hand column shows all accounts with *credit* balances and their total. The two totals should be equal. Accountants compute trial balances as a partial check of the arithmetic accuracy of the entries previously made. See *adjusted, preclosing, post-closing, unadjusted trial balance, plug, slide, and transposition error*.

troubled debt restructuring. As defined in *SFAS No. 15*, a concession (changing of the terms of a *debt*) that is granted by a *creditor* for economic or legal reasons related to the *debtor's* financial difficulty and that the creditor would not otherwise consider.

TSE. *Toronto Stock Exchange.*

treasury stock — uncollectible account

t-statistic. For an estimated *regression* coefficient, the estimated coefficient divided by the *standard error* of the estimate.

turnover. The number of times that *assets*, such as *inventory* or *accounts receivable*, are replaced on average during the period. Accounts receivable turnover, for example, is total sales on account for a period divided by the average accounts receivable balance for the period. See *ratio*. In the United Kingdom, “turnover” means *sales*.

turnover of plant and equipment. See *ratio*.

t-value. In *regression analysis*, the ratio of an estimated regression coefficient divided by its *standard error*.

20-F. Form required by the *SEC* for foreign companies issuing or trading their securities in the United States. This form reconciles the foreign accounting amounts resulting from using foreign *GAAP* to amounts resulting from using U.S. *GAAP*.

two T-account method. A method for computing either (1) *foreign-exchange gains and losses* or (2) *monetary gains or losses for constant-dollar accounting statements*. The left-hand *T-account* shows actual net balances of *monetary items*, and the right-hand *T-account* shows implied (common) dollar amounts.

2/10, n(et)/30. See *terms of sale*.

 U

unadjusted trial balance. *Trial balance* taken before the accountant makes *adjusting* and *closing entries* at the end of the period.

unappropriated retained earnings. *Retained earnings* not appropriated and therefore against which the *board* can declare *dividends* in the absence of retained earnings restrictions. See *restricted retained earnings*.

unavoidable cost. A *cost* that is not an *avoidable cost*.

uncertainty. See *risk* for definition and contrast.

uncollectible account. An *account receivable* that the *debtor* will not pay. If the firm uses the preferable *allowance method*, the entry on judging a specific account to be uncollectible *debits* the allowance for uncollectible

unconsolidated subsidiary — unrealized gross margin (profit)

accounts and *credits* the specific account receivable. See *bad debt expense* and *sales contra, estimated uncollectibles*.

unconsolidated subsidiary. A *subsidiary* not consolidated and, hence, not accounted for in the *equity method*.

uncontrollable cost. The opposite of *controllable cost*.

underapplied (underabsorbed) overhead. An excess of actual *overhead costs* for a period over costs applied, or charged, to products produced during the period; a *debit balance* remaining in an overhead account after the accounting assigns overhead to product.

underlying document. The record, memorandum, *voucher*, or other signal that is the authority for making an *entry* into a *journal*.

underwriter. One who agrees to purchase an entire *security issue* for a specified price, usually for resale to others.

undistributed earnings. *Retained earnings*. Typically, this term refers to that amount retained for a given year.

unearned income (revenue). *Advances from customers*; strictly speaking, a contradiction in terms because the terms “income” and “revenue” mean earned.

unemployment tax. See *FUTA*.

unencumbered appropriation. In governmental accounting, portion of an *appropriation* not yet spent or encumbered.

unexpired cost. An *asset*.

unfavorable variance. In *standard cost* accounting, an excess of expected revenue over actual revenue or an excess of actual cost over standard cost.

unfunded. Not *funded*. An obligation or *liability*, usually for *pension costs*, exists, but no *funds* have been set aside to discharge the obligation or liability.

Uniform Partnership Act. A model law, enacted by many states, to govern the relations between partners when the *partnership* agreement fails to specify the agreed-upon treatment.

unissued capital stock. *Stock* authorized but not yet issued.

uniting-of-interests method. The IASB’s term for the *pooling-of-interests method*. The IASB allows uniting of interests only when the merging firms are roughly equal in size and the shareholders retain substantially the same, relative to each other, voting rights and interests in the combined entity after the combination as before.

unit-level activities. Work that converts resources into individual products. Examples include *direct materials*, *direct labor*, and energy to run the machines.

units-of-production method. The *production method of depreciation*.

unlimited liability. The legal obligation of *general partners* or the sole proprietor for all debts of the *partnership* or *sole proprietorship*.

unqualified opinion. See *auditor’s report*.

unrealized appreciation. An *unrealized holding gain*; frequently used in the context of *marketable securities*.

unrealized gain (loss) on marketable securities. An *income statement account* title for the amount of *gain (loss)* during the current period on the portfolio of *marketable securities* held as *trading securities*. *SFAS No. 115* requires the firm to recognize, in the income statement, gains and losses caused by changes in market values, even though the firm has not yet *realized* them.

unrealized gross margin (profit). A *contra account* to *installment accounts receivable* used with the *installment method* of revenue recognition; shows the amount of profit that

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unrealized holding gain — VIE (variable interest entity)

the firm will eventually realize when it collects the receivable. Some accountants show this account as a *liability*.

unrealized holding gain. See *inventory profit* for the definition and an example.

unrecovered cost. *Book value* of an *asset*.

unused capacity. The difference between resources supplied and resources used.

usage variance. *Efficiency variance*.

use of funds. Any transaction that reduces funds (however “funds” is defined).

useful life. *Service life*.

 V

valuation account. A *contra account* or *adjunct account*. When the firm reports *accounts receivable* at expected collectible amounts, it will credit any expected uncollectible amounts to the *allowance for uncollectibles*, a valuation account. In this way, the firm can show both the gross receivables amount and the amount it expects to collect. *SFAC No. 6* says a valuation account is “a separate item that reduces and increases the carrying amount” of an asset (or liability). The accounts are part of the related assets (or liabilities) and are not assets (or liabilities) in their own right.

value. Monetary worth. This term is usually so vague that you should not use it without a modifying adjective unless most people would agree on the amount. Do not confuse with cost. See *fair market price (value)*, *entry value*, and *exit value*.

value added. *Cost* of a product or *work-in-process* minus the cost of the material purchased for the product or work-in-process.

value-added activity. Any activity that increases the usefulness to a customer of a product or service.

value chain. The set of business functions that increase the usefulness to the customer of a product or service; typically including research and development, design of products and services, production, marketing, distribution, and customer service.

value engineering. An evaluation of the activities in the value chain to reduce costs.

value variance. *Price variance*.

variable annuity. An *annuity* whose periodic payments depend on some uncertain outcome, such as stock market prices.

variable budget. *Flexible budget*.

variable costing. In allocating costs, a method that assigns only *variable manufacturing costs* to products and treats *fixed manufacturing costs* as *period expenses*. Contrast with *full absorption costing*.

variable costs. *Costs* that change as activity levels change. Strictly speaking, variable costs are zero when the activity level is zero. See *semi-variable costs*. In accounting, this term most often means the sum of *direct costs* and *variable overhead*.

VIE (variable interest entity). An entity arranged so that one cannot analyze controlling financial interest by analyzing voting interest, because the entity has insufficient *owners' equity* at risk, which means it cannot finance its operations without additional financial support, such as the promises of another entity. The entity's owners' equity lacks attributes associated with equity: the ability to absorb losses, the right to receive residual returns, and the ability, conveyed by voting rights, to make decisions. The entity may, but need not, have a “primary beneficiary,” which absorbs (or receives) a majority of the

variability of outcomes of the entity. If there is a primary beneficiary, that business will consolidate the VIE, regardless of ownership.

variable overhead efficiency variance. The difference between the *actual* and *standard cost driver* volume times the standard cost driver rate.

variable overhead price variance. The difference between the *actual* and *standard cost driver* rate times the actual cost driver volume.

variable overhead variance. Difference between actual and *standard variable overhead costs*.

variable rate debt. *Debt* whose interest rate results from the periodic application of a formula, such as “three-month LIBOR [London Interbank Offered Rate] plus 1 percent [one hundred basis points] set on the 8th day of each February, May, August, and November.”

variables sampling. The use of a sampling technique in which the sampler infers a particular quantitative characteristic of an entire population from a sample (e.g., mean amount of accounts receivable). See also *estimation sampling*. See *attribute(s) sampling* for contrast and further examples.

variance. Difference between actual and *standard costs* or between *budgeted* and actual *expenditures* or, sometimes, *expenses*. The word has completely different meanings in accounting and in statistics, where it means a measure of dispersion of a distribution.

variance analysis. *Variance investigation*. This term’s meaning differs in statistics.

variance investigation. A step in managerial control processes. *Standard costing systems* produce *variance* numbers of various sorts. These numbers seldom exactly equal to zero. Management must decide when a variance differs sufficiently from zero to study its cause. This term refers both to the decision about when to study the cause and to the study itself.

variation analysis. Analysis of the causes of changes in financial statement items of interest such as *net income* or *gross margin*.

VAT (value-added tax). A tax levied on the market value of a firm’s outputs less the market value of its purchased inputs.

vendor. A seller; sometimes spelled “vender.”

verifiable. A qualitative *objective* of financial reporting specifying that accountants can trace items in *financial statements* back to *underlying documents*—supporting *invoices*, canceled *checks*, and other physical pieces of evidence.

verification. The auditor’s act of reviewing or checking items in *financial statements* by tracing back to *underlying documents*—supporting *invoices*, canceled *checks*, and other business documents—or sending out *confirmations* to be returned. Compare with *physical verification*.

vertical analysis. Analysis of the financial statements of a single firm or across several firms for a particular time, as opposed to *horizontal* or *time-series analysis*, in which the analyst compares items over time for a single firm or across firms.

vertical integration. The extension of activity by an organization into business directly related to the production or distribution of the organization’s end products. Although a firm may sell products to others at various stages, a vertically integrated firm devotes the substantial portion of the output at each stage to the production of the next stage or to end products. Compare *horizontal integration*.

vested. An employee’s *pension plan* benefits that are not contingent on the employee’s continuing to work for the employer.

VIE. *Variable interest entity*.

visual curve fitting method. One crude form of cost *estimation*. Sometimes, when a firm needs only rough approximations of the

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amounts of *fixed* and *variable costs*, management need not perform a formal *regression analysis* but can plot the data and draw a line that seems to fit the data. Then it can use the parameters of that line for the rough approximations.

volume variance. *Production volume variance*; less often, used to mean *sales volume variance*.

voucher. A document that signals recognition of a *liability* and authorizes the disbursement

volume variance — weighted average

of cash; sometimes used to refer to the written evidence documenting an *accounting entry*, as in the term *journal voucher*.

voucher system. In controlling *cash*, a method that requires someone in the firm to authorize each *check* with an approved *voucher*. The firm makes no *disbursements* of currency or coins except from *petty cash funds*.

vouching. The function performed by an *auditor* to ascertain that underlying data or documents support a *journal entry*.

W

wage. Compensation of employees based on time worked or output of product for manual labor. But see *take-home pay*.

warning signal. Tool used to identify quality-control problems; only signals a problem. Contrast with *diagnostic signal*, which both signals a problem and suggests its cause

warrant. A certificate entitling the owner to buy a specified number of shares at a specified time(s) for a specified price; differs from a *stock option* only in that the firm grants options to employees and issues warrants to the public. See *right*.

warranty. A promise by a seller to correct deficiencies in products sold. When the seller gives warranties, proper accounting practice recognizes an estimate of *warranty expense* and an *estimated liability* at the time of sale. See *guarantee* for contrast in proper usage.

wash sale. The sale and purchase of the same or similar *asset* within a short time period. For *income tax* purposes, the taxpayer may not recognize *losses* on a sale of stock if the taxpayer purchases equivalent stock within 30 days before or after the date of sale.

waste. Material that is a residue from manufacturing operations and that has no sale value.

Frequently, this has negative value because a firm must incur additional costs for disposal.

wasting asset. A *natural resource* that has a limited *useful life* and, hence, is subject to *amortization*, called *depletion*. Examples are timber, oil and gas, and ore deposits.

watered stock. Shares issued for *assets* with *fair market price (value)* less than *par* or *stated value*. The firm records the assets on the books at the overstated values. In the law, for shares to be considered watered, the *board of directors* must have acted in bad faith or fraudulently in issuing the shares under these circumstances. The term originated from a former practice of cattle owners who fed cattle ("stock") large quantities of salt to make them thirsty. The cattle then drank much water before their owner took them to market. The owners did this to make the cattle appear heavier and more valuable than otherwise.

weighted average. An average computed by counting each occurrence of each value, not merely a single occurrence of each value. For example, if a firm purchases one unit for \$1 and two units for \$2 each, then the simple average of the purchase prices is \$1.50, but

weighted-average cost of capital — write off

the weighted average price per unit is $\$5/3 = \1.67 . Contrast with *moving average*.

weighted-average cost of capital. Measured as the *weighted-average* of the *after-tax cost of long-term debt* and the *cost of equity*.

weighted-average inventory method. Valuing either *withdrawals* or *ending inventory* at the *weighted-average* purchase price of all units on hand at the time of withdrawal or of computation of ending inventory. The firm uses the *inventory equation* to calculate the other quantity. If a firm uses the *perpetual inventory method*, accountants often call it the *moving average method*.

where-got, where-gone statement. A term allegedly used in the 1920s by W. M. Cole for a statement much like the *statement of cash flows*. Noted accounting historian S. Zeff reports that Cole actually used the term “where-got-gone” statement.

wind up. To bring to an end, such as the life of a corporation. The *board* winds up the life of a corporation by following the winding-up provisions of applicable statutes, by surrendering the charter, or by following *bankruptcy* proceedings. See also *liquidation*.

window dressing. The attempt to make financial statements show *operating* results, or a *financial position*, more favorable than they would otherwise show.

with recourse. See *note receivable discounted*.

withdrawals. *Assets* distributed to an owner. *Partner's drawings*. See *inventory equation* for another context.

withholding. Deductions that are taken from *salaries* or *wages*, usually for *income taxes*, and that the employer remits, in the employee's name, to the taxing authority.

without recourse. See *note receivable discounted*.

work sheet (program). (1) A computer program designed to combine explanations and calculations. This type of program helps in

preparing *financial statements* and *schedules*. (2) A tabular schedule for convenient summary of *adjusting* and *closing entries*. The work sheet usually begins with an *unadjusted trial balance*. Adjusting entries appear in the next two columns, one for *debits* and one for *credits*. The work sheet carries the horizontal sum of each line to the right into either the *income statement* or the *balance sheet* column, as appropriate. The *plug* to equate the income statement column totals is, if a debit, the income or, if a credit, a loss for the period. That income will close retained earnings on the balance sheet. The income statement credit columns are the revenues for the period, and the debit columns are the expenses (and revenue contra) that appear on the income statement. “Work sheet” also refers to *schedules* for ascertaining other items that appear on the *financial statements* and that require adjustment or compilation.

working capital. *Current assets* minus *current liabilities*; sometimes called “net working capital” or “net current assets.”

work(ing) papers. The schedules and analyses prepared by the *auditor* in carrying out investigations before issuing an *opinion on financial statements*.

work-in-process (inventory account). Partially completed product; appears on the balance sheet as *inventory*.

worth, Value. See *net worth*.

worth-debt ratio. Reciprocal of the *debt-equity ratio*. See *ratio*.

write down. To *write off*, except that the firm does not charge all the *asset's* cost to *expense* or *loss*; generally used for nonrecurring items.

write off. To *charge* an *asset* to *expense* or *loss*; that is, to *debit* expense (or loss) and *credit* the asset.

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write-off method — zero-base(d) budgeting (ZBB)

write-off method. For treating *uncollectible accounts*, a method that *debits bad debt expense* and *credits* accounts receivable of specific customers as the firm identifies specific accounts as uncollectible. The firm cannot use this method when it can estimate uncollectible amounts and they are significant. See *bad debt expense*, *sales contra*, *estimated uncollectibles*, and the *allowance method* for contrast.

write up. To increase the recorded *cost* of an *asset* with no corresponding *disbursement of funds*; that is, to *debit* asset and *credit revenue* or, perhaps, *owners' equity*; seldom done in the United States because currently accepted accounting principles await actual transactions before recording asset increases. An exception occurs in accounting for *marketable equity securities*.

Y

yield. *Internal rate of return* of a stream of cash flows. Cash yield is cash flow divided by book value. See also *dividend yield*.

yield curve. The relation between *interest rates* and the term to maturity of loans. Ordinarily, longer-term loans have higher interest rates than shorter-term loans. This is called a “normal” yield curve. Sometimes long-term and short-term rates are approximately the same—a “flat” yield curve. Sometimes short-term loans have a higher rate than long-term ones—an “inverted” yield curve. *Term structure* of interest rates.

yield to maturity. At a given time, the *internal rate of return* of a series of cash flows; usually said of a *bond*; sometimes called the “effective rate.”

yield variance. Measures the input-output relation while holding the standard mix of inputs constant: (Standard price × Actual amount of input used in the standard mix) – (Standard price × Standard quantity allowed for the actual output). It is the part of the *efficiency variance* not called the *mix variance*.

Z

zero-base(d) budgeting (ZBB). One philosophy for setting budgets. In preparing an ordinary *budget* for the next period, a manager starts with the budget for the current period and makes adjustments as seem necessary because of changed conditions for the next period. Since most managers like to increase the scope of the activities managed and since most prices increase most of the time, amounts in budgets prepared in the ordinary, incremental way seem to increase period after period. The authority approving the budget assumes that managers will carry out operations in the same way as in the past and

that next period's expenditures will have to be at least as large as those of the current period. Thus, this authority tends to study only the increments to the current period's budget. In ZBB, the authority questions the process for carrying out a program and the entire budget for the next period. The authority studies every dollar in the budget, not just the dollars incremental to the previous period's amounts. The advocates of ZBB claim that in this way, (1) management will more likely delete programs or divisions of marginal benefit to the business or governmental unit, rather than continuing with costs at

zero-base(d) budgeting (ZBB) — zero-base(d) budgeting (ZBB)

least as large as the present ones, and (2) management may discover and implement alternative, more cost-effective ways of carrying out programs. ZBB implies questioning the existence of programs and the

fundamental nature of the way that firms carry them out, not merely the amounts used to fund them. Experts appear to divide evenly as to whether the middle word should be “base” or “based.”

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