

2.5: Four Basic Terms Found in Financial Accounting

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Define “asset” and provide examples in financial reporting.
2. Define “liability” and provide examples in financial reporting.
3. Define “revenue” and provide examples in financial reporting.
4. Define “expense” and provide examples in financial reporting.

Question: Attaining a thorough understanding of financial accounting and U.S. GAAP is a worthwhile endeavor especially if a person hopes to become successful in analyzing businesses or other organizations. Where should the journey to gain knowledge of financial accounting and its principles begin?

Answer: The study of a language usually starts with basic terminology. That is also an appropriate point of entry for an exploration into financial accounting. Consequently, four fundamental terms will be introduced here. Knowledge of these words is essential to understanding accounting because they serve as the foundation for a significant portion of the financial information provided by any business or other organization.

To illustrate, when examining the 2022 financial statements presented by Darden Restaurants, Inc. (owner of restaurant chains including Olive Garden and Longhorn Steakhouse), four monetary balances stand out because of their enormous size. As of the May of that year, this corporation reported \$10.1 billion in **assets** along with \$7.9 billion in **liabilities**. During the year ending in May, 2022, Darden generated **revenues** of \$9.6 billion and incurred **expenses** of \$8.6 billion as they recovered from the impact of the global pandemic.

- Assets
- Liabilities
- Revenues
- Expenses

There are thousands of words and concepts found in financial accounting. However, no terms are more crucial to a comprehensive understanding than these four. Almost all discussions concerning financial reporting, whether practical or theoretical, come back to one or more of these words.

Question: The first term presented here is “asset.” Is an asset a complicated accounting concept? What general information is conveyed to a decision maker by the term “asset”?

Answer: Simply put, an asset is a future economic benefit that an organization either owns or controls¹. As of May 2022, Darden reported holding over \$10.1 billion of these economic benefits. If a customer walks into one of that company’s restaurants (Olive Garden for example), many of the assets are easy to spot. The building itself may well be owned/controlled by the company and certainly provides a probable future economic benefit by allowing Darden to cook food and serve customers. Other visible assets are likely to include cash registers, the cash held in those machines, available food from chicken to pasta (usually referred to as **inventory** in financial accounting), refrigerators, tables, ovens, and the decorations. The plan is that each of those assets will help the company prosper in the future.

Question: All decision makers evaluating the financial health of an organization should be quite interested in learning about its assets because those balances reflect the economic resources held at the present time. This is valuable information. To provide additional clarification, what are the largest assets reported by Darden?

Answer: As a result of financial reporting, such information is readily available to anyone wanting to learn about virtually any business. As of May of 2022, the following three assets were reported by Darden as having the highest dollar amounts:

Land, Building and Equipment	\$3.3 billion
Control over leased restaurants buildings	\$3.5 billion
Goodwill	\$1.0 billion

The underlying meaning of these three figures will be explained at later points in this textbook.

Test Yourself

The Gandolf Company purchases a building with land for a cost of \$50 million. This building will be used to manufacture its new game console systems. Gandolf will show the \$50 million for accounting purposes as:

- A. An asset
- B. An obligation
- C. An economic resource
- D. An expense

The correct answer is A. This building is a resource that Gandolf owns and controls by virtue of the purchase and expects to provide future benefit thus it will be listed as an asset in their financial reports.

Question: Darden also reported owing just over \$7.9 billion in liabilities as of May, 2022. Does this balance reflect the total amount that the company will eventually have to pay to outside parties? Are liabilities the equivalent of monetary debts?

Answer: A more formal definition of a liability is that it is a probable future sacrifice of economic benefits arising from present obligations but, for coverage here, liabilities can certainly be viewed as the debts of the organization.

The \$7.9 billion liability total disclosed by Darden probably includes (1) amounts owed to the vendors who supply food and supplies to the company's restaurants, (2) notes due to banks as a result of loans, (3) income tax obligations, (4) amounts owed to landlords for leasing restaurants and (5) balances to be paid to employees, utility companies, advertising agencies, and the like. The amount of such liabilities reported by many businesses can be staggering. Wal-Mart, for example, disclosed approximately \$153 billion in liabilities as of January 31, 2022. However, even that amount pales in comparison to the \$2.2 **trillion** liability total reported by Citigroup at the end of 2022. To ensure that a fairly presented portrait is being produced, companies such as Darden and Citigroup must make certain that the reported data contain no material misstatements. Thus, all the information that is provided to decision makers about liabilities should be based on the rules and principles to be found in U.S. GAAP.

Test Yourself

Amounts owed to employees and amounts borrowed from the bank are two examples of which accounting element?

- A. Assets
- B. Revenues
- C. Liabilities
- D. Equity

The answer is C. Wages or salaries payable and loans or notes payable are examples of liabilities that require the future sacrifice or payment of assets to satisfy the obligation. The obligation must have arisen out of a past event and cannot just be anticipated (like we might have to pay for a broken leg if an employee falls on the job – not until they actually fall).

Question: In financial accounting, a company reports its assets, which are future economic benefits, such as buildings, equipment, and cash. Liabilities (debts) are also included in the financial information being disclosed. Both of these terms seem relatively straightforward. The third basic term to be discussed at this time—revenues—is one that initially appears to be a bit less clear. Darden reported that its stores generated revenues of over \$9.6 billion in fiscal 2022 alone. What information is conveyed by a company's revenue balance?

Answer: The term “revenue” is a measure of the financial impact on a company resulting from a particular process. This process is a sale. A customer enters a Darden restaurant (say Olive Garden) and pays \$60 for dinner with friends. The company receives an asset, possibly three \$20 bills. This \$60 asset inflow into the company results from a sale and is called revenue. Revenue is *not* an

asset; it is a measure of the increase in the company's net assets² that results from sales of inventory and services. As will be discussed in more detail in Chapter 3 "In What Form Is Financial Information Actually Delivered to Decision Makers Such as Investors and Creditors?", for reporting purposes, these sales must result from the primary or central operation of the business. Thus, for The Coca-Cola Company, revenues are derived from the sale of soft drinks. Sales resulting from noncentral parts of the company's operations (perhaps the disposal of a piece of land, for example) will be reported in a different manner.

Throughout each day of the year, Darden makes sales to customers and accepts cash, checks, or credit card payments. The reported revenue figure is merely a total of all sales made during the period, clearly relevant information to any decision maker attempting to determine the financial prospects of this company. During fiscal 2022, the multitude of Darden restaurants located around the United States sold food and received over \$9.6 billion in assets in exchange. That is the information communicated by the reported revenue balance. To reiterate, this figure is not exact, precise or accurate. However, according to the company, it is a fairly presented total determined according to the rules of U.S. GAAP so that it contains no material misstatement. Any outside party analyzing Darden should be able to rely on this number with confidence in making possible decisions about the company as a whole.

Test Yourself

According to the reading, Darden earns revenue by which of the following?

- A. Hiring employees and training them.
- B. Providing meals and drinks to customers in exchange for payment.
- C. Borrowing money from bank to build additional restaurants.
- D. Changing their menu to match new dining trends.

The answer is B. Providing goods and services are the essential process by which businesses earn revenue. As a restaurant chain, this takes the form of providing meals and drinks to customers (a combination of goods (food) and services (cooking and bringing it to the table).

Question: That leaves "expense" as the last of the four basic accounting terms being introduced at this point. Darden reported \$8.6 billion in total expenses during fiscal 2022. This figure apparently is essential information that helps paint a proper portrait of the company. What is an expense?

Answer: An expense is an outflow or reduction in net assets⁴ that was incurred by an organization in hopes of generating revenues. To illustrate, assume that—at the end of a week—a local business pays its employees \$12,000 for the work performed during the previous few days. A \$12,000 salary expense must be reported. Cash (an asset) was reduced by that amount and this cost was incurred because the company employed those individuals to help generate revenues. The same general logic can be applied in recording insurance expense, rent expense, advertising expense, utility expense (such as for electricity and water), and many other similar costs.

In some ways, expenses are the opposite of revenues that measure the inflows or increases in net assets created by sales. Expense figures reflect outflows or decreases in net assets incurred in hopes of generating revenues.

Test Yourself

Some might say that expenses are bad and should be eliminated, an accountant might respond;

- A. If you spend enough on expenses they may become assets.
- B. As long as you do not include them with liabilities they are not that bad.
- C. Expenses are very similar to revenues and thus can genuinely improve your business.
- D. Expenses are incurred with the hope of generating revenues and thus are necessary for an operating business.

The answer is D. Expenses are the costs of generating revenues and no business can really earn revenue without incurring expenses. Businesses try to find the most efficient way to earn those revenues and thus reduce expenses but eliminating them is really not an option.

Question: To reiterate, four terms are basic to an understanding of financial accounting. Almost any coverage of accounting starts with these four. What is the meaning of asset, liability, revenue, and expense?

Answer:

- *Asset*. A future economic benefit owned or controlled by the reporting company, such as inventory, land, or equipment.
- *Liability*. A probable future economic sacrifice or, in simple terms, a debt.
- *Revenue*. A measure of the inflow or increase in net assets generated by the sales made by a company. It is a reflection of the amounts brought into the company by the sales process during a specified period of time.
- *Expense*. A measure of the outflow or reduction in net assets caused by the company's attempt to generate revenues and includes costs, such as rent expense, salary expense, and insurance expense.

Key Takeaway

A strong knowledge of basic accounting terminology is essential for successful communication to take place in the reporting of financial information. Four terms provide a foundational core around which much of the accounting process is constructed. Assets are future economic benefits owned or controlled by an organization. Assets typically include cash, inventory, land, buildings, and equipment. Liabilities are the debts of the reporting entity, such as salary payable, rent payable, and notes payable. Revenue figures indicate the increase in a company's net assets (its assets minus its liabilities) that is created by a sale of goods or services. Revenues are the lifeblood of any organization. Without the inflow of cash or receivables that comes from generating sales, a company cannot exist for long. Expenses are decreases in net assets that are incurred by a company in hopes of generating revenues. Expenses incurred by most companies run a full gamut from rent and salary to insurance and electricity.

Talking with a Real Investing Pro

Following is a continuation of our interview with Kevin G. Burns.

Question: Financial accountants tend to place a heavy emphasis on the importance of generally accepted accounting principles (U.S. GAAP) to the world of business. After nearly three decades as an investment advisor, what is your opinion of the relevance of U.S. GAAP?

Kevin Burns: Before the accounting scandals of the late 1990s—such as Enron and WorldCom—financial information that adhered to U.S. GAAP was trusted worldwide. Investors around the globe took comfort in a standard that had such a great reputation for integrity. In the 1990s, though, I felt that U.S. GAAP become somewhat muddled because investors wanted to depend too heavily on one or two figures rather than judging the company as a whole. In the last several years, FASB has moved back to stressing clearer transparency for reported information. That objective enables investors to better see and understand the organization standing behind those statements. That is important in order to maintain investor confidence.

As for the current state of the U.S. GAAP, it is certainly superior to the majority of the world's standards. Unfortunately, it is getting more complicated every year, which is not always a good goal.

Question: Are you bothered by the fact that the financial information that is reported to you by a business is not terribly exact?

KB: No reporting system can ever be exact and many estimates are necessary in reporting any business. Am I bothered by the lack of precision? No, not particularly. I will say, though, that I tend to avoid companies that have an excessive quantity of notes to their financial statements. Many of those companies can be extremely difficult to evaluate because of the complexity of their operations. I prefer businesses where the analysis is a bit simpler and I am able to gain a genuine understanding of what is happening.

Question: When you begin to study the financial data reported by a company that you are analyzing as an investment possibility, which do you look at first: revenues, expenses, assets, or liabilities?

KB: For me, assets have always been the most important determination in the investments that I have chosen. However, that is because I have always been strictly a value investor. There are many different styles of investing. Value investors look at the value of a company's assets and then look for bargains based on current market prices. In comparison, growth investors look at earnings momentum and don't care too much about asset values. They like to see a consistent rise in profitability each year. Over the years, being a value investor has worked well for my clients and me.

¹This is an opening chapter in an introductory financial accounting textbook. Definitions are somewhat simplified here so as to be more understandable to students who are just beginning their exploration of accounting. Many terms and definitions will be expanded in later chapters of this textbook or in upper-level accounting courses.

²“Net assets” is a term that reflects a company’s assets less its liabilities. Revenue can also be created by a decrease in a liability rather than an increase in an asset as we will learn in chapter 5.

³An expense can cause a reduction in assets, especially if cash is paid. Frequently, though, an expense creates an increase in liabilities if the cost is incurred but payment has not yet been conveyed. In either case—the reduction of an asset or the creation of a liability—the amount of net assets held by the organization decreases.

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