

ACCOUNTING ILLUSTRATED Dictionary

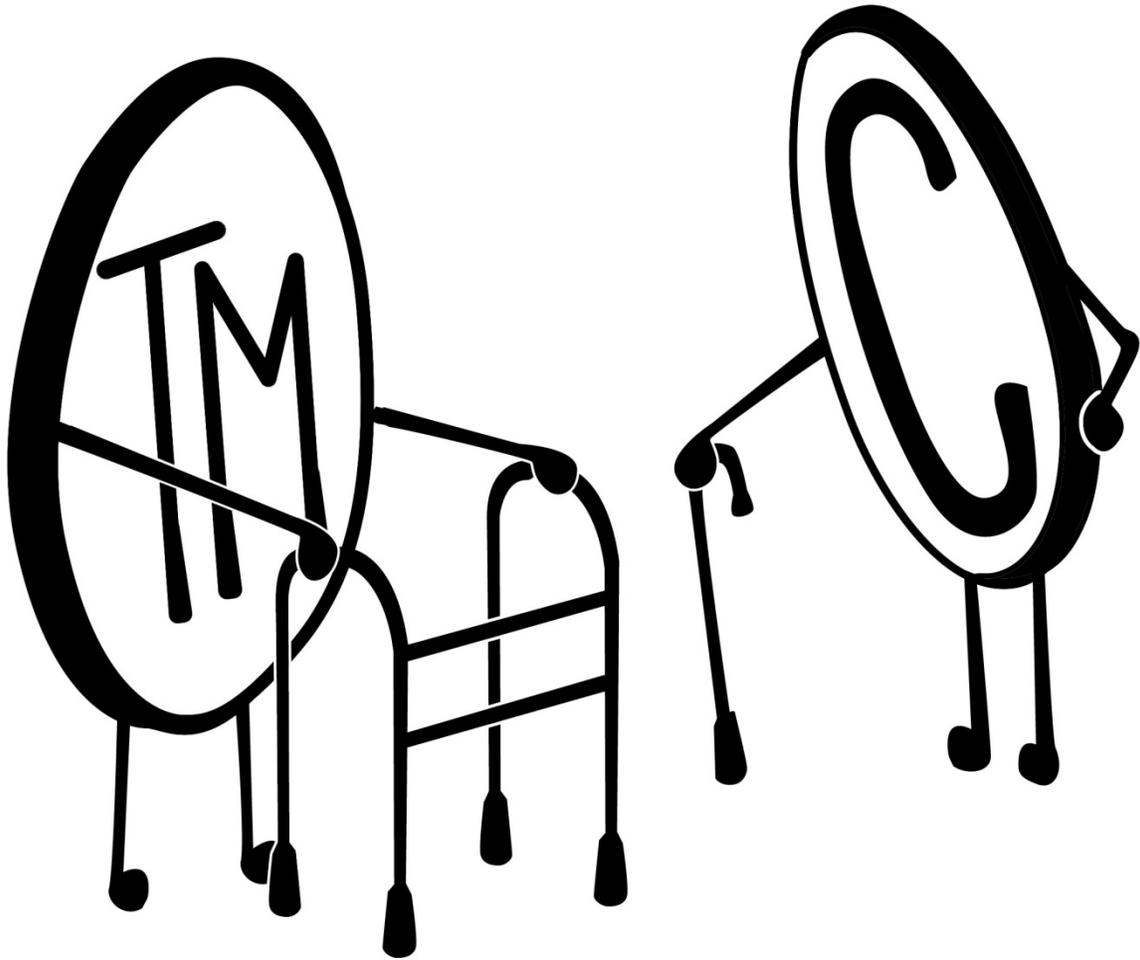


Learn Accounting Visually
AccountingPlay.com

JOHN GILLINGHAM CPA

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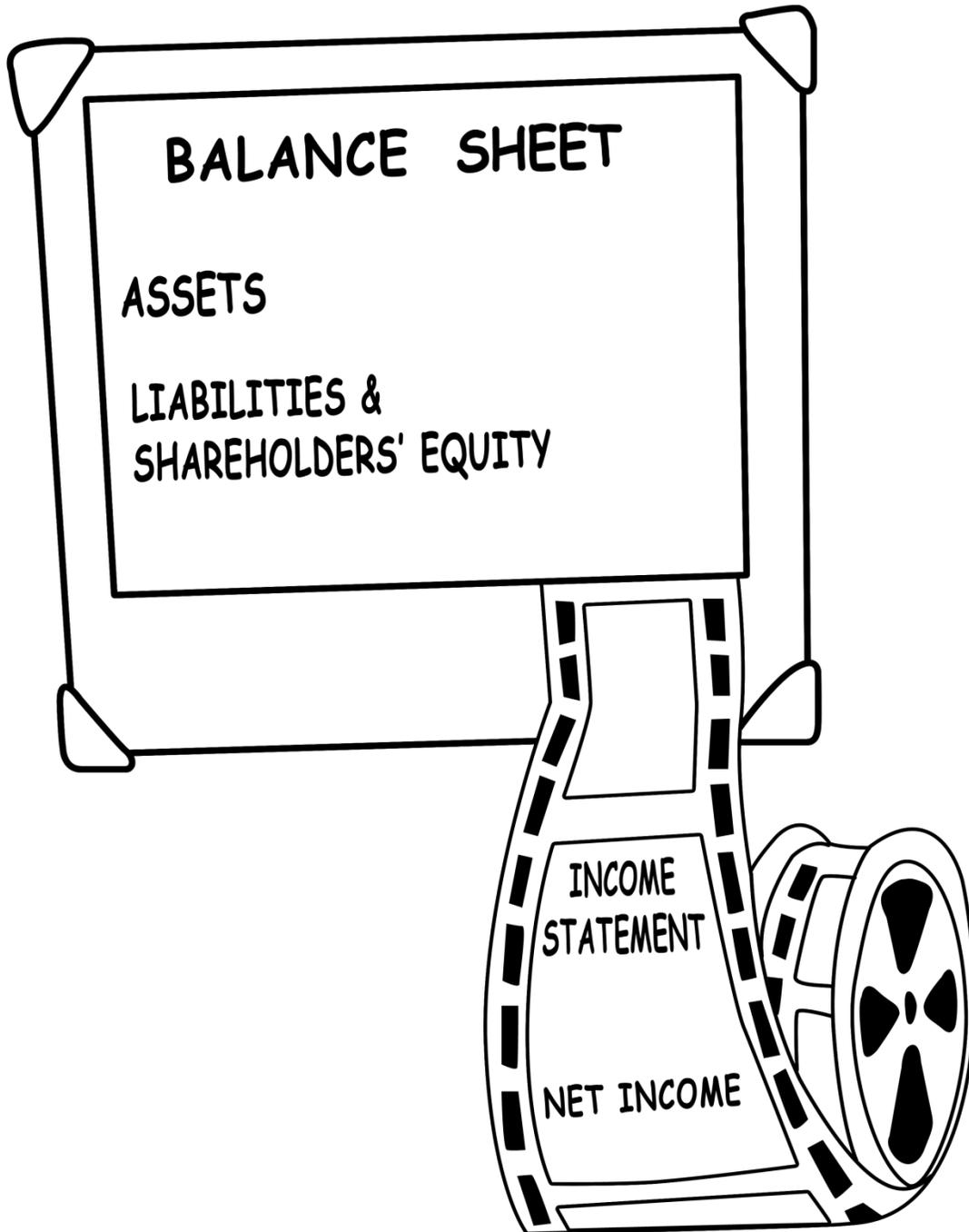


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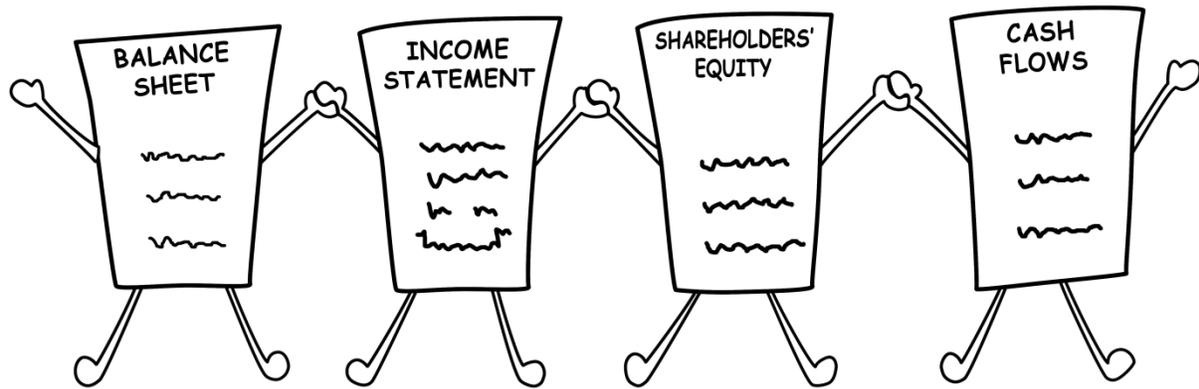
Entities

DEBIT		CREDIT	
↑	ASSETS	↓	ASSETS
↓	LIABILITY	↑	LIABILITY
↓	EQUITY	↑	EQUITY
↑	EXPENSES	↑	REVENUE

Intro

Welcome to the Accounting Illustrated Dictionary, by Accounting Play and John Gillingham CPA. Over one-hundred accounting terms are covered, each with a unique illustration. Financial accounting students and anyone wanting to learn differently can benefit from this resource. The AID is designed to be used with other related Accounting Play projects. Please check out books, games, videos, along with

the [Debits & Credits Rap](#) at [AccountingPlay.com](#). Check out the free 5-Star accounting education apps and game for iPhone and iPad in the [App Store](#). Your emails and reviews are always deeply appreciated. Email questions and concerns to Support@AccountingPlay.com. Thanks :) for your support.



About the Author

John Gillingham is a surfer CPA living in San Francisco California. He owns his own CPA firm, makes creative learning tools, and consults. He designed the AID to make learning accountancy fun. Learning [apps by Accounting Play](#) include: Accounting Flashcards, Accounting Play – Debits & Credits, and Accounting Review. For career or education consulting, please email Support@AccountingPlay.com.

About the Illustrator

All illustrations are hand drawn by Courtney Quirin, artist and journalist: [CourtneyIllustrates.com](#).

Licensing

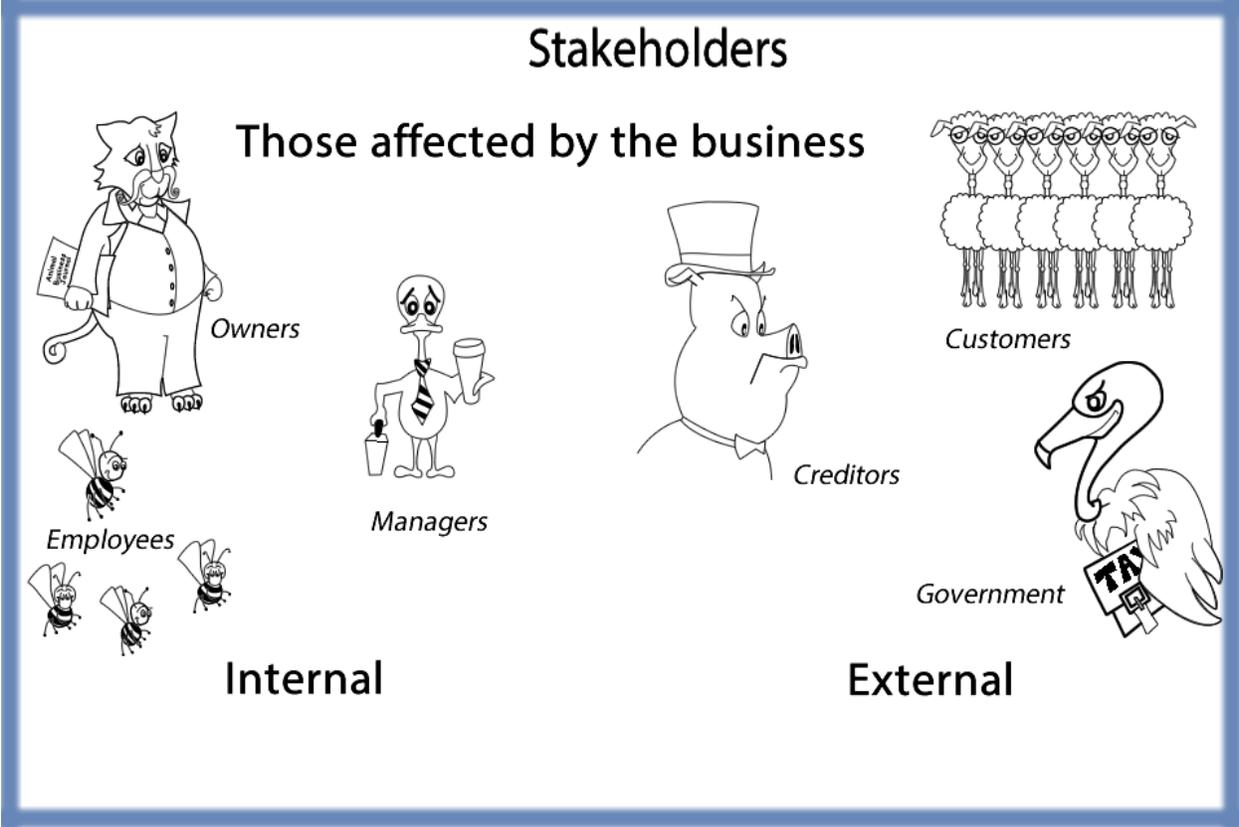
All images are available for affordable licensing and commercial use. Please contact Support@AccountingPlay.com.

How to Use

Accounting Illustrated Dictionary teaches accounting terminology visually. Specific terms can be studied according to user needs, whether a student or professional. Please see [AccountingPlay.com](#) and the [App Store](#) for more comprehensive resources.

Character Background

Accounting Illustrated Dictionary features characters from AccountingPlay.com, set in the animal world of business. The plot centers around a bear named Teddy, who starts his own toy company. Teddy receives investment from Investor Fat Cat and a loan from Banker Pig. In the story, Teddy starts out as a corporation from the advice of his legal counsel, Mouse & Mouse LLP. Names, characters, businesses, places, events and incidents are either the products of the author's imagination or used in a fictitious manner. Any resemblance to actual persons, living or dead, or actual events is purely coincidental. ;)



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Work-in-process (WIP)

Characters

[AP Monkey](#): Accounts payable clerk and employee of Teddy Fab

[Banker Pig](#): Owner of Bank of Piggy and lender to Teddy Fab

[Broke Badger](#): Customer who owes money to Teddy Fab

[Bunny CPA](#): Certified Public Accountant (CPA) to Teddy Fab

[Construction Birds](#): Construction workers

[Consumer Sheep](#): Consumers

[Cougar Controller](#): Controller of Teddy Fab

[Dolphins](#): Couriers

[Duck](#): Manager at Teddy Fab

[Eager Beavers](#): Shareholders

[Elephant](#): Vendor

[Fat Cat Investor](#): President of Fat Cat Investment Bank and investor in Teddy Fab

[GAAP Lion](#): Head of accounting pronouncements

[Giraffe](#): Vendor

[Mice](#): Partners in a limited partnership law firm, Mouse & Mouse LLP

[Rickety Rooster](#): Conservative investor

[Snakes](#): Partners in a general partnership, Snake & Snake

[Tax Vulture](#): Tax collector

[Teddy](#): Chief executive officer (CEO) of Teddy Fab

[Turtle](#): Owner of Turtle Toys, a sole proprietorship

[Wall Street Cats](#): Employees of Fat Cat Investment Bank

[Weasel CFO](#): Chief financial officer (CFO) of Teddy Fab

[Worker Bees](#): Production line workers for Teddy Fab

Entities

[Fat Cat Investment Bank](#): Investment bank

[Mega Corp](#): Publically traded corporation

[Mouse & Mouse LLP](#): Limited liability partnership law firm

[Piggy Bank](#): Local bank

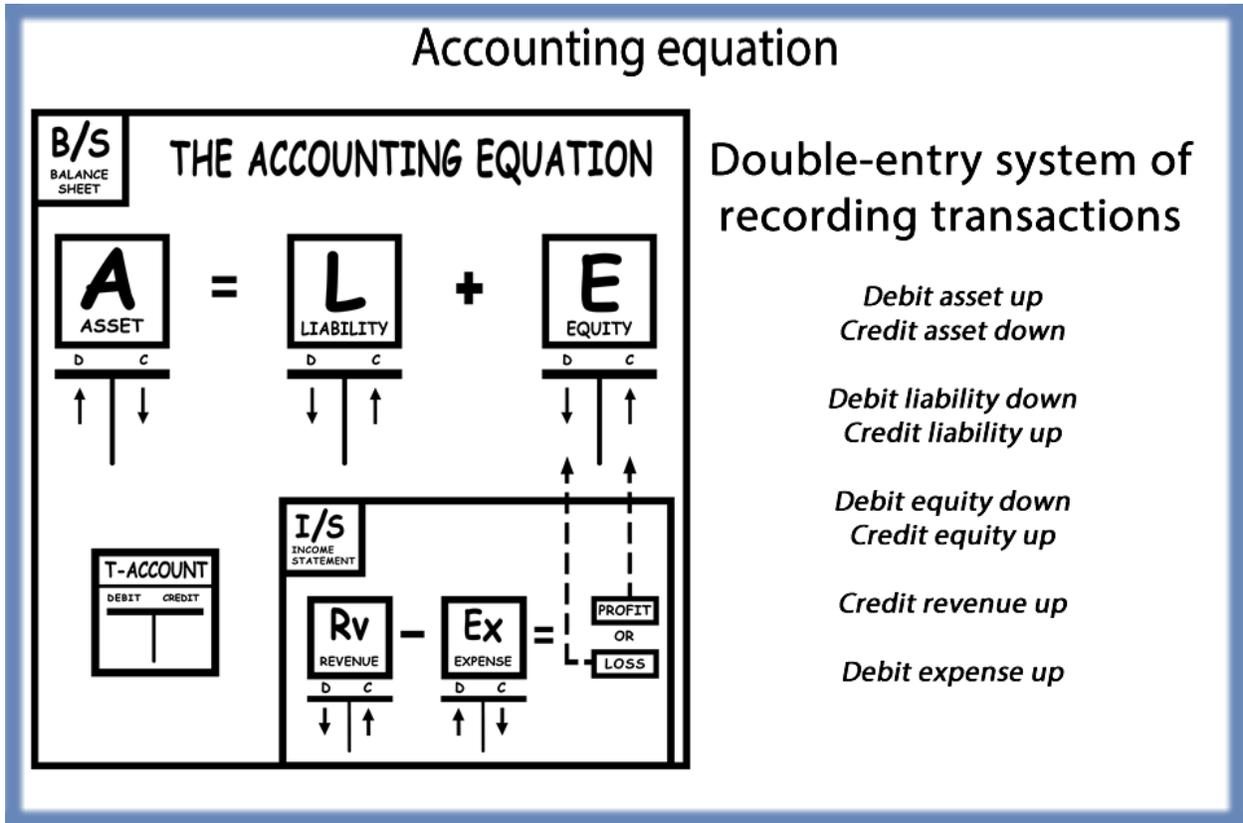
[Snake & Snake](#): General partnership

[Teddy Fab Inc.](#): Corporation that manufactures toys, owned primarily by Teddy

[Turtle Toys](#): Sole proprietorship owned by Turtle

Accounting equation The double-entry accounting framework expressed as: Assets = Liabilities + Equity

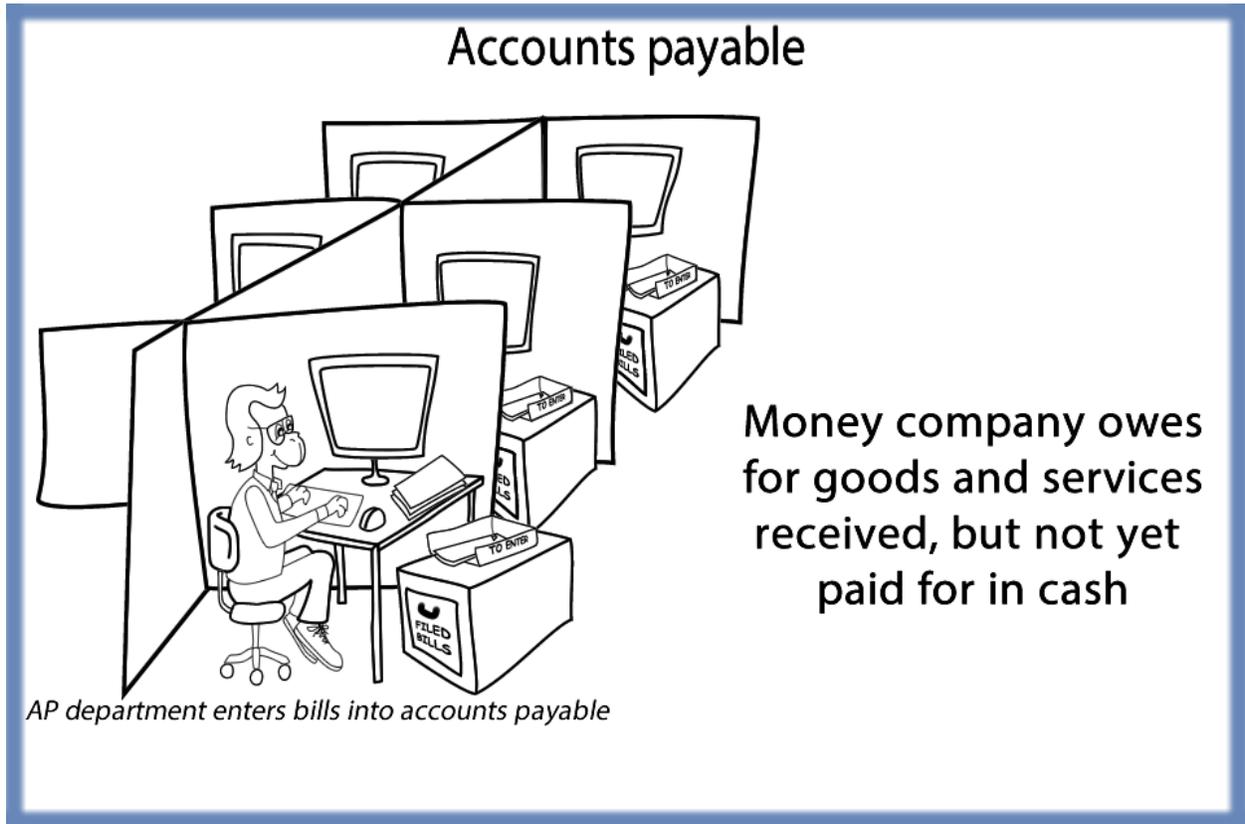
- * May be expressed as Equity = Assets - Liabilities
- * Assets, liabilities, and equity represent balance sheet accounts
- * Revenue and expenses are income statement accounts that combine to create net income or net loss
- * Net income or loss gets added or subtracted to retained earnings at the end of the accounting period



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Accounts payable (AP) Money owed to creditors and vendors

- *Increased when expense incurred
- *Decreased when expense paid in cash
- *Considered a liability because it represents amounts owed to vendors



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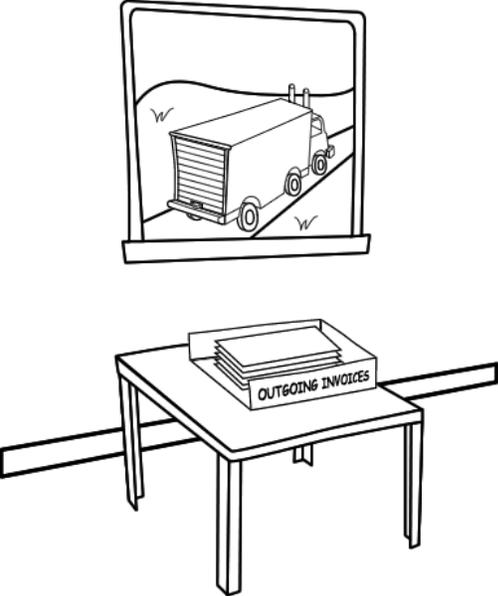
Accounts receivable (AR) Cash due from customers who have purchased merchandise or received services not yet paid for

*Increased when sale is made

*Decreased when sale is collected

*Converted to cash by collection, discounting, or factoring customer accounts

Accounts receivable



The illustration consists of two parts. The top part shows a window with a delivery truck inside, with the letters 'W' written on the window panes. The bottom part shows a table with a stack of papers on it, labeled 'OUTGOING INVOICES'.

Represents uncollected cash
from customers

*AR Department sends invoices for goods
shipped and services rendered*

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Accounts receivable turnover Measures the frequency of the revenue collection cycle

*Helps monitor the rate of collection for credit sales

*A low ratio implies that collection of credit sales is slow

*365 / accounts receivable turnover ratio = Average collection period

Accounts receivable turnover

$$\begin{array}{l} \text{ACCOUNTS RECEIVABLE} \\ \text{TURNOVER RATIO} \end{array} = \frac{\text{SALES}}{\text{AVERAGE ACCOUNTS RECEIVABLES}}$$

Turnover Ratio

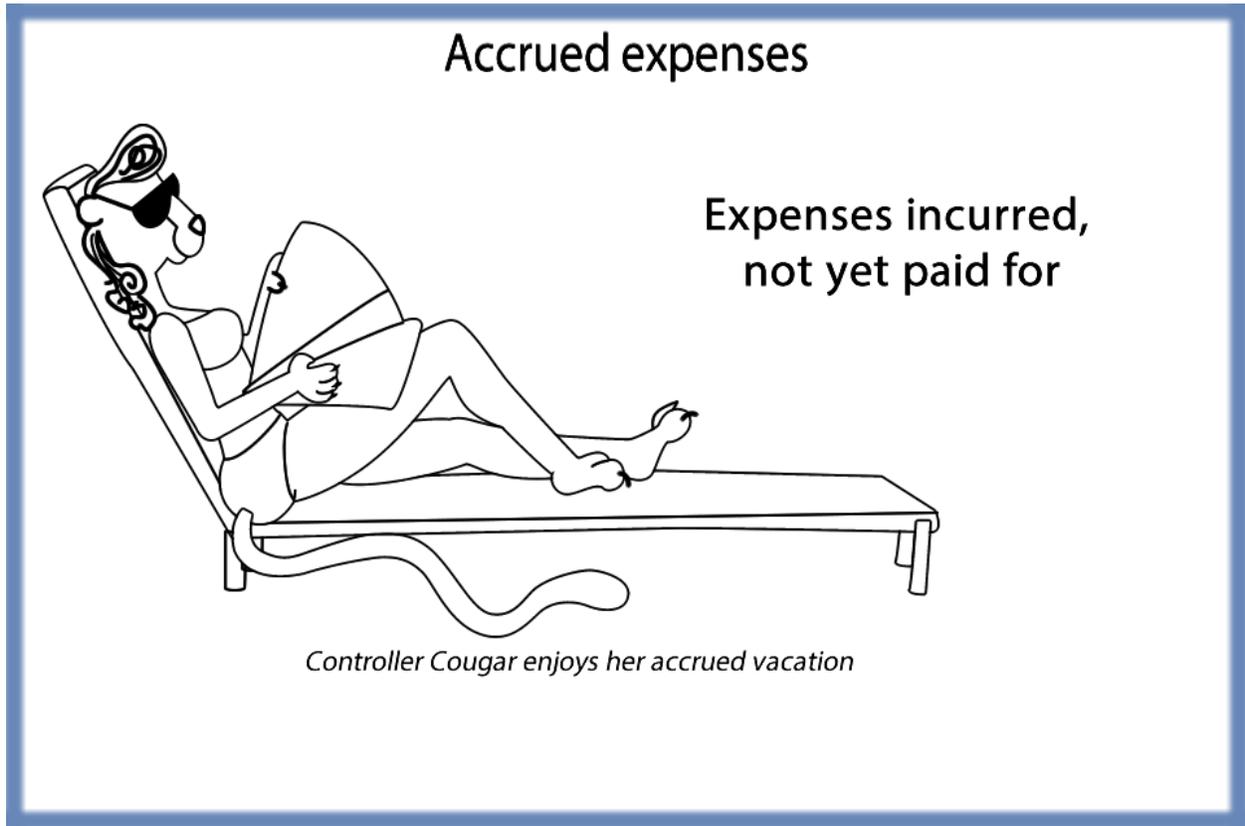
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Accrued expenses Expenses incurred before the end of the accounting period, but not yet paid for

Examples

*Wages earned by employees not paid at year-end

*Employee benefits not yet paid, such as vacation



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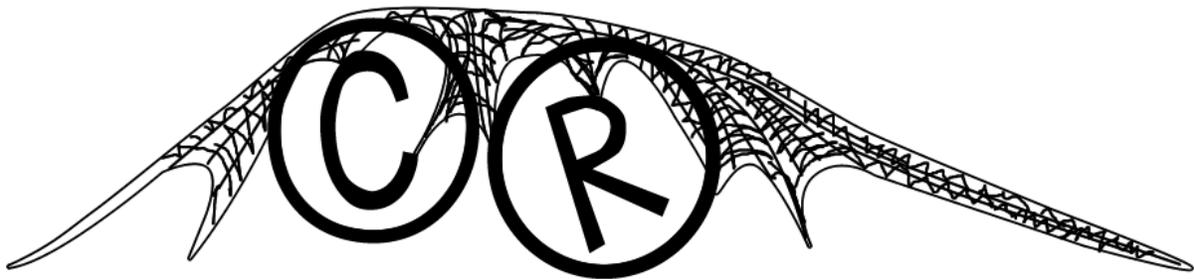
Accumulated amortization The sum of prior amortization expense

*Contra account presented as a negative number (credit) in the asset section of the balance sheet

*Offsets intangible asset value recorded at cost, such as: patents, trademarks, copyrights, franchise licenses, and goodwill

Accumulated amortization

Contra account, reduces amortizable asset value



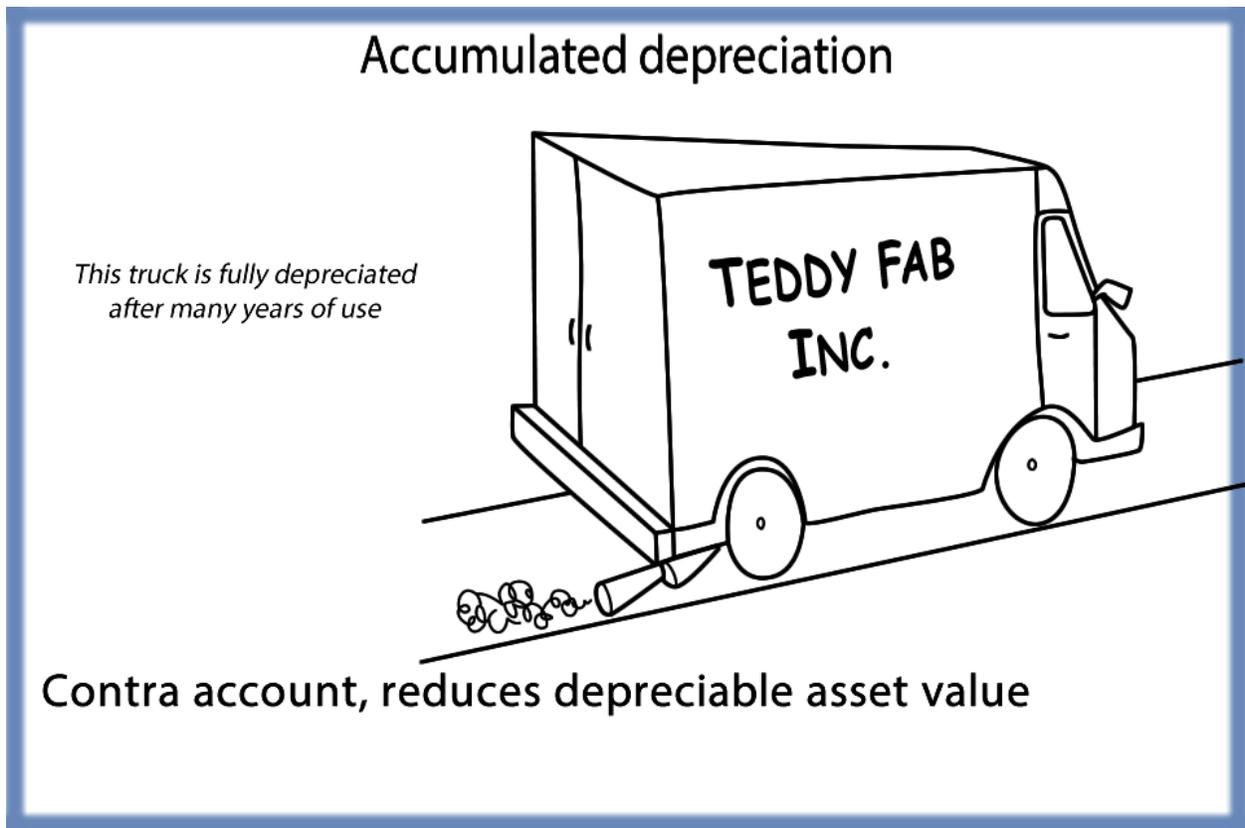
These copyrights and registered trademarks are less valuable over time

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Accumulated depreciation The sum of prior depreciation expense

*Contra account presented as a negative number (credit) in the asset section of the balance sheet

*Offsets tangible asset value recorded at cost, such as property, plant, and equipment

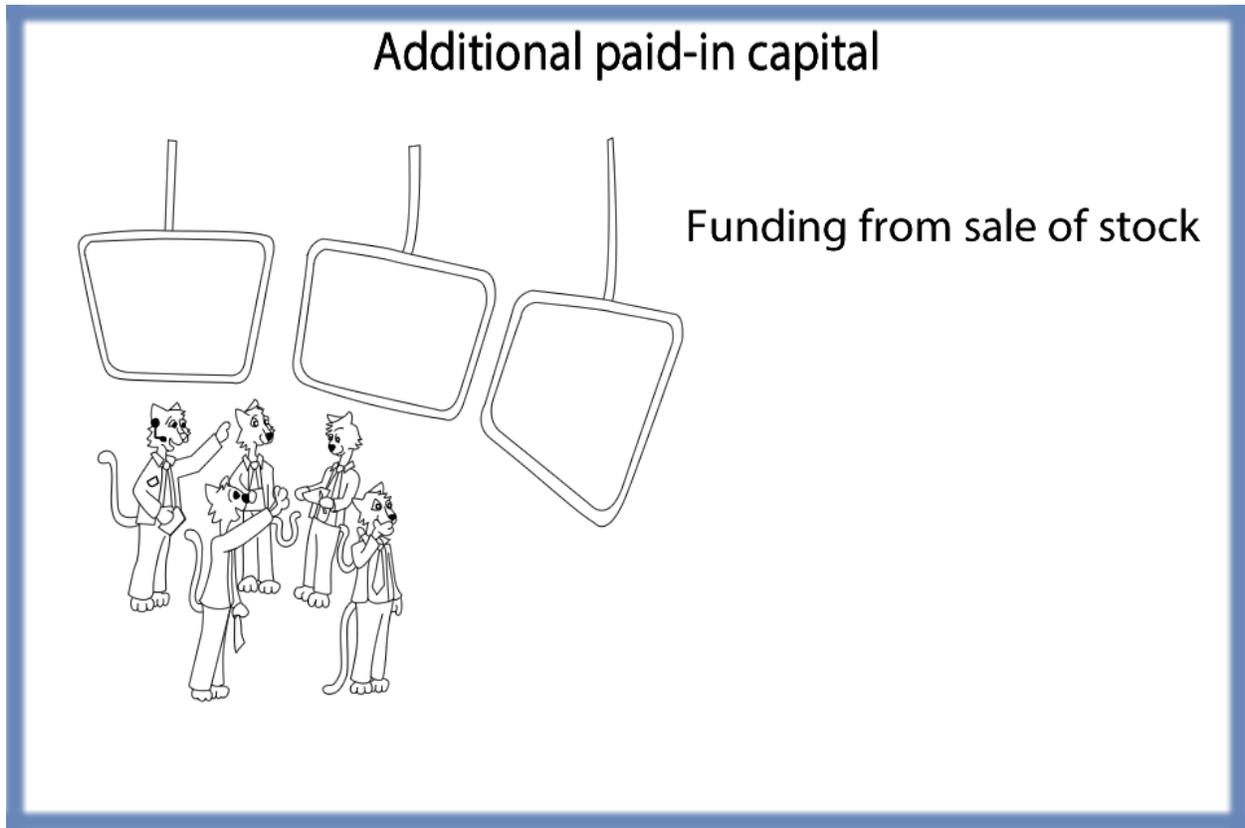


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Additional paid-in capital Investment received by corporation, in excess of par value per share

*Par value typically set low, such as \$.01 per share

*Classified as equity on the balance sheet



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Adjusting journal entries Adjusts records directly by increasing or decreasing accounts

*Directly adjusts the books and records without changing individual transactions

Common adjustments: depreciation, amortization, capitalization of assets purchased, accrued expense liabilities, prepaid assets, investment performance adjustments, and unearned revenue

		Adjusting journal entries		
TEDDY FAB INC. ADJUSTING JOURNAL ENTRIES December 31, 2100		Debit	Credit	
AJE-1	Depreciation expense	5,000.00		
	Accumulated depreciation		5,000.00	
	Record depreciation expense			
AJE-2	Amortization			
	Accumulated amortization	200.00		
	Record amortization expense		200.00	
AJE-3	Property, plant, & equipment	1,200.00		
	Operating expense		1,200.00	
	Reclassify fixed asset purchase			
AJE-4	Prepaid expense	2,000.00		
	Rent expense		2,000.00	
	Reclassify January rent paid in December			
AJE-5	Intangible assets	4,000.00		
	Startup expenses		4,000.00	
	Reclassify startup expenses			
		<u>\$ 12,400.00</u>	<u>\$ 12,400.00</u>	

Used to adjust the accounting record directly

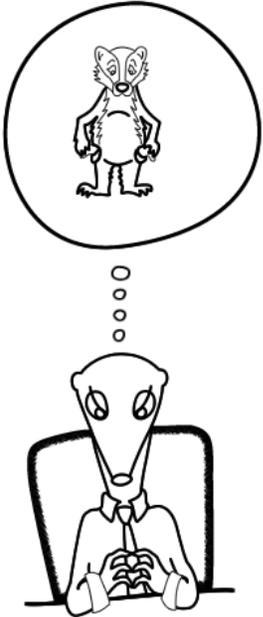
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Allowance for doubtful accounts Used to estimate uncollectible credit sales

*Contra account presented as a negative number (credit) in the asset section of the balance sheet

*Allowance is increased along with bad debt expense if more customers are expected to not pay amounts due

Allowance for doubtful accounts



**Estimate of credit sales that
will not be collected**

*To establish the allowance for doubtful accounts,
the CFO considers customers that might default*

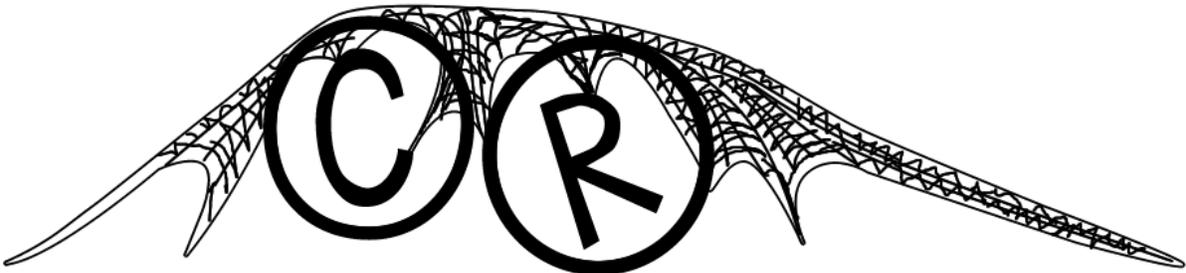
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Amortization expense Represents the cost of an intangible asset over time

*Represents decline in intangible assets such as patents, trademarks, and copyrights

*Tax law and Generally Accepted Accounting Principles (GAAP) differ on amortization methodologies

Amortization expense
Intangible asset cost recognized over time



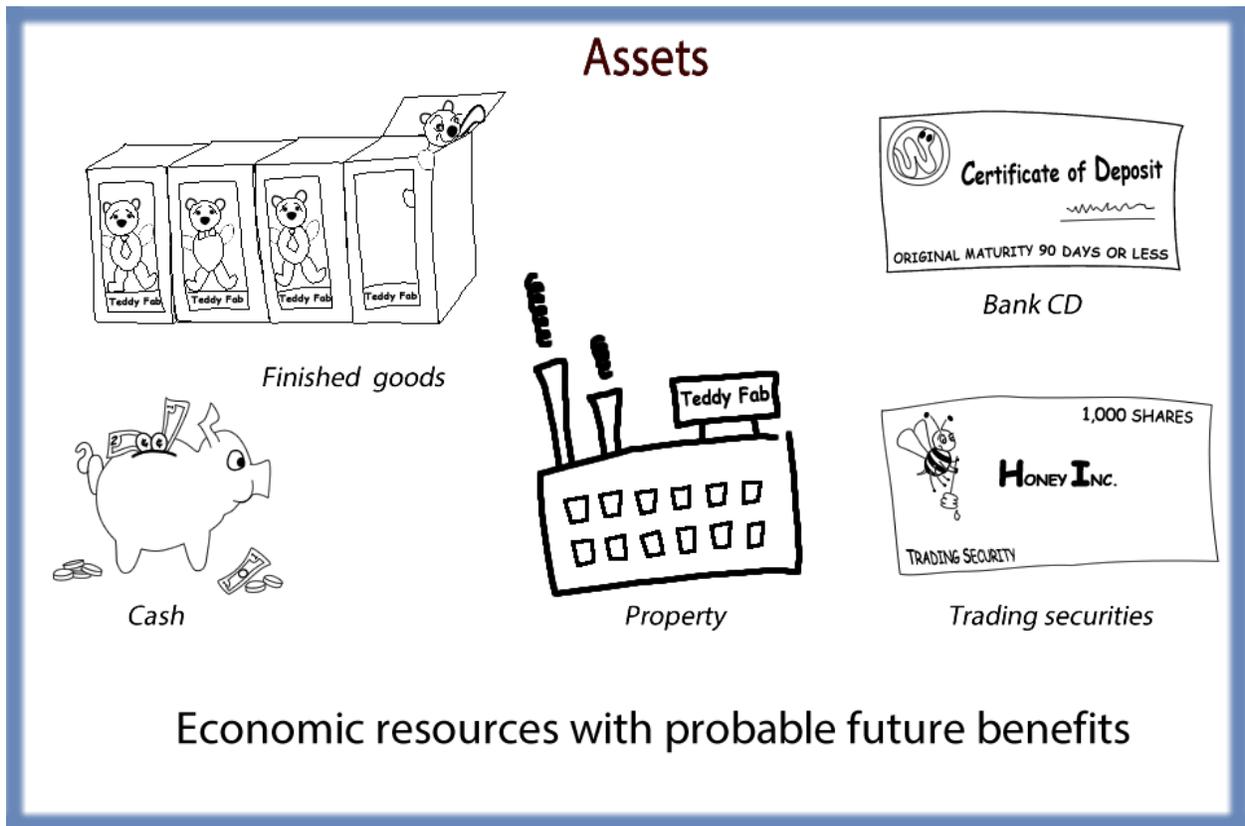
*Copyrights and registered trademarks are examples
of intangible assets which can lose value*

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Assets Economic resources with probable future benefits

Examples: cash and cash equivalents, accounts receivable, inventory, prepaid expenses, investments, property, plant, and equipment, and intangible assets

Financial statement: balance sheet

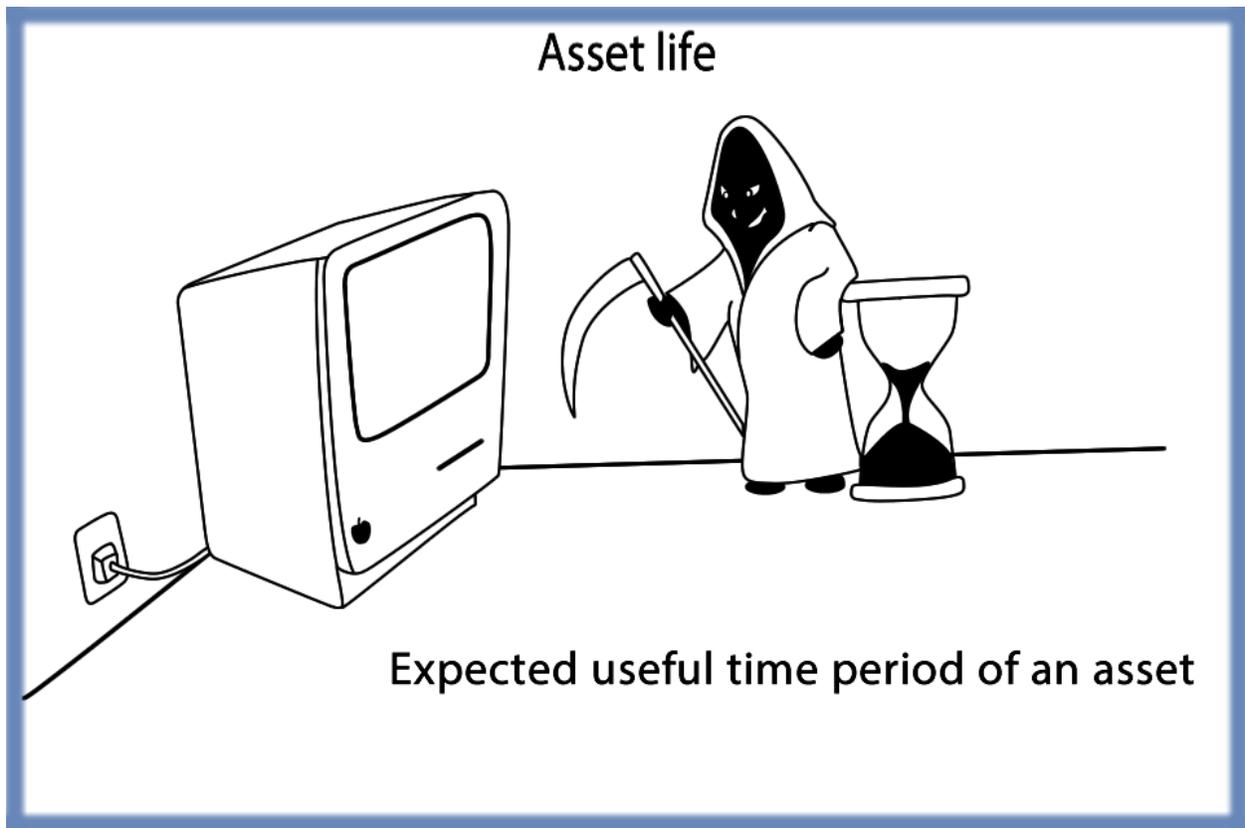


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Asset life Estimated length of time an asset is expected to be useful

*Typically asset life will be in years

*Under units-of-production depreciation method, useful life is estimated by machine output or hours

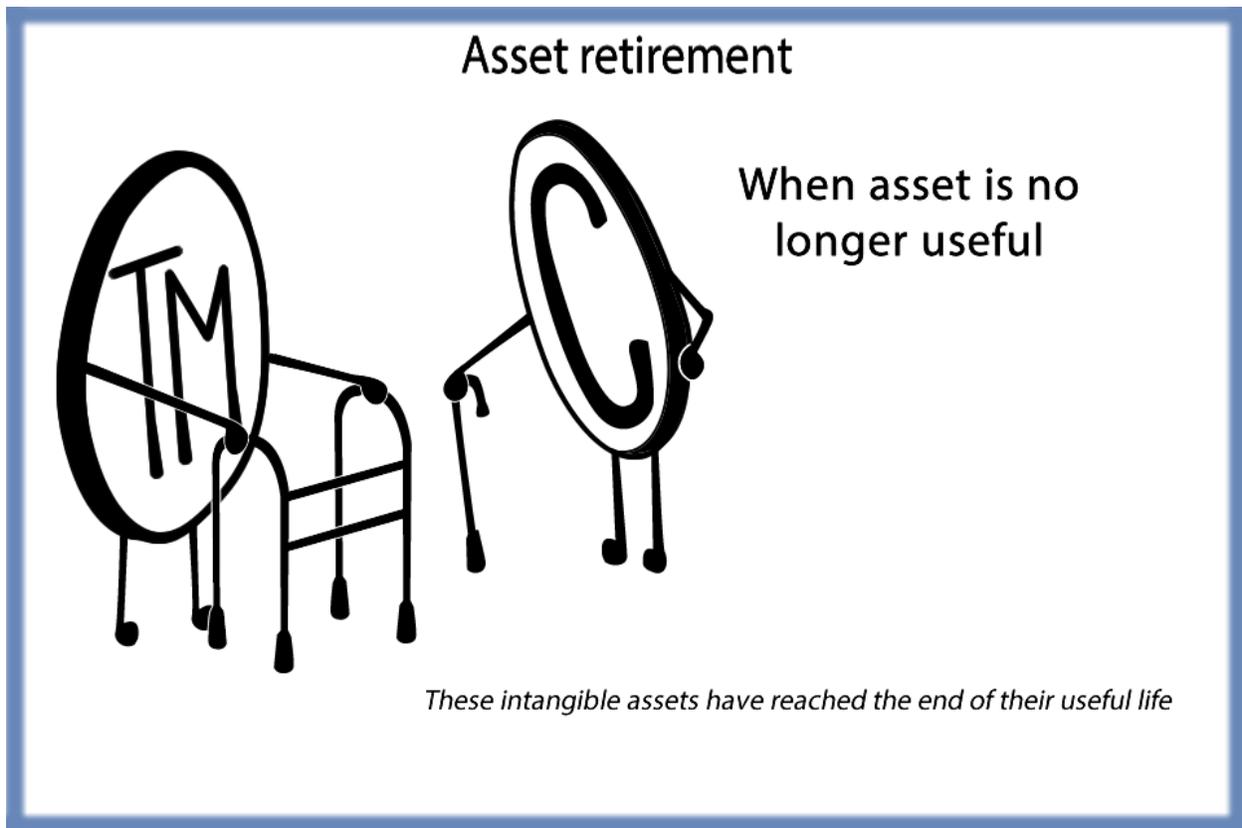


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Asset retirement Point at which asset is no longer useful and is disposed of

*Asset cost and accumulated depreciation for the asset are removed from the books

*Gain or loss on disposition whether sold or scrapped, will likely be classified as extraordinary income

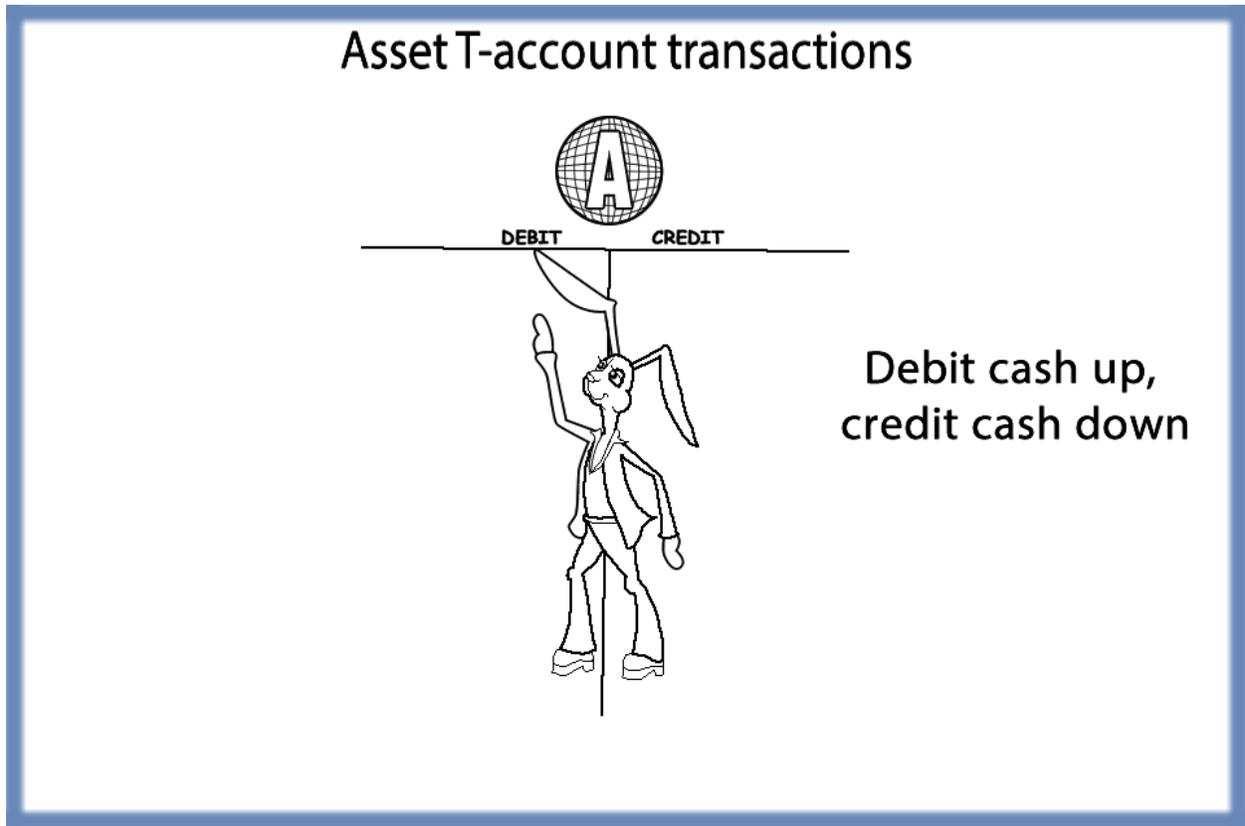


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Asset T-account transactions Increase assets with a debit and decrease with a credit

Basic entries

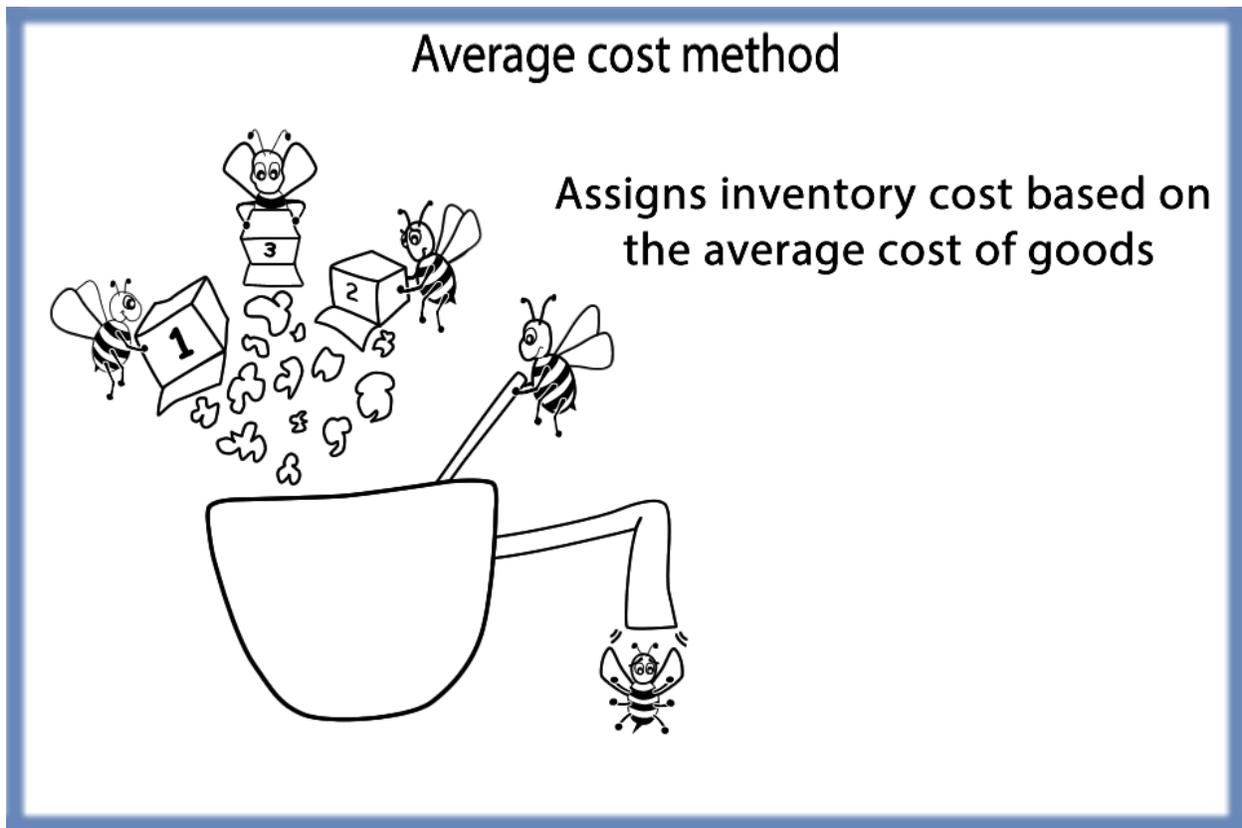
- *Receive outside investment: debit cash, credit equity
- *Receive a loan: debit cash, credit liability
- *Receive refund of expense: debit cash, credit expense
- *Pay bills: debit accounts payable, credit cash
- *Repay loan: debit liability, credit cash



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Average cost method Inventory accounting system which assigns cost based upon an average purchase price to determine ending inventory and the cost of goods sold

*Works well for homogenous inventory items, such as bulk cotton used in manufacturing

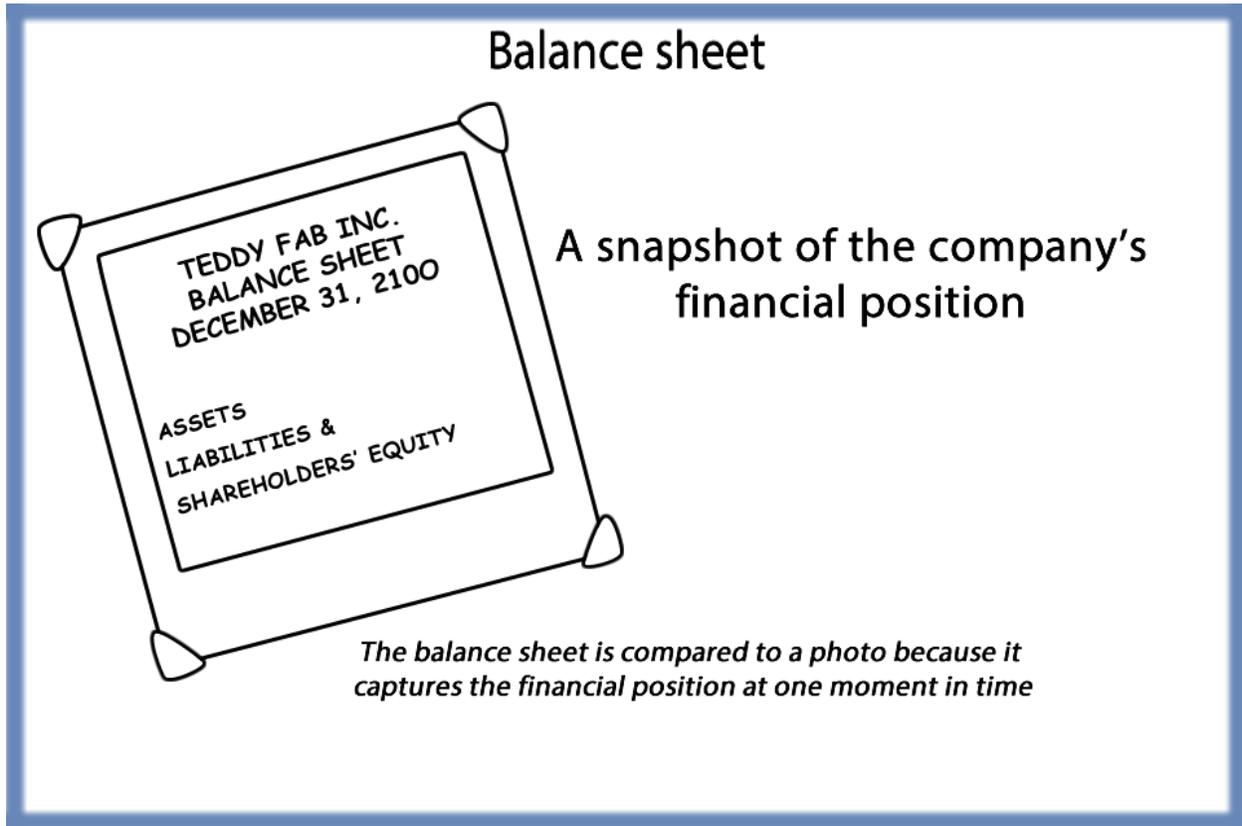


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Balance sheet Statement that reports the financial position of a company by presenting assets, liabilities, and equity

*At a fixed date in time

*Presents accumulation of financial activity



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Balance sheet example Presents assets, liabilities, and equity of a company at a given point in time

*Balance sheet format similar to the accounting equation: Assets = Liabilities + Equity

*Assets are presented in order of liquidity, classified as current or long-term

*Liabilities are presented in the order of date due

Balance sheet example			
TEDDY FAB INC.			
BALANCE SHEET			
December 31, 2100			
ASSETS			
Current assets			
Cash and cash equivalents	\$	100,000	
Accounts receivable		20,000	
Inventory		15,000	
Prepaid expense		4,000	
Investments		10,000	
Total current assets		149,000	
Property and equipment			
Land		24,300	
Buildings and improvements		250,000	
Equipment		50,000	
Less accumulated depreciation		(5,000)	
Other assets			
Intangible assets		4,000	
Less accumulated amortization		(200)	
Total assets	\$	472,100	
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable	\$	30,000	
Notes payable		10,000	
Accrued expenses		5,000	
Deferred revenue		2,000	
Total current liabilities		47,000	
			Long-term debt 200,000
			Total liabilities 247,000
Shareholders' Equity			
			Common stock 10,000
			Additional paid-in capital 20,000
			Retained earnings 197,100
			Treasury stock (2,000)
			Total liabilities and shareholders' equity \$ 472,100

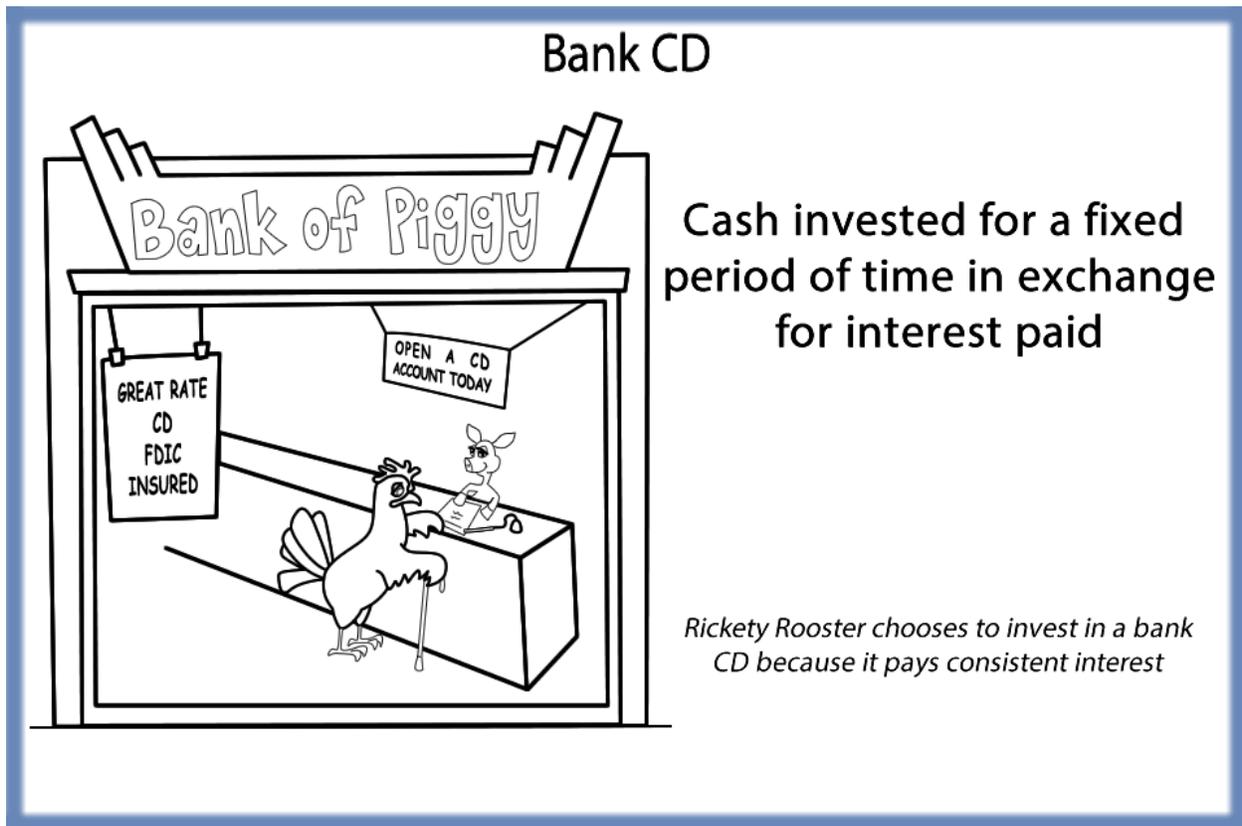
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Bank CD Certificate of deposit promises a rate of return to the investor and allows the bank use of funds for the investment period

*Considered a cash equivalent if CD has an original maturity date of 90 days or less

*Redeemable in cash

*Typically a penalty due for early redemption



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Bank reconciliation Proves the differences between cash per books and cash per bank

*Balance per books = bank balance – outstanding checks + outstanding deposits

*Balance per bank = balance per books + outstanding checks – outstanding deposits

*Reconciliation shows the differences between the bank statement and accounting record

Bank reconciliation

	BALANCE PER BANK STATEMENT
+	
	DEPOSITS IN TRANSIT
-	
	OUTSTANDING CHECKS
+/-	
	BANK ERRORS
	<hr/>
	BALANCE PER BOOK

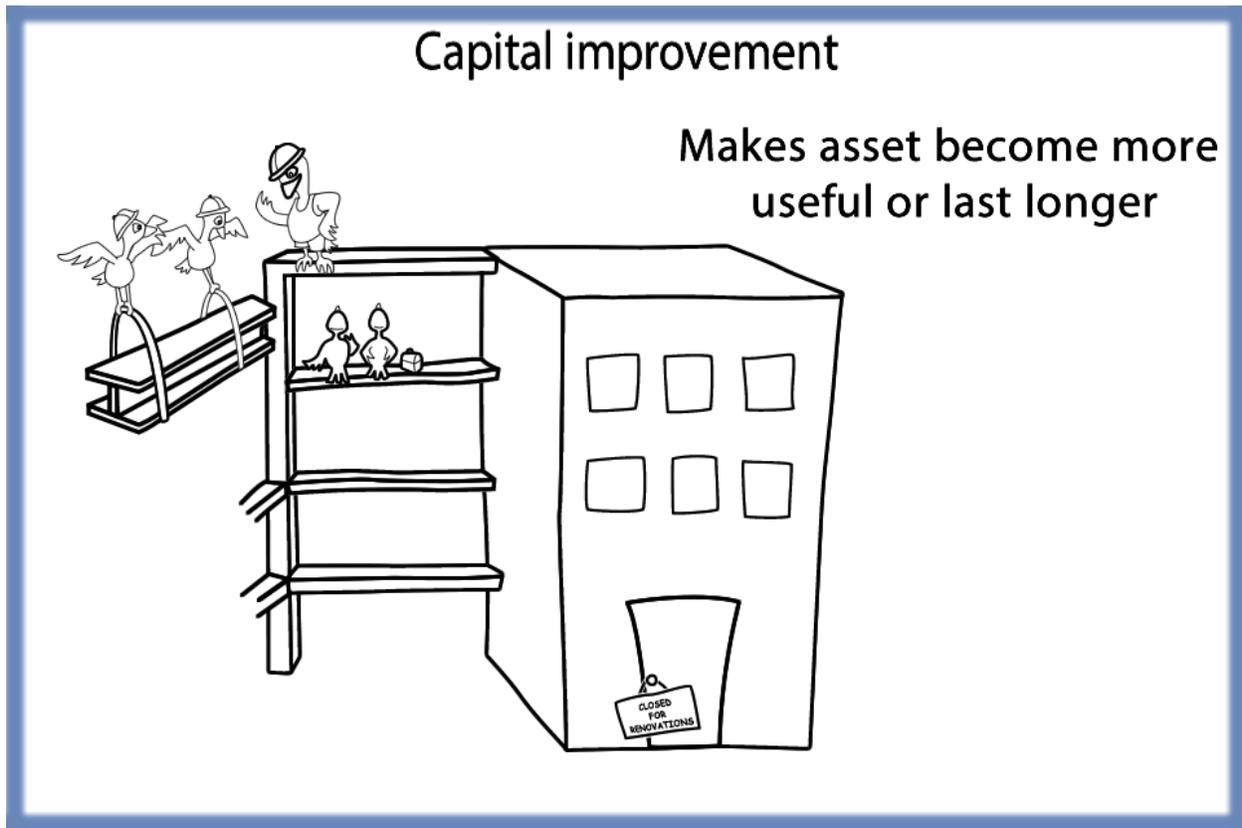
Ties cash book balance to cash bank account balance

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Capital improvement Existing assets made to last longer, increase productivity, or extend use value

*Added to asset value and depreciated

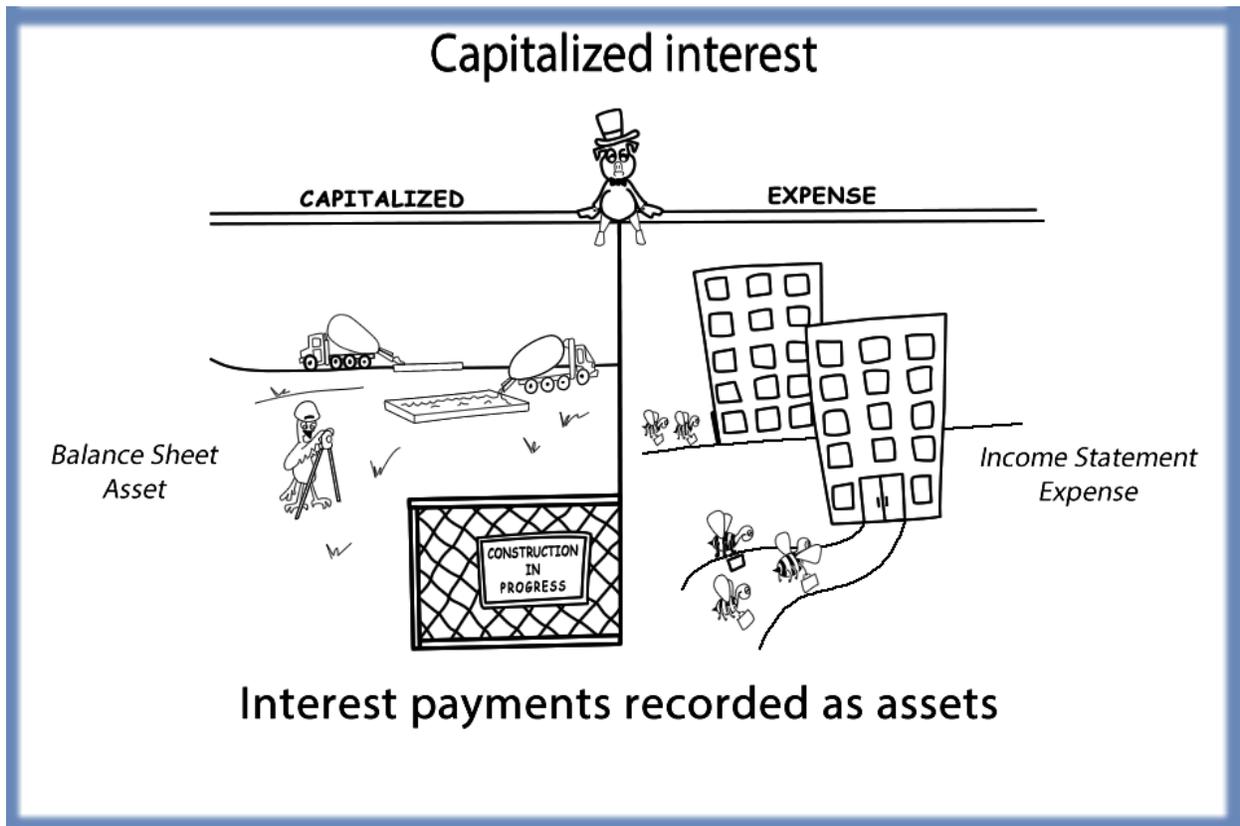
*Depreciation expense recognizes the cost of the improvement over time



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Capitalized interest Interest payments treated as an asset, instead of an expense, in certain circumstances

- *Interest payments related to construction are capitalized until a structure is complete
- *Interest payments following the completion of an asset are expensed
- *Capitalized interest increases the basis of an asset



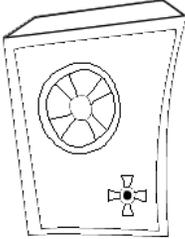
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Cash & cash equivalents The most liquid asset on the balance sheet

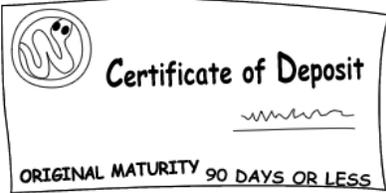
*Easily converted to cash, original maturity 90 days or less

Examples: negotiable paper, bank CDs, money market accounts, petty cash, savings accounts, and checks not mailed

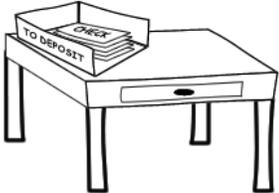
Cash & cash equivalents



Cash



Bank CD



Checks not mailed

**Currency and cash accounts with
original maturity of 90 days or less**

*Current assets on
balance sheet*

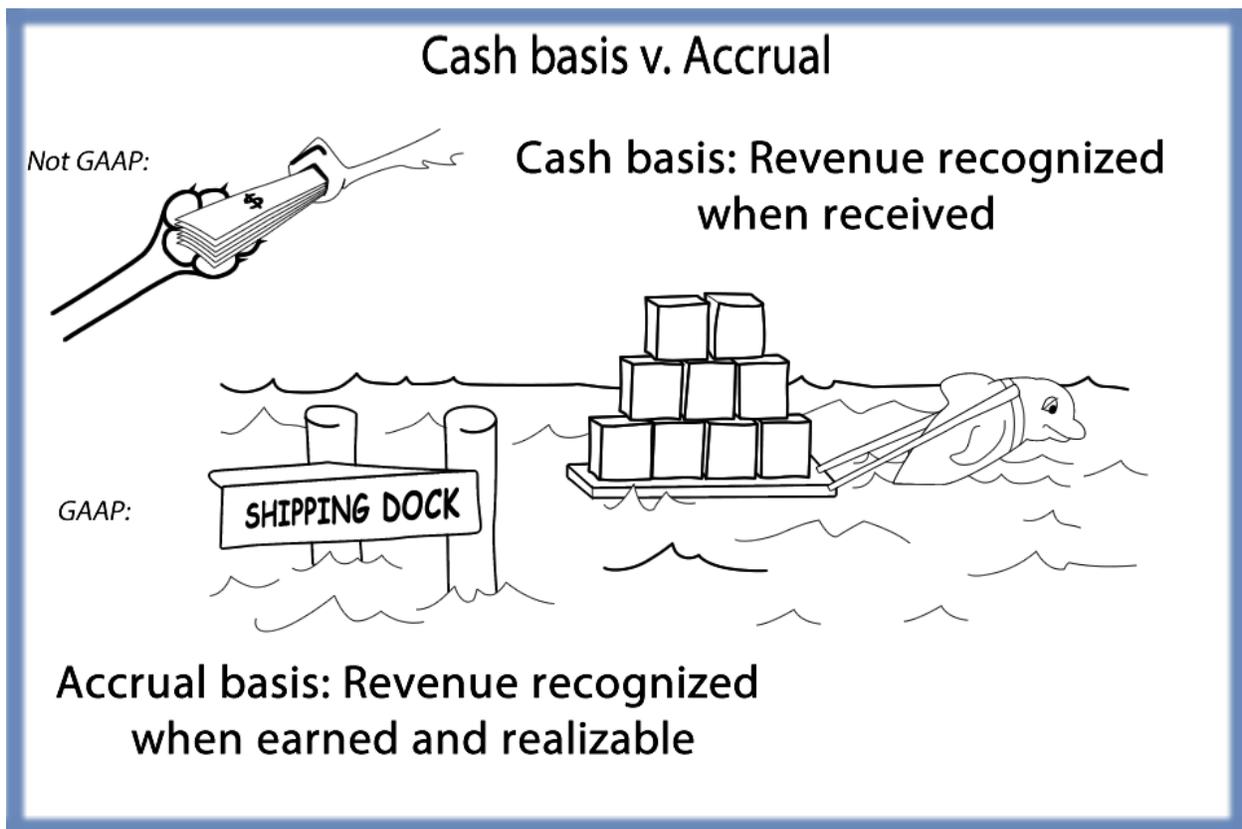
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Cash basis v. Accrual The cash basis method of accounting recognizes transactions only when cash or equivalents have been exchanged, while accrual basis follows the matching principle and recognizes transactions as they occur

*Cash basis accounting records revenue and expenses only when cash or equivalents have been exchanged

*Only accrual basis accounting is an acceptable method under US Generally Accepted Accounting Principles (US-GAAP)

*Accrual basis accounting records revenue when earned and realizable and expenses as incurred, even if cash has not been paid

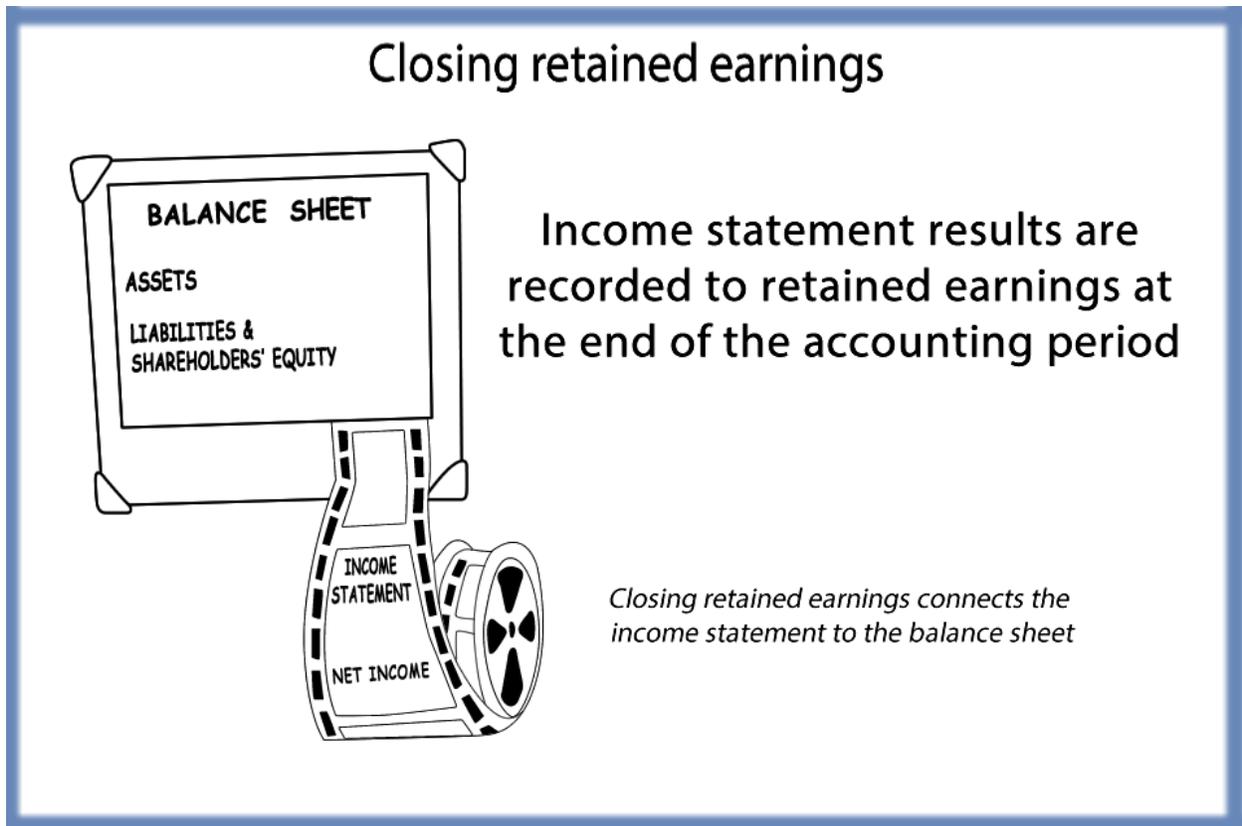


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Closing retained earnings Net income or loss on the income statement is added or subtracted to retained earnings on the shareholders' equity section of the balance sheet, at the end of the accounting period

*Income summary accounts are used to record income statement profit or loss to retained earnings

*Recording income statement activity to retained earnings is also referred to as closing retained earnings



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Commercial loan Borrowed money, typically from a bank, to finance company operations

- *Appears as a liability on the balance sheet as a note payable
- *Amounts payable within a year appear as a current liability
- *Accrued interest at year-end becomes an accrued expense

Commercial loan

Money borrowed to finance company operations



Bank of Piggy
Commercial Loan

Term: 30 years, Principal & Interest
Amount: \$1,000,000
Rate: 10%
Security: Teddy Fab Warehouse
Address: #1 Ocean View
Animal Kingdom



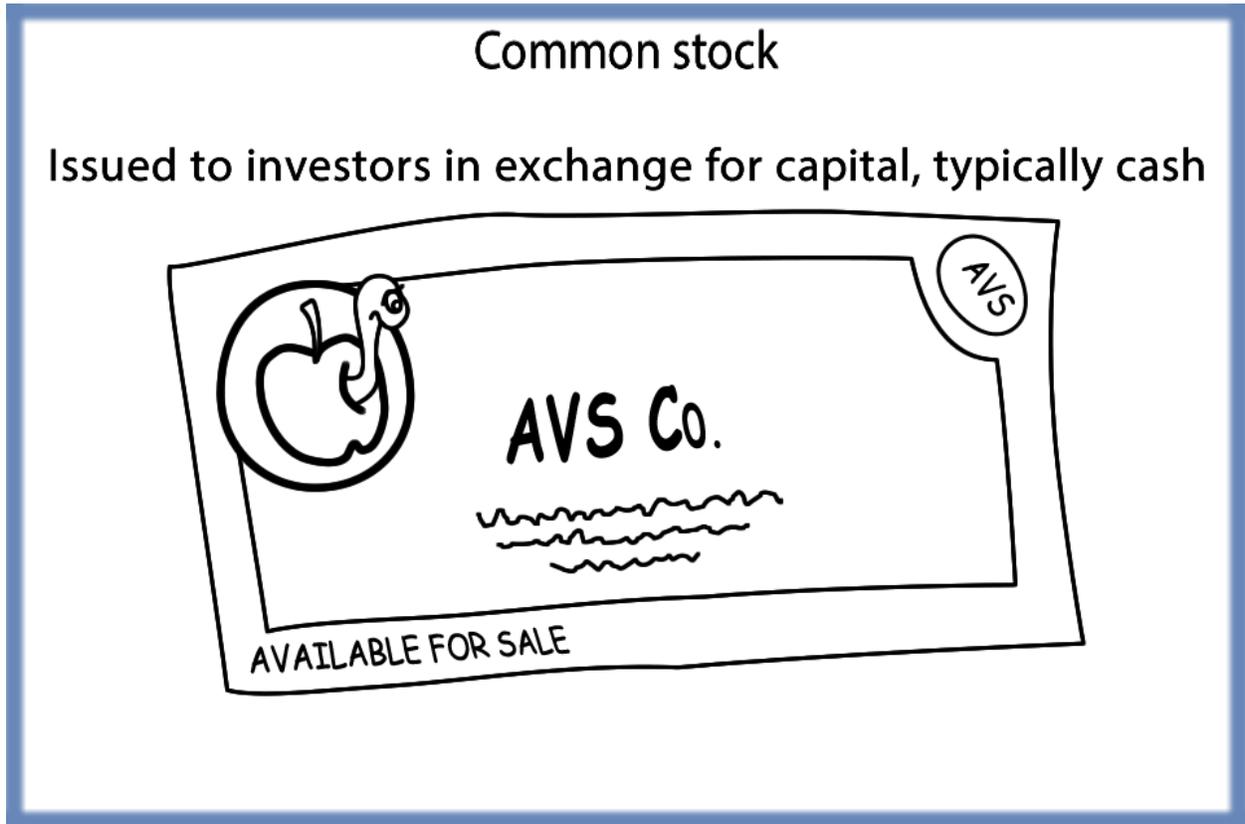
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Common stock Represents ownership of a corporation

*Shareholders own stock

*Common shareholders influence the company by electing the board of directors

*Stocks may pay dividends to shareholders

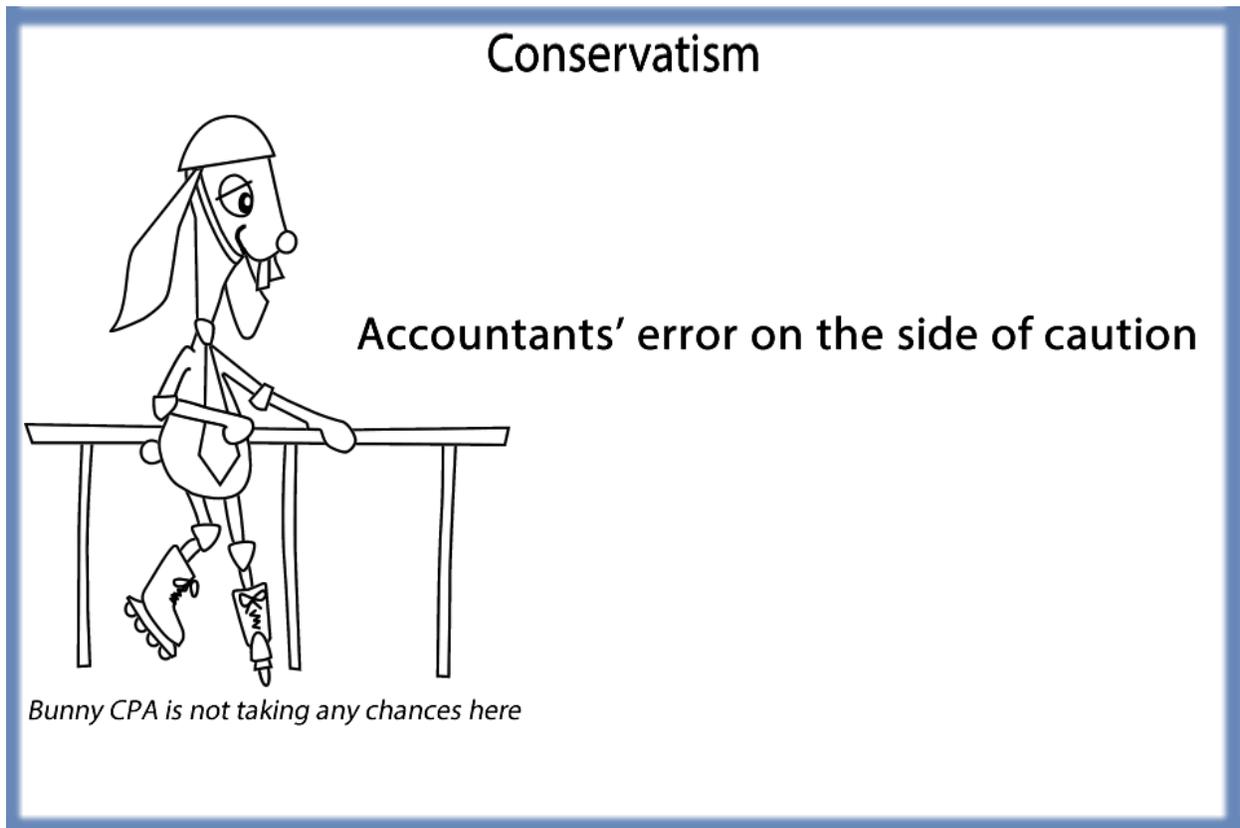


Conservatism Reporting income and expenses in an accurate manner and erring towards understatement of net income and asset values

*Error on the side of understating revenue

*Error on the side of overstating expense

*Example: inventory reported at historical cost or lower

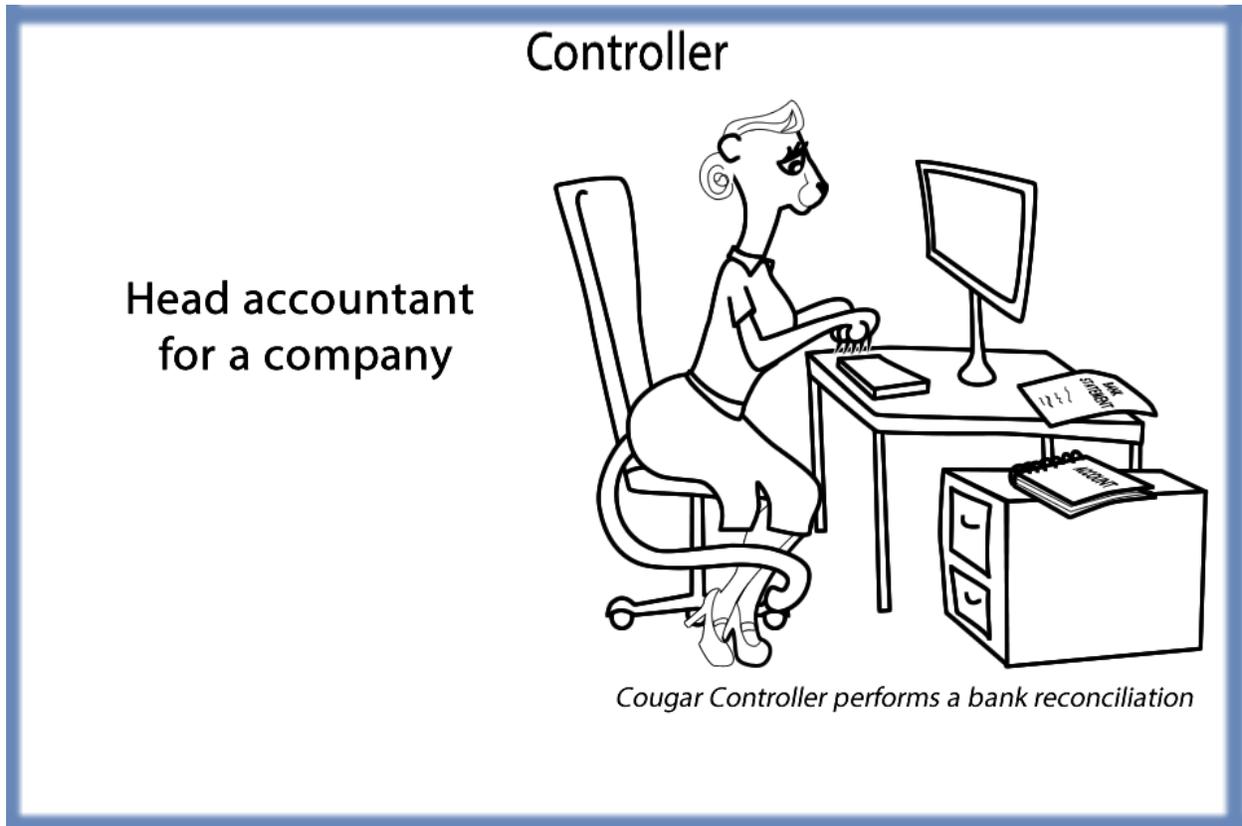


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Controller Head accountant for a company

*Duties may include: general accounting, bank reconciliations, and journal entries

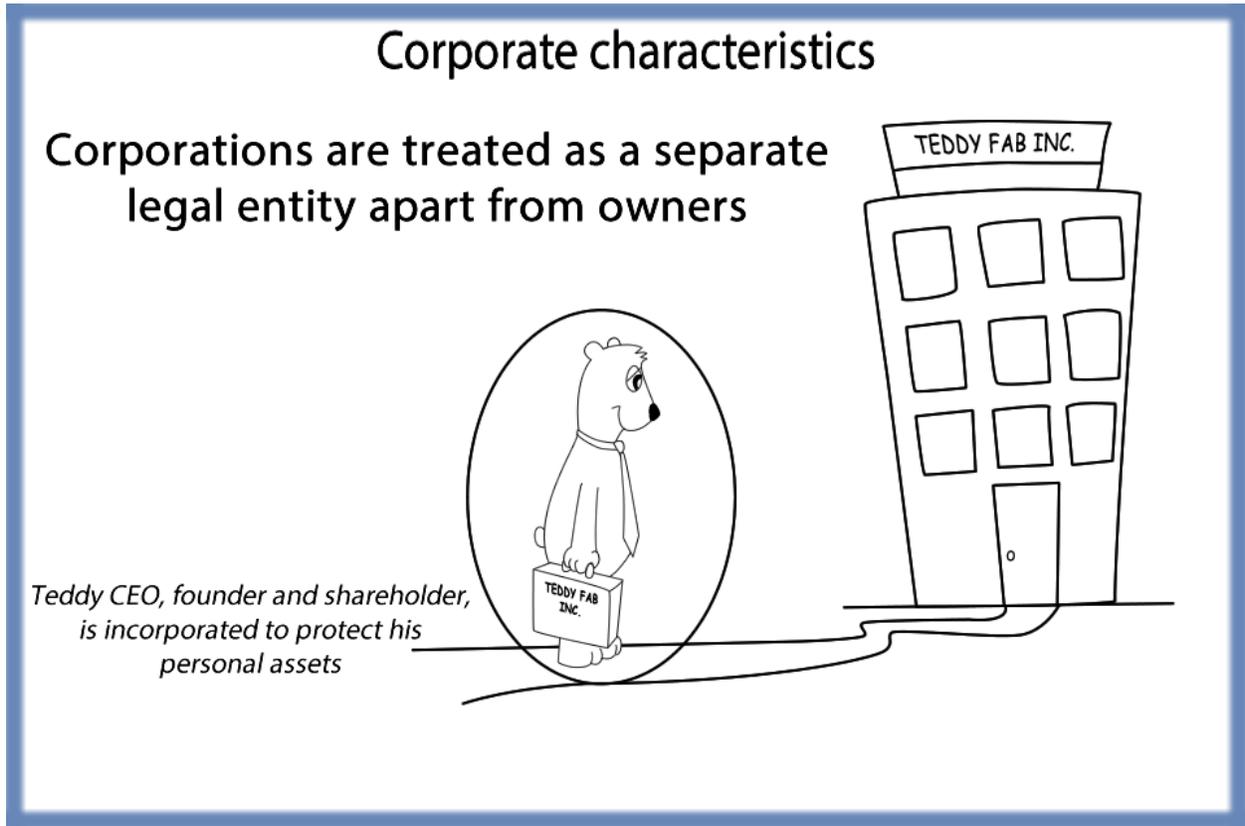
*A controller works for one company, also referred to as private accounting



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Corporate characteristics Provides owners limited liability

- *Liability limited to amount invested
- *Corporation may continue in perpetuity
- *Shareholders (owners) may still be liable if they commit crimes



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Cost of goods sold (COGS) Price of goods sold during the accounting period

*Deduction from revenue to calculate gross profit or loss

*May include: raw materials cost, machine costs, labor, and other overhead costs for a manufacturing entity

*Revenue - Cost of goods sold = Gross profit

Cost of goods sold (COGS)



BEGINNING INVENTORY

+ INVENTORY PURCHASES

- ENDING INVENTORY

COST OF GOODS SOLD

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Current assets Resources expected to be used or converted into cash within one year of the balance sheet date or longer, if the operating cycle is greater than a year

Examples

- *Cash and cash equivalents: currency and cash accounts with an original maturity 90 days or less
- *Accounts receivable: cash customers owe a business
- *Inventory: materials used to make products
- *Prepaid expenses: expenses paid in advance
- *Investments: purchased for financial gain

Current assets

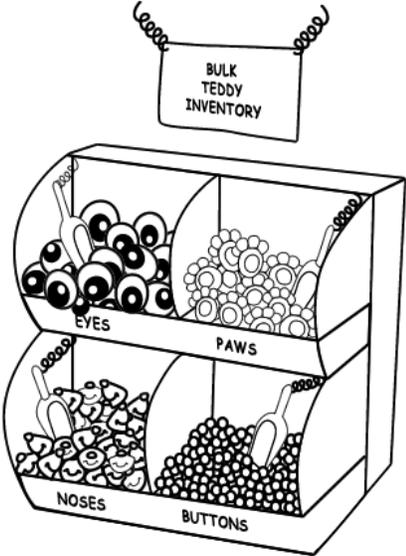
Teddy Fab Inc 12/31/2100

PAY TO LAND LORD \$ XXXX

XXX DOLLARS

BANK OF PIGGY 

FOR January Rent *Teddy*



Inventory

Prepaid rent



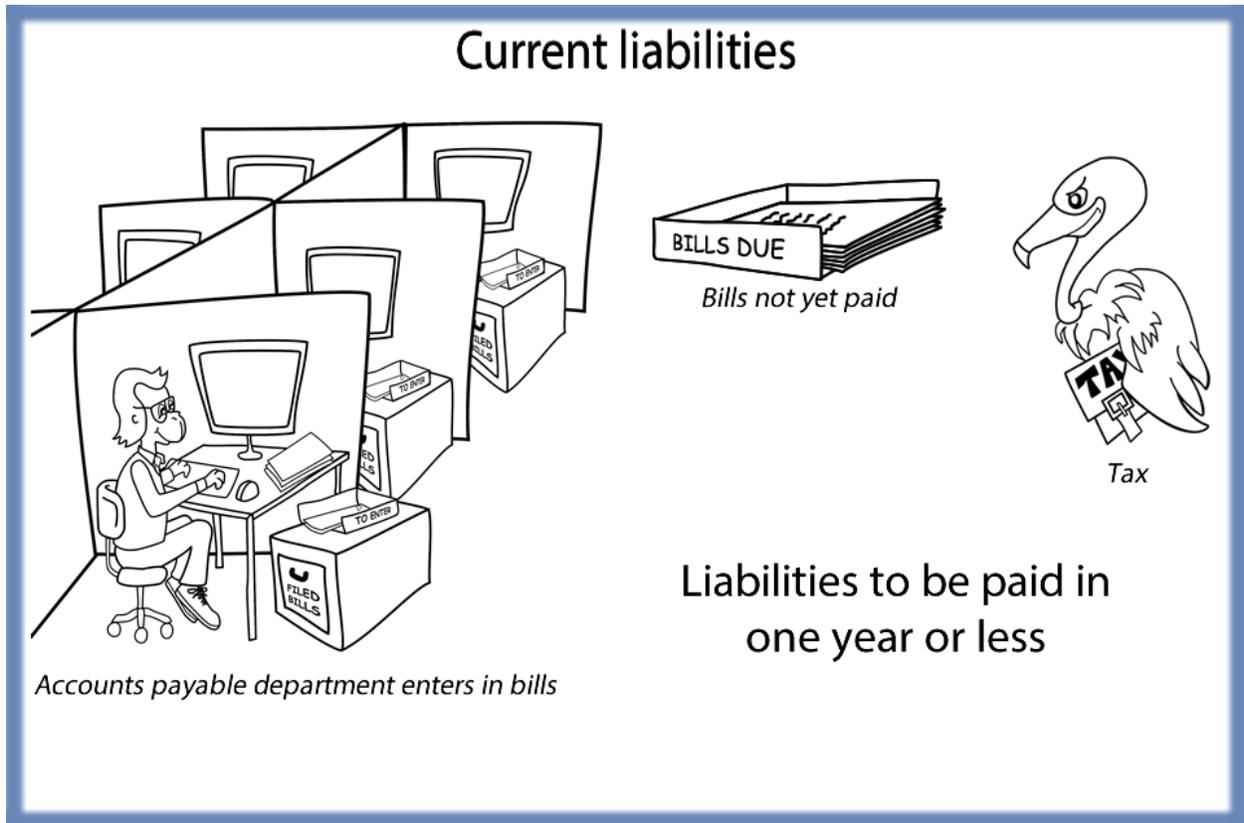
**Assets to be used or converted
to cash within a year or less**

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Current liabilities Obligations due in one year or less

Examples

- *Accounts payable: cash owed to others
- *Income tax payable: tax owed to government
- *Dividends payable: dividends owed to shareholders
- *Accrued expense: expenses incurred, not yet paid for
- *Current portion of long-term debt: portion of debt due in a year or less



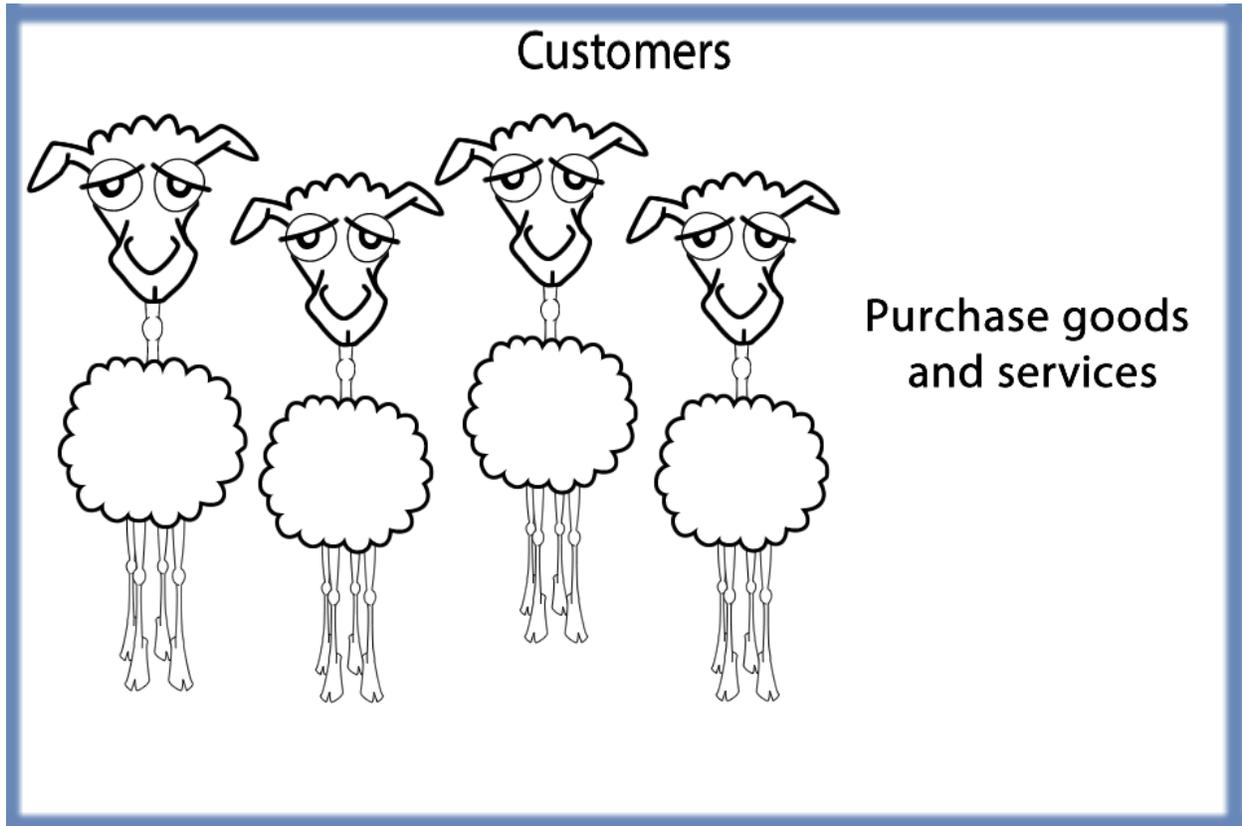
[Return to Dictionary Index](#)

Customers Purchase goods and services from a company

*Credit sales to customers involve shipping goods or performing services prior to getting paid

*Accounts receivable department typically sends invoices and collects cash

*External stakeholders



[Return to Dictionary Index](#)

Debits and credits system The accounting system increases and decreases account balances with a debit or credit (also known as double-entry accounting)

- *The system helps users understand the significance of the transaction
- *Sum of debits always equals the sum of credits
- *Debits and credits combined form a trial balance
- *Transactions are all accounted for

DEBIT		CREDIT	
↑	ASSET	↓	ASSET
↓	LIABILITY	↑	LIABILITY
↓	EQUITY	↑	EQUITY
↑	EXPENSE	↑	REVENUE

Accounts are increased and decreased with a debit or credit

[Return to Dictionary Index](#)

Debt to total assets Measures the amount of debt there is relative to assets

*The lower the ratio, the more assets a company has relative to debt

*A low debt to asset ratio is generally viewed favorably by investors

Debt to total assets

$$\text{DEBT RATIO} = \frac{\text{TOTAL LIABILITIES}}{\text{TOTAL ASSETS}}$$

Debt Service Ratio

[Return to Dictionary Index](#)

Debt to total equity Proportion of financing that is debt related

*Generally a high debt to equity ratio indicates a company has utilized a significant amount of financing to grow

Debt to total equity

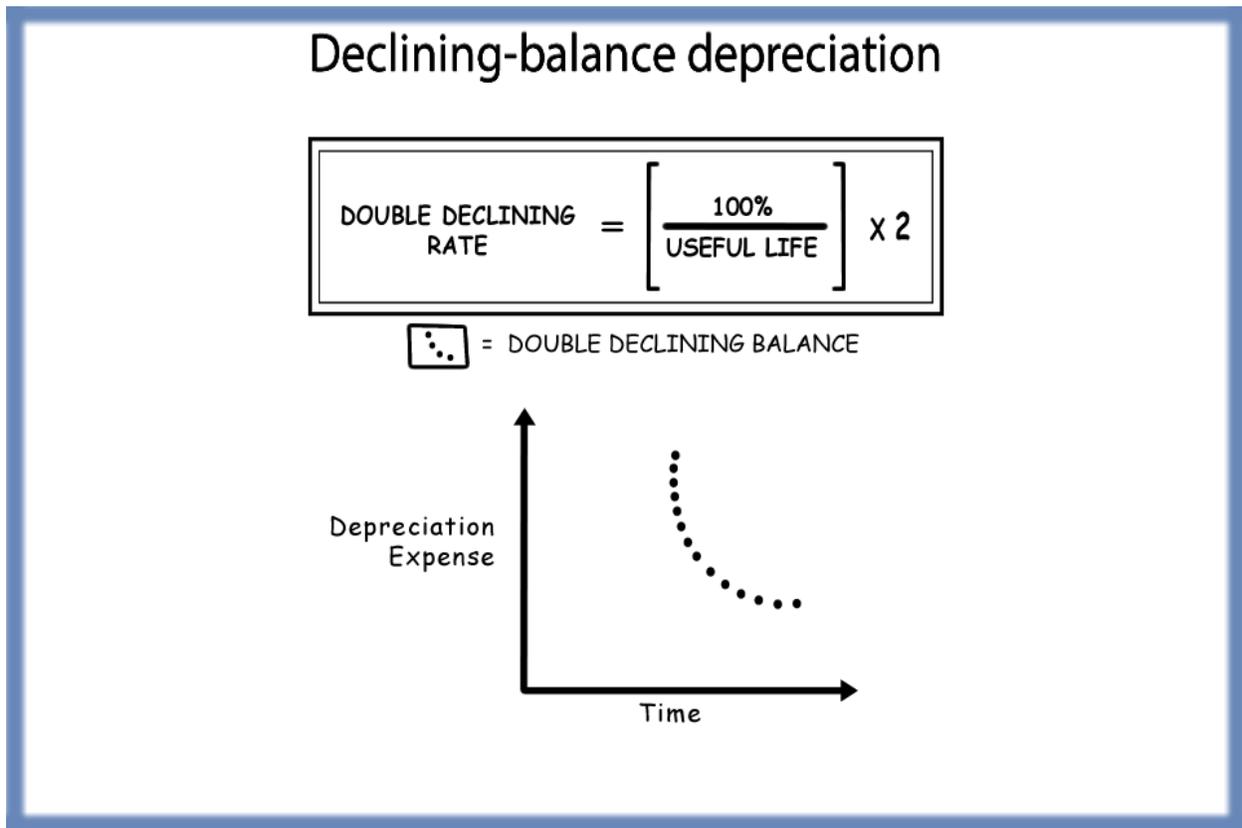
$$\text{DEBT TO EQUITY RATIO} = \frac{\text{TOTAL LIABILITIES}}{\text{TOTAL STOCKHOLDERS' EQUITY}}$$

Debt Service Ratio

[Return to Dictionary Index](#)

Declining-balance depreciation Accelerated depreciation method, generates more expense in earlier years

- *No salvage value taken into account
- *Logical if best use of asset is in earlier years of life
- *Often used for tax purposes

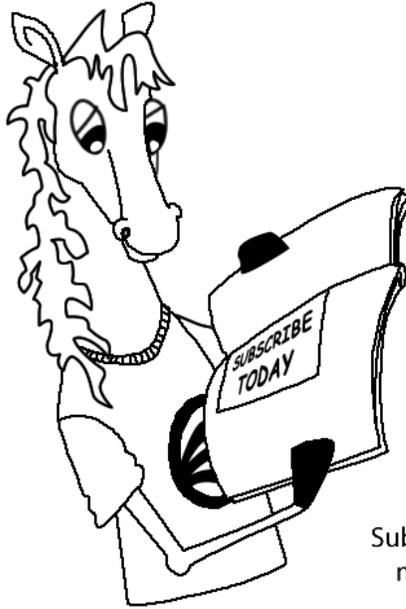


[Return to Dictionary Index](#)

Deferred revenue Cash received in advance, but not yet earned

Examples: subscriptions, maintenance contracts, retainers, and cash received for future insurance coverage

Deferred revenue



Cash received in advance for goods and services not yet rendered

Subscriptions are deferred revenue until the materials are delivered to the subscriber

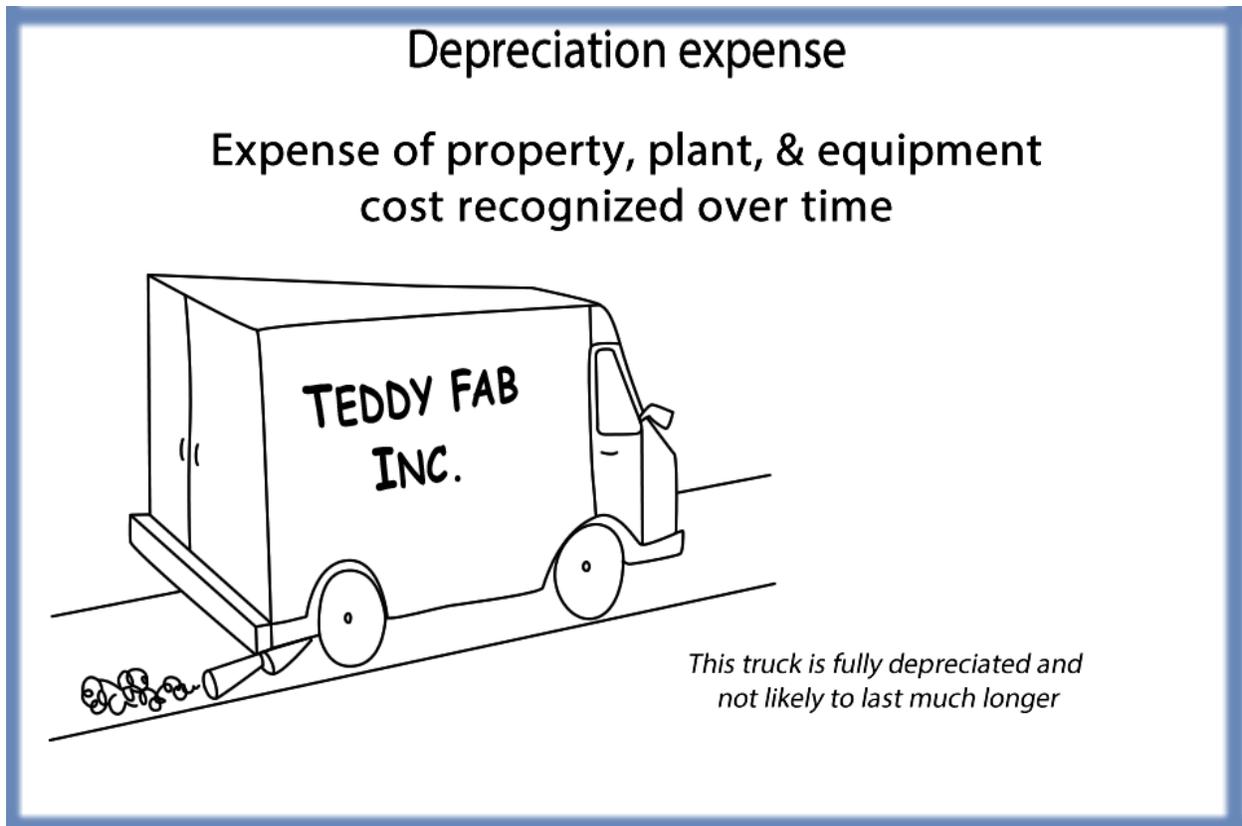
[Return to Dictionary Index](#)

Depreciation expense Represents the cost of fixed assets over time

*Recorded to capture the decline in business asset use-value over time

*Matches the expense of the asset as it is being used up

Depreciation method examples: straight-line, accelerated depreciation, sum-of-the-years-digits', and units of production



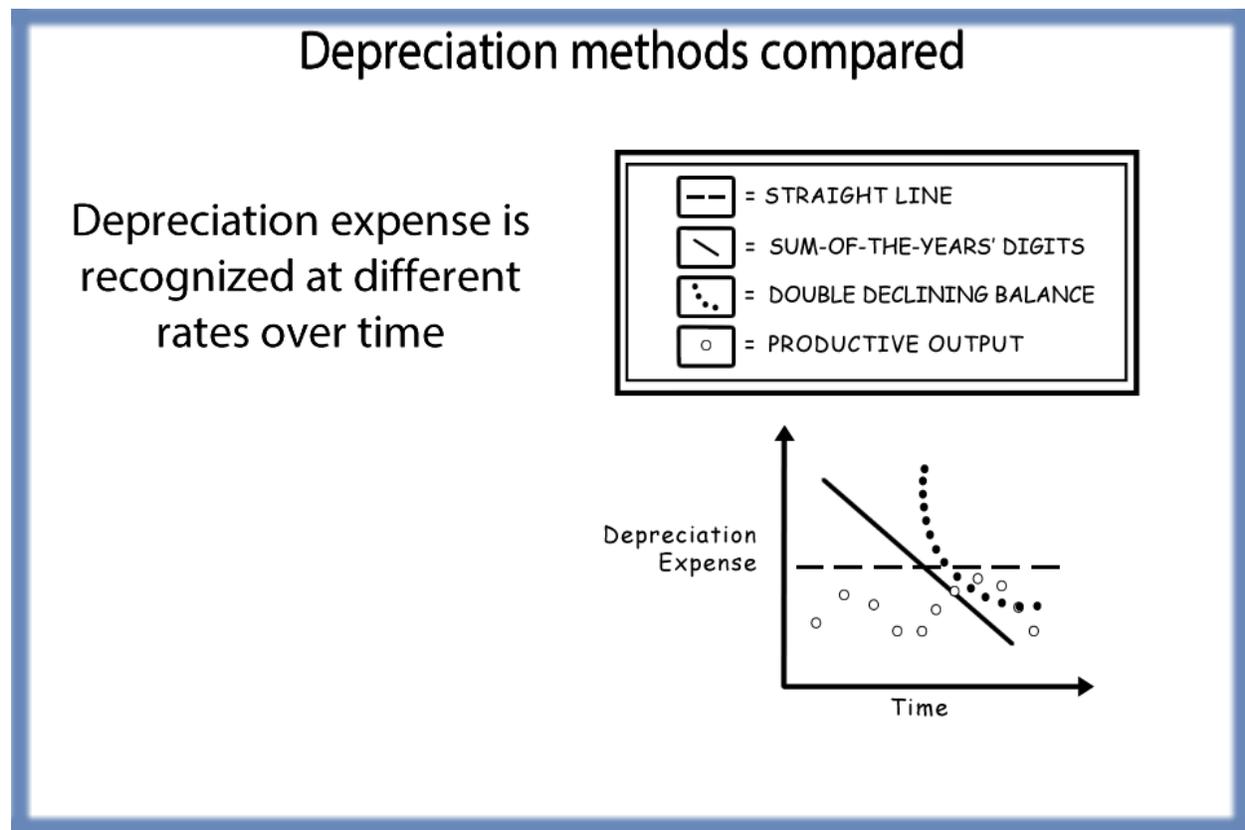
[Return to Dictionary Index](#)

Depreciation methods compared

Different methods result in different timing of expense

*Accelerated methods result in more expense earlier in the asset life

*Different methods of depreciation result in timing differences for depreciation expense

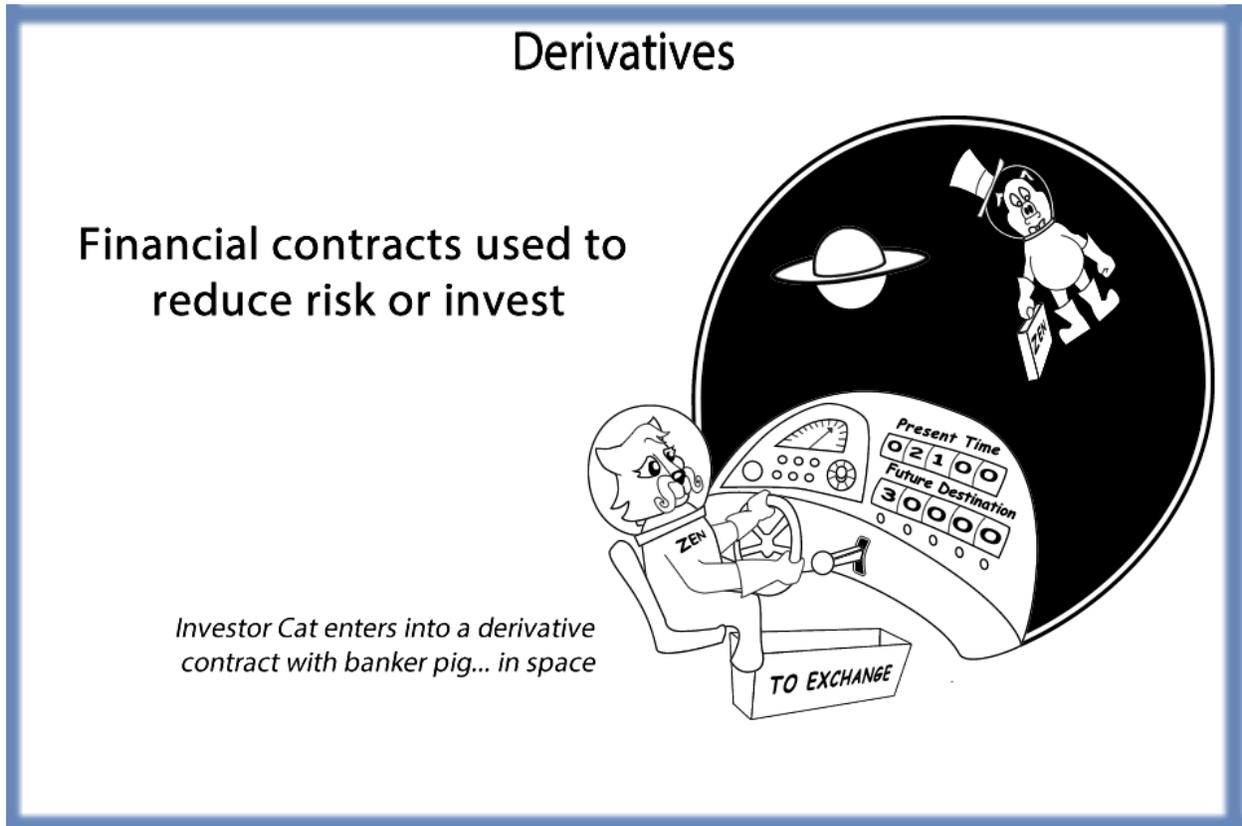


[Return to Dictionary Index](#)

Derivatives Financial contracts to buy or sell assets based upon specified conditions

Characteristics:

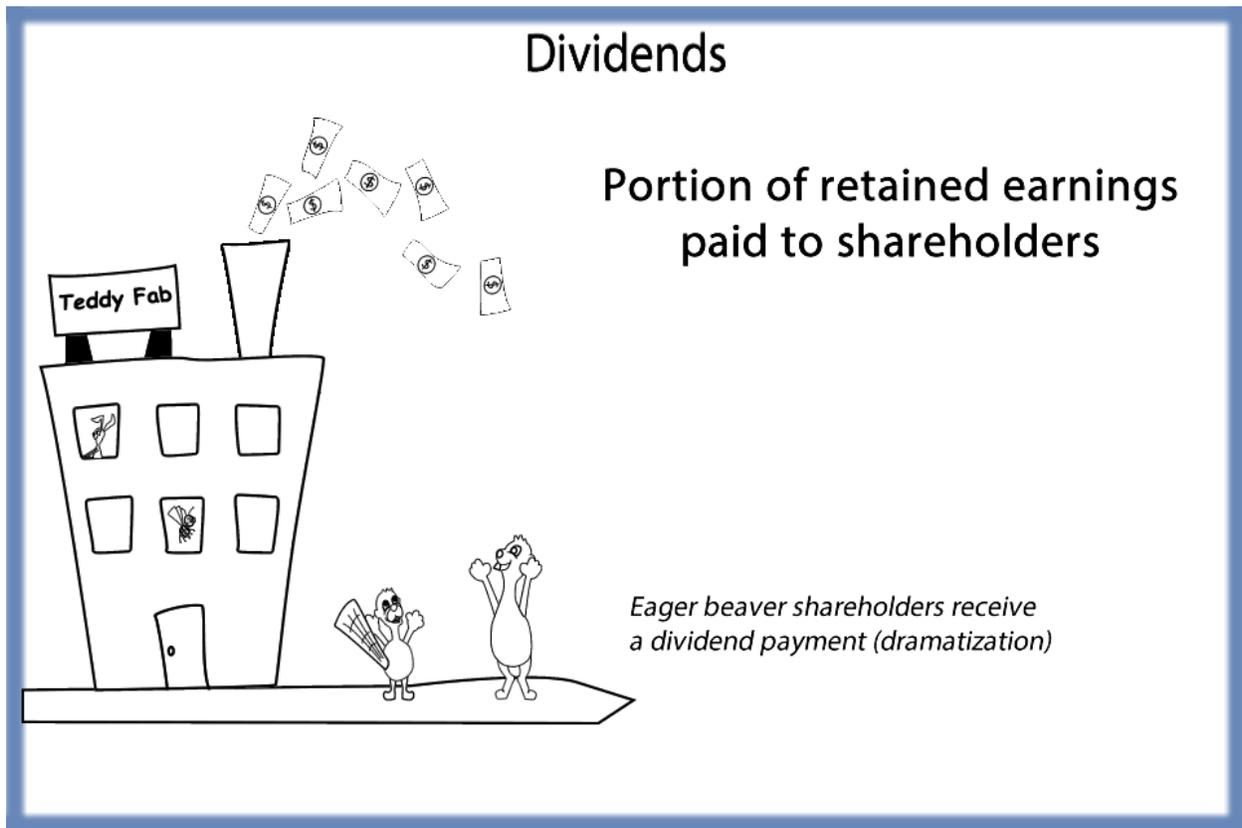
- *Zero net investment
- *Equivalent to cash or cash settlement
- *Notional and underlying amount



[Return to Dictionary Index](#)

Dividends Corporate profits paid to shareholders

- *Reduce retained earnings
- *Authorized by the board of directors
- *Typically paid when company is performing well
- *Cash paid to shareholders in excess of retained earnings is a return of capital, not a dividend

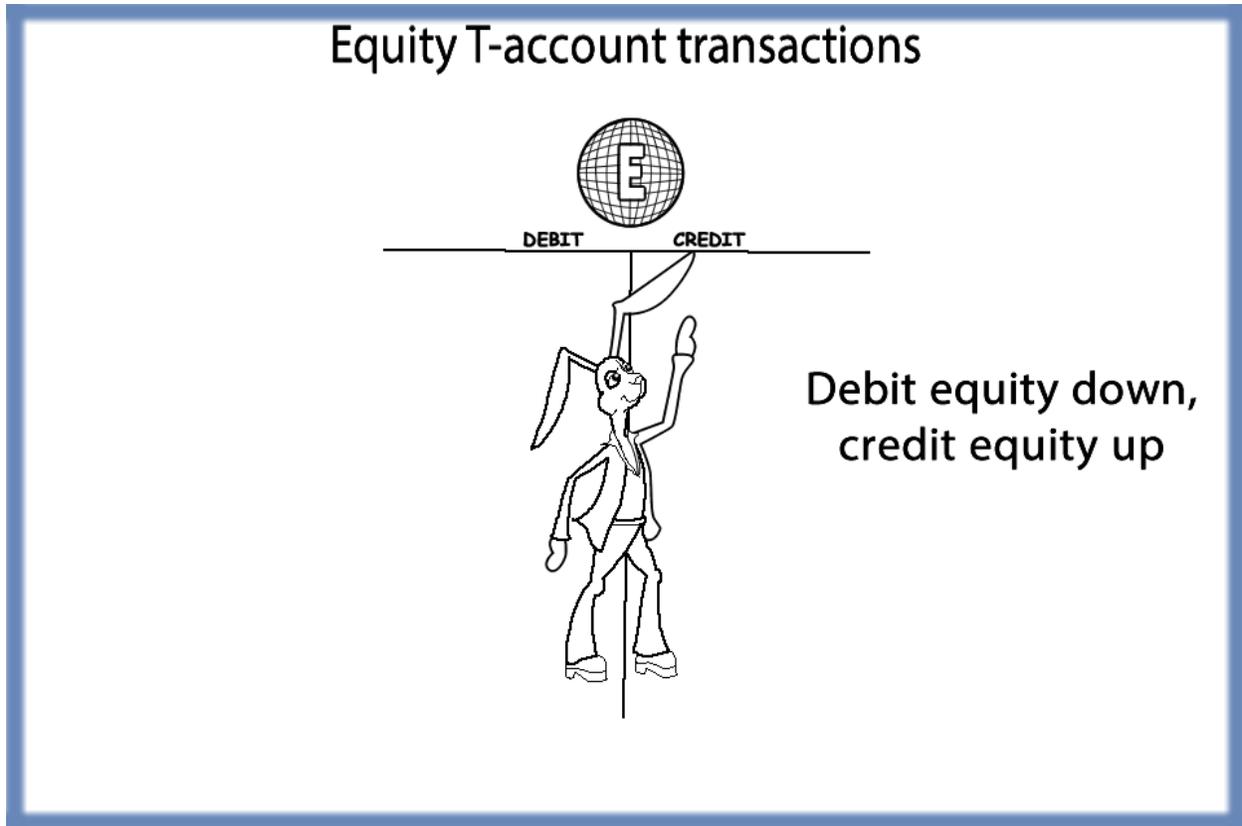


[Return to Dictionary Index](#)

Equity T-account transactions Equity decreases with a debit and increases with a credit

Basic entries

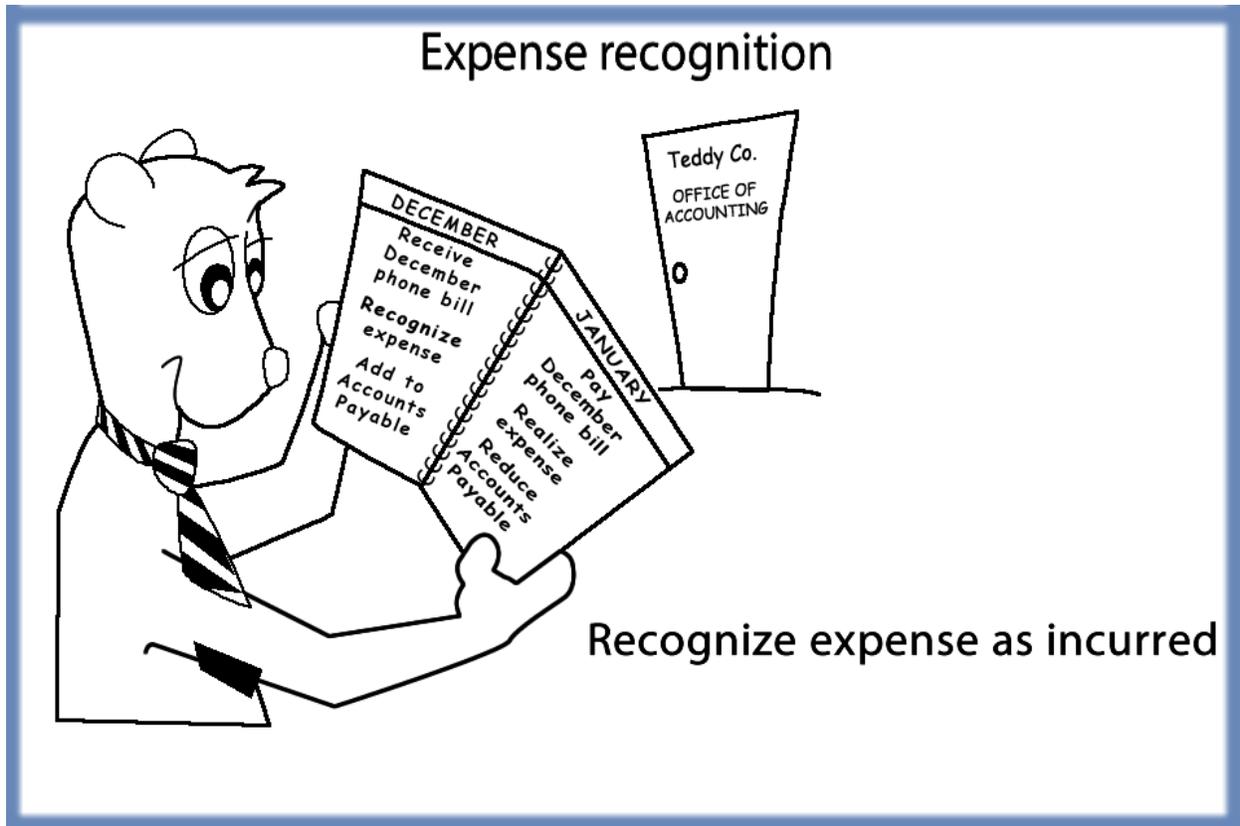
- * Increase equity from stock issue: debit cash and credit equity
- * Increase equity from net income: debit income summary and credit retained earnings
- * Decrease equity from net loss: debit retained earnings and credit income summary
- * Decrease equity from declared dividend: debit retained earnings and credit dividend payable



[Return to Dictionary Index](#)

Expense recognition Expenses are recognized when incurred, as goods are used and services received

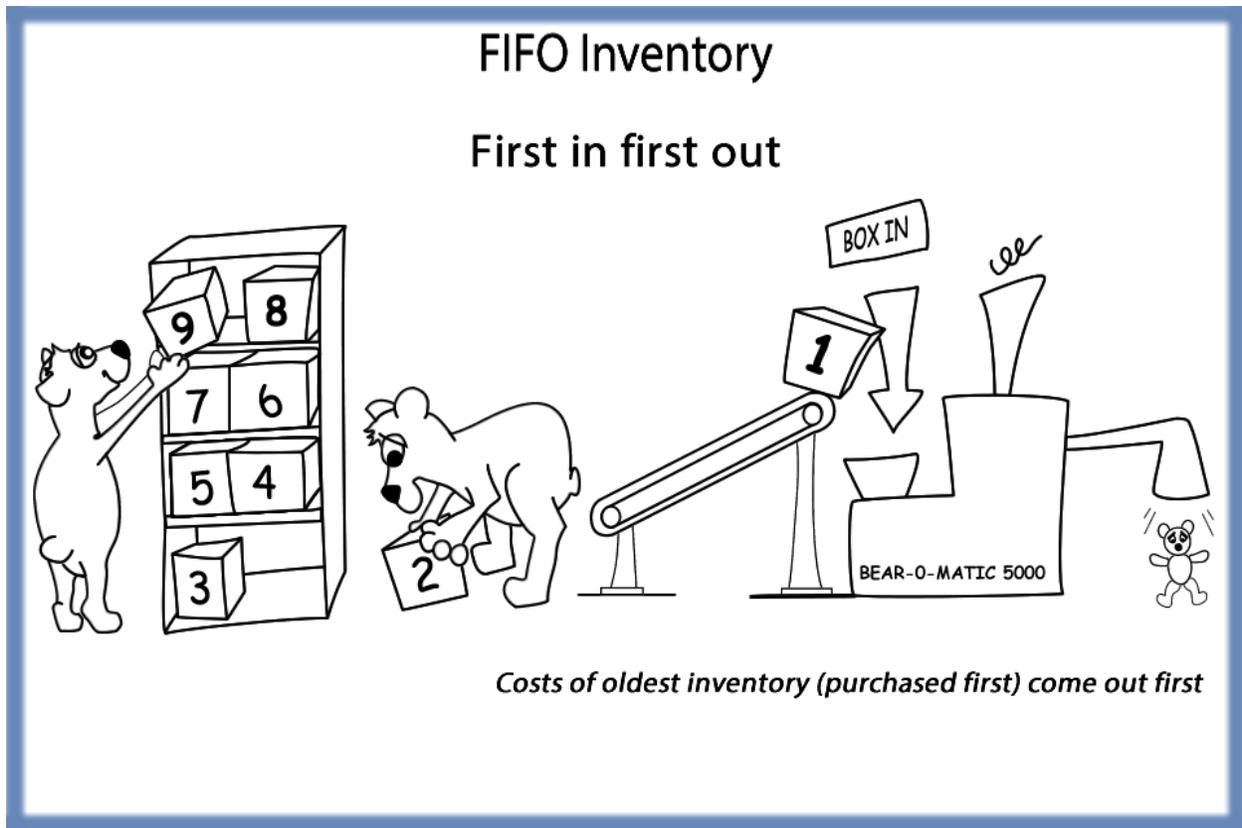
- *Inventory items will not be an expense until sold
- *Matching principle dictates that expenses be matched with related revenue in the same period
- *Payments for rent and insurance are prepaid assets if paid in advance and are recognized as expenses as they are used over time
- *Property, plant, and equipment are capitalized assets, not expenses



[Return to Dictionary Index](#)

First in first out Inventory accounting system in which items purchased earliest are the first to be used to determine ending inventory and the cost of goods sold

- *Costs are similar to the physical flow of inventory
- *Results in higher net income in a period of rising prices when compared to the LIFO method
- *Inventory value is overstated in period of rising prices
- *Acceptable method under both US-GAAP & IFRS



[Return to Dictionary Index](#)

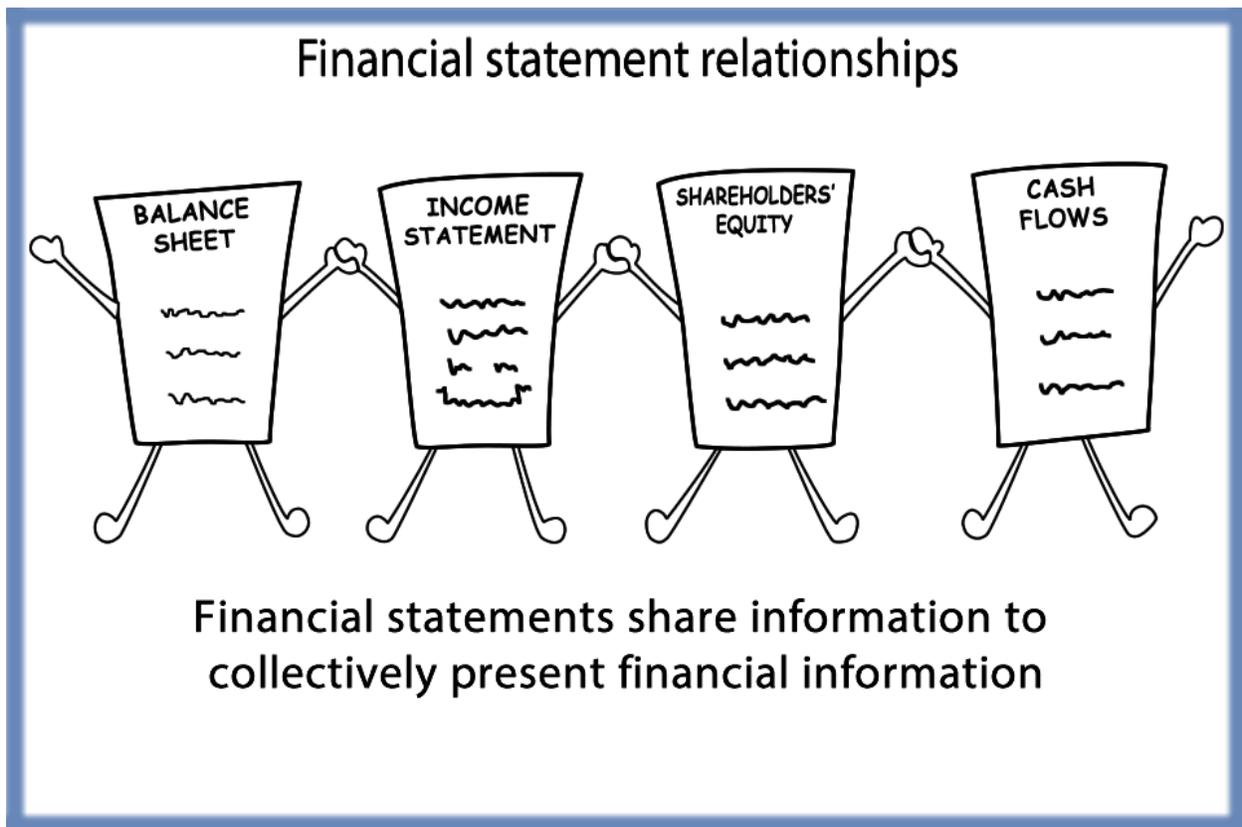
Financial statement relationships Financial statements are dependent on each other for financial reporting

*The income statement reports net income or loss

*Net income is added or a net loss is deducted from retained earnings on the balance sheet at end of accounting period

*The statement of cash flows uses net income and changes in balance sheet accounts to present the cash ins and outs

*The statement of shareholders' equity reports the balance sheet equity detail



[Return to Dictionary Index](#)

Finished goods Product ready for sale that includes raw material, manufacturing labor, and overhead costs

*Raw material examples: wood, steel, parts, stuffing, cloth, oil, and plastic

*Manufacturing labor includes machine operators

*Overhead costs include electricity and water to power machines



[Return to Dictionary Index](#)

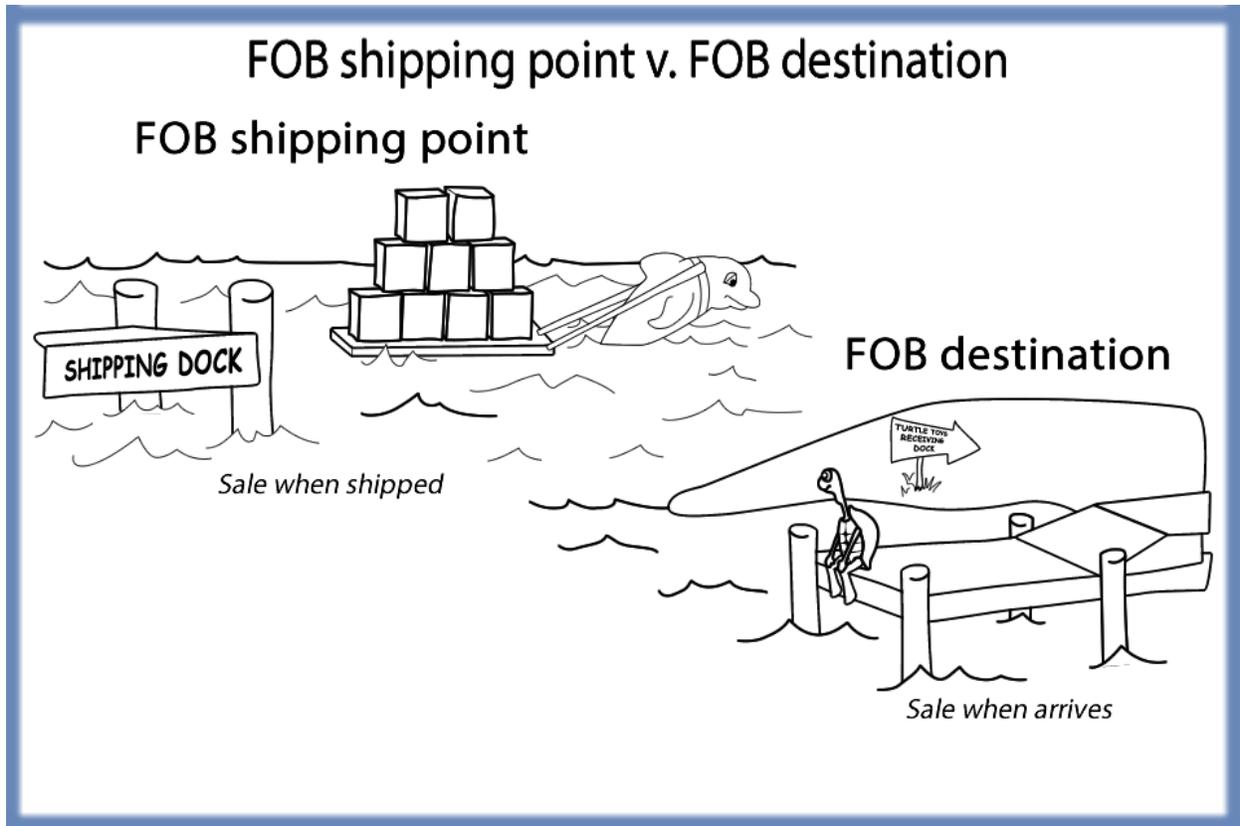
FOB shipping point v. FOB destination FOB shipping point recognizes the sale of an item when the seller ships it, while FOB destination recognizes the sale of an item when the buyer receives the item

*Defines terms of sale and accounting treatment

*FOB: Free On Board

*Item included in books of buyer at year-end under FOB shipping point

*Item included in books of seller at year-end under FOB destination



[Return to Dictionary Index](#)

General ledger Record of all accounting transactions

- *May be summarized in a trial balance for financial statement preparation
- *Presented in order of the balance sheet, then income statement accounts: assets, liabilities, equity, revenue, and expenses
- *Debits presented as positive numbers and credits as negative

General ledger				
TEDDY FAB INC.				
GENERAL LEDGER				
December 31, 2100				
Type	Date	Name	Amount	Balance
Cash Operating				25,000.00
Collect sale	1/1/2100	Turtle Toys	15,489.11	40,489.11
Collect sale	1/15/2100	Mega Corp	70,000.00	110,489.11
Pay vendor	1/16/2100	Vendor Giraffe	(45,400.11)	65,089.00
Receive loan	1/19/2100	Piggy Bank	10,000.00	75,089.00
Collect sale	1/20/2100	Blue Dolphin Toys	6,515.46	81,604.46
Continued...	Continued...	Continued...	Continued...	Continued...
Total ending				90,496.74
Cash Savings				9,500.00
Interest paid	9/30/2100		1.11	9,501.11
Interest paid	12/31/2100		2.15	9,503.26
Total ending				9,503.26
Accounts receivable				100,000.00
Collect sale	1/1/2100	Turtle Toys	(15,489.11)	84,510.89
Collect sale	1/15/2100	Mega Corp	(70,000.00)	14,510.89
Collect sale	1/20/2100	Blue Dolphin Toys	(6,515.46)	7,995.43
Sale	2/15/2100	Mega Corp	26,500.00	34,495.43
Continued...	Continued...	Continued...	Continued...	Continued...
Total ending				20,000.00
Parts inventory				
Continued...	Continued...	Continued...	Continued...	Continued...
Raw materials inventory				
Continued...	Continued...	Continued...	Continued...	Continued...
Work in process inventory				
Continued...	Continued...	Continued...	Continued...	Continued...
Finished goods inventory				
Continued...	Continued...	Continued...	Continued...	Continued...
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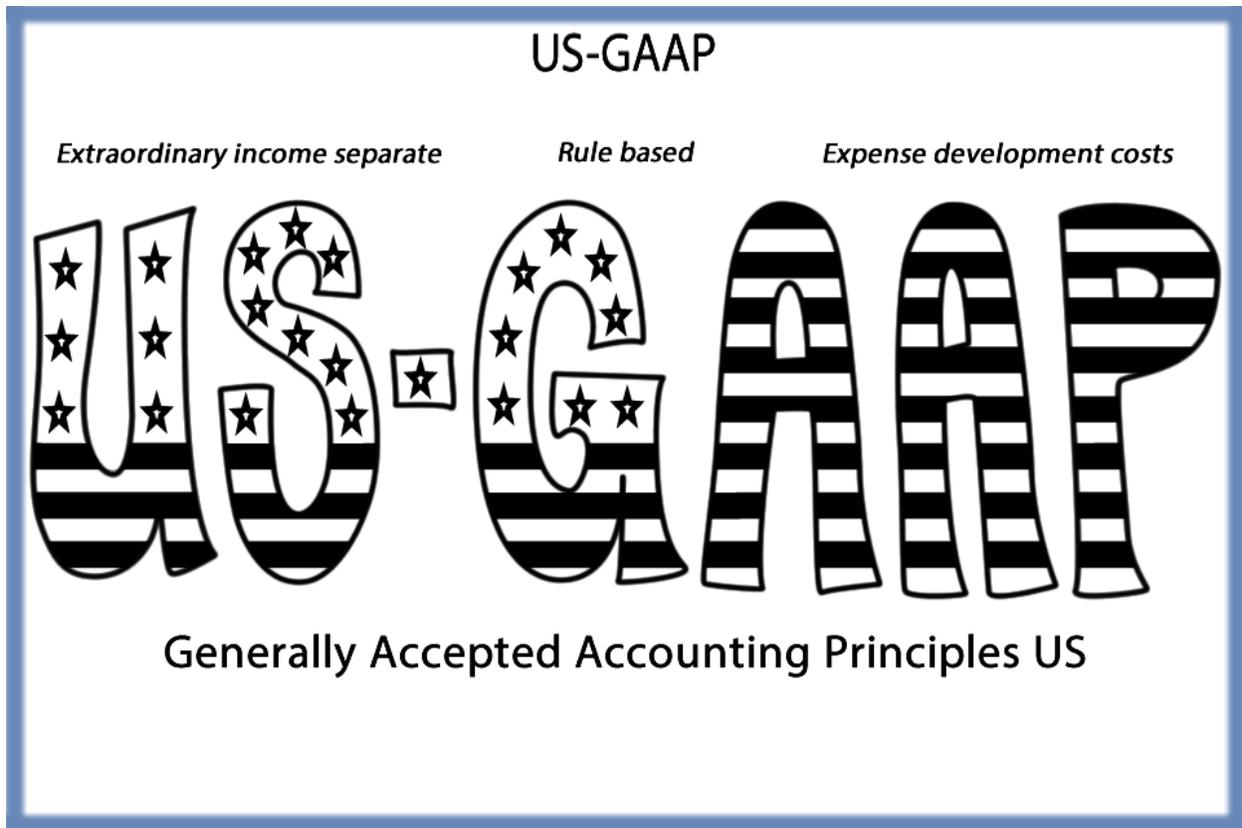
Record of all accounting transactions

Debits = Credits

[Return to Dictionary Index](#)

Generally Accepted Accounting Principles (US-GAAP) Accounting system established by FASB (Financial Accounting Standards Board) that governs financial reporting

- *Rule based system
- *Extraordinary income items presented separately
- *LIFO inventory permissible
- *Development costs expensed



[Return to Dictionary Index](#)

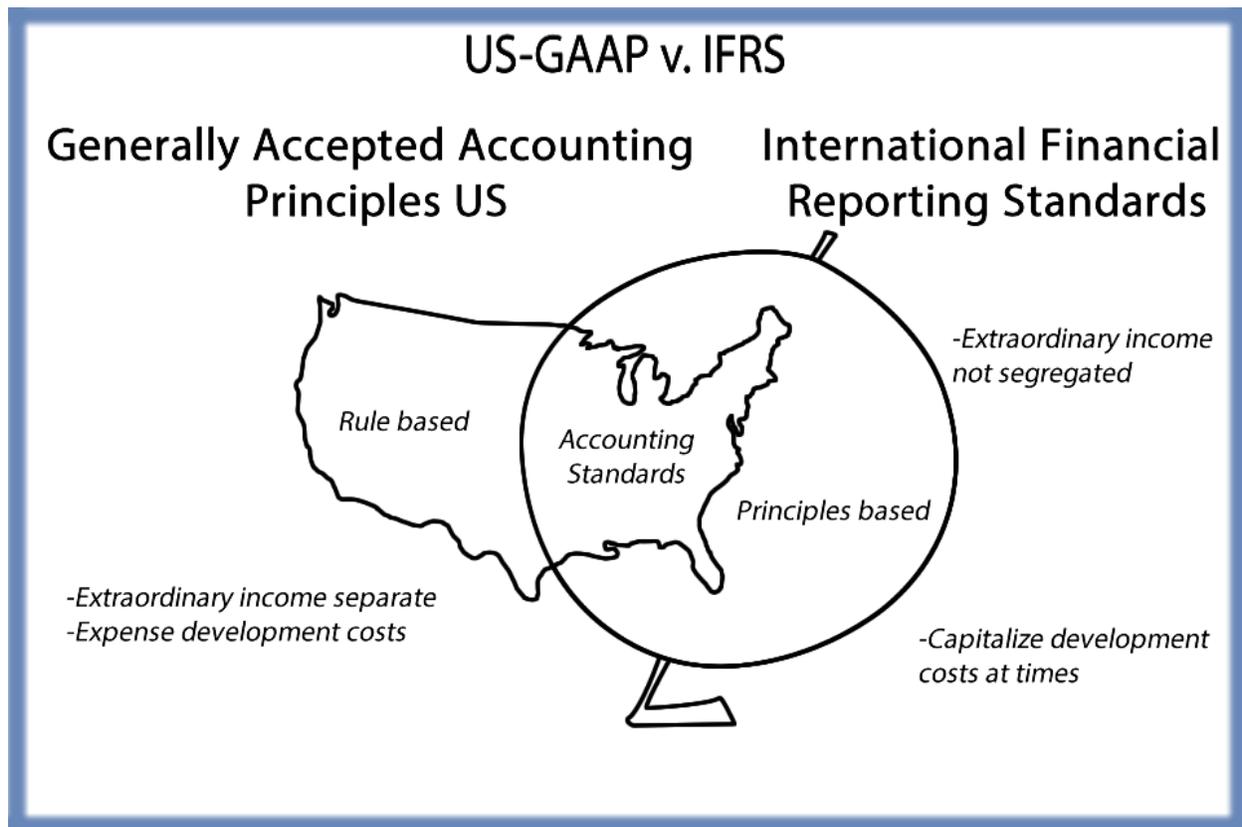
Generally Accepted Accounting Principles (US-GAAP) v. International Financial Reporting Standards (IFRS)

US-GAAP

- *Rule based system
- *Extraordinary income items presented separately
- *LIFO inventory permissible
- *Development costs expensed

IFRS

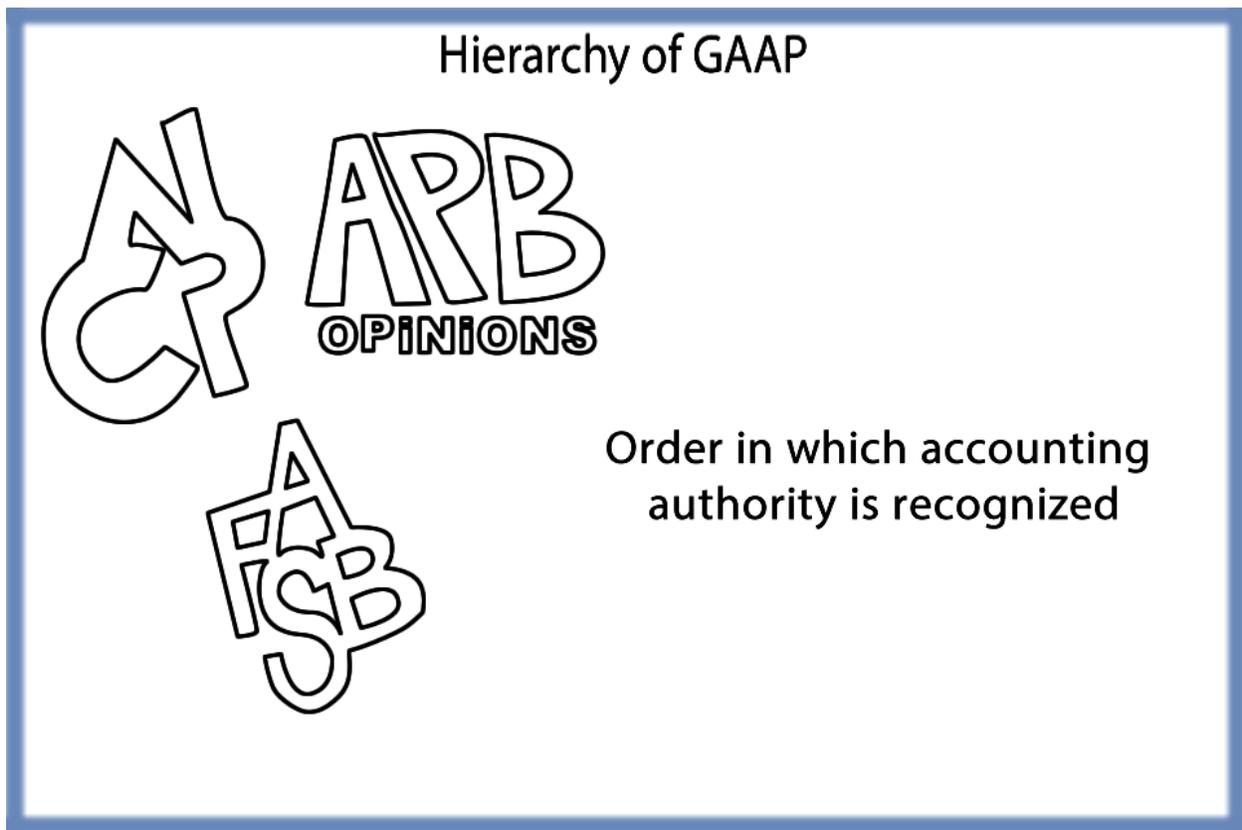
- *Principles based system
- *Extraordinary income not separated
- *No LIFO inventory
- *Development cost capitalization possible



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Generally Accepted Accounting Principles hierarchy The rank of authority for accounting standards

- *AICPA Accounting Research Bulletins
- *APB Opinions
- *FASB Statements on Financial Accounting Standards
- *FASB Interpretations
- *FASB Staff Positions
- *FASB Statement 133 Implementation Issues



[Return to Dictionary Index](#)

Gross profit Initial profit on sales after cost of goods is deducted

*Appears on income statement after revenue and cost of goods sold

*High gross profit would indicate that goods sold do not cost much relative to the revenue generated from sales

$$\begin{array}{r} \text{Gross profit} \\ \text{REVENUE} \\ \text{⊖} \\ \text{COST OF GOODS SOLD (COGS)} \\ \hline \text{GROSS PROFIT} \end{array}$$

GROSS PROFIT EQUATION

[Return to Dictionary Index](#)

Gross profit margin Measure of remaining revenue after deducting the cost of goods sold

*High gross profit margin indicates that the cost of goods sold is low relative to the selling price

*High profit margins may generally be favorable, but do not account for other operating expenses

Gross profit margin

$$\text{PROFIT MARGIN} = \frac{\text{NET INCOME}}{\text{SALES}}$$

Profitability Ratio

[Return to Dictionary Index](#)

International Financial Reporting Standards (IFRS) Financial reporting standard adopted widely outside of the US

- *US companies primarily report under Generally Accepted Accounting Principles (US-GAAP); however, IFRS is an optional reporting method in some instances
- *Principles based system
- *Extraordinary income not segregated on income statement
- *No last in first out (LIFO) inventory permissible
- *Development costs may be capitalized under certain criteria

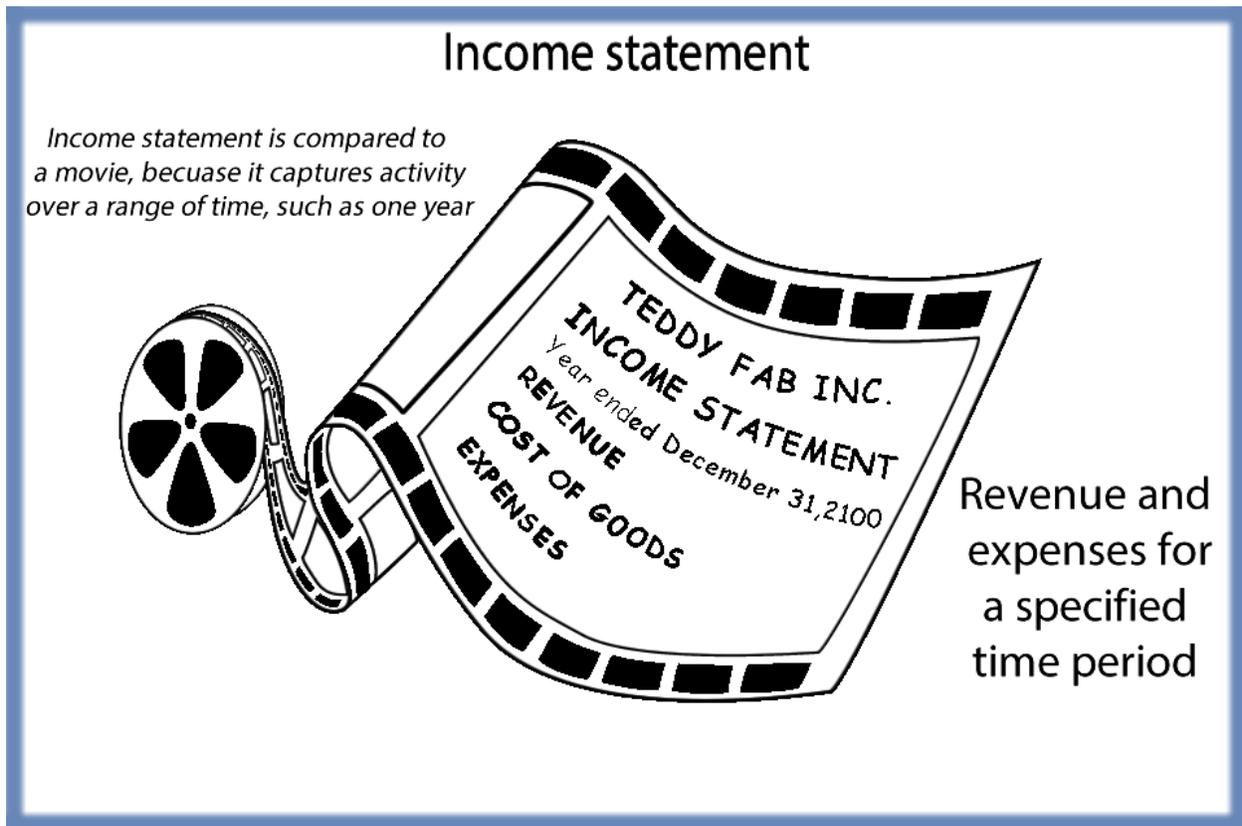


[Return to Dictionary Index](#)

Income statement Statement that reports the financial performance of a company for a specified period of time

*Expenses are deducted from income to arrive at net income or net loss (profit or loss) for a period of time

*Net income or loss at the end of the accounting period flows to retained earnings on balance sheet



[Return to Dictionary Index](#)

Income statement example Statement reporting financial performance for a specified period of time

*Income - expenses = Net income or loss

*Operating income is from normal business activity

Income statement example	
TEDDY FAB INC.	
STATEMENT OF INCOME	
Year Ended December 31, 2100	
Revenues	\$ 1,000,000
Cost of goods sold	<u>200,000</u>
Gross profit	<u>800,000</u>
Operating expenses	
Selling, general, and administrative expense	357,700
Interest expense	20,000
Depreciation and amortization expense	<u>5,200</u>
Operating income	<u>417,100</u>
Interest income	20,000
Net earnings before taxes	<u>437,100</u>
Income tax expense	<u>240,000</u>
Net income	<u><u>\$ 197,100</u></u>

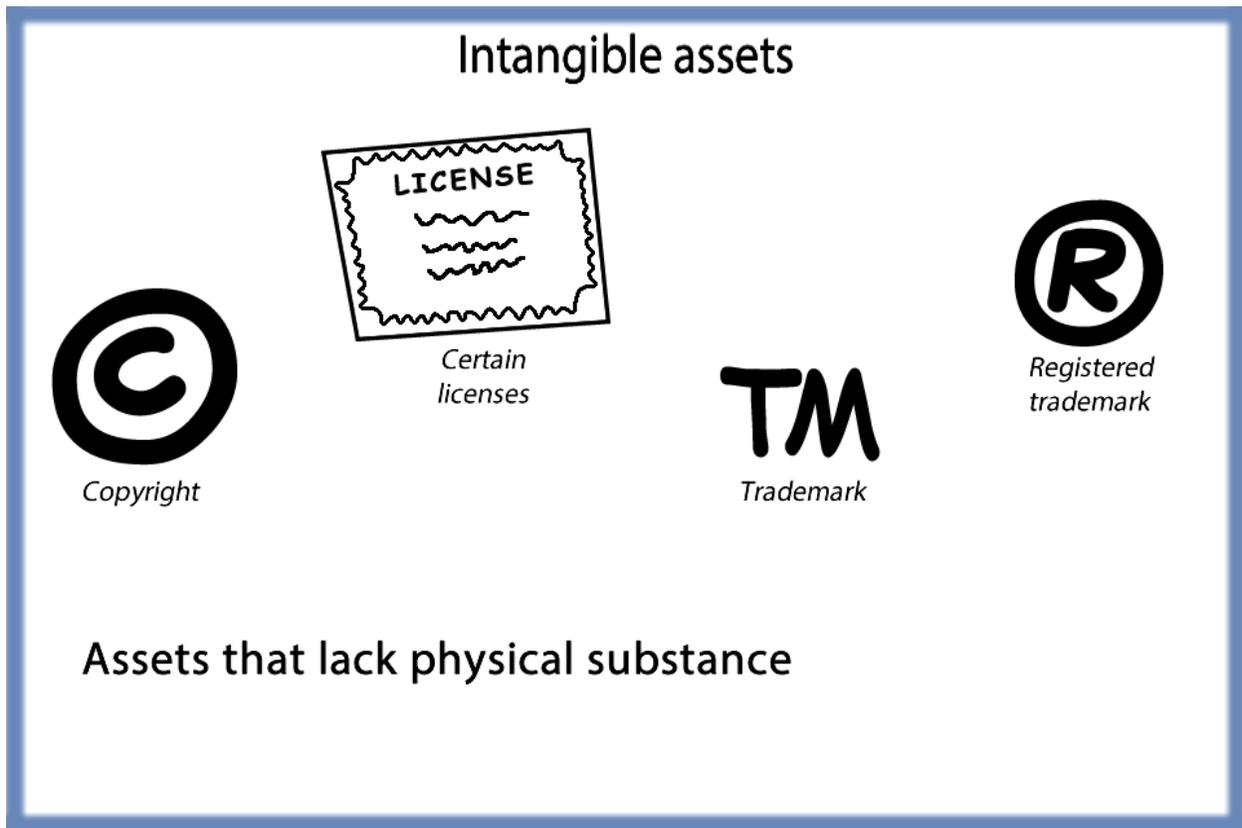
[Return to Dictionary Index](#)

Intangible assets Non-physical assets, unlike property, plant, and equipment

*Purchased and internally developed in some cases

*Amortized (expensed) over the life of the asset

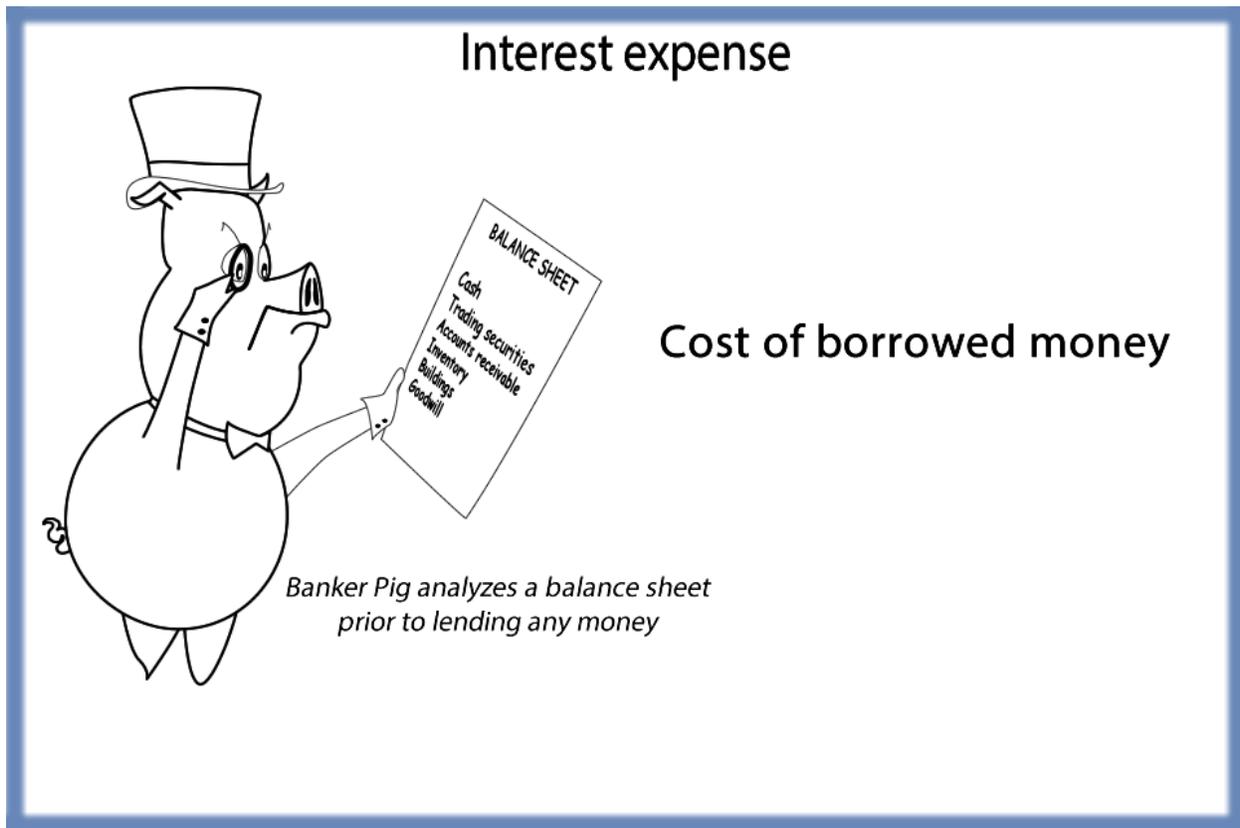
Examples: patents, trademarks, copyrights, franchise licenses, and goodwill



[Return to Dictionary Index](#)

Interest expense Cash paid to lenders for the use of borrowed money

- *Most interest is a financing expense used for general operations
- *Some interest, such as interest in connection with construction, is capitalized and becomes a part of the overall cost of the asset
- *Interest expense is generated from debt, notes payable, and other company borrowings

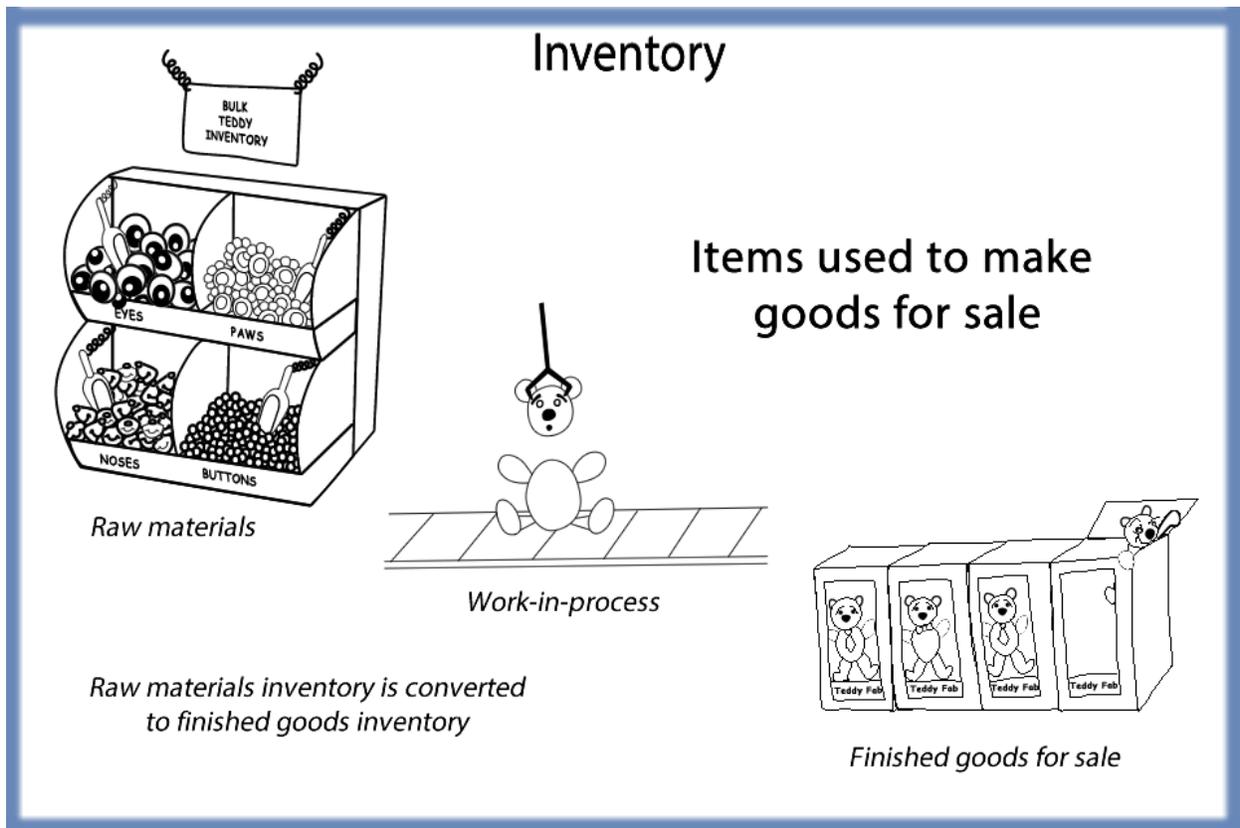


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Inventory Cost of products ready to be sold or used in the manufacturing process

*Manufacturing inventory starts as raw material, moves to work-in-process, and finally a finished good

*Recorded at cost or lower, if the value has declined using a lower of cost or market valuation



[Return to Dictionary Index](#)

Inventory turnover Measures the frequency that inventory is used and replaced

*Used to monitor inventory management

*Low turnover may indicate company is not selling enough or has over purchased inventory

*Turnover ratio should be used in context of the prior year performance or as a comparison to other competitors

Inventory turnover

$$\text{INVENTORY TURNOVER RATIO} = \frac{\text{COST OF GOODS SOLD}}{\text{AVERAGE INVENTORY}}$$

$$\frac{\text{BEGINNING + ENDING INVENTORY}}{2} = \text{AVERAGE INVENTORY}$$

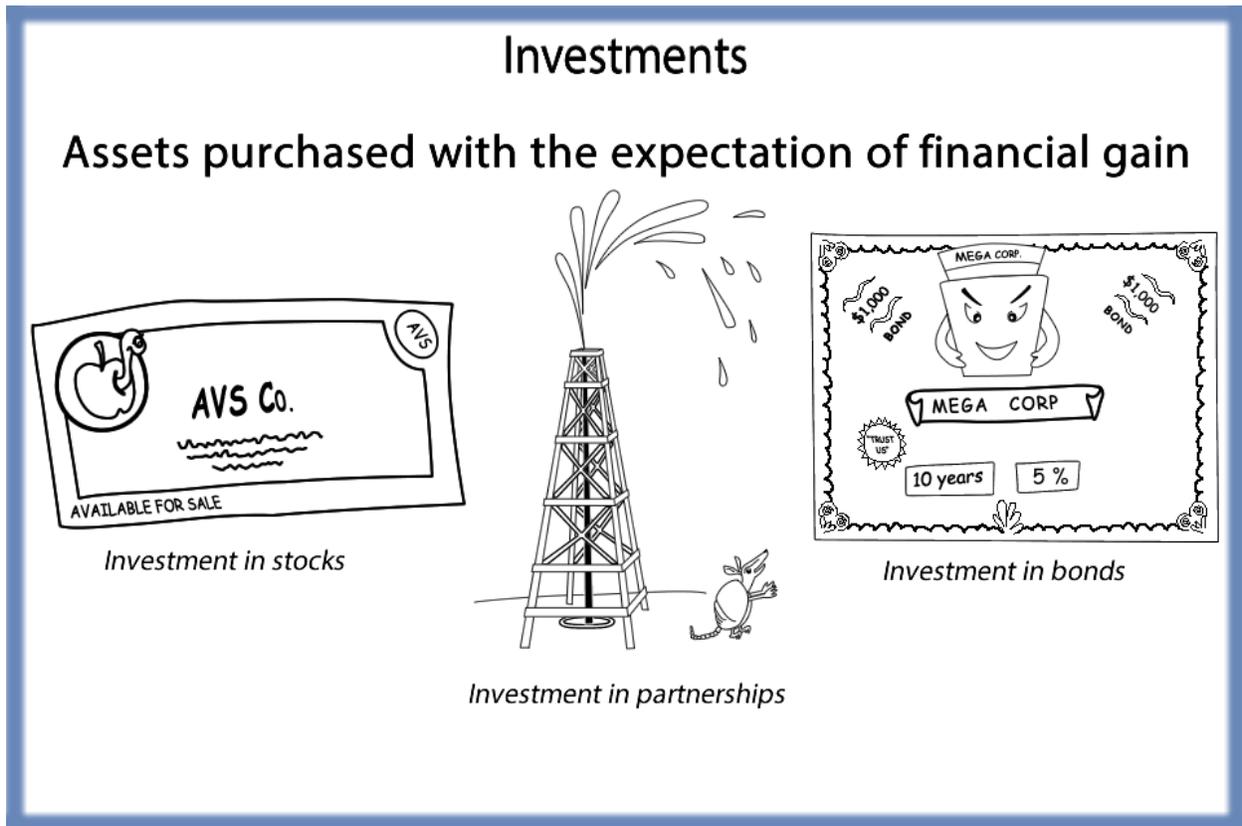
Turnover Ratio

[Return to Dictionary Index](#)

Investments Assets purchased for financial gain

*Investment classification affects reporting on the financial statements

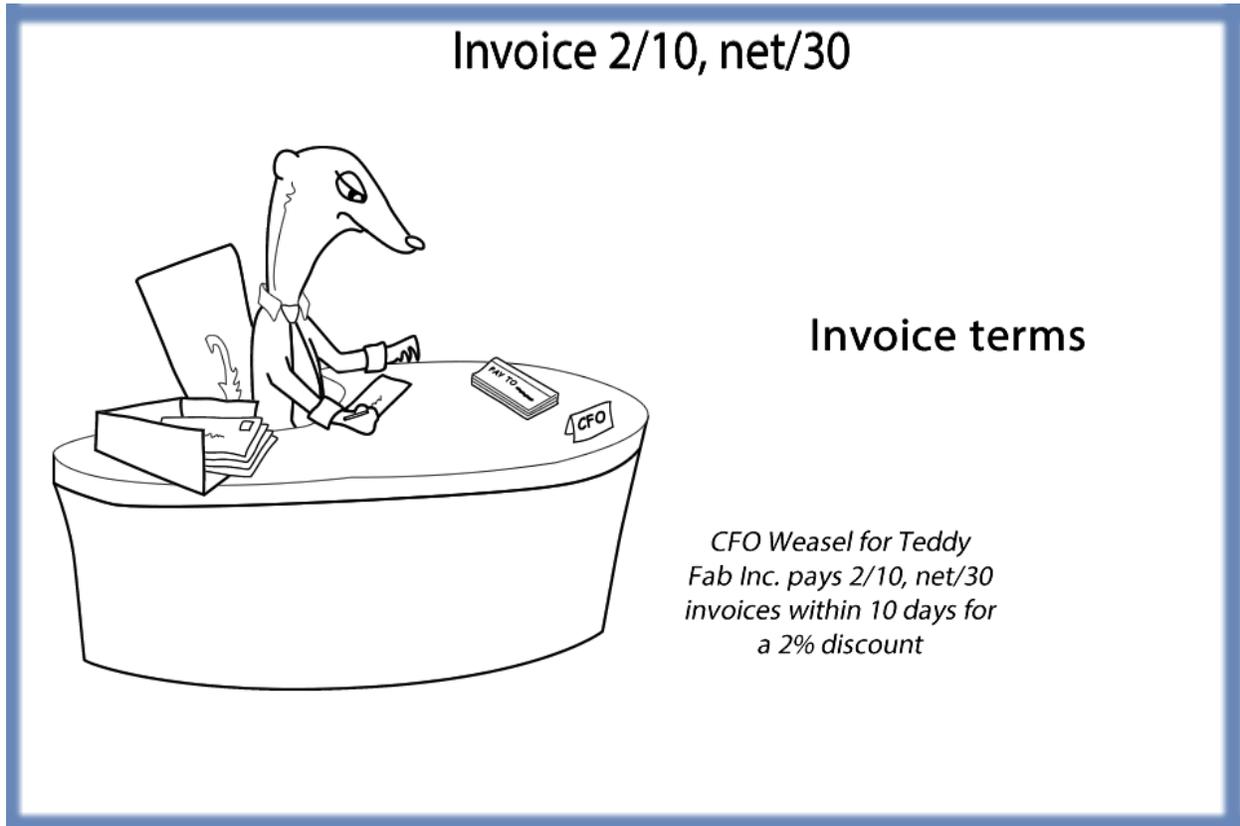
Examples: stocks, bonds, and partnership interests as well as physical assets such as land and gold



[Return to Dictionary Index](#)

Invoice 2/10, net/30 Payment terms for items sold

- *If paid in 10 days, the customer may have a 2% discount
- *If paid in 30 days, the invoice must be paid in full
- *Generally terms used to encourage customers to pay faster

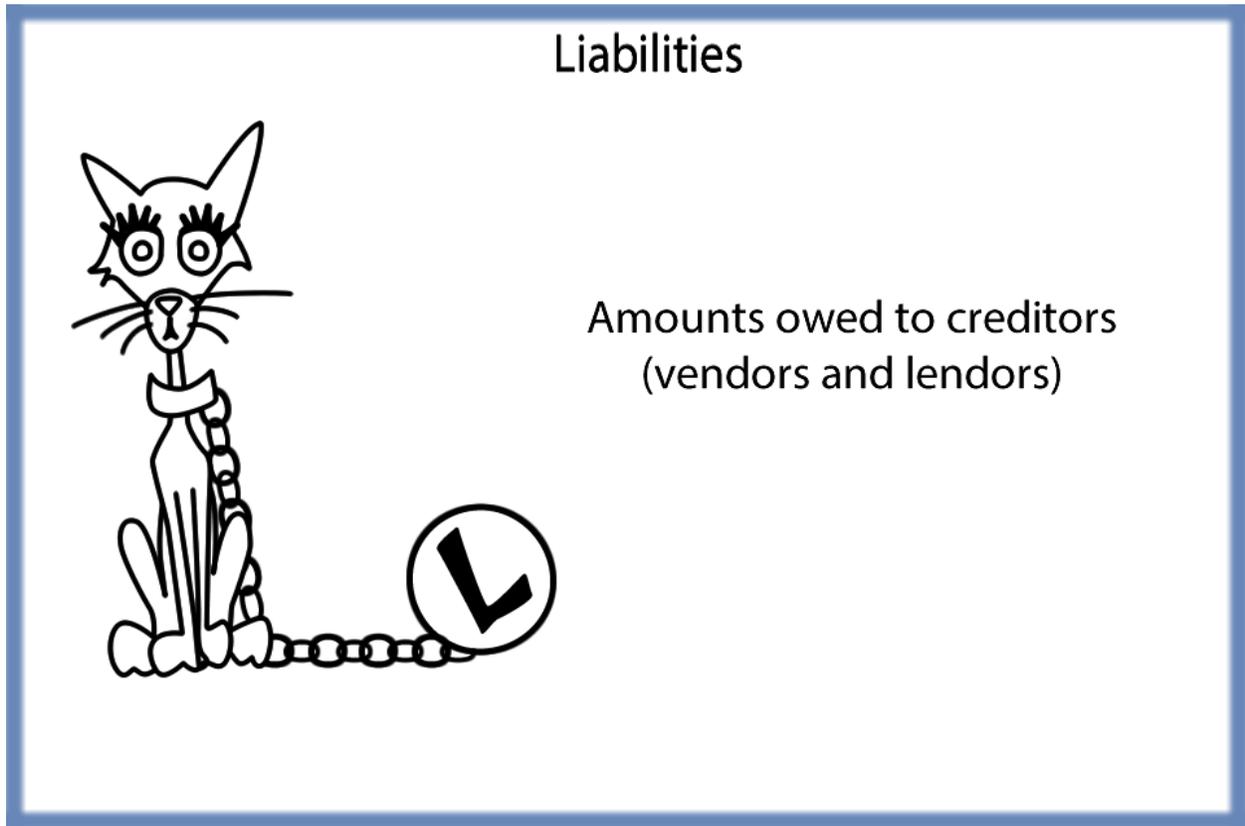


[Return to Dictionary Index](#)

Liabilities Debts owed by a business, typically paid in cash when due

Examples: accounts payable, income tax payable, dividends payable, accrued liabilities, and long-term debt payable

Financial statement: balance sheet



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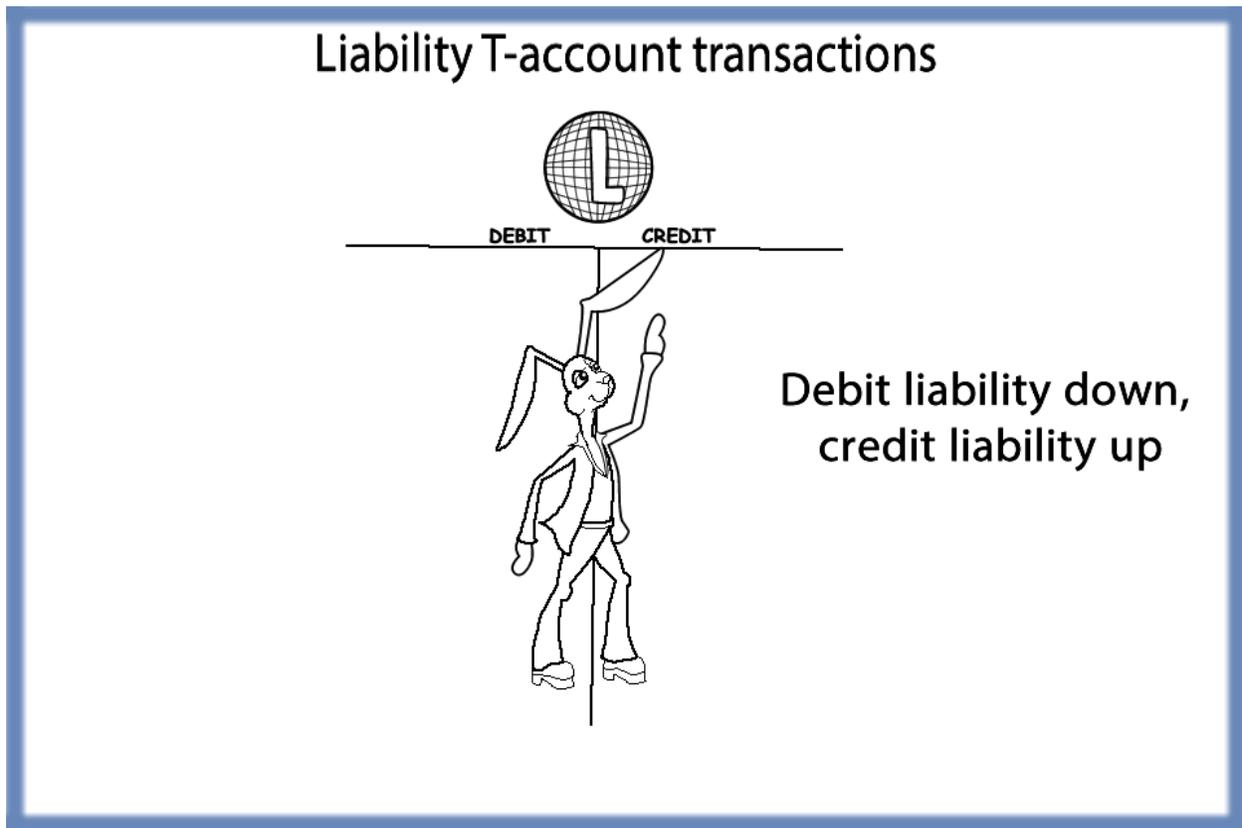
Liability T-account transactions Decrease liabilities with a debit and increase with a credit

Basic entries

* Increase liability from a loan: debit cash, credit liability

* Increase liability for expense: debit expense, credit liability

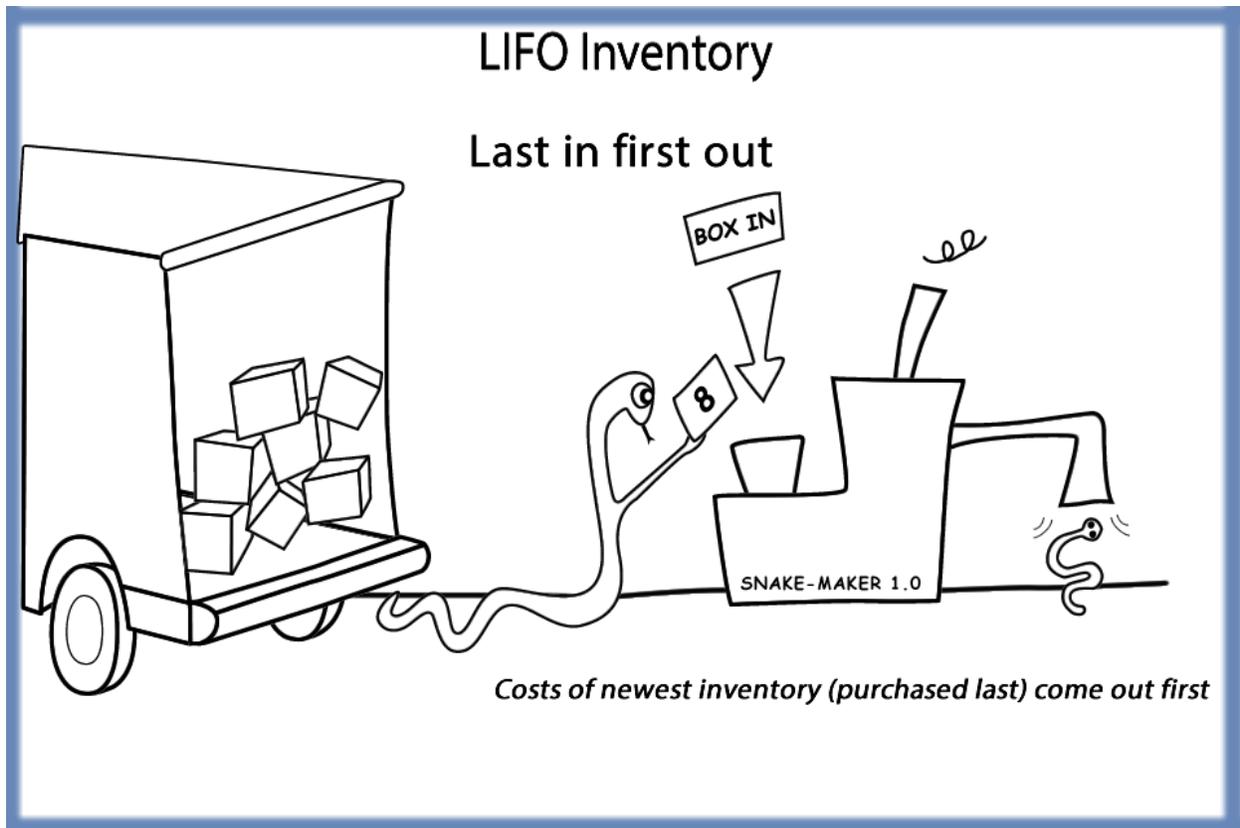
* Decrease liability from a loan repayment: debit liability, credit cash



[Return to Dictionary Index](#)

Last in first out Inventory accounting system in which last purchases are the first to be used to determine ending inventory and the cost of goods sold

- *Oldest costs tend to remain in the inventory account
- *Results in lower net income in a period of rising prices when compared to the FIFO method
- *Inventory value is understated in period of rising prices
- *Acceptable method only under US-GAAP



[Return to Dictionary Index](#)

Long-term assets Expected benefit greater than one year

Examples

*Depreciable assets: physical assets used in ordinary operations (property, plant, and equipment)

*Intangible assets: non-physical assets used in ordinary operations (copyrights, trademarks, goodwill)

Long-term assets

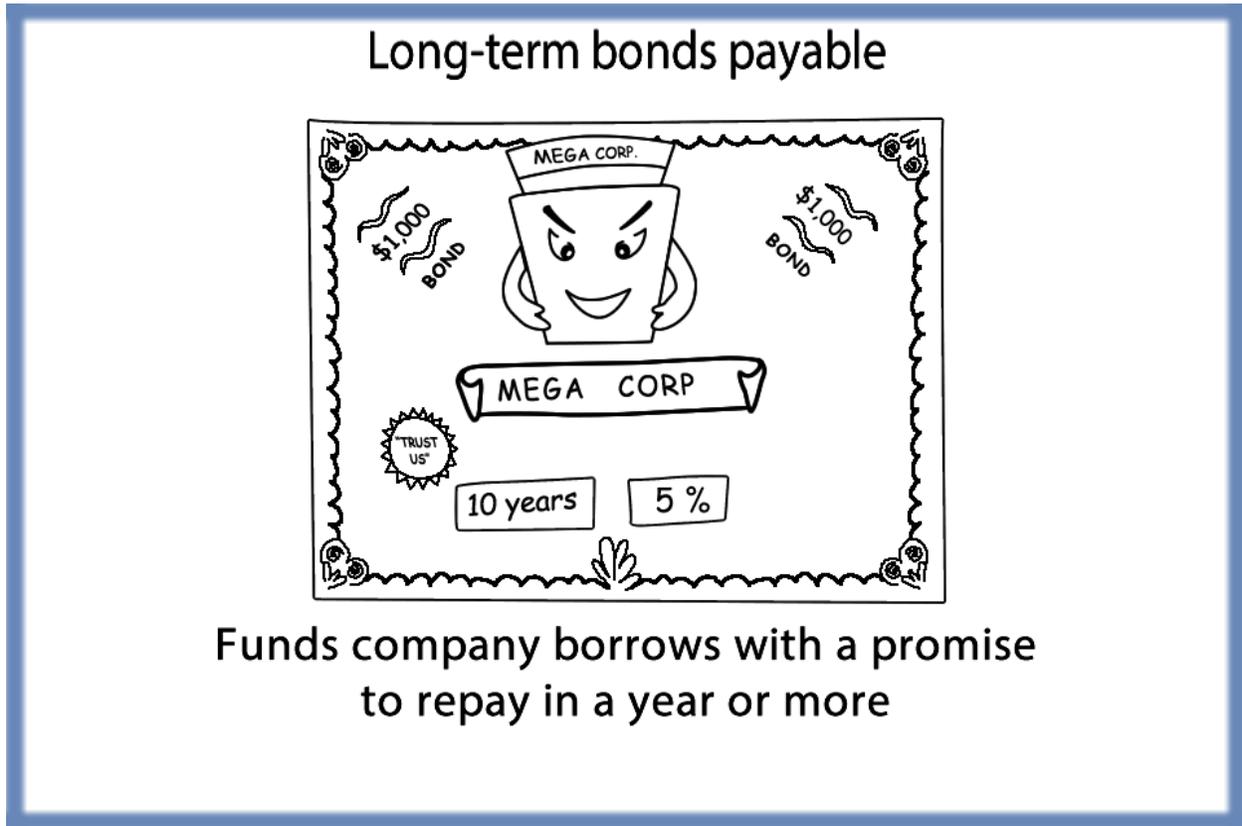
Assets expected to last more than one year

[Return to Dictionary Index](#)

Long-term bonds payable Represents money borrowed to finance company operations, due in more than one year

* Issued to investors to raise funding

* Form of debt financing



Long-term liabilities Debts owed to creditors, due in more than one year from the balance sheet date

Examples: bonds payable, notes payable, and mortgage loans payable

Long-term liabilities



**BANK OF PIGGY
COMMERCIAL LOAN**

TERM: 30 YEARS, PRINCIPAL & INTEREST

AMOUNT: \$1,000,000

RATE: 10%

SECURITY: TEDDY FAB WAREHOUSE

ADDRESS: #1 OCEAN VIEW
ANIMAL KINGDOM



Portion of liabilities due in more than a year from the balance sheet date

The principal portion of this loan due in one year is a short-term liability and the excess is classified a long-term liability

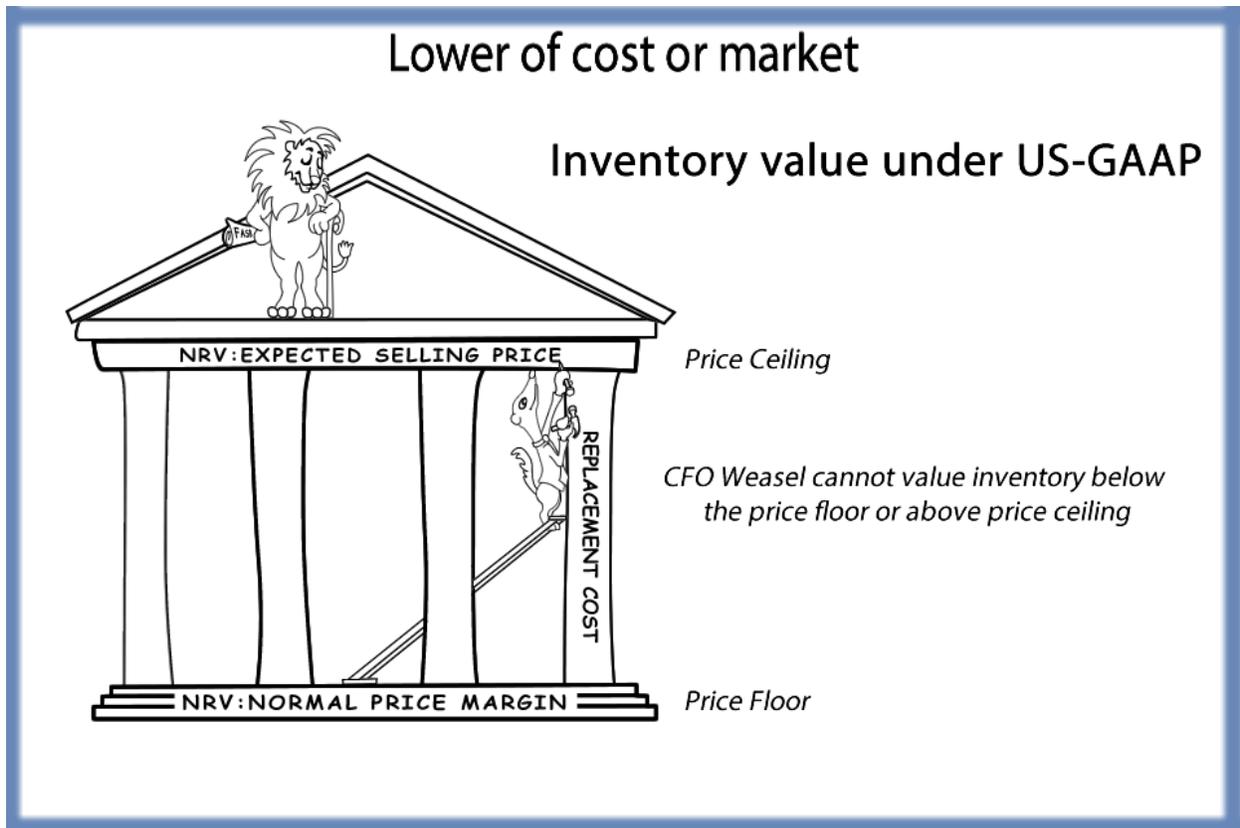
[Return to Dictionary Index](#)

Lower of cost or market Inventory valuation methodology based on price paid or a lower value calculated following US-GAAP

*Inventory cost is never greater than cost

*Cost is the price paid for the item

*Market value determined by calculating three different values: replacement cost, net realizable value (NRV), and NRV less normal profit margin

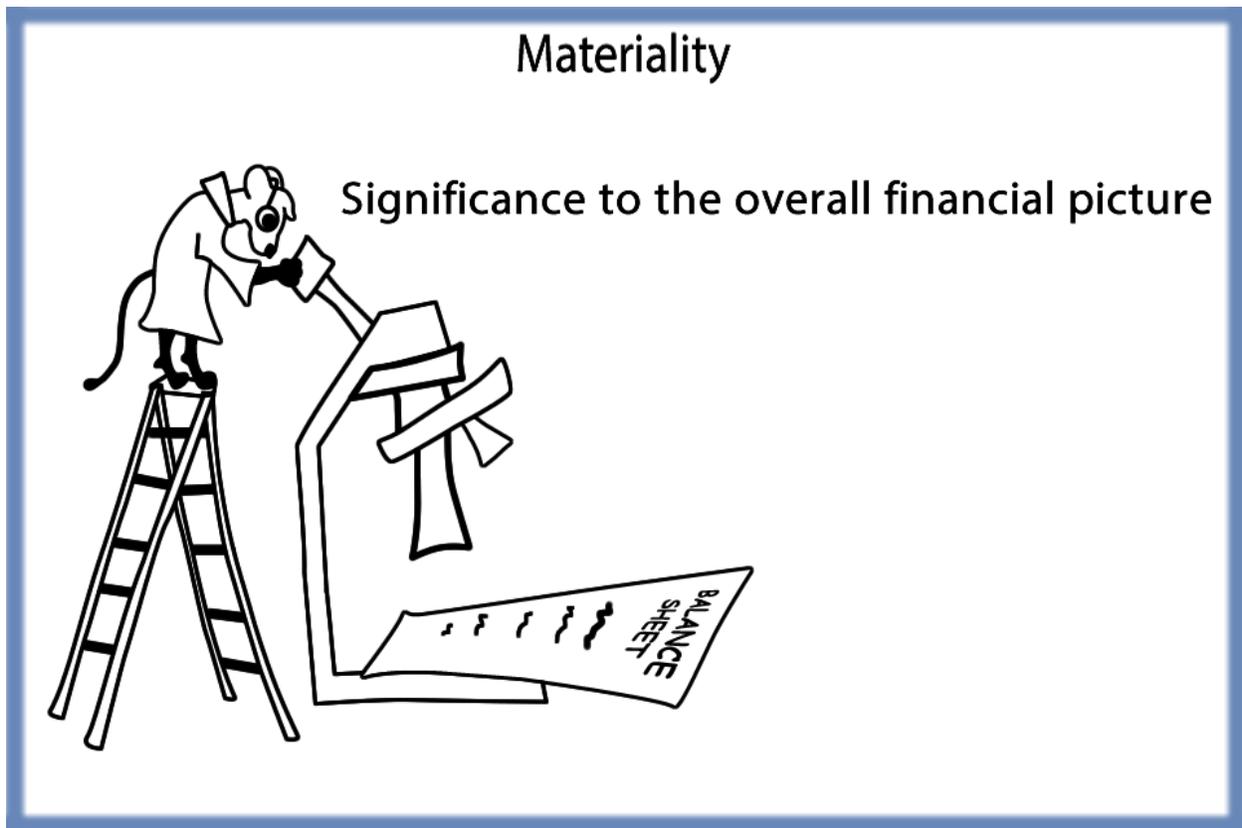


[Return to Dictionary Index](#)

Materiality Defines the level to which certain accounting principles do not apply

*Financial statement rounding to the nearest dollar or greater, depending on the size of the company

*Any violation of accounting principles do not change the overall interpretation by the end user



[Return to Dictionary Index](#)

Net profit on sales Measures profitability on sales

*Useful for comparison across similar companies and trend analysis

*Ratio may not be very useful alone because a company may have low total profit with a high net profit on sales ratio

Net profit on sales

$$\text{NET PROFIT RATIO} = \frac{\text{NET PROFIT}}{\text{NET SALES}} \times 100$$

Profitability Ratio

[Return to Dictionary Index](#)

Notes payable Debts owed to banks or other creditors based on written agreements

*Split on balance sheet as a short-term liability (owed in one year or less) and long-term (due in more than one year)

*Rate of interest and terms specified in lending document

Notes payable

FAT CAT BANK

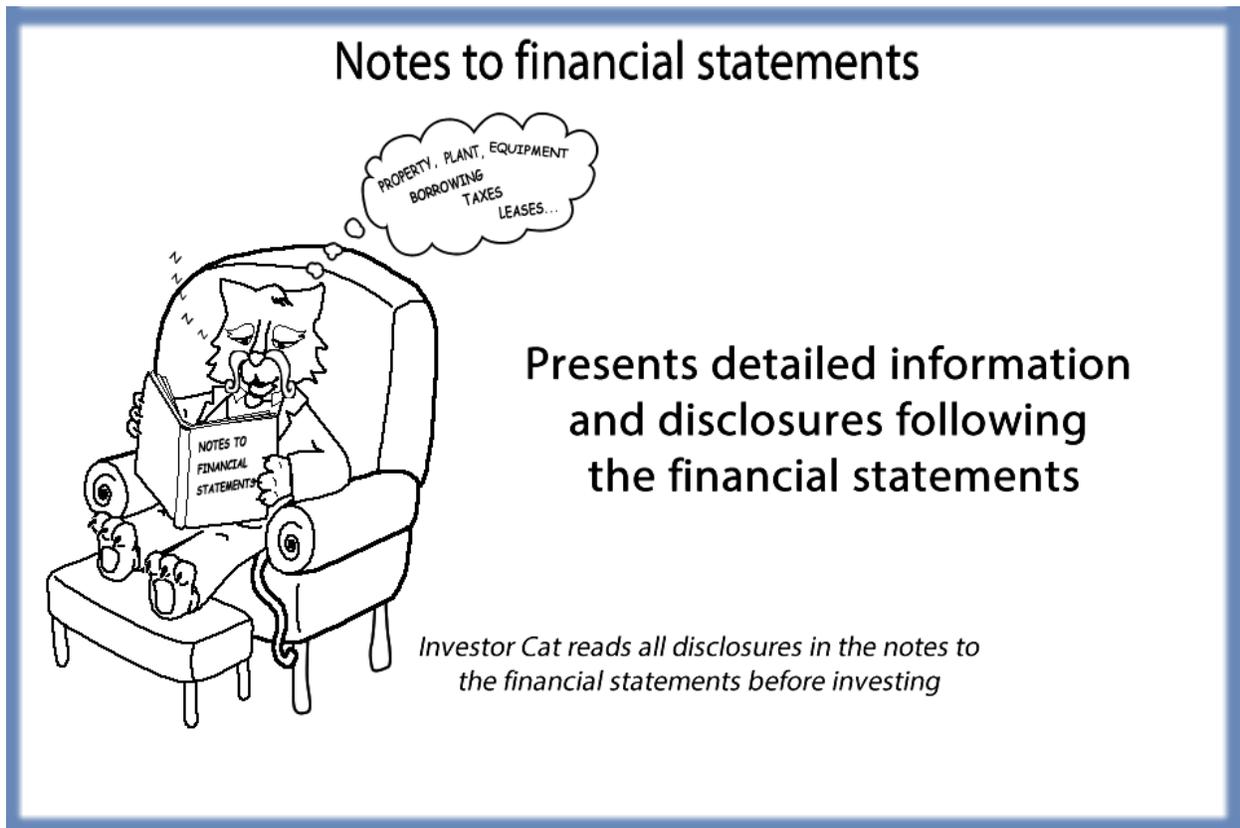
For Cash received,
the undersigned,
TEDDY FAB INC.,
borrower promises to
pay to
FAT CAT BANK,
the "Lender", \$100,000
with 10% interest
within one year.

Debt owed for money borrowed

[Return to Dictionary Index](#)

Notes to financial statements Detailed financial information issued with the financial statements

Topics that may be covered: basis of financial presentation, business changes, risks, uncertainties, accounting developments, business combinations, risk exposure, fair value measurement, investments, asset summaries, income taxes, related party transactions, debt detail, and other disclosures



[Return to Dictionary Index](#)

Partnerships v. limited partnerships Members of a general partnership have personal liability for their own actions and actions of partners, while limited partners of a limited partnership have liability protection, but the general partner does not

*General partnership may be formed if any two people are in business together absent any agreements

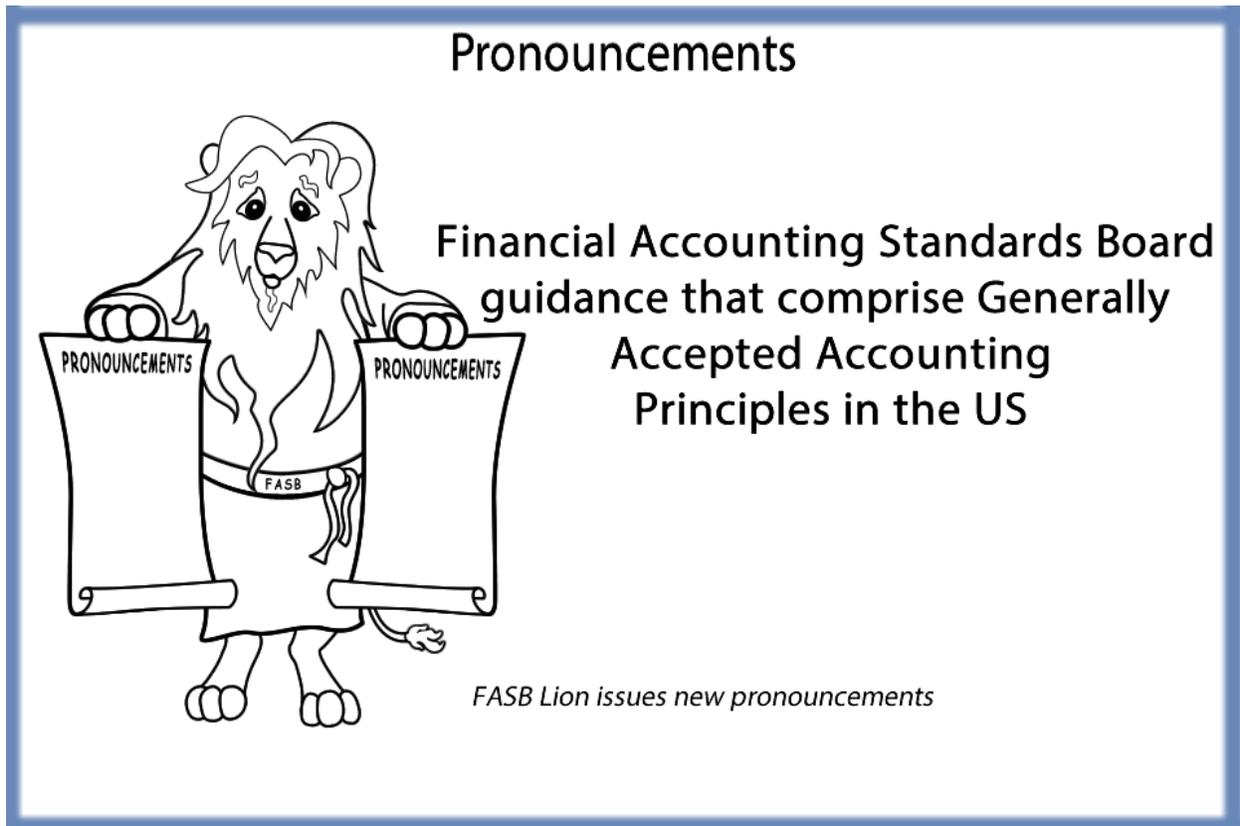
*Limited partnerships are formal and granted limited liability by the state



[Return to Dictionary Index](#)

Pronouncements Financial Accounting Standards Board (FASB) guidance that comprises Generally Accepted Accounting Principles in the US (US-GAAP)

*Comprised of: Statements of Financial Accounting Standards (FAS), Statements of Financial Accounting Concepts, Interpretations, Technical Bulletins, and Staff Positions



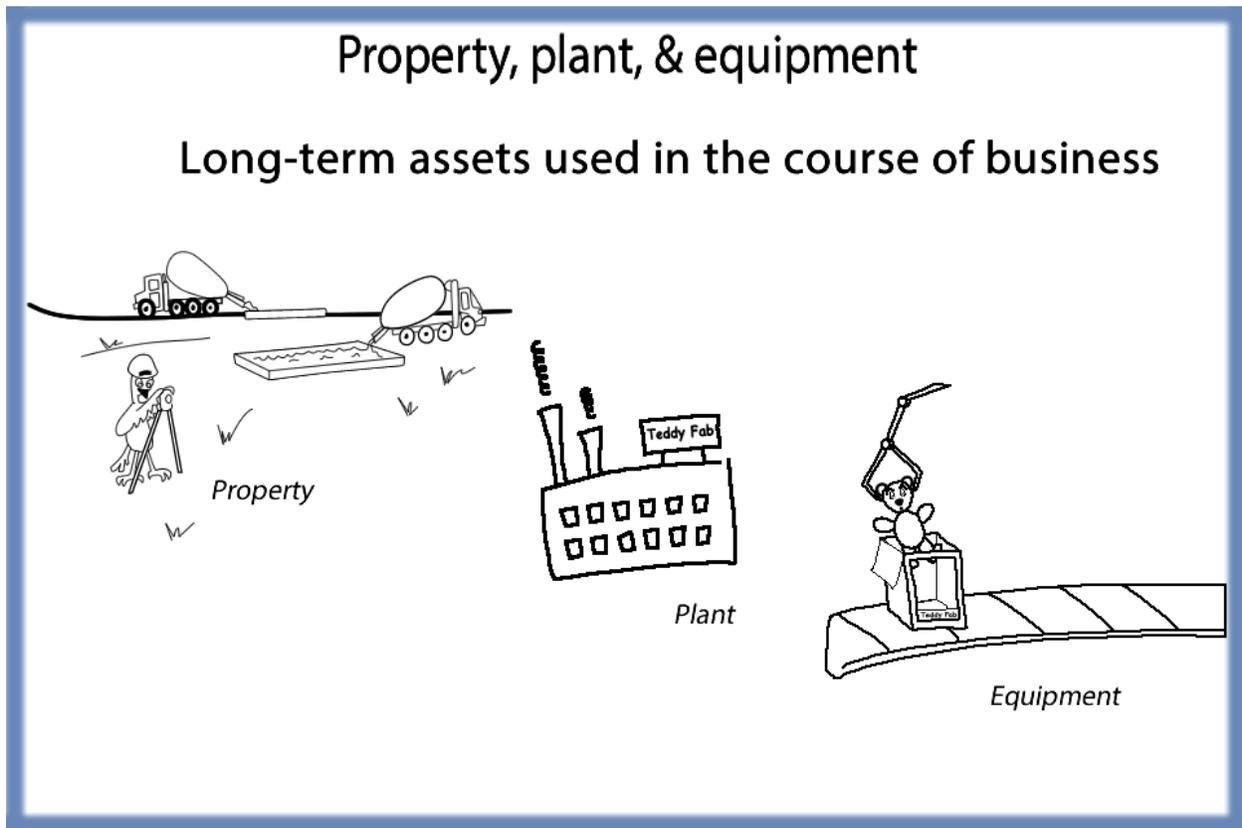
[Return to Dictionary Index](#)

Property, plant, and equipment (PP&E) Long-term assets used in the course of business

*Reported on the balance sheet at cost

*Depreciated to represent decline in asset value over time

Examples: land, buildings, leasehold improvements, office equipment, furniture, fixtures, and vehicles

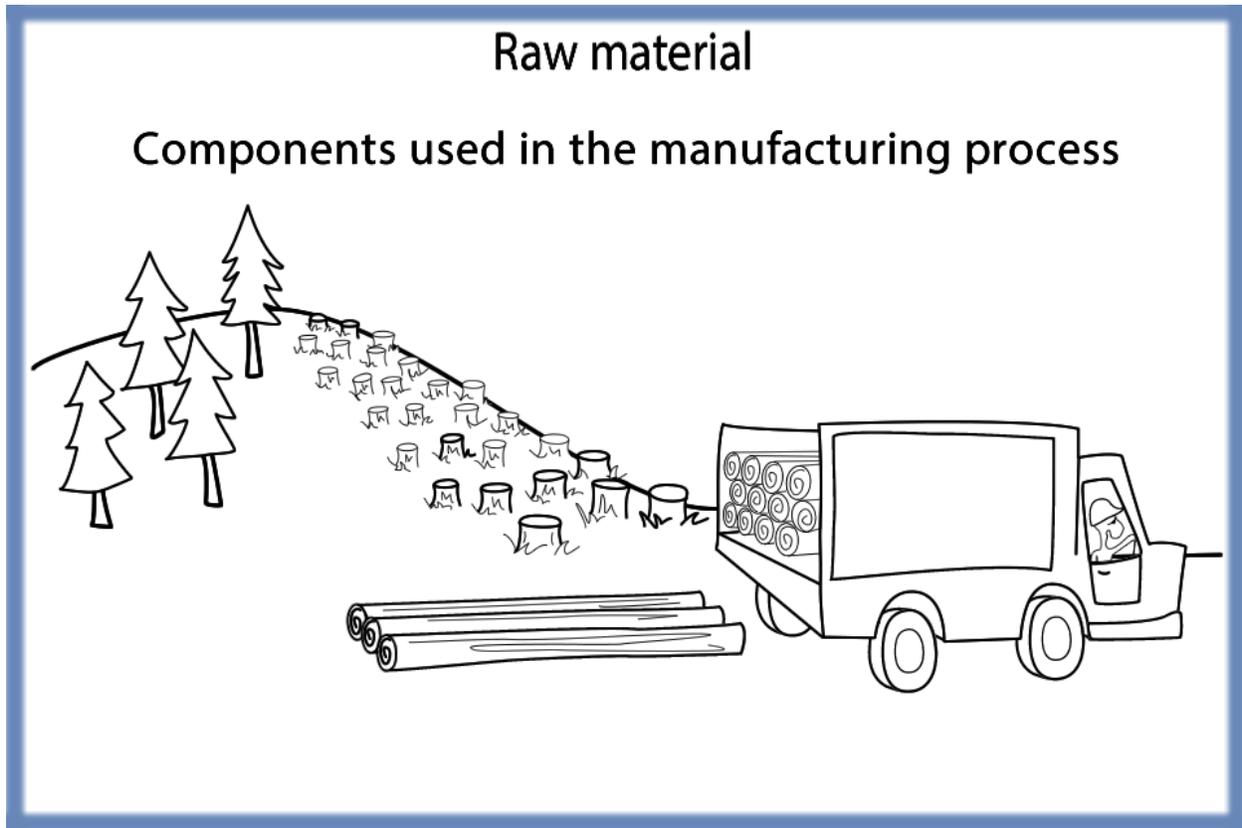


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Raw material Components used in the manufacturing process that are part of direct costs

*Examples: wood, steel, parts, stuffing, cloth, and oil

*Does not include indirect costs such as factory utilities or manufacturing labor

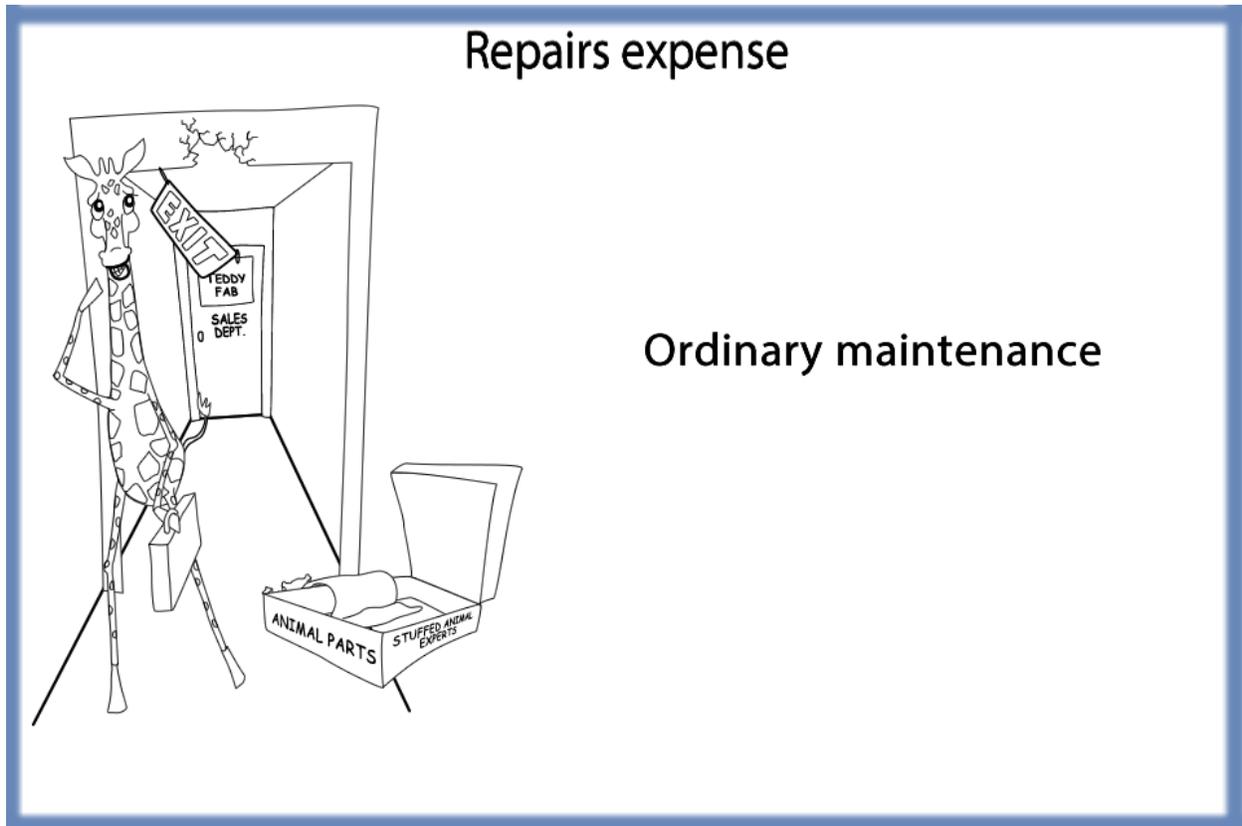


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Repairs expense Costs of maintaining assets

*Expensed costs recognized on the income statement

*Ordinary maintenance that does not improve an asset

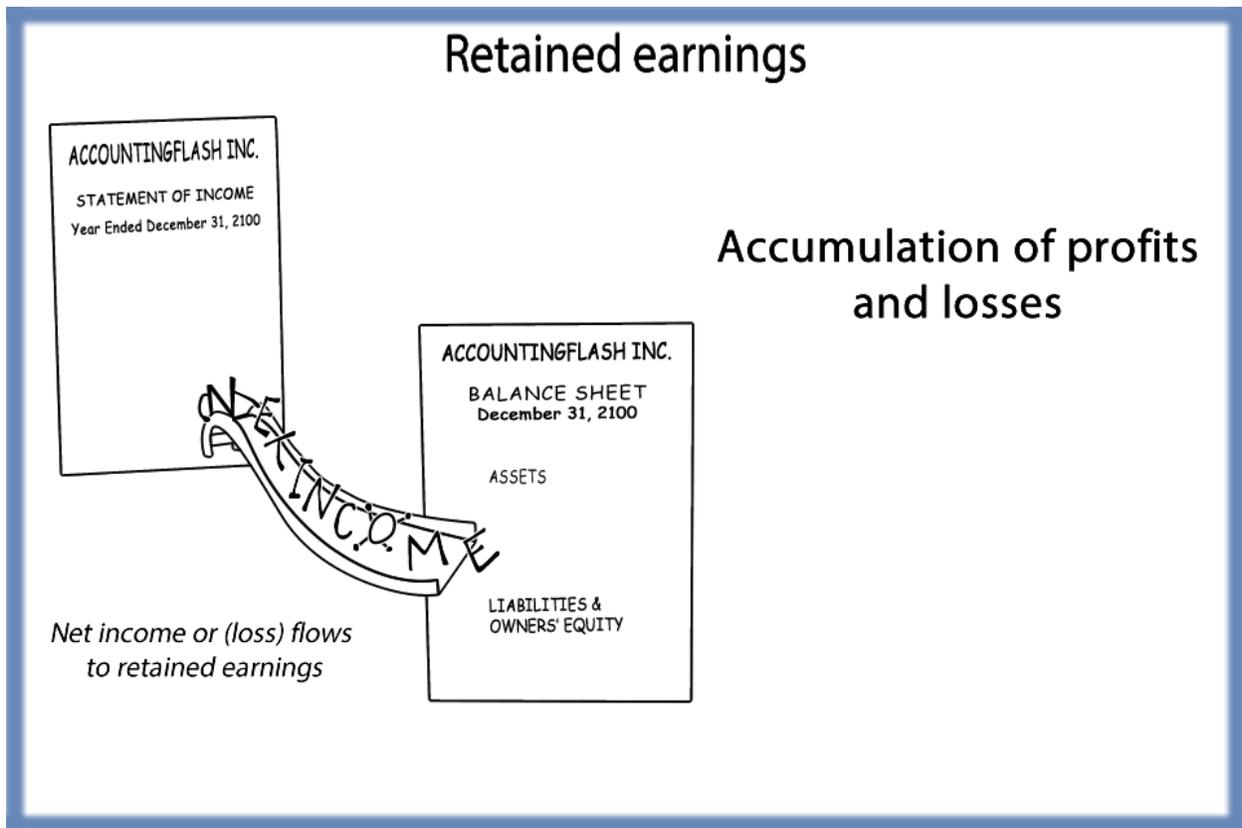


[Return to Dictionary Index](#)

Retained earnings Sum of all previous profit and losses, less dividends

*Net income or loss is recorded to retained earnings at the end of the accounting period

*Dividends declared reduce retained earnings



[Return to Dictionary Index](#)

Return on assets Measures asset utilization compared to net income

*Useful for comparison across similar companies and trend analysis

*Less useful for companies that do not utilize assets much in the production of revenue, such as consulting firms

Return on assets

$$\text{RETURN ON ASSETS RATIO (ROA)} = \frac{\text{NET INCOME}}{\text{AVERAGE TOTAL ASSETS}}$$

Profitability Ratio

[Return to Dictionary Index](#)

Return on equity Measure of profit compared to amounts invested into the company

*Useful for comparison across similar companies and trend analysis

*High ratio indicates strong profitability relative to the investment

Return on equity

$$\text{RETURN ON EQUITY RATIO (ROE)} = \frac{\text{NET INCOME}}{\text{AVERAGE STOCKHOLDER'S ASSETS}}$$

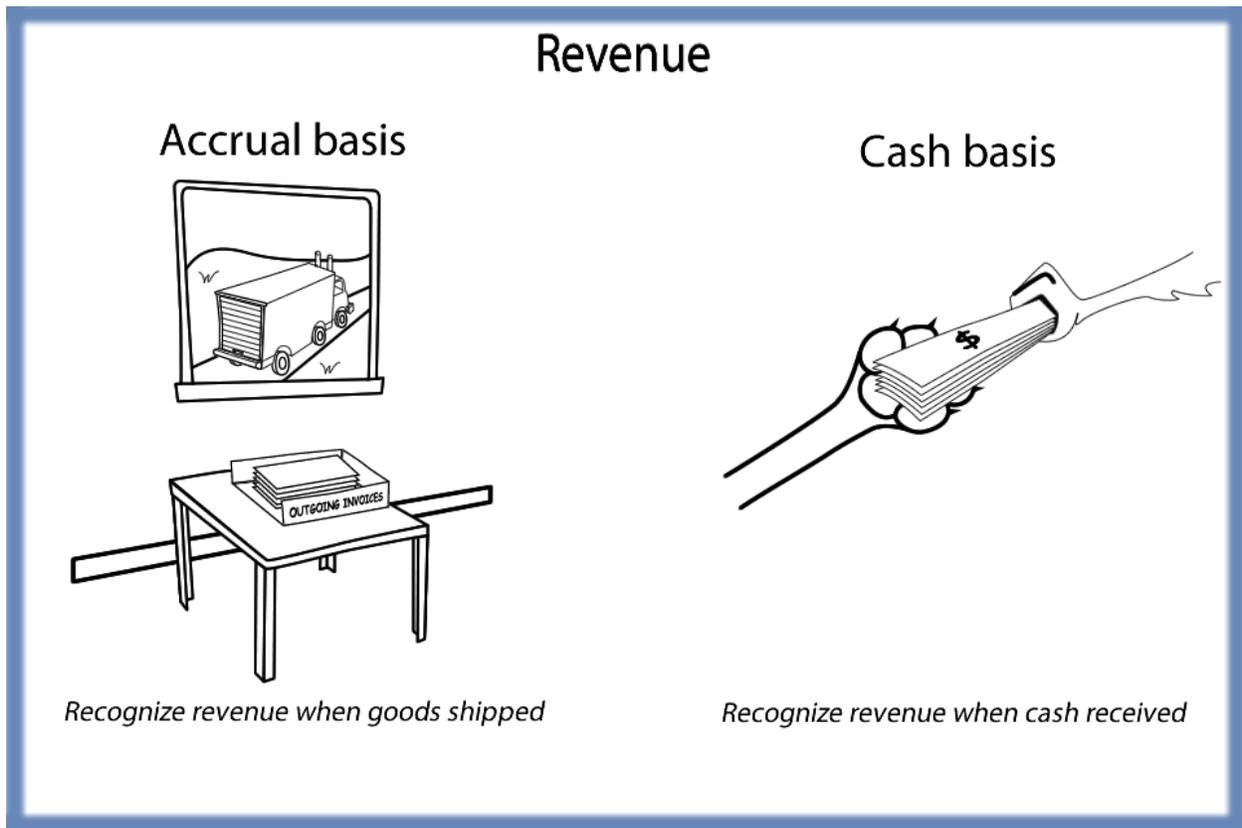
Profitability Ratio

[Return to Dictionary Index](#)

Revenue Income earned from the sale of goods and services

Accrual basis accounting: revenue recognized when goods are delivered or services performed

Cash basis accounting: revenue is recognized when cash is received for goods delivered or services performed



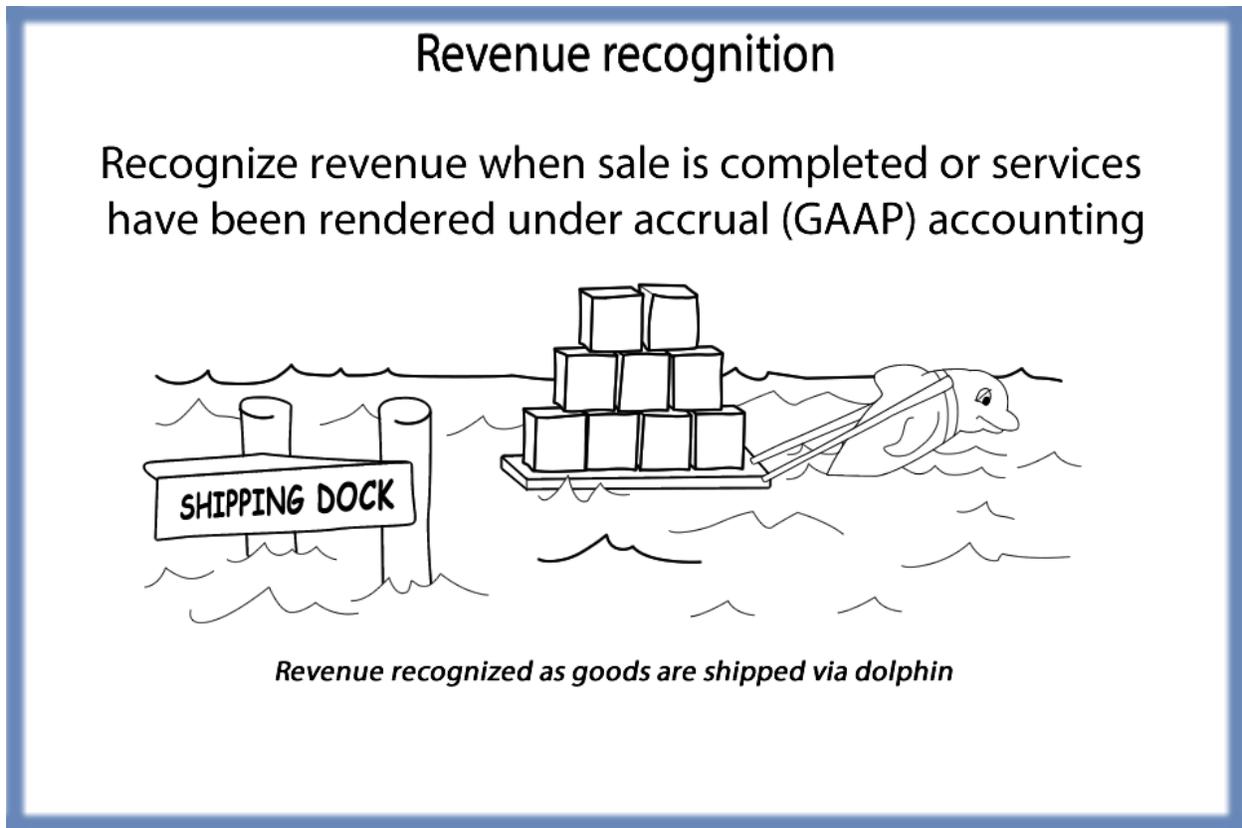
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Revenue recognition Recognize revenue when it is earned and realizable

- *Goods shipped or services rendered
- *Revenue recorded before cash is collected

Realize revenue: When cash is received

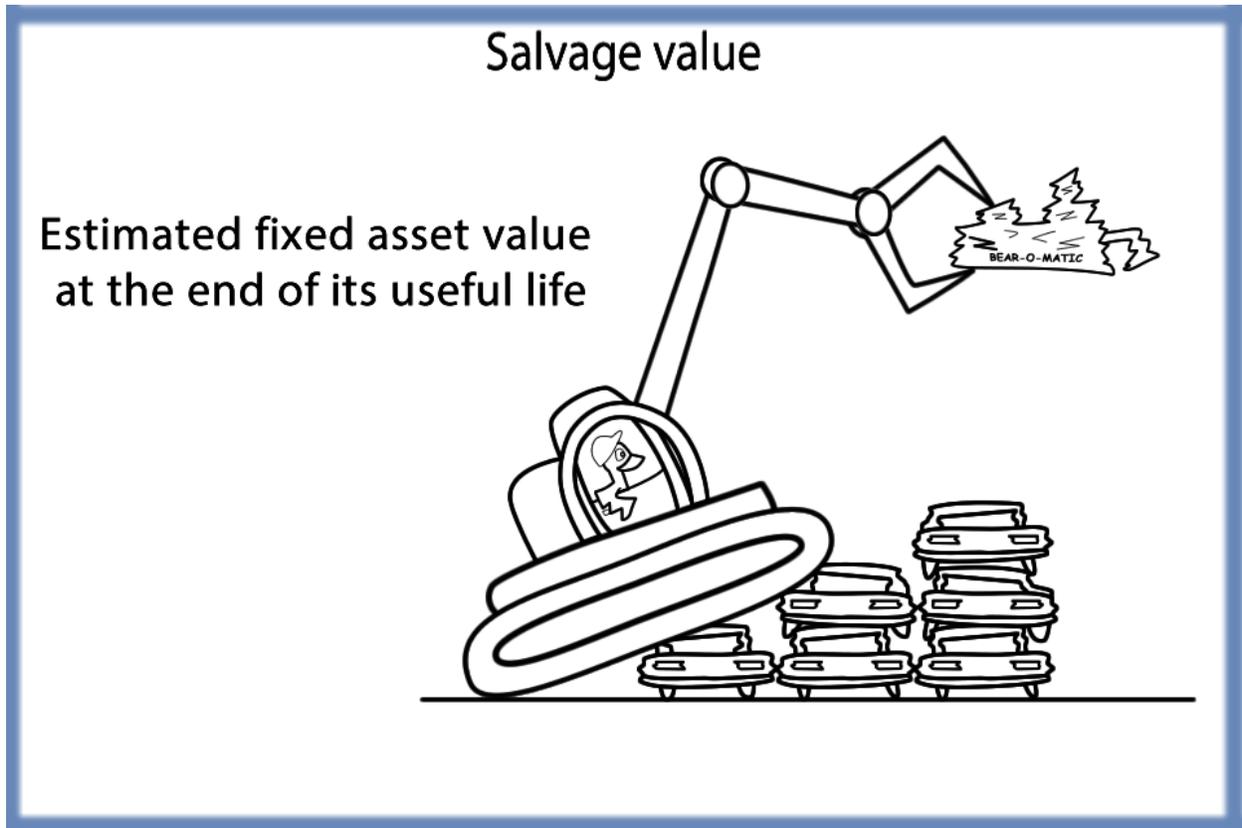
- *Customer pays for goods delivered or services rendered



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Salvage value Estimated value of a fixed asset at the end of its useful life

*Used in depreciation methods: straight-line method, units of production method, and sum-of-the-years-digits' method



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Selling, general, and administrative expense Costs expensed as they occur

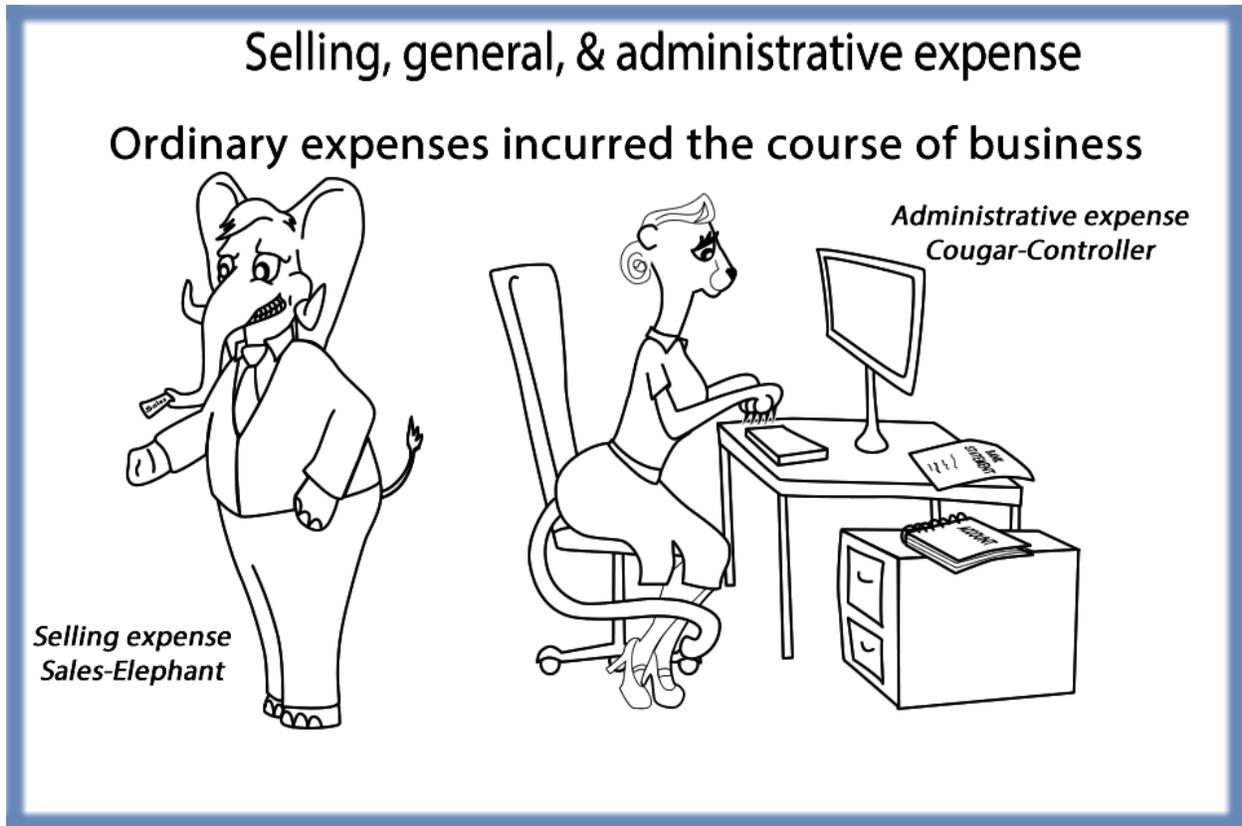
*Costs expensed on the income statement in the period in which they occur

*Not added to inventory or fixed assets

Selling: costs not in cost of goods sold, such as commissions

General: expenses such as taxes and miscellaneous costs

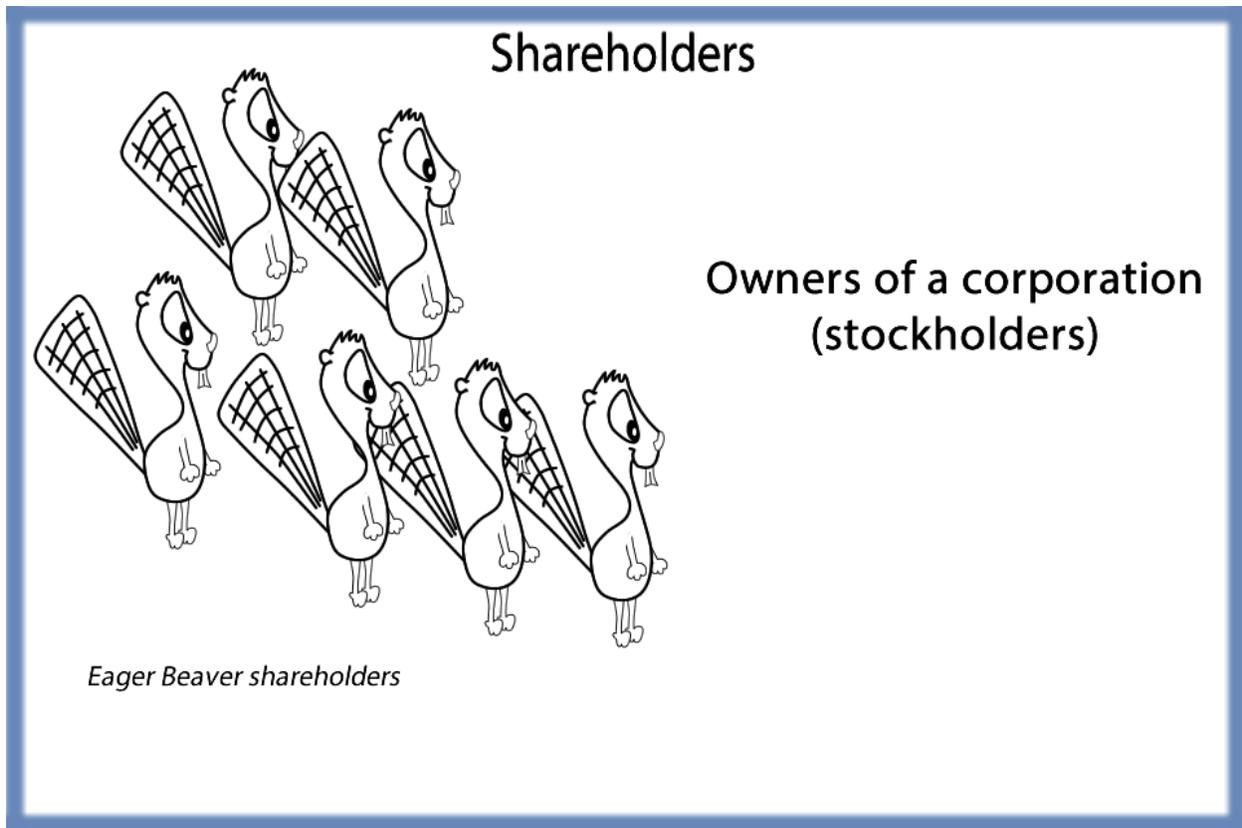
Administrative: general support and salaries not directly related to manufacturing



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Shareholders Owners of a corporation

- *Influence the company by electing the board of directors
- *Board of directors elects chief executive officer (CEO) of company
- *Corporate shareholders limit losses to their original investment and are not personally liable for corporate actions
- *Shareholders may be rewarded with stock appreciation, dividends, and sales



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Shareholders' equity Represents value retained by the company

*Equity on the balance sheet is defined as: $\text{Equity} = \text{Assets} - \text{Liabilities}$

*Generally comprised of stock, additional paid-in capital, and retained earnings

*Represents a value per book which does not take into account certain changes in fair market value

Financial statement: balance sheet

Shareholders' equity

Equity = Assets - Liabilities

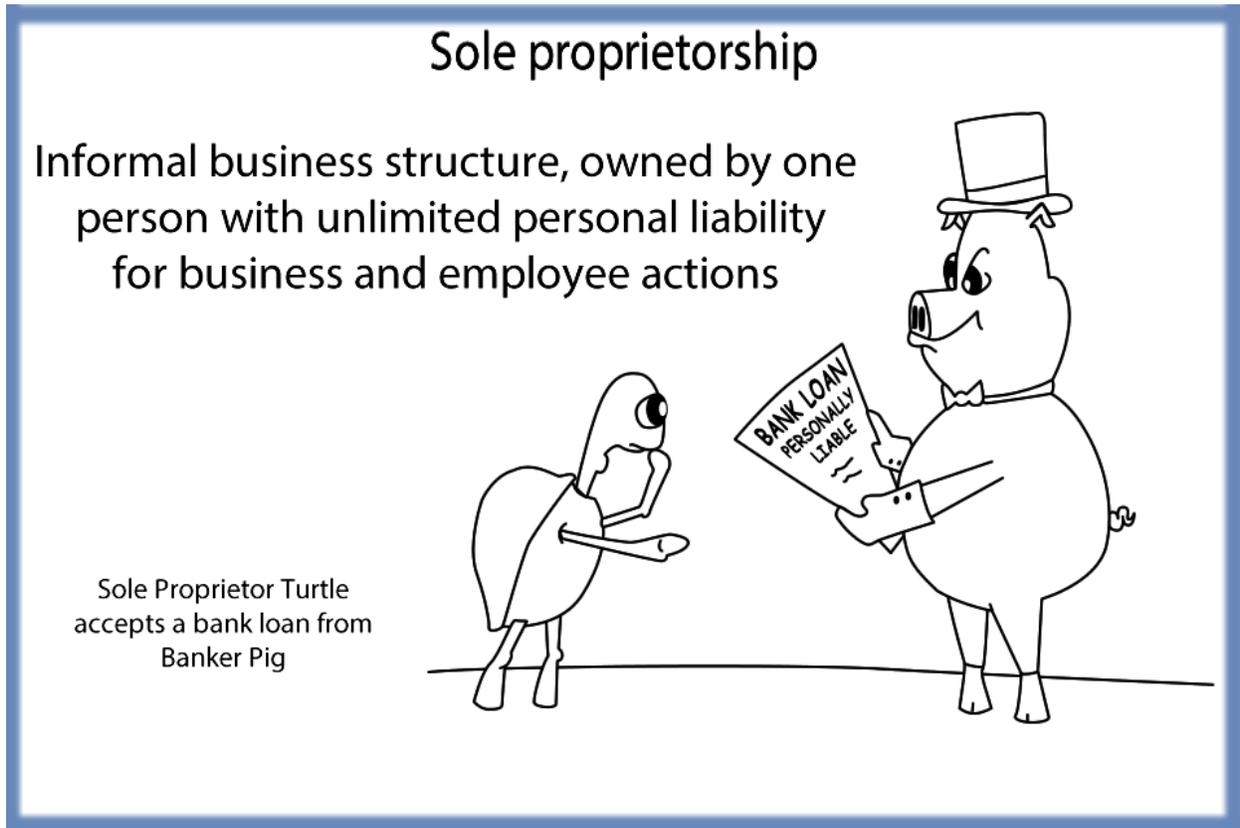


Teddy is stoked on equity

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Sole proprietorship Owned by one person with unlimited liability, because there is no legal separation from the business and the owner

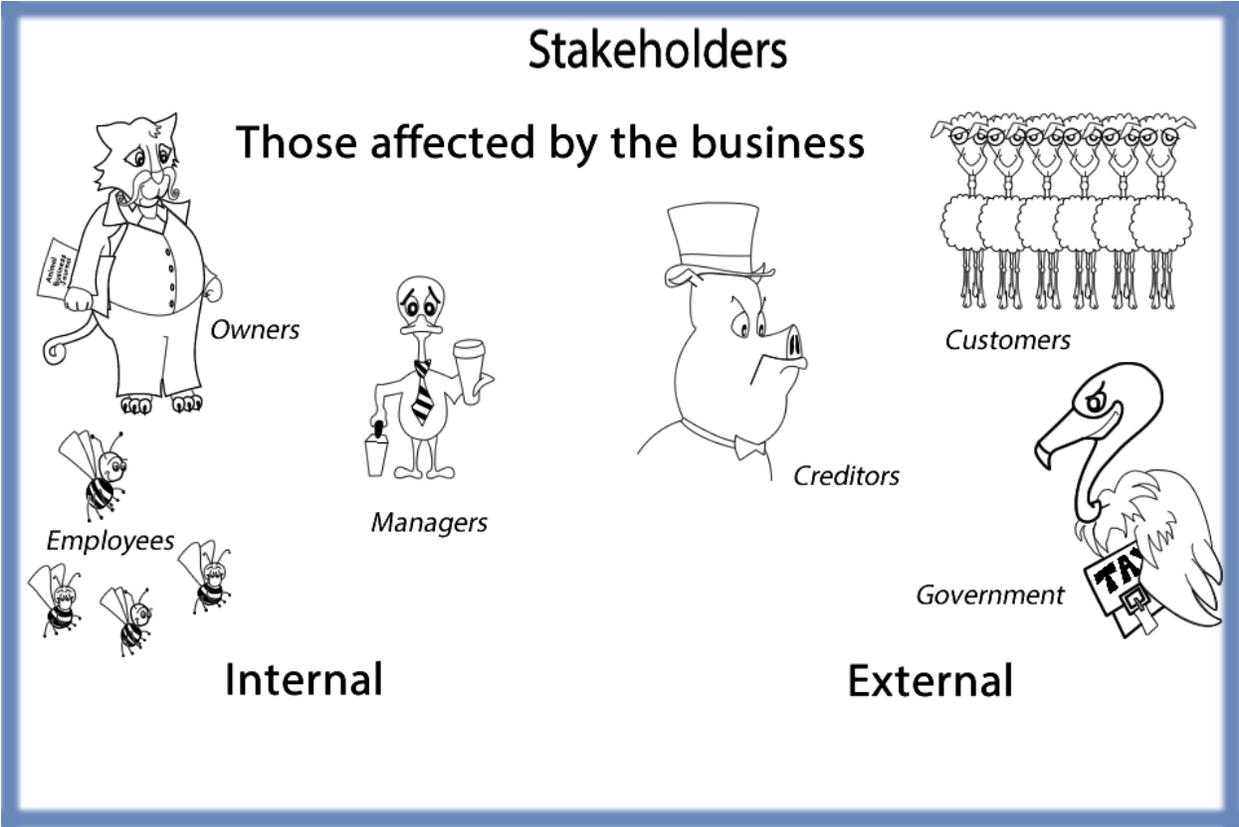
- *Most common form of doing business
- *No shareholders
- *Owner is personally liable for business and employee actions



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Stakeholders Those affected by the outcome of the business

*Users of financial information



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Statement of cash flows Reports cash in and out of a company for a given period of time

*Reconciles beginning period cash to ending cash in three categories: operating, investing, and financing

*Indirect method of preparation uses net income or loss from the income statement to reconcile beginning cash to ending cash for the period

Statement of cash flows defined

Reports cash in and out for a specified time period

Statement of cash flows is compared to a movie, because it captures activity over a range of time, such as one year

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Statement of cash flows example Statement reporting cash flow activity for a specified period of time

*Statement reconciles net income or loss to ending cash

*Changes in cash categorized: operating, investing, and financing

Statement of cash flows example	
TEDDY FAB INC. STATEMENT OF CASH FLOWS Year Ended December 31, 2100	
Cash flows from operating activities:	
Net income	\$ 197,100
Adjustments to reconcile net income to net cash used in operating activities:	
Depreciation and amortization	5,200
Changes in operating assets and liabilities:	
Accounts receivable	(20,000)
Inventories	(15,000)
Prepaid expenses	(4,000)
Accounts payable	30,000
Accrued expenses	5,000
Deferred revenue	2,000
Total adjustments	<u>3,200</u>
Net cash used in operating activities	<u>200,300</u>
Cash flows from investing activities:	
Purchase of property and equipment	(324,300)
Intangible asset purchase	(4,000)
Investment purchase	(10,000)
Net cash used in investing activities	<u>(338,300)</u>
Cash flows from financing activities:	
Proceeds from notes payable	10,000
Proceeds from additional paid-in capital	20,000
Proceeds from issuance of common stock	10,000
Proceeds from bond issuance	200,000
Purchase of treasury stock	(2,000)
Net cash provided by financing activities	<u>238,000</u>
Net increase (decrease) in cash and cash equivalents	100,000
Cash and cash equivalents, beginning	0
Cash and cash equivalents, ending	\$ <u>100,000</u>

Sources of cash presented

Statement reconciles to ending cash

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Statement of shareholders' equity Reports changes in equity during a specified time period due to earnings and financing activity

Items which may change shareholders' equity: net income or loss, dividends, other changes in equity, common stock issuance, additional paid-in-capital, other comprehensive income, and treasury stock transactions

Statement of shareholders' equity defined

TEDDY FAB INC.

STATEMENT OF SHAREHOLDERS' EQUITY
YEAR ENDED DECEMBER 31, 2100

BEGINNING BALANCE	
NET INCOME	
OTHER COMPREHENSIVE	
DIVIDENDS	
ENDING BALANCE	=
	=

ONE YEAR ACCOUNTING RECORD

--	--	--	--	--

Reports changes of retained earnings for a specified time period

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Statement of shareholders' equity example Statement reporting shareholders' equity activity for a specified period of time

Equity accounts presented: common stock, additional-paid-in-capital, retained earnings, accumulated other comprehensive income, and treasury stock

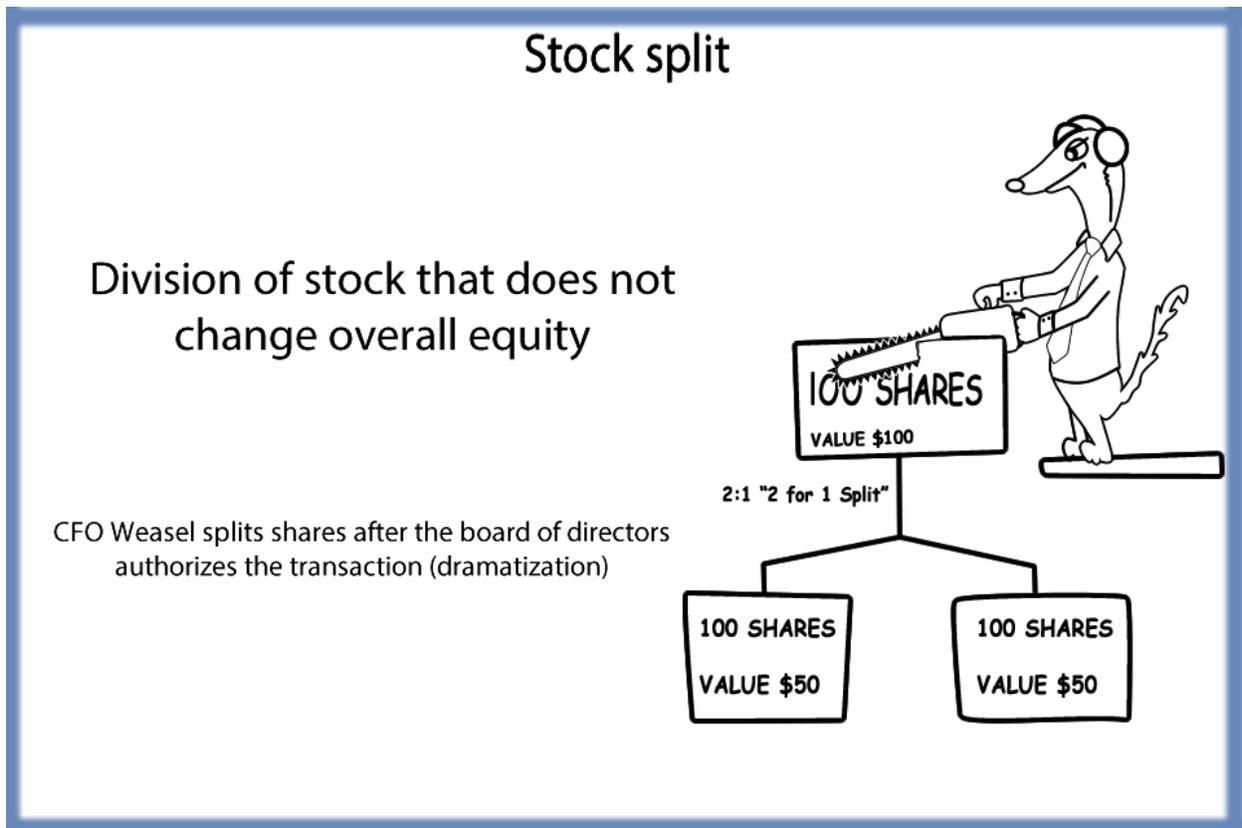
TEDDY FAB INC. STATEMENT OF SHAREHOLDERS' EQUITY December 31, 2100							<i>Items affecting equity are presented in detail</i>
	Common Stock	Additional Paid- In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total	
BALANCE, DECEMBER 31, 2099	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	0
Net Income (Loss) for 2100			197,100				197,100
Common Stock Issued	10,000						10,000
Additional Paid-In-Capital		20,000					20,000
Treasury Stock					(2,000)		(2,000)
BALANCE, DECEMBER 31, 2100	<u>\$ 10,000</u>	<u>\$ 20,000</u>	<u>\$ 197,100</u>	<u>\$ 0</u>	<u>\$ (2,000)</u>	<u>\$ 225,100</u>	

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Stock split More shares issued, but overall share value stays the same

*Increases outstanding shares and reduces par value per share proportionately

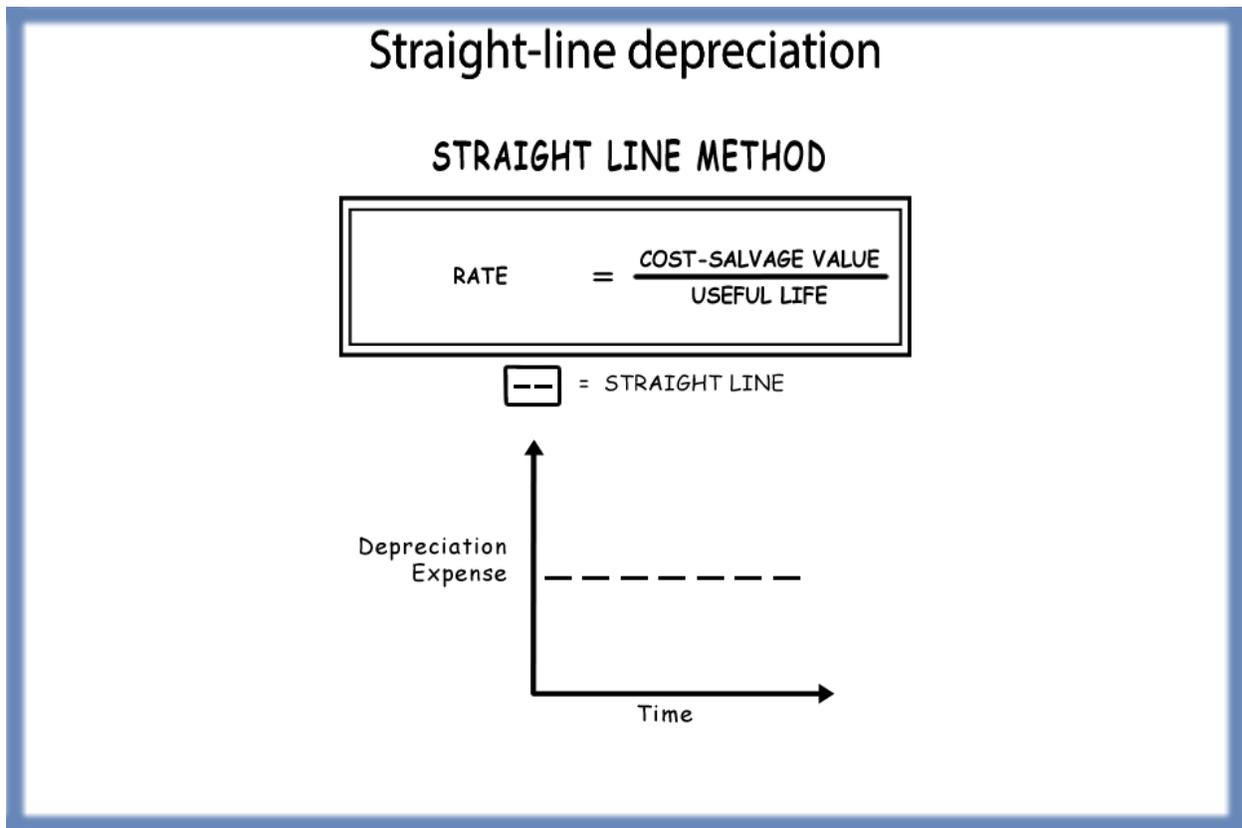
*Similar to exchanging a dollar bill for 4 quarters because value is the same, only further divided



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Straight-line depreciation Depreciation method, generates same expense each year until asset has reached the estimated end of its useful life

*Takes into account salvage value



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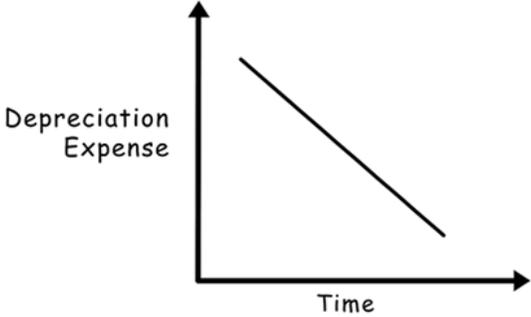
Sum-of-the-years-digits' depreciation Accelerated depreciation method, generates more expense in earlier years

*Takes into account salvage value

Sum-of-the-years-digits' depreciation

$$\text{DEPRECIATION EXPENSE} = (\text{COST-SALVAGE VALUE}) \times \frac{\text{\# OF YEARS LEFT IN ASSET LIFE}}{\text{SUM OF YEARS IN ASSET LIFE}}$$

 = SUM-OF-THE-YEARS' DIGITS



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Times interest earned Measures ability to meet interest obligations

*Useful for comparison across similar companies and trend analysis

*A higher ratio indicates a better ability to repay interest obligations

Times interest earned

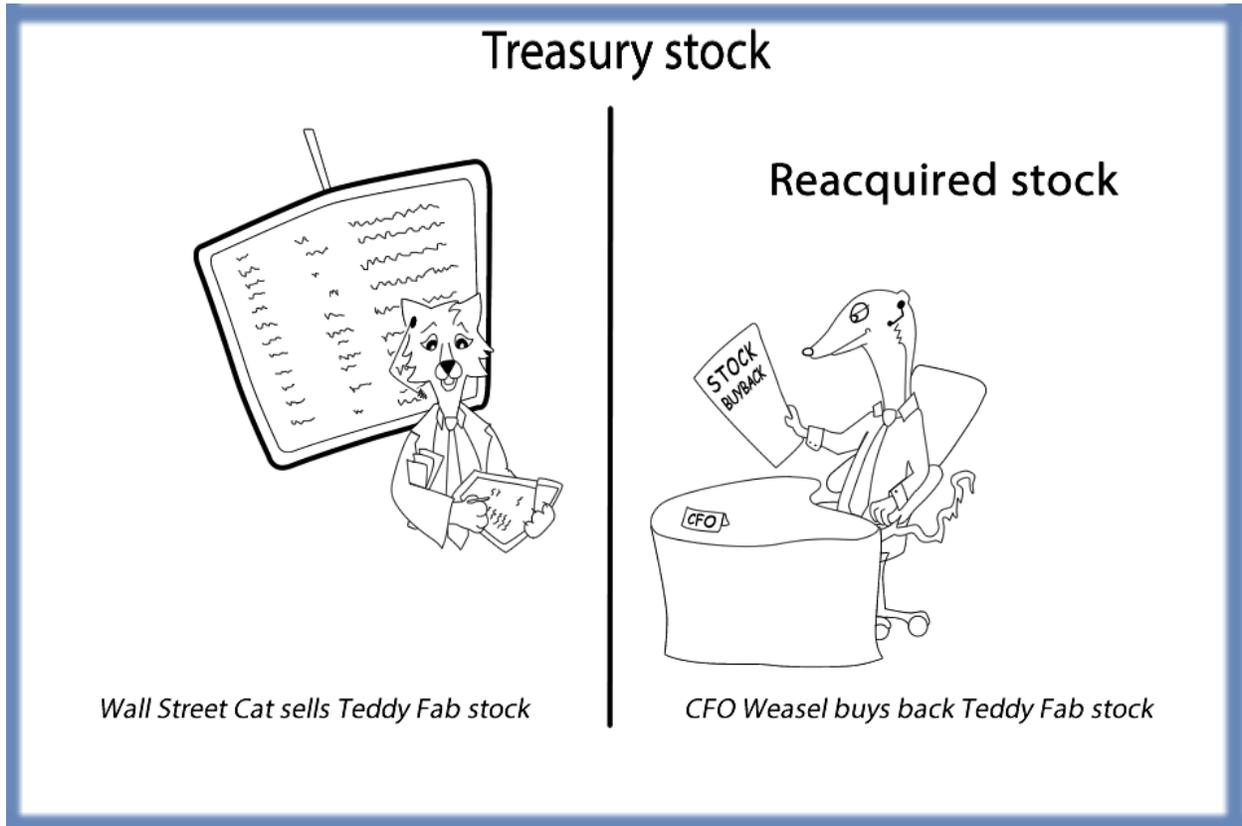
$$\text{TIMES INTEREST EARNED RATIO} = \frac{\text{EARNINGS BEFORE INTEREST AND TAX}}{\text{NET INTEREST EXPENSE}}$$

Debt Service Ratio

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Treasury stock Stock repurchased by company

- *Reduces outstanding shares
- *Recorded at cost
- *Contra account presented as a negative number on financial statements



[Return to Dictionary Index](#)

Trial balance Summarizes all general ledger accounts in a consolidated format

- *Used to form the financial statements
- *Summarizes debit and credit balances by account
- *Can be adjusted with journal entries

Trial balance

TEDDY FAB INC. TRIAL BALANCE 12/31/2100		Debit	Credit
	\$	\$	
Assets			
Cash and cash equivalents	100,000.00		
Accounts receivable	20,000.00		
Inventory	15,000.00		
Prepaid expense	4,000.00		
Investments	10,000.00		
Land	24,300.00		
Buildings and improvements	250,000.00		
Equipment	50,000.00		
Accumulated depreciation			5,000.00
Intangible assets	4,000.00		
Accumulated amortization			200.00
Liabilities			
Accounts payable			30,000.00
Notes payable			10,000.00
Accrued expenses			5,000.00
Deferred revenue			2,000.00
Long-term debt			200,000.00
Shareholders' Equity			
Common stock			10,000.00
Additional paid-in capital			20,000.00
Retained earnings			-
Treasury stock			(2,000.00)
Revenue			
Sales revenue			1,000,000.00
Expenses			
Cost of goods sold	200,000.00		
SG&A	357,700.00		
Interest	20,000.00		
Depreciation	5,000.00		
Amortization	200.00		
Interest income			20,000.00
Income tax	240,000.00		
BALANCE			
DECEMBER 31, 2100	<u>\$ 1,300,200.00</u>		<u>\$ 1,300,200.00</u>

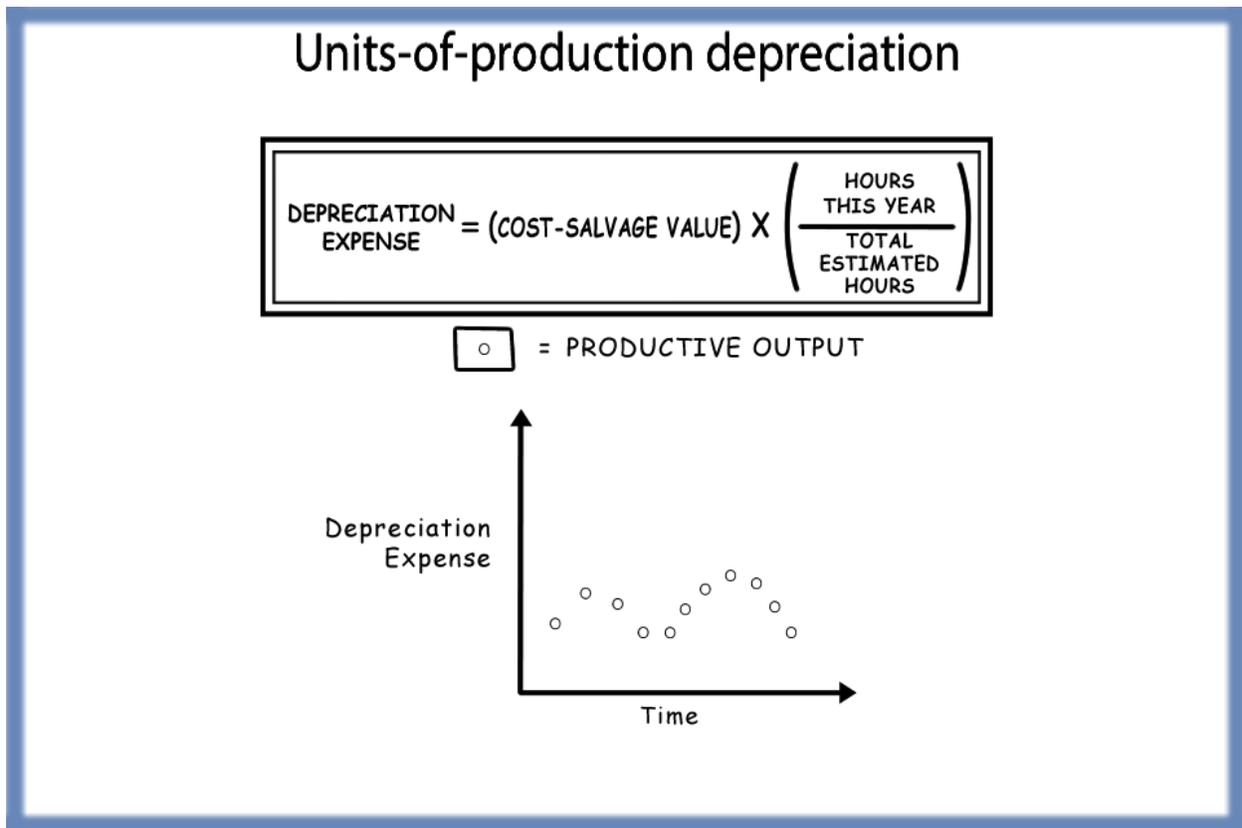
Sum of asset, liability, and equity
accounts used to summarize
general ledger accounts

Debits = Credits

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Units-of-production depreciation Depreciation method, matches expense with machine output

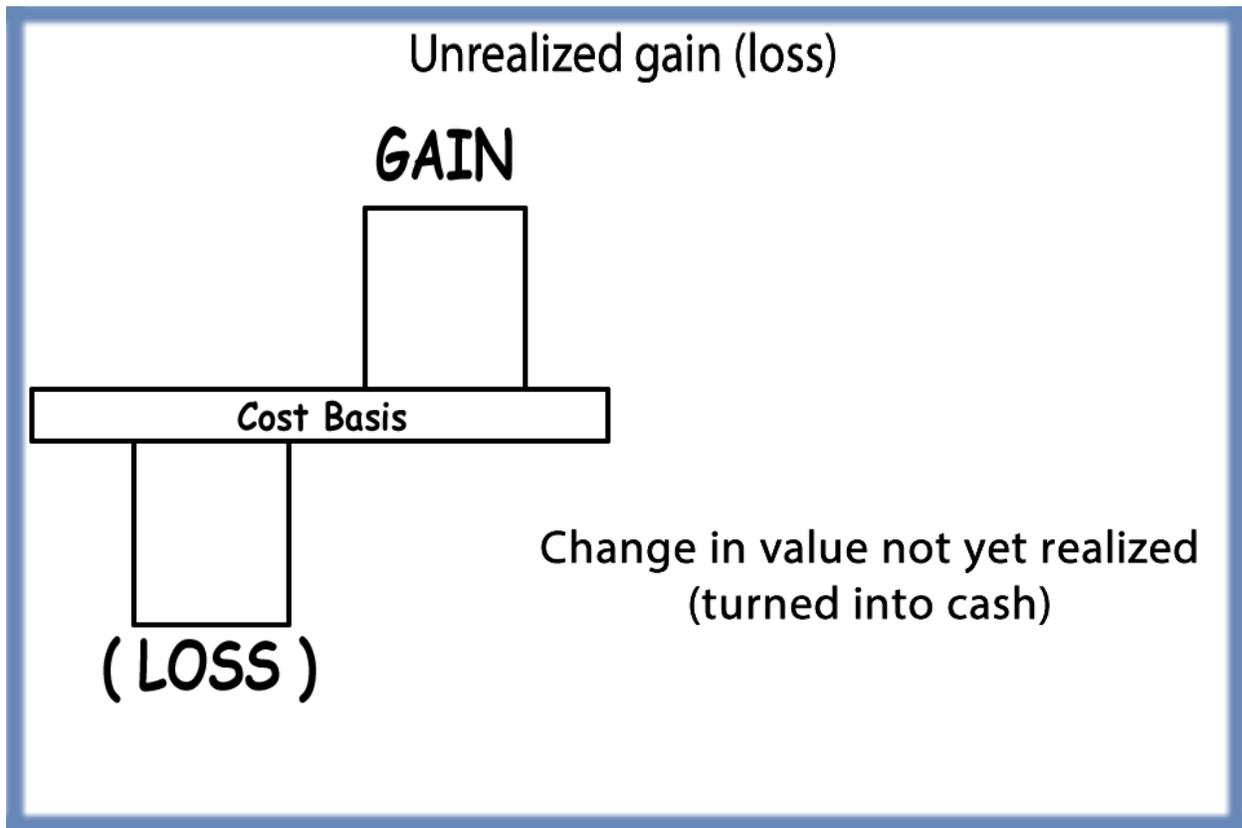
*Takes into account salvage value



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Unrealized gain (loss) Change in value of an asset still owned

- *A gain or loss is unrealized until the asset is sold or otherwise disposed of
- *Depending on financial reporting, may or may not appear in financial statements
- *Stock will have an unrealized gain if the current value is greater than the basis (purchase price)
- *Stock will have unrealized loss if the current value is less than the basis (purchase price)

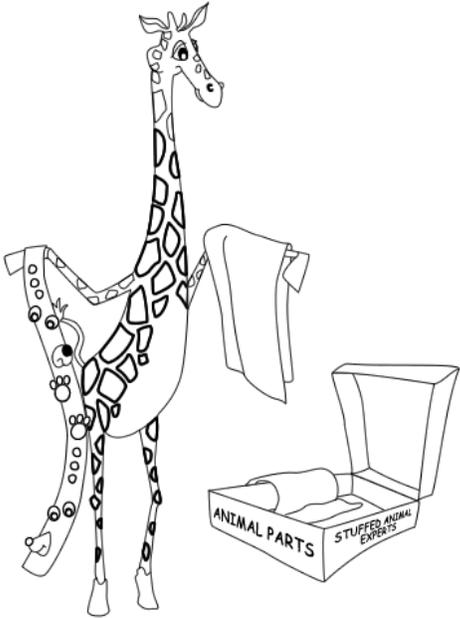


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Vendor Sells goods and services to customers

*Credit purchases become a part of accounts payable

Vendor



**Supplies goods or services
to a company**

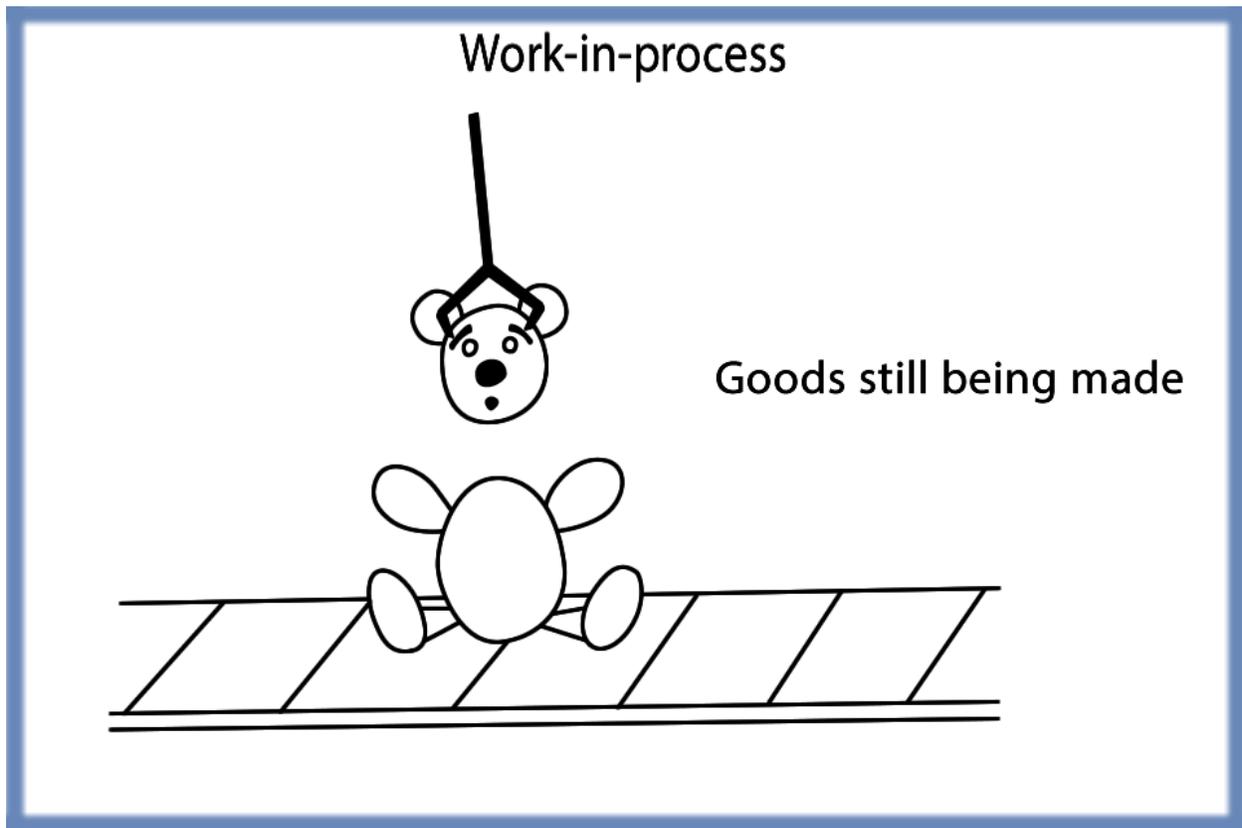
*Vendor Giraffe looks to sell
Teddy Fab Inc. some stuffed
animal components*

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Work-in-process (WIP) Asset account that accumulates manufacturing costs until the good is finished

*Raw materials, manufacturing labor, and manufacturing overhead added to WIP

*Costs such as raw material and manufacturing labor accumulate in a WIP account until the item is finished, at which point they move to finished goods (FG)



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