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**Financial Accounting**

V.G. Narayanan and Dennis Campbell, Co-Series Editors

READING

# Preparing Financial Statements: The Balance Sheet

**V.G. NARAYANAN**
HARVARD BUSINESS SCHOOL

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V.G. Narayanan, Thomas D. Casserly, Jr. Professor of Business Administration, Harvard Business School, developed this Core Reading with the assistance of writers Mark Bell, CPA, Ashley H. Hartman, M. Penelope K. Rossano, and Michael P. Griffin, CPA.

# 1 INTRODUCTION

Suppose that Shark Tank investor Kevin O'Leary offered to invest $1 million in your business. What should you do with the money? Pay down debt? Purchase a new building? Expand product offerings? Knowing how to best use the cash, or even whether to take it, would depend on your business and a variety of factors—and you'd need accurate and timely information to understand them. For his part, venture capitalist (VC) O'Leary also would need accurate and timely financial information. A manager cannot manage a company, and an investor cannot judge a business's current financial position or potential, without a solid handle on the numbers. Both look to financial statements for those numbers.

For gaining trust, a financial report is required

dilligence = concentration

Part of an investor's **due diligence** process involves the study of the financial statements of target companies. The VC firm wants to know whether its investment would make a difference in the growth of the business. For example, how would an infusion of capital strengthen the balance sheet? What would new investments in manufacturing mean to the future prospects of the enterprise? Would more capital enhance its marketing capability and sales? The VC will review the enterprise's financial statements and business plan to determine its needs for fixed asset capital and working capital, and will project the ***balance sheet*** one, three, and five years into the future.

VC will project balance sheet based of needs

All private and public entities, large and small, must organize, track, and record internal and external ***business transactions*** and then aggregate that information into financial reports. Key among those reports is the balance sheet, the subject of this reading. The balance sheet reveals an entity's financial standing at a moment in time.

Balance Sheet:

The balance sheet is a product of financial accounting—a system that organizes financial information and business transactions into standard financial reports. The ***accounting cycle*** is a term used to describe the sequence of activities that transforms data into information; it takes business transactions, which are supported by ***source documentation***, and enters them into the ***books*** of the entity. Those transactions are eventually summarized in the financial statements mentioned above.

Financial statements thus provide a view of the financial resources of a company and the claims against those resources. Because an entity's long-term bahir wale (external stakeholeders(investers,analyst,lenders,suppliers,regulators)) use financial info to invest,buissness krna. internal stakeholder(?????) use krta hai so that us ko reputation pata lage aur wo us pr internal analysis kre.

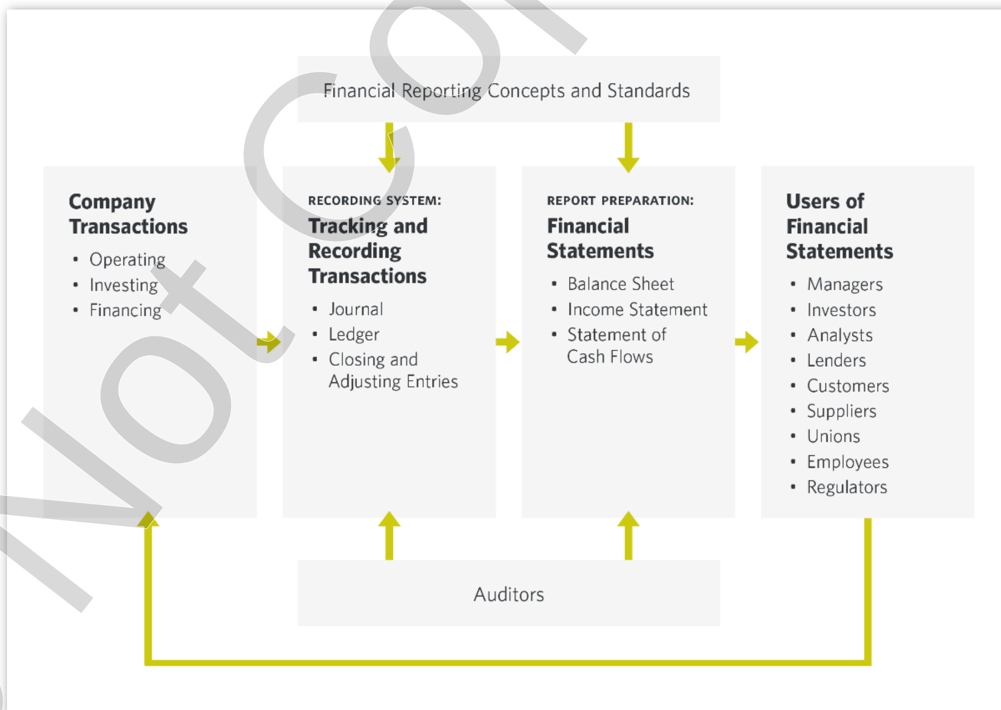
success is dependent on the efficient use of the resources provided by its owners and lenders, accurate tracking and reporting of financial information is crucial. While both internal and external stakeholders use financial information, financial statements are specifically concerned with accurate reporting to external stakeholders. Internal stakeholders may use financial statements to track internal processes, make projections about the business, and conduct internal analyses. However, external stakeholders, including investors, analysts, lenders, suppliers, and regulators, use financial statements to assess the potential risks and rewards associated with an entity, for example, through an investment, by extending credit, or by doing business as a supplier.

Preparers:

Auditors:

Those responsible for tracking and recording business transactions and presenting financial information in standard financial statements are called preparers; those charged with assessing whether an entity's financial statements correctly follow accounting principles are called auditors. See **Exhibit 1** for a depiction of the roles involved in preparing an entity's financial statements.

**EXHIBIT 1** Roles and Inputs in the Preparation of Financial Statements




Source: Adapted from Healy and Hawkins, Financial Accounting Online Course: Introductory Section, 2010.

This reading will describe the preparation process for one of the three main financial reports: the balance sheet. We will review the rules governing financing accounting and introduce key accounting concepts and principles. These include the entity concept, money measurement, going concern, consistency, and materiality. We will also discuss two important qualities of financial accounting information—relevance and reliability—and how the use of accrual accounting and generally accepted accounting principles (GAAP) help accountants pursue these qualities. Although ***generally accepted accounting principles*** often refers to US GAAP (the ***accounting standards*** in use in the United States), this reading assumes that GAAP refers to the accounting standards applicable within a particular country or region. For example, ***International Financial Reporting Standards*** **(*IFRS*)** are often referred to as international GAAP.

Throughout this reading, we will look at the steps that Ashmont Cycles, a bike shop located in Dorchester, Massachusetts, took in preparing its financial statements, and offer examples that show how accounting concepts and principles apply to that business.[a]

Buissness entity:

Accounting assumes a ***business entity*** for which all the accounting reports are prepared. Because financial accounting is based on the assumption that the entity is a going concern, meaning that it will continue to operate for the foreseeable future unless there's evidence that suggests otherwise, all entities that conform to US GAAP follow the rules for accrual accounting. ***Accrual accounting*** stipulates that events are recorded as they happen, regardless of whether cash has been exchanged.

Accural accounting:

It is important to note that financial statements have inherent limitations; for example, some assets are listed at ***historical cost*** whereas others reflect fair ***market value***. In practice, these may differ greatly. Also, some accounts, such as the allowance for doubtful accounts, are estimated. These estimates may be subject to error or bias; if these estimates are wide of the mark, the financial statements will not be completely accurate.

# 2 ESSENTIAL READING

## 2.1 Financial Accounting Rules and Principles

It is important that the financial information presented in financial statements be comparable to historical results and across industries and geographies. This

[a] Ashmont Cycles is a real business, but the figures used as examples are fictional.

is why standards for presenting information have been developed. In the United States, these rules are referred to as US Generally Accepted Accounting Principles (US GAAP). They are guidelines that accountants and managers of publicly traded companies must follow when preparing and auditing accounting information for external reporting purposes. The application of these guidelines results in reasonably reliable and comparable financial reports.

US GAAP are set by the ***Financial Accounting Standards Board*** **(*FASB*)**, an independent, not-for-profit organization, and its standards are followed by publicly listed companies in the United States. The FASB's stated mission is to "establish and improve financial accounting and reporting standards to provide decision-useful information to investors and other users of financial statements." With the support of an independent, full-time research staff, the FASB solicits participation from many stakeholders in financial reporting[1] in making pronouncements, called Statements of Financial Accounting Standards. These standards specify how to account for certain business practices. Each new standard becomes a part of US GAAP.

US GAAP is based on certain key principles, outlined in the text box, "Assumptions, Principles, and Constraints Underlying US GAAP."

My brain stop here?!

### Assumptions, Principles, and Constraints Underlying US GAAP

As of this writing, US GAAP, which is largely determined by the FASB under authority from the *Securities and Exchange Commission* (*SEC*), is based on four assumptions, four principles, and four constraints:

Assumptions:

- The business entity is separate from its owners and other businesses, and its revenues and expenses are kept separate from personal expenses.
- The business will continue as a going concern.
- A stable currency, specifically the US dollar, will be the monetary unit of record.
- A business's economic activities can be divided into artificial time periods.

(continued)

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Principles:

- Companies perform accounting and financial reporting based on a historical cost principle rather than fair market value for most assets and liabilities.
- Companies may not record revenue until it is realized and earned, but losses must be recognized when their occurrence becomes probable.
- Expenses must be matched with revenues whenever reasonable to do so.
- Information must be fully disclosed so that analyses can be conducted in order to make an investment, credit, or other financial decision.

Constraints:

- Company financial statements are based on objective evidence.
- All material and significant information should be reported.
- Consistent accounting principles and methods are used from period to period.
- When choosing between two solutions, the one with the less favorable outcome—for example, the more conservative option—is chosen.



Much of the rest of the world follows a set of accounting principles called International Financial Reporting Standards (IFRS). While many principles of IFRS are similar to those of US GAAP, there can be differences in terms of revenue recognition and various decisions related to depreciation and fair value determination. IFRS are set by the ***International Accounting Standards Board*** **(*IASB*)**, an accounting standards body, and are used by many different companies and countries. Based in London, the IASB determines the accounting standards followed by companies in about 120 jurisdictions (as of 2014). A key difference between the IASB and the FASB is that the IASB is not authorized by any statutory international body to create recording standards, whereas the FASB is given authority by the SEC to set accounting standards in the United States. As a result, IFRS is differentially applied and enforced on an individual country basis.

The IASB traces its history to 2002, but efforts to produce ***international accounting standards*** **(*IAS*)** date back to at least 1973, when the International

Accounting Standards Committee (IASC) emerged as an association of private-sector national accounting bodies of several countries. In the late 1990s, the European Union (EU) led efforts to create a more authoritative international rulemaking body for accounting. By 2001, the structure and process for the IASB was largely in place, and the EU committed to using rules based on IFRS in its jurisdictions by 2005. Commitment to IFRS among countries has varied. For example, Canada made a near-complete commitment to IFRS as of 2014. In contrast, China's approach has been to customize IFRS to fit the particular needs of its stakeholders. In another example, India has delayed convergence of its standards to IFRS because of domestic concerns about the standards' suitability to Indian conditions.

Differences in accounting rules can lead to misunderstandings and challenges in comparative analyses. As a result, convergence of IFRS and US GAAP has produced ongoing discussion among standard-setters and users alike. Supporters of conver-gence gained momentum through the early 2000s and, in 2007, foreign companies listed on US exchanges were allowed to provide IFRS financial statements instead of financial statements prepared according to US GAAP. However, since 2008, convergence has encountered some resistance, which is partly attributed to the interconnectedness among US GAAP, US corporate law, and other US corporate governance institutions.

In this reading, we will focus on US GAAP.

### 2.1.1 Terms and Concepts

Accounting standards provide guidance on accounting policy decisions so that businesses will record transactions and events similarly. The basic concepts behind the standards make up the broader framework that defines both the value and the limitations of financial statements.

- The ***entity concept*** assumes that accounts kept for an entity are distinct from the people who own, run, or do business with the entity. Essentially, it draws a boundary around the entity.
- The ***money measurement concept*** states that financial accounting deals only with transactions that can be represented in monetary terms.
- The ***going concern concept*** says that the entity is expected to remain in operation for the indefinite future.[b]

[b] Unless evidence suggests otherwise, those preparing and auditing general purpose financial statements for a business entity assume that it will continue operations into the foreseeable

- The ***consistency concept*** states that an entity should use the same accounting methods and procedures from period to period unless there is a sound reason to change. It does not forbid a change in accounting procedures, but the change must be justified.

- The ***materiality concept*** states that an entity needs to record and report only items that are material, that is, significant to potential users of the financial statements. However, the materiality of an item is open to judgment and discretion. The general rule is that an item is material if its disclosure would impact the decisions of the users of the accounts.

- The ***matching concept*** stipulates that expenses should match revenues as closely as possible during the period in which they occurred.

- The ***conservatism concept*** states that revenues should be recognized only when they are reasonably certain, but expenses should be recognized as soon as reasonably possible.

- Accountants recording events should rely as much as possible on objective, verifiable documentary evidence, referred to as the reliability of evidence concept, instead of on the subjective and potentially biased judgments of a person.

- The ***disclosure concept*** states that accounting reports should disclose enough information that they will not mislead readers in financial matters.

## 2.2 Accounting Cycle

Requiring companies and accountants to follow established rules and guidelines in preparing financial reports causes those reports to be reliable and comparable with others. A financial accounting system involves decisions on whether, when, and how to record transactions and the different ways to

future. The going concern assumption reflects management and investors' normal expectation about the life of a business. To avoid misleading readers, the financial statements of business entities with limited lives must clearly indicate the terminal date and type of liquidation involved. Otherwise, the reader will assume that the accounts are based on the presumption that the enterprise has an indefinitely long life.

aggregate those records into financial reports. Preparation of financial statements generally occurs after an entity has been in business for an accounting period and records the events that took place during that period. The quality of those financial reports depends on the relevance and reliability of the data presented. Here, ***relevance*** refers to the timeliness and usefulness of the information to users; reliability refers to the objectivity and verifiability of the information.

Over the course of an operating period, every company goes through an accounting cycle. An accounting cycle occurs within an ***accounting period*** (also called a reporting period), which is typically defined as one month, one quarter, or one year. At the end of an accounting period, a ***trial balance*** is prepared. A trial balance lists all the accounts in the company's general ledger. It is from the trial balance that accountants prepare the ***financial statements***. **Exhibit 2** depicts the typical accounting cycle.

**EXHIBIT 2** The Accounting Cycle


In this reading you'll encounter various accounting cycles of Ashmont Cycles, owned by Jack Pelletier. An avid cyclist, Pelletier recognized the need for a bike shop in his neighborhood and opened Ashmont Cycles in 20X1. We will look at the financial position of Ashmont Cycles for the accounting cycle that spans the year 20X1.

## 2.3 Preparing Financial Statements

The main financial reports included in an entity's annual statement are the balance sheet, the income statement, and the statement of cash flows. Most entities also prepare a statement of retained earnings. This reading focuses on the accounts and transactions that impact the balance sheet and its format. In practice, the order of preparation for the financial statements is to first prepare the ***statement of income*** (also called the income statement). Once the income statement is complete, the statement of retained earnings (or a statement of stockholders' equity) can be prepared, followed by the balance sheet. Completing a full set of financial statements would involve the preparation of a ***statement of cash flows***, which is the last statement to be prepared because it draws upon data from the income statement, the retained earnings statement, and the balance sheet. The balance sheet reflects information *as of a point in time*. For example, a company might report its financial standing as of June 30 of a particular year, showing the assets, liabilities, and equity as of the close of business on June 30.

### 2.3.1 The Balance Sheet

The balance sheet, also called a statement of financial position, reports an entity's financial situation at a particular point in time. In that sense, it is a snapshot of financial position. The statement has three main sections: the ***assets***, which are the resources controlled by the entity; the ***liabilities***, which are the claims against those resources; and the ***owner's equity*** in the business (sometimes called stockholders' equity). The opening balance sheet of an accounting cycle is simply the balance sheet from the end of the prior period. **Exhibit 3** shows an opening balance sheet for Ashmont Cycles.

**EXHIBIT 3** Ashmont Cycles Balance Sheet as of December 31, 20X1

| **Balance Sheet** as of December 31, 20X1 | |
|---|---|
| **Assets** | |
| Cash | $5,368 |
| Accounts Receivable | $2,200 |
| Inventory | $55,500 |
| Prepaid Expenses | $1,700 |
| Other Current Assets | $600 |
| Total Current Assets | $65,368 |
| Property, Plant & Equipment | $10,400 |
| Accumulated Depreciation | ($1,480) |
| Net Property, Plant & Equipment | $8,920 |
| **Total Assets** | **$74,288** |
| **Liabilities** | |
| Accounts Payable | $2,200 |
| Line of Credit | $5,000 |
| Current Portion of Long-Term Debt | $1,000 |
| Accrued Expenses | $1,100 |
| **Total Current Liabilities** | **$9,300** |
| Long-Term Debt | $10,000 |
| **Total Liabilities** | $19,300 |
| **Owner's Equity** | |
| Contributed Capital | $50,000 |
| Retained Earnings | $4,988 |
| **Total Owner's Equity** | **$54,988** |
| **Total Liabilities and Equity** | **$74,288** |

The three main sections are related by the ***accounting equation*** (also known as the balance sheet formula):

$$\text{Assets} = \text{liabilities} + \text{owner's equity}$$

Although business transactions affect the accounting equation by increasing or decreasing various assets, liabilities, and equity, the equation always balances. This reading utilizes the accounting equation as a tool in analyzing and understanding the impact of basic business transactions.

## Assets

The assets section of a corporation's balance sheet reports "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events"[2] as of the date of the balance sheet. An asset has four key characteristics:

1. It has been acquired at a measurable ***cost***.
2. It is likely to generate a future benefit by contributing to the firm's cash flow either directly or indirectly.
3. The entity on whose balance sheet the asset is recorded controls the asset.
4. The transaction that has given the entity control over the asset has already occurred.

There are many different types of assets with these characteristics. For example, some common assets for Ashmont Cycles include cash, inventory, and accounts receivable. Another category is ***intangible assets***, such as an entity's brand value.

## Liabilities and Equity

Liabilities are a company's obligations—amounts the company owes (including debts such as amounts owed to suppliers and banks). Examples of liabilities include notes payable, accounts payable, salaries and wages payable, interest payable, and income taxes payable.

Liabilities can be viewed in two ways:

- Claims by creditors against the company's assets
- Source of funds—along with owner or stockholder equity—of the company's assets

Stockholders' equity is the amount left over after liabilities are deducted from assets:

$$\text{Assets} - \text{liabilities} = \text{stockholders' equity}$$

You'll find more on liabilities later in this reading.

Owner's or stockholders' equity also reports the amounts invested into the company by the owners plus the cumulative net income of the company that has not been withdrawn or distributed to the owners. There will be more on equity later in this reading.

### 2.3.2 Transaction Analysis and Double Entry Accounting

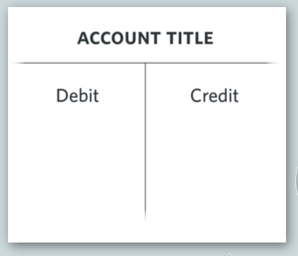
If a company keeps accurate records, the accounting equation will always be "in balance," meaning that the left side (assets) will always equal the right side (liabilities + stockholders' equity). The balance is maintained because every business transaction affects at least two of a company's accounts. For example, when a company borrows money from a bank, the company's assets will increase and its liabilities will increase by the same amount. When a company purchases inventory for cash, one asset will increase and one asset will decrease. Because there are two or more accounts affected by every transaction, the accounting system is referred to as ***double entry accounting***.

Part of the responsibilities of an organization's accounting function is to identify all transactions that occur in the business and to translate those transactions to financial position and results. This is initially done through the use of accounts. An ***account*** is a standardized format that organizations use to accumulate the dollar effect of a transaction, or the records where increases, decreases, and balances are kept for all the major financial items of a business. There are accounts for each type of asset, liability, equity, revenue, and expense of a business. A business can have dozens of accounts. For example, cash, inventory, accounts receivable, land, buildings, and equipment are names given to asset accounts.

Account balances are kept so that financial statements can eventually be prepared. When you examine the balance sheet of a corporation, many of the categories found there are really summations or aggregations of several accounts. For example, accounts receivable—money owed to the business by customers who have purchased on credit shown on a balance sheet could be composed of hundreds of subsidiary accounts representing all of the company's customers. The same is true of accounts payable—money owed to all the vendors of a company.

## T-Accounts

In a financial accounting system, journal entries are used to enter data. Specific transactions are posted to an entity's ledger using what are referred to as *T-accounts*. Each account is tracked with a separate T-account. A T-account looks like this:




The T-account aids our understanding of how an account is increased and what causes it to decrease. By convention, for asset accounts, increases are posted on the left side of the T-account in the form of a debit. Decreases are on the right side, called credits. For liabilities and owner's equity accounts the opposite is true. Decreases are on the left, or debit, side of the T-account and increases are on the right, or credit, side. Increases in sales are recorded as credits and increases in expenses are recorded as debits. It is important to remember the category for a particular T-account because that will determine whether the debit or credit is an increase or a decrease.

Companies maintain a ***chart of accounts***—a list of all account names, usually organized by financial statement elements. For example, the chart of accounts lists all the asset, liability, equity, revenue, and expense accounts. **Exhibit 4** is an example of a chart of accounts. It would serve as a table of contents for a company's ledger (collection of accounts).

**EXHIBIT 4** Example of a Chart of Accounts

| Account Number | Account Title |
|---|---|
| 101 | Cash |
| 120 | Accounts Receivable |
| 140 | Merchandise Inventory |
| 150 | Supplies |
| 160 | Prepaid Insurance |
| 170 | Land |
| 175 | Buildings |
| 178 | Accumulated Depreciation—Buildings |
| 180 | Equipment |
| 188 | Accumulated Depreciation—Equipment |
| 201 | Accounts Payable |
| 210 | Notes Payable (Short-Term) |
| 220 | Wages Payable |
| 230 | Interest Payable |
| 240 | Unearned Revenues |
| 250 | Mortgage Loan Payable |
| 290 | Capital Stock |
| 295 | Retained Earnings |
| 301 | Sales |
| 310 | Service Revenue |
| 315 | Interest Revenue |
| 400 | Cost of Goods Sold |
| 405 | Salaries |
| 410 | Wages |
| 430 | Supplies Expense |
| 460 | Rent Expense |
| 470 | Utilities Expense |
| 475 | Telephone Expense |
| 480 | Advertising Expense |
| 490 | Depreciation Expense |
| 495 | Interest Expense |
| 496 | Income Tax Expense |

Company managers and their accountants have some discretion over the naming of certain accounts. Ashmont Cycles's current assets include cash, accounts receivable (e.g., the amounts owed to the company as a result of its past merchandise sales and bike repair services), prepaid expenses (e.g., the amount the company paid to cover its property insurance), and inventory (e.g., bikes and accessories). Its only long-term assets are property, plant, and equipment (e.g., the tools and equipment used to make repairs).

Transaction analysis is the process of studying an event to determine its economic effect on the accounting equation. To perform transaction analysis, two important rules must be followed:

1. Every transaction affects at least two accounts.
2. The accounting equation must remain in balance after each transaction. In other words, equilibrium must always be in place (both before and after the transaction's effects have been recorded):

Assets = liabilities + stockholders' equity

Consider our example company. In opening Ashmont Cycles in 20X1, Jack invested $50,000 of his personal savings. Initially, Ashmont Cycles had no assets, no liabilities, and no owner's equity. Jack's cash contribution changed this. His $50,000 altered the balance sheet in two ways: Ashmont Cycles now had $50,000 in assets (cash) and $50,000 in owner's equity. Both assets and equity increased by the same amount, balancing the accounting equation, as explained in **Exhibit 5**.

**EXHIBIT 5** First Balance Sheet Transaction

| Assets = | Liabilities + | Equity |
|---|---|---|
| Cash is an asset and it increased.<br>Cash + $50,000 | There is no change in liabilities, as liabilities are obligations, and no additional financial obligations occurred because of this transaction. | The source of the cash is the owner's investment in the business, otherwise known as capital stock. Capital stock is a type of equity.<br>Capital Stock + $50,000 |

**Exhibit 6** details how the initial balance sheet would appear.

**EXHIBIT 6** Ashmont Cycles Initial Balance Sheet

| **Balance Sheet**<br>as of January 1, 20X1 | |
|---|---|
| **Assets** | |
| Cash | $50,000 |
| **Total Assets** | **$50,000** |
| **Liabilities** | |
| **Total Liabilities** | **$0** |
| **Owner's Equity** | |
| Contributed Capital | $50,000 |
| **Total Owner's Equity** | **$50,000** |
| **Total Liabilities and Equity** | **$50,000** |

Every transaction affects at least two items in the basic accounting equation and preserves the equation's equality. This is known as the dual aspect concept. Recording both sides of each transaction (the double entry accounting method) keeps the basic accounting equation balanced. The text box "Recording Transactions with Debits and Credits" details how this is accomplished.

## Recording Transactions with Debits and Credits

There are two different systems for recording transactions and providing information about an entity's assets, liabilities, and owner's equity. The first, accrual accounting, focuses on the economic characteristics of transactions rather than their cash flows. Accrual accounting specifically ties a transaction with economic consequences for the business to the accounting period during which the transaction occurs rather than when cash is paid or received. The second, cash-basis accounting, records the cash impact of each transaction. US GAAP requires the use of accrual accounting, and it is the method that most companies, including Ashmont Cycles, use.

Transactions are categorized into separate accounts through *journal entries*. An account is the basic record used in an accounting system to keep track of the balances of assets, liabilities, equities, revenues, and expenses of an organization. Under manual accounting systems, business transactions are first *journalized*, or recorded in a journal. Each journal entry will typically include the appropriate date of the transaction, the amount and account that will be debited, the amount and account that will be credited, a short description of the transaction, and any relevant references (e.g., check number). The company simply records the adjusting entry at the end of the accounting period.

Debits are accounting entries that increase the balance of asset and expense accounts and decrease the balance of liability, equity, or revenue accounts. Credits are accounting entries that increase the balance of liability, equity, or revenue accounts and decrease the balance of asset and expense accounts.

| Debits | Credits |
|---|---|
| Increase asset and expense accounts | Increase liability, equity, and revenue accounts |
| Decrease liability, equity, and revenue accounts | Decrease asset and expense accounts |

Suppose Ashmont Cycles purchased $500 worth of inventory on January 1, 20X1, and paid cash to the supplier. The journal entry would look like this:

| Date | Account Name | Debit | Credit |
|---|---|---|---|
| January 1, 20X1 | Inventory | $500 | |
| | Cash | | $500 |

(continued)

(continued)

Journal entries will then be posted to the entity's *general ledger*, which is a complete record of financial transactions over the life of the entity. The general ledger holds information about individual accounts, including accounts for assets, liabilities, owner's equity, revenues, and expenses. This information is used to prepare financial statements. Examples of accounts on the general ledger for Ashmont Cycles include cash, accounts receivable, inventory, accrued wages, long-term debt, revenues, cost of goods sold, and utilities expense. The names of the specific accounts in the general ledger may vary from company to company. As a result, financial statement users should understand how accounts are categorized rather than memorizing the specific name of an account.

A specific type of entry must be made at the end of each accounting period so that financial statement users can see the impact of the passage of time on the resources of an entity. These are referred to as *adjusting entries*.



## Current Assets

Balance sheet assets are grouped into two broad categories: short-term (or current) assets and long-term (or noncurrent) assets. An asset's categorization depends on its average useful life. Assets that will likely be consumed or disposed of within one year, including cash, ***marketable securities***, inventory, and accounts receivable, are called short-term assets. Assets that will be consumed or used for periods longer than one year, including property and equipment, are called long-term assets. Assets are generally recorded on the balance sheet at historical cost (what they cost at the time of purchase) and are typically listed in order of liquidity, which refers to the efficiency or ease with which the asset can be converted into cash.

Most balance sheets are prepared using a ***classified format***, meaning that current assets are shown first, grouped within their own section, followed by a section of noncurrent assets. The same is true on the liability side of the balance sheet, where ***current liabilities***—obligations that will be paid or satisfied within a year—are grouped together and shown first, followed by the long-term liabilities. This type of format facilitates analysis of liquidity and solvency, or the ability of the firm to pay its bills.

The following accounts would typically be included in the current assets section of the balance sheet:[c]

- **Cash** (may include ***cash equivalents***) Includes bank deposits, deposits in transit (as of the last day of the accounting period), undeposited checks, cash on hand, and may include marketable securities.

- **Accounts Receivable or Trade Accounts Receivable** Amounts legally owed to a company as a result of past credit sales of goods and services.

- **Other Receivables** Amounts legally owed to a company, other than trade accounts receivable.

- **Prepaid Expenses** Amounts paid to vendors for goods or services to be delivered in future periods. Insurance policy payments-in-full at the beginning of the policy period are typical examples.

- **Inventory** Tangible goods purchased for resale in the ordinary course of business.

Besides Jack Pelletier's cash investment, many other transactions had to occur before Ashmont Cycles could open for business. For example, the new company had to lease a building and purchase bikes to sell. On January 15, 20X1, Ashmont Cycles decided to purchase 20 bikes for $200 each from its suppliers. Once acquired, those bikes represent merchandise inventory—items available for sale. That transaction increased inventory by $4,000 (20 × $200) and decreased the cash balance by $4,000. Although this transaction affected only one side of the accounting equation—the assets—the accounting equation was still balanced because one asset account increased and the other decreased, both by the same amount as shown in **Exhibit 7**.

[c] Financial statements have historically been prepared on a conservative basis. The concept of conservatism generally states that if there are two options available for a financial statement preparer, the option that minimizes the risk of overstating assets or income is the option that should be taken. As it relates to the assets on the balance sheet, the conservatism concept indicates that all assets are initially recorded at historical cost and they should be valued at the lower of the cost of the asset or their current market value.

**EXHIBIT 7** Inventory Purchase

| Assets | = | Liabilities | + | Equity |
|---|---|---|---|---|
| Inventory is an asset and is increased.<br>Inventory + $4,000<br>Cash is an asset and it decreased.<br>Cash – $4,000 | | There is no change in liabilities. | | There is no change in equity. |

Assuming that this was Ashmont Cycles's first transaction following Jack's initial investment, the balance sheet would now look like **Exhibit 8**.

**EXHIBIT 8** Ashmont Cycles Balance Sheet as of January 15, 20X1

| **Balance Sheet**<br>as of January 15, 20X1 | |
|---|---|
| **Assets** | |
| Cash | $46,000 |
| Inventory | $4,000 |
| **Total Assets** | **$50,000** |
| **Liabilities** | |
| **Total Liabilities** | **$0** |
| **Owner's Equity** | |
| Contributed Capital | $50,000 |
| **Total Owner's Equity** | **$50,000** |
| **Total Liabilities and Equity** | **$50,000** |

For accounting purposes, business transactions are measured initially in terms of their actual (historical) cost, a value evidenced by reliable sources such as contracts, invoices, and other forms of documentation. This basic accounting concept applies not only to the initial recording of transactions but also, in many cases, to the subsequent reporting of transactions. While the historical cost concept ensures that there is a degree of reliability in the data and a conservative approach to value, it ignores the monetary, or market, value of items. As a result, financial statements are said to conform to the mixed attributes accounting model. That is some balances, such as property, plant, and equipment, are reported under US GAAP on a historical cost basis, while others, such as marketable securities held for trading purposes, are reported on some measure of ***current value***.

It is important that financial statement users learn when and which accounts are stated at their historical cost versus current value. For example, after several years of operations, Ashmont Cycles might purchase a new, larger retail space. This purchase would be recorded at its historical cost—the price Ashmont Cycles paid for it. Even though the space will likely have a different market price in the future, it will continue to be recorded as an asset at its historical cost because that is the most reliable figure. However, there are certain situations in which a recorded asset should be adjusted to reflect the price it would command if sold in the current market.

Accountants have to balance reliability and relevance of information. Historical cost information may be more reliable, but market prices may be more relevant. Recording assets at historical versus ***fair value*** differs by accounting systems. While agreeing with the need to record historical cost initially, the FASB and IASB have concluded that, under certain conditions, financial statements would be more useful if actual or estimates of current value—known as fair value—were substituted for historical costs.

### Long-Term Assets

Long-term assets have an expected useful life of a year or more. Some of these assets, such as property, plant, and equipment, give the business productive capacity, and some, such as loans owed to the business, notes receivable, and investments (by the company), are income-producing financial assets.

- **Loans/Notes Receivable** Amounts legally owed to the company as a result of loans granted to others. This account should be shown net of any estimated uncollectible amounts.

- **Investments** Money invested in other companies' equity or debt securities, partnerships, certain property investments, etc. This account is classified as short term if the maturity of the debt is less than one accounting cycle or if the company intends to hold the equity investment for less than one accounting cycle.

- **Property, Plant, and Equipment (PP&E)** Tangible assets, also referred to as fixed assets, that were acquired by the company for use in operations and that have an expected useful life greater than one accounting period. All tangible assets, except for land, have limited lives. PP&E is listed on the balance sheet at its ***net book value***, which means that its carrying value is cost less ***accumulated depreciation***.

- **Intangible Assets** Resources without physical substance that provide future economic benefit. This category includes both intangible assets with finite lives, such as patents and copyrights, and intangibles without finite lives, such as goodwill.

## Liabilities

The liabilities section of a corporation's balance sheet reports obligations of the company as of the date provided in the financial statements. A liability is defined as an obligation that a firm has to another party. The obligation is generally the result of past transactions or events that must be settled in the future through the transfer or use of assets, provision of services, or some other means of transferring economic benefit to the party that is owed. In other words, an important defining criterion is that a liability is an obligation that has already been incurred. Examples of liabilities for Ashmont Cycles might include money owed on a loan from a financial institution, money owed to suppliers for products Ashmont has received, or money owed for warranties in the event of product failures.

For example, what if on October 1, 20X1, Jack decided to no longer lease a building and bought a building for his business? **Exhibit 9** shows how the transaction would appear if the building cost $300,000 and was financed with $60,000 cash and a mortgage loan for the remainder.

**EXHIBIT 9** Building Purchase

| Assets = | Liabilities + | Equity |
|---|---|---|
| Cash would decrease by the amount of the down payment.<br>Cash – $60,000<br>The building account would increase by the acquisition cost.<br>Building + $300,000 | A mortgage loan is a liability and would increase.<br>Mortgage note payable<br>+ $240,000 | There is no change in equity. |

Notice that the accounting equation would remain in balance after the above transaction. Assets would increase by $240,000 ($300,000–$60,000) and the other side of the equation would also increase by $240,000 (mortgage note payable).

Like assets, liabilities are classified as short or long term. Current, or short-term, liabilities are defined as the obligations that are reasonably expected to be liquidated within one operating cycle, which is commonly defined as one year. Long-term liabilities are those that will come due in greater than one operating cycle. On the balance sheet, liabilities are generally listed in order of liquidity.

### Current Liabilities

Current liabilities may be generated from a variety of sources. For example, accounts payable may be a compilation of transactions with many different creditors. Accounts payable reports amounts owed to suppliers or vendors who have provided materials or services to the firm but who have not yet been paid. This is a convenient business practice that minimizes the need for frequent cash or cash equivalent payments. Maintenance of a significant number of accounts payable, also referred to as the use of credit in business operations, results in smoother business operations.

On January 20, 20X1, Ashmont Cycles purchased 10 new bike racks to store its inventory. It paid $60 for each. However, Ashmont Cycles had established 30-day credit terms with its rack supplier and planned to pay for that equipment at a later date. This transaction increased equipment by $600 (10 × $60) and increased accounts payable, which represents its obligation to pay, by $600, as explained in **Exhibit 10**.

**EXHIBIT 10** Equipment Purchase

| Assets = | Liabilities + | Equity |
|---|---|---|
| Equipment is an asset and it increases by the acquisition cost of the 10 bike racks.<br><br>Equipment + $600 | The supplier of the equipment extends credit. Accounts payable is a liability and has increased as a result of this transaction.<br><br>Accounts payable + $600 | There is no change in equity. |

**Exhibit 11** details how Ashmont Cycles's balance sheet would appear.

**EXHIBIT 11** Ashmont Cycles Balance Sheet as of January 20, 20X1

| **Balance Sheet**<br>as of January 20, 20X1 | |
|---|---|
| **Assets** | |
| Cash | $46,000 |
| Inventory | $4,000 |
| **Total Current Assets** | **$50,000** |
| Property, Plant, and Equipment | $600 |
| **Total Assets** | **$50,600** |
| **Liabilities** | |
| Accounts Payable | $600 |
| **Total Liabilities** | **$600** |
| **Owner's Equity** | |
| Contributed Capital | $50,000 |
| **Total Owner's Equity** | **$50,000** |
| **Total Liabilities and Equity** | **$50,600** |

Another type of current liability account is ***accrued expenses***, which are amounts owed for services that have been performed by an entity, such as a contractor to the company, but have not yet been billed. Wages payable, which are amounts owed to employees for work performed but not yet paid, is another example of an accrued expense. Obligations that become due within one operating period, generally one year, will transition from noncurrent to current liabilities with the passage of time.

Ashmont Cycles's current liabilities include accounts payable (e.g., the amounts the company owes to suppliers for bikes or other materials not yet paid for), accrued wages (e.g., the amounts owed to employees for work performed but as yet unpaid), and the current portion of long-term debt (the portion of long-term debt that is due within one accounting period).

Company management and its accountants have discretion over the naming of liability accounts. The following are accounts that would typically be included in the liabilities section of the balance sheet:

- **Dividends Payable** Represents the obligation of the company to pay its shareholders to compensate for their investment.

- **Interest Payable** Represents the obligation of the company to pay its lenders interest for using their cash during the current accounting period.

- **Taxes Payable** Includes any tax obligations owed to a local, state, or federal government agency. In some cases, income tax liability is reported separately.

- **Unearned Revenue** A liability account that represents an obligation to deliver goods or services in the future. If an entity collects cash from a customer prior to delivering a product or providing a service, then the cash collected is not a sale but a liability because, as a result of accepting that cash (and booking it among its assets), the entity has a legal obligation to provide that service or product.

### Long-Term Liabilities

The second category of liabilities is referred to as noncurrent, or long-term, liabilities. These are obligations that are not expected to be settled within one operating cycle, generally within one year. Rather, they are agreements to pay back a loan at some future point in time or at regular, pre-agreed intervals. Noncurrent liabilities may take the form of an agreement between parties (e.g., mortgage or trust note), or they may be packaged into a debt security and be traded in the securities markets (e.g., debenture bonds).

With reference to the earlier example of Ashmont Cycles's balance sheet shown in Exhibit 3 (as of December 31, 20X1), its long-term liabilities include long-term debt, such as a $20,000 five-year Small Business Administration (SBA) loan, any amount borrowed under its $10,000 long-term line of credit, and the mortgage note payable on the building. Other examples of noncurrent liabilities might include issued long-term bonds, notes payable, long-term leases, mortgages, pension obligations, and long-term product warranties. The distinction between current and noncurrent liabilities may not be precise and may depend on the firm’s definition. Types of noncurrent liabilities include:

- **Long-Term Debt** Includes loans received from banks or other entities with a maturity date greater than one year from the reporting date. Amounts are recorded at the present value of the future cash payments. Mortgage loans are usually long-term debt.

- **Bonds Payable** Companies issue bonds to investors, generally in increments of $1,000. Interest must be paid to those investors in accordance with the bond contract; the face value of the bond is due and payable upon maturity. Bonds are a financing vehicle for very large corporations and governments. Small- to medium-size businesses do not “float” bonds to raise cash and therefore bonds payable will not be found on their balance sheets.

## Owner’s Equity

Companies can be structured under different legal entities. Some are structured as corporations and are authorized by a state to operate under a legal charter established by the entity’s ***articles of incorporation***. The corporation is governed by a board of directors who set and follow the corporate bylaws, the intent of which is to protect the rights of shareholders (i.e., owners). An advantage of the corporate legal structure is the fact that liability is limited for shareholders, and corporate assets are insulated from personal assets. Another benefit of the corporate structure is that it allows for fundraising through the issuance of shares. Finally, the corporate structure facilitates transfer of ownership in the event that owners want to sell or transfer their shares.

Ashmont Cycles is a sole proprietorship, owned solely by Jack, and has no share-holders. As a result, the cycle company’s owner’s equity includes only Jack’s $50,000 investment and retained earnings.

Owner’s equity is related to the other parts of the balance sheet through the accounting equation:

Assets = liabilities + owner’s equity

Financial accounting rules are relatively detailed about the definition and measurement of assets and liabilities. Owner’s equity, as a result, is often treated as the residual in the equation. Because owner’s equity represents the assets of a company less the claims against those assets, it can also be considered a residual interest, or what is left over after creditors’ claims have been satisfied. ***Equity*** is also referred to as the ownership piece of the accounting equation.

Several accounts are typically included in the owner’s equity section of the balance sheet:

- **Common Stock, Par Value** Common stock is recorded at the par value, or stated value of the stock, which is stipulated in the corporate charter. This account is also referred to simply as common stock.

- **Additional Paid-In Capital on Common Stock** Amount paid to a company per share of common stock less the par value per share.

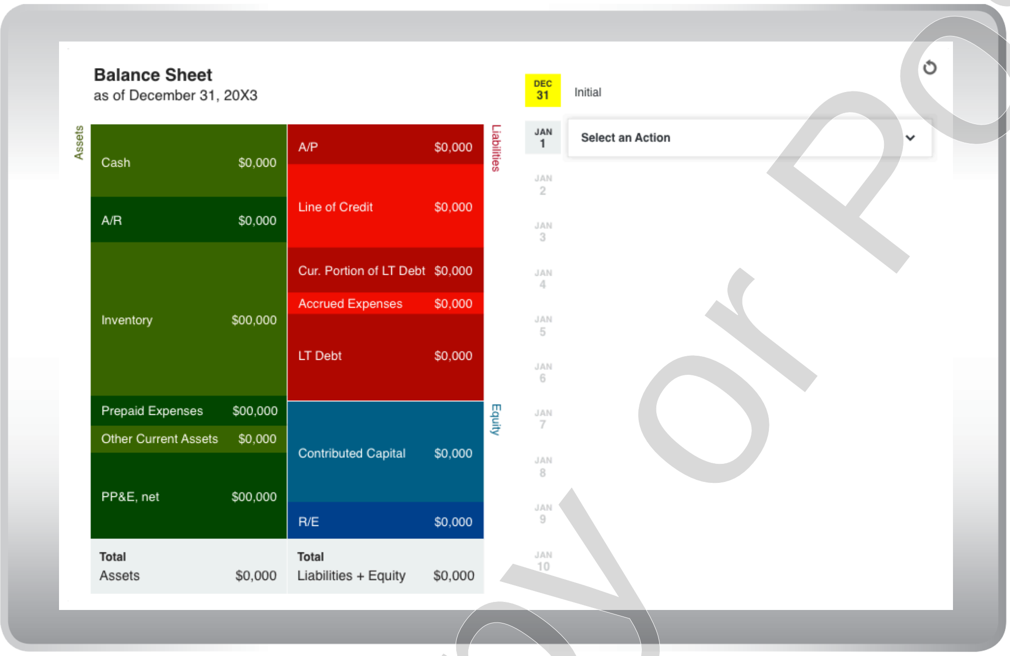
- **Retained Earnings** Represents the cumulative net income earned by the company since inception less any dividends declared since inception. Therefore, any amount of retained earnings disclosed on a balance sheet is the ending balance for the period. It will be the result of the following formula:

Beginning Retained Earnings + (−) Net Income (Loss) − Dividends = Ending Retained Earnings

- **Accumulated Other Comprehensive Income** Certain transactions and other events that result in unrealized gains or losses for the company are recorded directly to ***accumulated other comprehensive income***, an equity account, rather than as a gain or loss on the current period income statement. These items do not involve the operations of the company. Examples include unrealized gains/losses on investments and foreign currency translation adjustments.

**Interactive Illustration 1** displays a simplified graphical depiction of a balance sheet. To the right of the graphic is a list of dates. Use the drop-down menu to select a business transaction for the adjacent date. The graphic will respond by highlighting which accounts on the balance sheet are affected. Select one of the remaining transactions for the next date, and so on. Note that a typical business would normally experience many transactions every day; this interactive displays only one per day for illustrative purposes.

**INTERACTIVE ILLUSTRATION 1** Balance Sheet




## 2.3.3 Types of Accounts

Many asset and liability accounts reported on the balance sheet are considered ***permanent accounts***. A permanent account is one that does not reset to zero at the end of the accounting period. For example, the cash in a bank account does not reset to zero at the end of the month just because it's the end of the month. Rather, the balance at the end of the last day of the preceding month is the same balance at the beginning day of the current month. Another example is a loan owed to a bank. The balance owed to the bank on the last day of any given month is not reset to zero at month's end. Instead, the same balance is owed on the first day of the subsequent month. A ***temporary account***, on the other hand, is reset to zero at the end of the accounting period. This affords the entity the opportunity to analyze its business from period to period. Revenues and expenses, which are recorded on the income statement, are temporary accounts. Distinguishing permanent from temporary accounts will become clear as the company prepares its closing entry at the end of an accounting period. **Exhibit 12** lists different types of permanent and temporary accounts.

**EXHIBIT 12** Examples of Permanent and Temporary Accounts for Ashmont Cycles

| Permanent | Temporary |
|---|---|
| Cash | Sales |
| Accounts Receivable | Cost of Goods Sold |
| Inventory | Operating Expenses |
| Prepaid Expenses | General and Administrative Expenses |
| Property, Plant, and Equipment | Advertising Expense |
| Accounts Payable | Rent Expense |
| Deferred Revenue | Wage Expense |
| Notes Payable | Impairment Loss |
| Long-Term Debt | Interest Expense |
| Owner's Equity | Gain on Sale of Long-Term Asset |

At the end of the accounting cycle, a final entry is prepared, the ***closing entry***. The closing entry resets the revenue and expense temporary accounts back to zero at the end of the accounting period. Balances in temporary accounts are transferred into permanent accounts. The process calculates the difference between the revenue and gain accounts and the expense and loss accounts. Then the difference, net income, is put into retained earnings, an equity account on the balance sheet (see below for more information). After the closing entry is made, the only accounts with balances will be the permanent accounts.

## 2.4 Consolidated Corporate Balance Sheets

Corporations whose stock trades on a public exchange such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ) must file an annual report, ***Form 10-K***, with the US Securities and Exchange Commission (SEC). That report provides a comprehensive summary
of a company's financial performance and includes consolidated financial statements and information on company history, organizational structure, executive compen-sation, and so forth.

Most large corporations control more than one business entity. Consequently, they prepare consolidated financial statements. These combine the financial statements of the separate legal entities controlled by the parent company into one set of financial statements. **Exhibit 13** shows the consolidated balance sheet for Google as of December 31, 2013, and December 31, 2014. This is a comparative format, as it shows the account balances from two successive balance sheets. Comparative balance sheets aid in ***financial analysis*** and can be used to spot trends. A comparative balance sheet is not required under GAAP for privately held companies or for nonprofit entities, but the SEC does require it for Form 10-K.

## **EXHIBIT 13** Google Consolidated Balance Sheet ($ in millions)

| **Assets** | As of 12/31/13 | As of 12/31/14 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $18,898 | $18,347 |
| Marketable securities | 39,819 | 46,048 |
| **Total cash, cash equivalents, and marketable securities** (including securities loaned of $5,059 and $4,058) | **58,717** | **64,395** |
| Accounts receivable, net of allowance of $631 and $225 | 8,882 | 9,383 |
| Receivable under reverse repurchase agreements | 100 | 875 |
| Deferred income taxes, net | 1,526 | 1,322 |
| Income taxes receivable, net | 408 | 1,298 |
| Prepaid revenue share, expenses, and other assets | 3,253 | 3,412 |
| **Total current assets** | **72,886** | **80,685** |
| Prepaid revenue share, expenses, and other assets, noncurrent | 1,976 | 3,280 |
| Nonmarketable equity investments | 1,976 | 3,079 |
| Property and equipment, net | 16,524 | 23,883 |
| Intangible assets, net | 6,066 | 4,607 |
| Goodwill | 11,492 | 15,599 |
| **Total Assets** | **$110,920** | **$131,133** |
| **Liabilities and Stockholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $2,453 | $1,715 |
| Short-term debt | 3,009 | 2,009 |
| Accrued compensation and benefits | 2,502 | 3,069 |
| Accrued expenses and other current liabilities | 3,755 | 4,434 |
| Accrued revenue share | 1,729 | 1,952 |
| Securities lending payable | 1,374 | 2,778 |
| Deferred revenue | 1,062 | 752 |
| Income taxes payable, net | 24 | 96 |
| **Total current liabilities** | **15,908** | **16,805** |
| Long-term debt | 2,236 | 3,228 |
| Deferred revenue, noncurrent | 139 | 104 |
| Income taxes payable, noncurrent | 2,638 | 3,407 |
| Deferred income taxes, net, noncurrent | 1,947 | 1,971 |
| Other long-term liabilities | 743 | 1,118 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Class A and Class B common stock, and Class C capital stock and additional paid-in capital | $25,922 | $28,767 |
| Accumulated other comprehensive income | 125 | 27 |
| **Retained earnings** | **61,262** | **75,706** |
| **Total stockholders' equity** | **87,309** | **104,500** |
| **Total liabilities and Stockholders' Equity** | **$110,920** | **$131,133** |

Source: Google 2014 Annual Report

The balance sheet of a large corporation such as Google is far more complex than that of a small company such as Ashmont Cycles and uses vastly larger numbers (in millions—which means the reader must add six zeros to the numbers shown on the balance sheet). However, there are many similarities between Ashmont Cycles's balance sheet and Google's. Both report financial position (assets = liabilities + equity) as of a particular date. Both companies group assets and liabilities according to current and noncurrent classifications.

How can an outside party—an investor, a creditor, a supplier, or an analyst—know that these balance sheet numbers are accurate and representative of the reporting company's underlying financial position and activities? The answer is that external accounting firms have audited 10-Ks and other publicly available corporate annual reports. For example, Ernst & Young LLP, an independent public accounting firm, audited Google's financial statements.

## 2.5 Conclusion

An accounting system is made up of procedures, policies, rules, software, source documents, and people; all are necessary parts of a process that produces a set of financial statements. An accounting system runs on a cycle of analysis of business transactions, interpretation, recording, adjusting, and the preparation of trial balances. The cycle culminates at the end of a fiscal year with a set of financial statements that managers, stakeholders, and the public can use to understand the activities conducted by the business during the accounting period.

A company's full set of financial statements will include a balance sheet, an income statement, a statement of retained earnings (a statement of changes in stockholders' equity), and a statement of cash flows. Each statement tells a different part of the entity's story. The balance sheet reveals the financial position of the company. It lists its assets and the composition of those resources, indicating whether they are current or long-term assets. It shows the company's obligations, also grouped into current and long-term categories. Finally, the balance sheet indicates the total amount of equity in the business and the components of that equity, so that reviewers of the balance sheet can understand how the owners have helped finance the entity. Corporations that are conglomerates of business entities combine the financial figures for their resources, and claims against them, onto one statement called a consolidated statement of financial position.

Users of financial statements must trust the numbers they see, otherwise the accounting system and its cycle would be fruitless. For example, they need to know that there is ***representational faithfulness*** when examining the balance sheet, meaning that the financial statements faithfully represent the transactions and events that occurred during the period. That way, when Jack Pelletier—or any sole proprietor—applies for a business loan, his bank can have confidence in Jack's representation of his company's financial position (see **Video 1**).

**VIDEO 1** Ashmont Cycles

An ***audit*** by independent accountants enhances the information processing that is the accounting cycle. The certified public accounting (CPA) firms that perform audits follow established procedures to determine compliance with generally accepted accounting principles. If compliance is evident, then the auditors provide a very important assurance—a clean opinion—upon which investors, potential investors, creditors, potential creditors, and many other stakeholders can rely in making critical decisions.

# 3 SUPPLEMENTAL READING

## 3.1 Detailed Account Definitions

### *Assets*

**Assets** Assets are generally recorded at the amount paid to prepare the asset for its intended use. This includes items such as sales tax and shipping costs.

**Short-Term (or Current) Assets** Assets expected to be utilized/consumed during the current accounting cycle. Assets are generally listed in order of liquidity, which refers to the efficiency with which the asset can be converted into cash. Current assets and current liabilities are the basis for measuring a company's overall liquidity.

**Cash (may include Cash Equivalents)** Includes deposits with banks, deposits in transit (as of the last day of the accounting period), undeposited checks, cash on hand, and possibly marketable securities.

**Accounts Receivable** Amounts legally owed to a company as a result of past credit sales of goods and services. This account is sometimes referred to as trade accounts receivable. Because there is risk associated with accounts receivable, it is reported net of any estimated uncollectible amounts. This can be thought of as reporting the accounts receivable at its most likely market value, not the original cost of the asset. The uncollectible amount is generally referred to as the "allowance for doubtful accounts" and is an estimate based upon past experience and knowledge of the industry and customer base. The allowance for doubtful accounts is generally referred to as a "contra account" because its balance is a credit balance, despite its being classified within assets. In adherence with the matching concept, the allowance for doubtful accounts will be allocated to revenues through a bad debt expense, which will be shown on the income statement.

**Other Receivables** Amounts legally owed to a company. This account includes amounts other than trade accounts receivable.

**Prepaid Expenses** Amounts paid to vendors for goods or services to be delivered in future periods. Insurance policies are the most typical example.

**Inventory** Tangible goods purchased for resale in the ordinary course of business. Inventory is recorded at the acquisition cost; however, that value may be adjusted to the market value at the end of the accounting period. This is referred to as the lower of cost or market. For manufacturing companies, inventory cost includes raw materials as well as the labor and overhead consumed in converting that raw material into finished goods. For manufacturers, that cost of the raw materials plus the labor and overhead involved in converting the raw material into finished goods is an example of a ***product cost***. These costs are not expensed as they are incurred, rather they are included as a part of the cost of inventory and held as an asset on the balance sheet until the asset is sold. If the inventory is not sold, no expense is incurred because no resource has been consumed.

**Loans/Notes Receivable** Amounts legally owed to the company as a result of a loan granted to others by the company are tracked in accounts receivable. This account should be shown net of any estimated uncollectible amounts.

**Investments** Money invested in other company's equity or debt securities, partnerships, certain property investments, etc. This account is classified as short term if the maturity of the debt investment or the intent to hold the equity investment (in the case of an equity investment that does not mature) is less than one accounting cycle. Accounting rules for investments vary depending on whether the investments are part of a company's trading portfolio (i.e., part of its operations). If the company is in the business of investing for the purpose of generating a profit, then it is classified as trading securities, that is, a brokerage firm. Debt or equity investments classified as trading investments are valued at the current market value and any difference between cost and market value is recognized as an unrealized gain or loss in the current period income statement. An investment not held for the purpose of generating a profit and not intended to be held until maturity is classified as available for sale. Debt and equity investments classified as available for sale are measured at the current market value, and any difference between cost and market value is recognized as an unrealized gain or loss. For companies that are not in the business of trading securities, if the investment is not being held to maturity, then the investment is carried at the lower of the cost or market value and any gain or loss associated with that investment may be recognized directly in the owner's equity section of the balance sheet as part of accumulated comprehensive other income (see discussion below). For investments held to maturity, the asset is accounted for at its amortized cost basis, as adjusted for any discounts or premiums associated with the cost of the security.

**Property, Plant, and Equipment** Tangible, or fixed, assets that were acquired by the company for use in operations and that have an expected useful life greater than one accounting period. All tangible assets, except for land, have limited lives. The cost of tangible assets is generally allocated over its useful life as an operating expense to be compared with the revenue earned over its useful life. This application of the matching concept is also called depreciation. Upon acquisition of property, plant, and equipment, depreciation is calculated based on the expected usage and life of the asset. Although many different methods can be utilized to calculate depreciation (straight line, sum of the years' digits, declining balance, and units of production activity), the straight-line method is the most common. Similar to receivables and inventory, property, plant, and equipment (PP&E) items are initially recorded at cost. Any time management believes the market value of PP&E has suffered a permanent decline to an amount below the book value (cost minus accumulated depreciation), a test must be conducted to determine the market value. For fixed assets, market value determination is referred to as an impairment test, which determines the most likely recoverable or realizable value for the asset. For example, if an asset has a book value (i.e., the cost of the asset minus accumulated depreciation or amortization) of $10,000 and had $2,000 in accumulated depreciation, but its realizable value (i.e., its market value) was only $6,000, then financial statement users would want to see the value on the balance sheet at $6,000 because this is the true worth of the asset as of the balance sheet date. When this condition exists and is considered permanent, the carrying value of the asset must be written down to the realizable value and a loss reported in the current period income statement for the amount written off. This is an application of the conservatism concept.

**Capital Leases** See "capital lease obligations" in long-term liabilities.

**Intangible Assets** Resources without physical substance that provide future economic benefit. There are two types of intangible assets. The first are intangible assets with a finite life. These are assets with useful lives that can be readily determined, such as patents and copyrights. With these, the US government has defined legal useful lives for patent and copyright usage. Intangible assets with finite lives are amortized over those lives. Amortization of an intangible asset is the methodology used to quantify the consumption of the resource over time, similar to the depreciation of a fixed asset. Goodwill is an example of an intangible asset without a finite life. It can emerge in accounting records in the situation of a business combination when the acquiring company pays more than the market value of the net assets for another entity. Goodwill is calculated as the excess of the consideration paid over the market value of the net assets acquired. The excess value does not have a finite life, and therefore goodwill is not amortized; however, goodwill can be reduced if the carrying value of the goodwill is found to exceed its fair value. If it does, the goodwill is reduced to the fair value. This is another example of an impairment test. Depreciation of a tangible noncurrent asset also reduces the balance sheet value of the asset. The difference in values is recorded in the accumulated depreciation account, which is a contra account (counterpart), to the asset account. The net effect is a reduction in the recorded value of an asset. The asset's historical cost minus its accumulated depreciation is called the net book value. For intangible noncurrent assets, the reduction of remaining useful life is calculated by recording the amortization expense. In this case, the expense directly diminishes the value of the intangible asset. There is no associated contra asset account on the balance sheet.

**Dividends Payable** Common stock and preferred stock shareholders can receive payments from an entity out of its retained earnings to compensate for their investment. These payments are referred to as dividends. Once a company declares a dividend it becomes a legal obligation that must be paid. Prior to the company declaring the dividend, no legal obligation is owed to shareholders. In some cases, preferred shareholders receive dividends before common shareholders. Dividends in arrears must be reported.

**Interest Payable** Entities that use loans from banks or that issue bonds or notes as a means of financing their asset purchases must pay interest to the lender. The interest cost is the price of using cash that belongs to another entity. Interest cost begins to accrue from the moment the debt originates and continues to accrue until the obligation is extinguished. The interest payable account represents the unpaid cost of using another entity's cash for the current accounting period and will remain a payable until paid by the entity.

**Taxes Payable** Any obligation to a local, state, or federal government agency for taxes owed. In some cases, income tax liability is reported separately from other taxes.

**Unearned Revenue** If an entity collects cash from a customer prior to delivering a product or providing a service, then the cash collected is not a sale but a liability because, as a result of accepting that cash, the entity has a legal obligation to provide that service or product. An example of this would be a newspaper company that provides annual subscriptions. Any customer who pays for an annual subscription is owed the newspaper for the next year. The newspaper entity would record the cash received as unearned revenue and incrementally recognize it as earned over the next year as the newspapers are delivered.

**Current Portion of Long-Term Debt** The portion of an entity's long-term debt that is due within one accounting period, generally at the end of the fiscal period. Because of the importance of determining a company's liquidity, financial statement users want to see all of the liabilities that are due within one accounting period, including the due portion of long-term debt. This is critical for financial statement users who seek a true picture of the company's ability to pay as well as its risk of bankruptcy.

**Notes/Loans Payable** Amounts legally owed by the company as a result of a loan previously made to the company. This account is classified as short term if the maturity of the loan/note is less than one accounting period.

**Contingencies** Amounts that could be owed by an entity depending on the outcome of a future event, such as the final court determination of an existing lawsuit. A contingent gain is an amount that could be owed to the company if, for example, the company expected to win a lawsuit against a competitor. In accordance with GAAP, continent gains are never recognized in the financial statements, but should be disclosed in footnotes to the financial statements. A contingent liability and loss occurs when an entity may owe an amount or be obligated to perform a service or provide a product in the future depending on the outcome of a future event. An example of this would be if the company expects to lose a lawsuit brought against it by a competitor. Another common example is a product warranty. In the event that a company provides a warranty on its product, it may have to record a contingent liability. Contingent liabilities are recognized if it is probable that a future cost will be incurred and the amount can be reasonably estimated. In many cases, contingent liabilities should be disclosed in the financial statements and/or accompanying notes. It is important for financial statement users to be informed of contingencies. A company that fails to disclose a contingent loss is not being transparent in reporting its financial position. ***Transparency*** refers to the financial statements showing the true underlying business events and position of a company.

**Deferred Income Taxes Payable** An entity's ***recognition*** of revenues and expenses for financial reporting purposes often differs in timing from its recognition for income tax determination purposes due to differing regulations. These differences are referred to as temporary differences. Consider the depreciation of fixed assets. Most US companies depreciate fixed assets using the straight-line method for US GAAP purposes, while they are required to follow the Modified Accelerated Cost Recovery System (MACRS) for tax purposes. Over the entire life of the asset, the cumulative amount of depreciation will be the same under financial and tax reporting. However, the timing of the recognition of that depreciation (and thus income) is different. In the early years, financial income is higher than tax income (because the depreciation expense is lower), thus indicating that in future years tax income will be higher than financial income and, therefore, the tax liability in future years will be greater due to higher taxable income. The tax impact of this difference must be recognized on the balance sheet. These deferred tax liabilities are classified as either current or long term, depending on the timing of the reversal. Deferred tax assets also occur. Deferred tax calculations can be complex and confusing. Remember that the purpose of financial statements is to show users how a company has performed over an accounting period and to mark its current financial status. As part of that reporting, financial statement users should be informed of upcoming tax liabilities that would be unknown if not reported. The exclusion of any obligation, including deferred tax liabilities, would prevent financial statement users from seeing the true state of a company at a certain point in time.

*Long-Term Liabilities*

**Long-Term Debt** Loans received from banks or other entities with a maturity date greater than one year from the reporting date. Amounts are recorded at the present value of the future cash payments.

**Bonds Payable** A specific kind of long-term debt. Companies issue bonds, generally in increments of $1,000, to investors. Interest is paid to investors in accordance with the bond contract, and the face value of the bond is due upon maturity.

**Capital Lease Obligations** A lease is a contract that provides a company (the lessee) with a service or a product over a specified period of time in exchange for periodic payment (to the lessor). If the lease meets certain criteria, then the risks and benefits of the leased asset are said to have passed to the lessee, and in accordance with GAAP, the lease must be treated as both an asset and a liability by the lessee. The amount reported as a liability is the present value of the future minimum lease payments. The asset is reported at the same amount and, under certain conditions, is depreciated over the life of the asset, or, under others, is depreciated over the lease term, as is similar for any other fixed asset. The FASB's decision to treat some leases as assets and liabilities is based on the goal of enabling financial statement users to see the underlying business position of a company. If certain criteria are met, the FASB believes a capital lease is no different than buying an asset with credit in exchange for a loan. In that case, financial statement users should be entitled to see the value of the asset as well as the obligation to repay the amount borrowed for that asset.

*Equity*

**Common Stock, Par Value** Common stock is recorded at par value, or stated value of the stock. The par value per share or stated value per share is stipulated in the corporate charter. Although not of significance today, a century ago the par value stipulated a minimum value for a company's stock and helped investors ensure they would not overpay if purchasing a company's stock. If a company's stock has no par value, then the entire amount paid to the company in exchange for the shares of stock is considered additional paid-in capital. This account is also referred to simply as common stock.

**Additional Paid-In Capital on Common Stock** The amount paid to a company per share of common stock less the par value per share. There is no significance to the split between par value of common stock and additional paid-in capital.

**Treasury Stock** Stock that a company repurchases and holds for later reissue. When treasury stock is acquired there is no effect on common stock, par value accounts, or additional paid-in capital for accounts. Unlike the other equity accounts treasury stock has a debit balance, making it a contra equity account, and, regardless of the par value, treasury stock is always recorded at cost.

**Preferred Stock** Although similar to common stock, preferred stock differs from common stock in several ways. First, owners of common stock are generally considered owners of the company and are entitled to vote on shareholder matters. Preferred shareholders usually have no such rights. Second, preferred stock is called "preferred" because preferred shareholders usually are entitled to receive dividends prior to common stock shareholders. Preferred stock originated as a way to allow a company to reduce the amount of fixed obligations it had (i.e., to reduce loans and bonds payable). Today, preferred stock is a widely accepted way for corporations to increase funds available for future growth.

**Retained Earnings** ***Retained earnings*** represents the cumulative net income earned by the company since inception less any dividends declared since inception.

**Accumulated Other Comprehensive Income** Certain transactions and other events that result in unrealized gains or losses for the company are recorded directly to accumulated other comprehensive income, which is an equity account, rather than through the current period income statement as a gain or loss on the income statement. These items do not involve the operations of the company. Examples of such items include unrealized gains/losses on investments and foreign currency translation adjustments.

## 3.2 Financial Statement Audit

The series of events that produces a set of financial statements is sometimes referred to as the financial reporting supply chain. The audit is an important part of that chain. A financial statement audit is conducted by external (independent) public accountants whose objective is to determine whether the accounting records are accurate and complete, prepared in accordance with

GAAP or other applicable accounting standards, and fairly present the organization's financial position (balance sheet) and the results of its financial operations (income statement). The final result of an external audit is the issuance of an ***audit opinion*** by the CPA firm. An auditor's opinion is a certification that accompanies financial statements.

There are three types of auditor opinions. A clean, or unqualified, opinion confers that the financial statements present a fair and accurate picture of the company and comply with generally accepted accounting principles. A qualified opinion contains exceptions—noted deviations from accounting standards. An adverse opinion contains a major exception or warning. The most well-known adverse opinion is the going concern exception, in which the accountant expresses doubts about the company's ability to remain in business.

**Exhibit 14** contains the auditor's clean opinion for Google's financial statements. The bold type is the opinion statement made by Ernst and Young LLP upon completing its audit of Google's financial statements.

**EXHIBIT 14** Report of Independent Auditors

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**The Board of Directors and Stockholders of Google Inc.**

We have audited the accompanying consolidated balance sheets of Google Inc. as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2014. Our audits also included the financial statement schedule listed in the Index at Item 15(a)2. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

**In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Google Inc. as of December 31, 2013 and 2014, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2014, in conformity with US generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Google Inc.'s internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 6, 2015, expressed an unqualified opinion thereon.

**Ernst & Young LLP**
San Jose, California
February 6, 2015

Source: Google 2014 Annual Report.

Even with an unqualified opinion, auditors do not provide foolproof guarantee, but a reasonable assurance that the statements have been presented fairly. There are many risks involved with an audit. Audit risk is the chance that the independent auditor will express an inappropriate audit opinion—for example, a clean opinion when the company's financial statements are materially misstated. There is inherent risk that an account will contain an error despite the existence of the company's internal controls. There is also control risk—the risk that the company's internal control system will fail to prevent or detect and correct a material misstatement of the financial statements, and there is the risk (detection risk) that the independent auditor's procedures will not detect a misstatement that exists.

Company management has primary responsibility for the firm's financial statements and for implementing and maintaining internal controls over financial reporting. In large US corporations, the audit committee of the board of directors is responsible for the appointment of the auditor and receives the financial statement audit report, the ultimate output of the audit. In accordance with Section 301 of the Sarbanes-Oxley Act of 2002:

> *The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.*

By serving the public interest, public accountants who provide financial statement audits are a key component of the financial reporting supply chain (along with management and the audit committee). Auditors must adhere to standards, including ethical codes of conduct, and must practice their craft with a skeptical mind. They must not hesitate to question management's assertions when those assertions seem incorrect or in conflict with the auditor's professional judgment.

Auditors of a public company are subject to strict independence rules as put forth by the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission. The PCAOB was created as a result of the Sarbanes-Oxley Act of 2002. The audit staff must be free from relationships that would prevent them from objectively performing the audit.

Although not required, most large companies employ an internal audit staff. As defined by the Institute of Internal Auditors, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations".[3] The scope of internal auditing is broader than that of a financial statement audit. That scope may also include examination of the efficiency and effectiveness of operations, the testing of internal controls, compliance with laws and regulations, and in some cases, the investigation of suspected or detected frauds.

# 4 KEY TERMS

**account** The basic record used in an accounting system to keep track of the balances of assets, liabilities, equities, revenues, and expenses of an organization.

**accounting cycle** The steps involved in the collective process of recording and processing information relating to accounting events of an entity, including collecting and analyzing data from transactions and events, putting transactions into the general or special journals, posting entries to the general ledger, preparing a trial balance, preparing period-end adjusting entries appropriately, preparing an adjusted trial balance, organizing accounts into the financial statements, closing the books, and preparing a post-closing trial balance to check the accounts.

**accounting equation** An equation that forms the basis for the double entry bookkeeping system: Assets = liabilities + shareholders' equity.

**accounting period** The period covered by a financial statement.

**accounting standards** Another name for accounting principles.

**accrual accounting** Stipulates that revenue is recognized when earned and expenses are recognized when incurred; events are recorded as they happen, regardless of whether cash has been exchanged.

**accrued expenses** Amounts owed for services that have been performed by an entity but have not yet been billed.

**accumulated depreciation** The amount of depreciation that has accumulated since the associated fixed asset was acquired.

**accumulated other comprehensive income** An account into which certain transactions and other events that do not involve operations and that result in gains or losses for the company are charged directly rather than being shown on the income statement. Examples of such items include unrealized gains/losses on certain investments and foreign currency translation adjustments.

**adjusting entries** Entries that must be made at the end of the accounting period so that financial statement users can see the impact of the passage of time on the resources of the entity.

**articles of incorporation** A charter to establish the existence of a corporation in the United States.

**assets** Probable future measurable economic benefit, which the reporting entity has acquired through a current or past transaction.

**audit** A series of procedures carried out by an accountant, including performing extensive tests of transactions and internal controls. These procedures help the accountant be reasonably certain that accounting systems perform as required by generally accepted accounting principles.

**audit opinion** Report presenting the results of an auditor's examination of an entity's financial statements.

**balance sheet** A financial statement that provides a snapshot of the company's resources and the claims on those resources at a specific point in time.

**books** A term that is synonymous with a financial recordkeeping system of journals and ledgers.

**business entity** A business activity for which accounting reports are prepared.

**business transaction** An economic event that involves a change in an asset, a liability, or stockholders' equity.

**cash equivalent** Short-term assets that are readily converted to cash and whose value will not change.

**chart of accounts** A listing of the accounts in the general ledger of the accounting system. The chart of accounts is ordered with balance sheet accounts (assets, liabilities, stockholders' equity), followed by income statement accounts (revenues, expenses, gains, losses).

**classified format** A balance sheet format that groups assets and liabilities into current and noncurrent categories.

**closing entry** A journal entry that resets the revenue and expense temporary accounts back to zero at the end of an accounting period and transfers the resulting net income or net loss to the retained earnings account. The process involves debiting all temporary accounts with a credit balance, generally the revenue and gain accounts; crediting all temporary accounts with a debit balance, generally the expense and loss accounts; and posting the difference—net income or net loss—to the retained earnings account.

**conservatism concept** Recommends that prudence be exercised in recording revenues and expenses. More specifically, revenues should be recognized only when they are reasonably certain, but expenses should be recognized as soon as reasonably possible.

**consistency concept** A principle that states that an entity should use the same accounting methods and procedures from period to period unless there is a sound reason for changing.

**cost** Monetary measurement of resources used to acquire property, goods, or services.

**current liabilities** Obligations that will be paid or satisfied within a year; they are grouped together and shown first within the liability section followed by the long-term liabilities.

**current value** Amount an asset could be sold for in an open market, or a liability liquidated at the reporting date.

**disclosure concept** A principle that accounting reports disclose enough information that they will not mislead careful readers who are reasonably well informed in financial matters. Special disclosure is made of unusual items, changes in expectations, significant contractual relations, and new activities. The disclosure can be in the body of a financial statement, the auditor's opinion, or the notes to the statement.

**double entry accounting method** Accounting system under which every business transaction involves at least two accounts. It ensures that the accounting equation remains in balance.

**due diligence** The steps an investor should take when evaluating a potential investment.

**entity concept** Defines the accountant's area of interest: a business entity that is separate and distinct from its owners. The concept thus sets limits on the possible objectives and contents of financial reports. The accountant's role is to prepare financial statements for the business entity—the affairs of the owners are irrelevant to those statements.

**equity** Assets−liabilities. This category represents the ownership claim on the assets of an entity.

**fair value** The price at which property would change hands between a buyer and a seller without any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.

**Financial Accounting Standards Board (FASB)** In the United States, an independent, not-for-profit organization whose stated mission is to establish and improve financial accounting and reporting standards.

**financial analysis** An assessment of the strengths, weaknesses, viability, stability, and profitability of a business by using various techniques, including financial ratios, examination of trends in revenues and costs, and interpretation of various disclosures contained in the notes to financial statements.

**financial statement** Financial information presented in a statement format such as a balance sheet, an income statement, a statement of comprehensive income, a statement of financial position, or a statement of cash flows.

**Form 10-K** A comprehensive summary of a company's financial performance that includes consolidated financial statements and information on a company's history, organizational structure, and executive compensation, as well as other information. In the United States, publically traded corporations annually file a Form 10-K with the Securities and Exchange Commission.

**general ledger** A complete record of financial transactions over the life of the entity.

**Generally Accepted Accounting Principles (GAAP)** Within the US regulatory system, accounting rules that all US publicly held companies and some US private companies follow. Within the context of the regulatory environments of other nations, GAAP can refer to the accounting rules of that country or region (i.e., European Union). For example, International Financial Reporting Standards (IFRS) are often referred to as international GAAP.

**going concern concept** Implies that the entity will continue to operate for at least the next fiscal year without the threat of liquidation.

**historical cost** The transaction price or cost of a good or service at the time of the original transaction.

**intangible assets** Resources without physical substance that provide future economic benefit. Includes both intangible assets with a finite life, such as patents and copyrights, and intangibles without a finite life, such as goodwill.

**International Accounting Standards (IAS)** Accounting standards originally issued by the International Accounting Standards Committee and subsequently adopted by the International Accounting Standards Board.

**International Accounting Standards Board (IASB)** An independent, private-sector body that develops and approves International Financial Reporting Standards, based on input from global accounting standard-setting bodies, and which are used in many markets around the world.

**International Financial Reporting Standards (IFRS)** Accounting standards adopted by the International Accounting Standards Board.

**journal entry** The recording of a transaction in chronological order with debits and credits to appropriate accounts.

**journalize** The act of entering transactions into a journal.

**liabilities** Legal obligations to pay or provide a service or deliver a product.

**market value** Price in an actual market.

**marketable security** A security for which a market exists in which the security can be traded.

**matching concept** An accounting concept that stipulates that expenses should match revenues as closely as possible during the period in which they occurred.

**materiality concept** States that an entity need only apply proper accounting to items that are material, that is, significant to potential users of the financial statements. However, what is and is not material is open to judgment and discretion. The general rule is that an item is material if its disclosure would impact the decisions of the users of the accounts.

**money measurement concept** Financial accounting deals only with things that can be represented in monetary terms.

**net book value** Carrying value on a balance sheet of an asset. For example, the cost of equipment less its accumulated depreciation is its net book value.

**owner's equity** Excess of an entity's assets over its liabilities.

**permanent account** An account that is not reset to zero at the end of an accounting period and is reported on the balance sheet.

**product cost** Any resource (i.e., asset) that is not expensed/consumed until it is sold to customers. Product costs remain on the balance sheet until sold, at which time they are expensed.

**recognition** The act of recording a transaction, an event, or an item in an entity's accounting records.

**relevance** An accounting principle that financial statements should present information that is timely and useful.

**reliability of evidence concept** When recording events, accountants rely as much as possible on objective, verifiable, documentary evidence instead of the subjective and potentially biased judgments of a person. Acceptable evidence includes such items as approved sales and purchase invoices.

**representational faithfulness** Information presented in the financial statements should faithfully represent the transaction and events that occur during a period.

**retained earnings** An account that represents the cumulative net income earned by the company since inception less any dividends declared.

**Securities and Exchange Commission (SEC)** An agency of the US federal government that is responsible for establishing US GAAP, enforcing federal securities laws, proposing securities rules, regulating the securities industry, and overseeing the audit process for publicly held corporations.

**source documentation** The evidence of a business transaction. Examples include invoices, checks, calculations (i.e, depreciation), purchase orders, and bills of lading.

**statement of cash flows** A financial statement showing cash sources and uses by a company over an accounting cycle.

**statement of income** Also called the income statement or the profit and loss statement, it shows revenues and expenses and the net income or loss of a business entity over a period of time.

**T-account** The debits and credits from the general ledger shown in an isolated account.

**temporary account** An annual account the balance of which is set to zero at the end of an accounting period.

**transparency** As pertains to financial statements, a situation in which a stakeholder can gain a true understanding of an entity's financial position by examining its balance sheet and evaluating its business performance using information found in other financial statements.

**trial balance** A listing of all accounts in an entity's general ledger accounts with their balances, at a certain period of time, including debit and credit balances. Its purpose is to ensure that total debit balances equal total credit balances and that the accounting equation remains in balance.

# 5 FOR FURTHER READING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# 6 ENDNOTES

[a] Financial Accounting Foundation. "What We Do: FASB." www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027541293, accessed July 18, 2016.

[b] FASB Concepts Statement No. 3.

[c] The Institute of Internal Auditors. "About Internal Auditors." https://global.theiia.org/about/about-internal-auditing/pages/about-internal-auditing.aspx, accessed July 18, 2016.

# 7 INDEX