PRINCIPLES OF ACCOUNTING

Needles ▪ Powers ▪ Crosson ▪ 12e

Principles of Accounting

TWELFTH EDITION

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LATEST RESEARCH ON STUDENT LEARNING

We talked to over 150 instructors and discovered that current textbooks did not effectively:

- Help students logically process information
- Build on what students already know in a carefully guided sequence
- Reinforce core accounting concepts throughout the chapters
- Help students see how the pieces of accounting fit together

The Needles/Powers/Crosson series addresses these challenges by creating a better solution for you. This includes new features and a brand new structure for enhanced learning.

We have worked hard to create a textbook that mirrors the way you learn!

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A LOGICAL METHODOLOGY TO BUILDING KNOWLEDGE: THE THREE SECTION APPROACH

Needles/Powers/Crosson continuously evolves to meet the needs of today's learner. As a result of our research, the chapters in Needles/Powers/Crosson have been organized into a **Three Section Approach**, which helps students more easily digest the content.

ThreeSection APPROACH

1. The first section is **Concepts** and focuses on the overarching accounting concepts that require consistent reiteration throughout the course.
2. With a clear understanding of the concepts, you can proceed to the second section, **Accounting Applications**. Here, you can practice the application of accounting procedures with features like "Apply It!" and a new transaction analysis model, which breaks down the transaction in a simple, visual format.
3. Finally, move to section three, **Business Applications**. This section illustrates how the concepts and procedures are used to make business decisions. Real company examples are used throughout the chapter to show the relevance of accounting.

"I think this new chapter structure would be much easier for students to read and comprehend."

Shannon Ogden
Black River Technical College

TriLevel PROBLEM

TriLevel Problems within CengageNOW mirror the Three Section Approach and connect the sections—Concepts, Accounting Applications, and Business Applications. In this way, the problems teach you to think holistically about an accounting issue.

Breaking Down the Three Section Approach

SECTION 1: CONCEPTS

In Section 1, students experience the **Concepts** related to each chapter. In this case, *concepts* are the overarching accounting concepts that need to be reinforced throughout the accounting course, such as revenue recognition, the matching rule, valuation, classification, and disclosure.

Every chapter's Section 1 reinforces these key concepts so that once students understand the concepts, they can apply them to every aspect of the accounting system—from measuring to processing to communicating information about a business. This is a clear and logical way to present accounting.

SECTION 1

CONCEPTS

- Accrual accounting (matching principle)
- Valuation
- Disclosure

RELEVANT LEARNING OBJECTIVE

LO 1 Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.

CONCEPTS

LO 1 Concepts Underlying Notes and Accounts Receivable

The most common receivables are *accounts receivable* and *notes receivable*. The *allowance method* is used to apply *accrual accounting* to the *valuation* of accounts receivable. Proper *disclosure* in the financial statements and the notes to them is important for users of the statements to interpret them.

Accounts Receivable

Accounts receivable are short-term financial assets that arise from sales on credit and are often called **trade credit**. Terms of trade credit usually range from 5 to 60 days, depending on industry practice, and may allow customers to pay in installments. Credit sales or loans not made in the ordinary course of business, such as those made to employees, officers, or owners, should appear separately under asset titles like Receivables from Employees. Exhibit 1 shows the level of accounts receivable in selected industries.

"It does a very good job in explaining each concept and reinforcing each one by giving specific examples."

Paul Jaijairam
Bronx Community College

SECTION 2: ACCOUNTING APPLICATIONS

In Section 2, students learn the accounting procedures and the technical **application** of concepts. Students can apply the fundamental concepts they have already learned in Section 1. Section 2 includes things like recording business transactions and creating financial statements in financial chapters, and then building budgets and creating schedules and reports in the managerial chapters.

SECTION 2 ACCOUNTING APPLICATIONS

ACCOUNTING APPLICATIONS

- Estimate uncollectible accounts and uncollectible accounts expense using
  - Percentage of net sales method
  - Accounts receivable aging method
- Write off uncollectible accounts
- Make common calculations for notes receivable

RELEVANT LEARNING OBJECTIVES

LO 2 Apply the allowance method of accounting for uncollectible accounts.

LO 3 Make common calculations for Notes Receivable

LO 2 Uncollectible Accounts

The allowance account is necessary because the specific uncollectible accounts will not be identified until later. It is not like another contra account, Accumulated Depreciation, whose purpose is to show how much of the plant and equipment cost has been allocated as an expense to previous periods.

If management takes an optimistic view and projects a small loss from uncollectible accounts, the resulting net accounts receivable will be larger than if management takes a pessimistic view. The net income will also be larger under the optimistic view because the estimated expense will be smaller. The company's accountant makes an estimate based on past experience and current economic conditions. For example, losses from uncollectible accounts are normally expected to be greater in a recession than during a period of economic growth. The final decision on the amount of the expense will depend on objective information, such as the accountant's analyses, and on certain qualitative factors, such as how investors, bankers, creditors, and others view the performance of the debtor company. Regardless of the qualitative considerations, the estimated losses from uncollectible accounts should be realistic.

Two common methods of estimating uncollectible accounts expense are the percentage of net sales method and the accounts receivable aging method.

Percentage of Net Sales Method

The basis for the **percentage of net sales method** is the amount of this year's *net sales* that will not be collected. The answer determines the amount of uncollectible accounts expense for the year.

Uncollectible Accounts: The Percentage of Net Sales Method

Transaction The following balances represent Varta Company's ending figures for 2014:

"Section 2 walks through the accounting procedures very well. I like the use of a visual plus the narrative to explain the procedures."

Gerald Childs
Waukesha County Technical College

SECTION 3: BUSINESS APPLICATIONS

With a solid foundation of the fundamental accounting concepts as well as how to apply these concepts when performing accounting procedures, students are now ready for Section 3: **Business Applications**. This section teaches students how accounting information is used to make business decisions. Included here are topics like using ratios to evaluate a company's performance.

SECTION 3 BUSINESS APPLICATIONS

BUSINESS APPLICATIONS

- Receivables turnover
- Days' sales uncollected
- Financing receivables
  - Factoring of accounts receivable
  - Securitization of accounts receivable
  - Discounting of accounts receivable
- Ethics

RELEVANT LEARNING OBJECTIVE

LO 4 Show how to evaluate the level of receivables, and identify alternative means of financing receivables.

LO 4 Evaluating the Level of Accounts Receivable and Ethical Ramifications

Receivables are an important asset for any company that sells on credit. For them, it is critical to manage the level of receivables. Two common measures of the effect of a company's credit policies are *receivables turnover* and *days' sales uncollected*. Further, many companies manage their receivables by using various means to finance them. Finally, the judgments in estimating uncollectible accounts are a temptation for unethical behavior.

Receivables Turnover

The **receivables turnover** shows how many times, on average, a company turned its receivables into cash during a period. It reflects the relative size of a company's accounts receivable and the success of its credit and collection policies. It may also be affected by external factors, such as seasonal conditions and interest rates.

The receivables turnover is computed by dividing net sales by the average accounts receivable (net of allowances). Theoretically, the numerator should be net credit sales; but since the amount of net credit sales is rarely available in public reports, investors use total net sales. Using data from **Nike**'s annual report, we can compute the company's receivables turnover in 2011 as follows (dollar amounts are in millions).

RATIO

Receivables Turnover: How Many Times Did the Company Collect Its Accounts Receivable During an Accounting Period?

$$\text{Receivables Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

$$\frac{\$20{,}962}{(\$3{,}138 + \$2{,}650)/2} = \frac{\$20{,}962}{\$2{,}894} = 7.2 \text{ times*}$$

* Rounded

"This is a nice and useful touch to help students tie everything together. The theory can be dry at times, so this recap helps engage the students' attention again."

Dennis Mullen
City College of San Francisco

EXAMPLES, ACTIVITIES, AND PRACTICE

Business Perspective
A Whirlwind Inventory Turnover—How Does Dell Do It?

Dell Computer Corporation turns its inventory over every 10 days. How can it do this when other computer companies have inventory on hand for 60 days or even longer? Technology and good inventory management are a big part of the answer.

Dell's speed from order to delivery sets the standard for the computer industry. Consider that a computer ordered by 9 A.M. can be delivered the next day by 9 P.M. How can Dell do this when it does not start ordering components and assembling computers until a customer places an order? First, Dell's suppliers keep components warehoused just minutes from Dell's factories, making efficient, just-in-time operations possible. Dell also saves time by sending an e-mail message for some finished products to a shipper, such as **United Parcel Service**, and the shipper picks up the product from a supplier and schedules it to arrive with the PC. In addition to contributing to a high inventory turnover, this practice saves Dell in freight costs. Dell is showing the world how to run a business in the cyber age by selling more than $39 million worth of computers a day on its website.[6]

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Business Perspective

Throughout the chapter, **Business Perspective** features keep students engaged by providing real business context and examples from well-known companies including **Google**, **CVS**, **Boeing**, **Ford Motor Company**, **Microsoft**, **L.L. Bean**, and **The Walt Disney Company**.

BUSINESS INSIGHT
Sung's Grill

Sung's Grill is a popular neighborhood restaurant. Its business has increased substantially over the past year, and Emma Sung, the restaurant's owner, has had to hire more cashiers, waiters, and kitchen help. She has become concerned about possible theft of cash and food inventory, and she is looking for ways to prevent it. She is also concerned about whether the restaurant's sales and other transactions are being recorded properly. She is particularly concerned about the accuracy of the restaurant's financial statements, because she is considering applying for a bank loan so that she can open a second restaurant. To obtain a loan, she will have to present Sung's Grill's financial statements to the bank.

1. **CONCEPT ▶** *Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?*

2. **ACCOUNTING APPLICATION ▶** *How can Sung's Grill maintain control over its cash?*

3. **BUSINESS APPLICATION ▶** *How can Sung's Grill's bank and other users of its financial statements be confident that the restaurant has an adequate system of internal control?*

TriLevel Problem

Sung's Grill

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The beginning of this chapter focused on Emma Sung, the owner of Sung's Grill, who was looking for ways to ensure that the restaurant's assets were protected and that all its transactions were recorded properly. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

Section 1: Concepts
Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?

Section 2: Accounting Applications
How can Sung's Grill maintain control over its cash?

In order to have better control over cash, Emma Sung has established several rules for cashiers. Match each of the internal controls with the control activities that follow. (*Hint:* Some may have more than one answer.)

Business Insight and TriLevel Problem ▲

Each chapter opens with a **Business Insight** that shows how a small company would use accounting information to make decisions. The Business Insight poses three questions—each of which will be answered in one of the three sections of the chapter. At the end of each chapter, a NEW **TriLevel Problem** revisits the Business Insight company to tie the three sections together.

Apply It! and Try It! ▶

Apply It! activities throughout the chapter illustrate and solve a short exercise and then reference end-of-chapter assignments where students can go to **Try It!** This provides students with an example to reference as they are working to complete homework, making getting started less intimidating.

APPLY IT!

Assume that on December 1, 2014, a company receives a 90-day, 8 percent, $5,000 note and that the company prepares financial statements monthly.

1. What is the maturity date of the note?
2. How much interest will be earned on the note if it is paid when due?
3. What is the maturity value of the note?
4. If the company's fiscal year ends on December 31, describe the adjusting entry that would be made, including the amount.
5. How much interest will be earned on this note in 2015?

SOLUTION

1. Maturity date is March 1, 2015, determined as follows.

Days remaining in December (31 – 1)	30
Days in January	31
Days in February	28
Days in March	1
Total days	90

2. Interest: $\$5,000 \times 8/100 \times 90/365 = \$98.63$*
3. Maturity value: $\$5,000 + \$98.63 = \$5,098.63$
4. An adjusting entry to accrue 30 days of interest income in the amount of $32.88* ($\$5,000 \times 8/100 \times 30/365$) would be needed.
5. Interest earned in 2015: $65.75 ($\$98.63 - \$32.88$)

* Rounded

TRY IT! SE6, SE7, SE8, E8A, E9A, E10A, E11A, E8B, E9B, E10B, E11B

Notes Receivable Calculations

SE8. On August 25, Intercontinental Company received a 90-day, 9 percent note in settlement of an account receivable in the amount of $20,000. Determine the maturity date, amount of interest on the note, and maturity value. (Round to the nearest cent.)

Business Transaction Model

A new business transaction model for all financial accounting chapters involving transactions visually guides students step-by-step through accounting for business transactions as follows:

- Statement of the transaction
- Analysis of the effect on the accounts
- Application of double-entry accounting in T accounts
- Illustration of the journal entry (linked to the T account showing the relationships between the methods and featuring account ing equations)
- Comments that offer supporting explanations regarding the significance of the transaction (often looping back to the concepts covered in Section 1)

Purchase of an Asset on Credit

Transaction On July 5, Blue Design Studio receives the office supplies ordered on July 2 and an invoice for $5,200.

Analysis The journal entry to record the purchase of office supplies on credit

▲ *increases* the asset account *Office Supplies* with a debit

▲ *increases* the liability account *Accounts Payable* with a credit

Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity
Office Supplies			**Accounts Payable**			
Dr.	*Cr.*		*Dr.*	*Cr.*		
July 5 5,200				**July 5 5,200**		

Journal Entry

		Dr.	*Cr.*
July 5	Office Supplies	5,200	
	Accounts Payable		5,200

Comment Office supplies in this transaction are *classified* as an asset (prepaid expense) because they will not be used up in the current month and thus will benefit future periods. The credit is *classified* as Accounts Payable because there is a delay between the time of the purchase and the time of payment.

RATIO

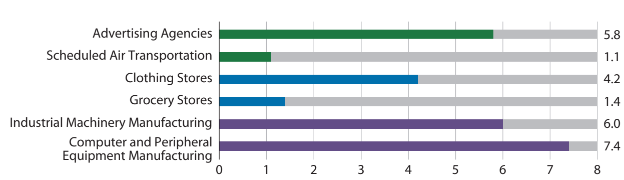
Profit Margin: How Much Income Does Each Dollar of Sales Generate?

Income Statement Numbers		Statement of Cash Flows Number	Balance Sheet Numbers		
Revenues	Net Income	Cash Flows from Operating Activities	Total Assets	Total Liabilities	Total Equity

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Revenues}}$$

$$= \frac{\$71{,}524}{\$1{,}248{,}624}$$

$$= 0.057, \text{ or } 5.7\%$$



Based on Bizmin Industry Financial Report, December 2011.

Ratio Analysis Model

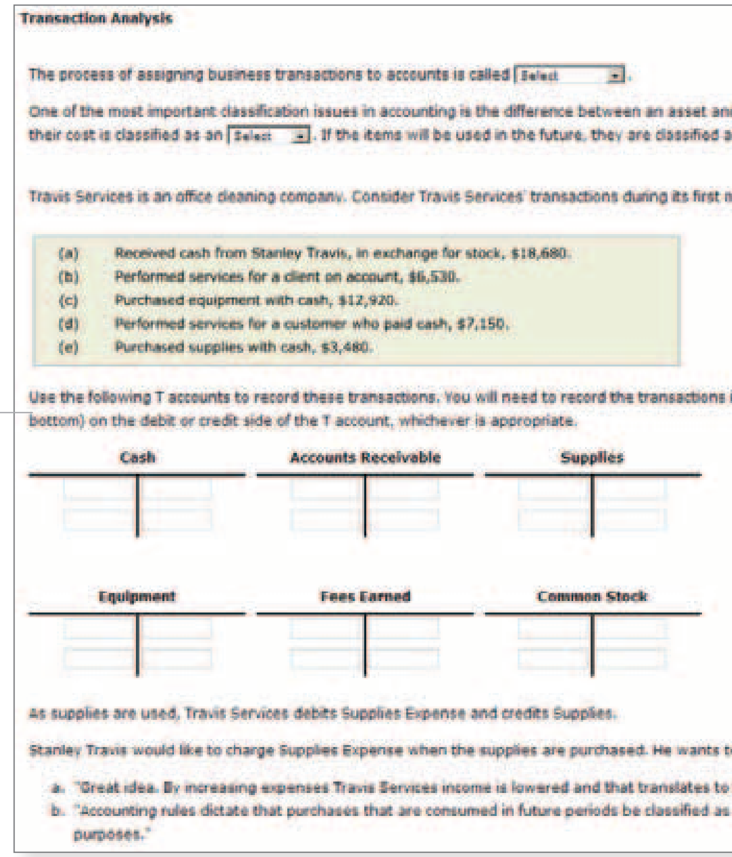
A new framework for teaching how to analyze company information and make informed decisions simplifies ratio analysis as follows:

- Key question regarding company performance (which the ratio answers)
- Elements of the financial statements that are needed to compute the ratio (focusing on revenue and net income from the income statement, cash flows from operating activities from the statement of cash flows, and total assets, total liabilities, and total equity from the balance sheet)
- Formula for the ratio (which links to the related elements of the financial statements)
- Computation/example
- Graph of industry averages
- Comments that explain what the ratio means (whether it's good or bad)

TRILEVEL PROBLEM:
TYING IT ALL TOGETHER!

TriLevel PROBLEM

NEW TriLevel Problems within CengageNOW follow the same Three Section Approach the book employs by including *Concepts, Accounting Applications*, and *Business Applications*. The problems reinforce and apply overarching concepts while also tying the three sections together to give students a complete understanding.



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"Any time the students are engaged in the learning process and have to actively participate, I think they enhance their retention of the material. The ability to relate this to an actual company (whether real or not) allows students to see this information in practice."

Chuck Smith
Iowa Western Community College

96% of instructors surveyed said that the TriLevel Problem adequately coached students through thinking about an issue.

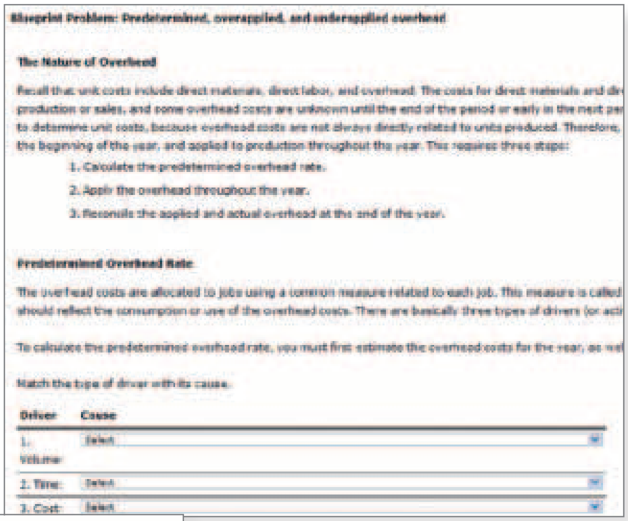
"The [TriLevel Problem] links procedure to the creation and use of information, and closes that loop between what students are doing and why it is useful."

Andy Williams
Edmonds Community College

"It reviews everything students have learned in a format they will find useful, and it links the three areas together. I love this. Each one ending with a business application."

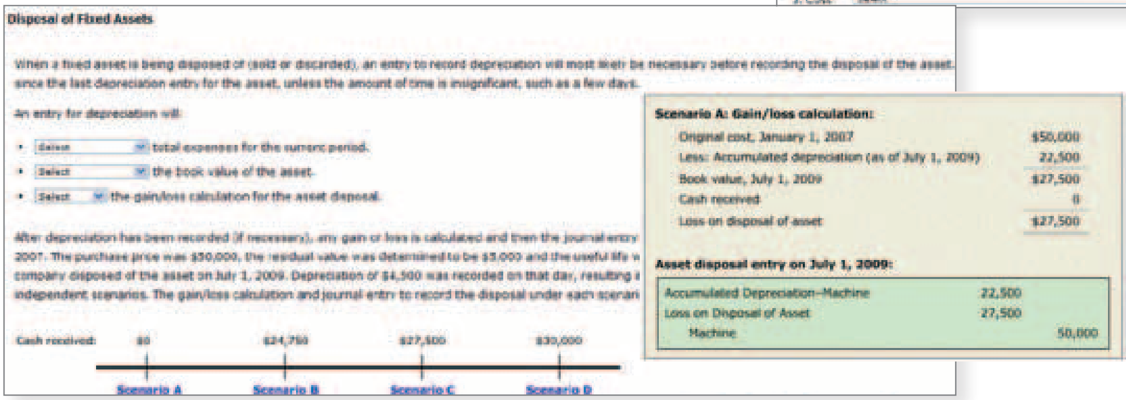
Joan Ryan
Clackamas Community College

NEW CENGAGENOW FEATURES HELP STUDENTS MAKE CONNECTIONS



NEW Blueprint Problems ▶

In CengageNOW, these problems cover primary learning objectives and help students understand the fundamental accounting concepts and their associated building blocks—not just memorize the formulas or journal entries required for a single concept. *Blueprint Problems* include rich feedback and explanations, providing students with an excellent learning resource.



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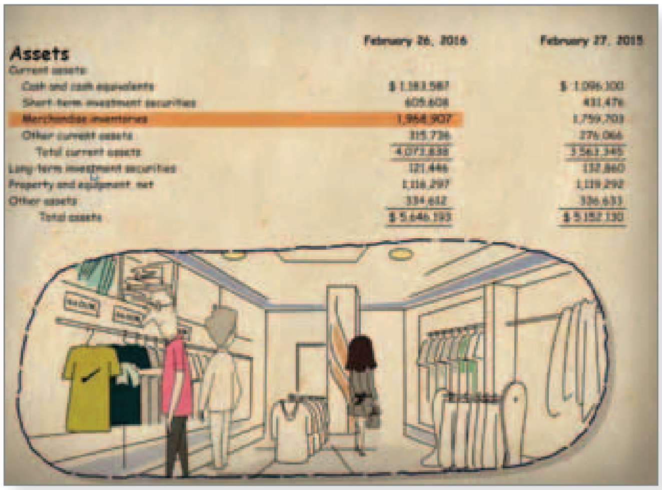
NEW Blueprint Connections ▲

Blueprint Connections in CengageNOW build upon concepts covered and introduced within the *Blueprint Problems*. These scenario-based exercises help reinforce students' knowledge of the concept.

NEW Animated Activities ▶

Animated Activities in CengageNOW are videos that guide students through selected core topics using a realistic company example to illustrate how the concepts relate to the everyday activities of a business.



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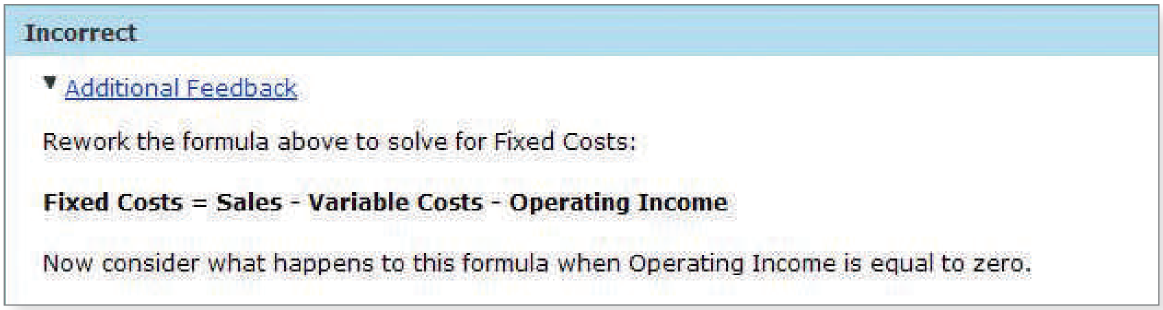
NEW CENGAGENOW FEATURES
HELP STUDENTS MAKE CONNECTIONS

NEW Check My Work Feedback ▼

Written feedback is now available when students click on "Check My Work" in CengageNOW to provide students with valuable guidance as they work through homework items.



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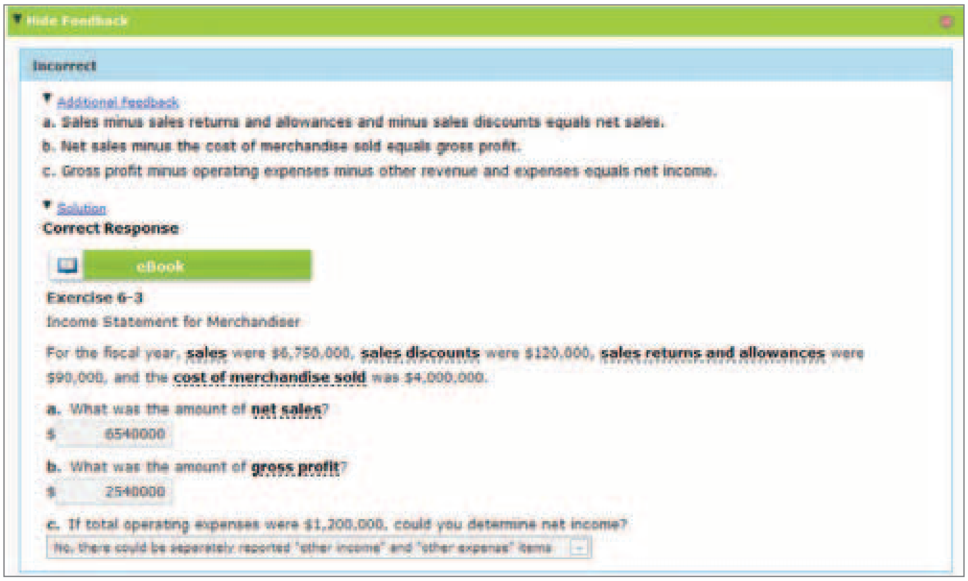
NEW Post-submission Feedback ▼

After students have submitted their assignments for a grade in CengageNOW, they can go back and see the correct answers to better understand where they might have gotten off track.



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NEW Apply It Demos

These demonstration videos in CengageNOW will help students complete end-of-chapter questions from Section 2.

ACKNOWLEDGMENTS

In developing and refining the twelfth edition of *Principles of Accounting*, we wanted to ensure that we were creating a textbook that truly reflected the way we teach accounting. To do so, we asked for feedback from over 150 professors, other professional colleagues, and students. We want to recognize those who made special contributions to our efforts in preparing this edition through their reviews, suggestions, and participation in surveys, interviews, and focus groups. We cannot begin to say how grateful we are for the feedback from the many instructors who have generously shared their responses and teaching experiences with us.

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Steve Teeter, *Utah Valley University*
Don Trippeer, *SUNY Oneonta*
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Scott Wandler, *University of New Orleans*
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Ronald Zhao, *Monmouth University*
Teri Zuccaro, *Clarke University*

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Community College. She is internationally known for her YouTube accounting videos as an innovative application of pedagogical strategies. In recognition of her professional and academic activities, she was a recipient of the Outstanding Service Award from the American Accounting Association (AAA), an Institute of Management Accountants' Faculty Development Grant to blend technology into the classroom, the Florida Association of Community Colleges Professor of the Year Award for Instructional Excellence, and the University of Oklahoma's Halliburton Education Award for Excellence. Currently, she serves as President of the Teaching, Learning, and Curriculum section of the AAA. Recently she served as a Supply Chain Leader for The Commission on Accounting Higher Education, which published *"Pathways to a Profession," Charting a National Strategy for the Next Generation of Accountants.* She has also served on various committees for the AICPA, Florida Institute of CPAs, and the Florida Association of Accounting Educators.

Principles of Accounting

TWELFTH EDITION

CHAPTER 1
Accounting Principles and the Financial Statements

BUSINESS INSIGHT
Keep-Fit Center

On January 1, 2014, Jenny Mullin, an experienced fitness coach, started a business called Keep-Fit Center, which offers classes and private instruction in aerobics, yoga, and Pilates. By December 31, 2014, the center had generated $375,500, and its clients were praising its excellent service. Jenny is now considering expanding the business. She would need a bank loan and, to qualify, both she and the bank would have to use various financial measures to determine the business's ability to repay the loan (i.e., its profitability and liquidity). Whether a business is small, like Keep-Fit Center, or large, like **CVS**, the same financial measures are used to evaluate it.

1. CONCEPT ▶ *What is* accounting*, and what are the concepts that underlie it?*

2. ACCOUNTING APPLICATION ▶ *What are three financial statements that Keep-Fit Center will need to present in a way that is useful to Jenny and to the bank?*

3. BUSINESS APPLICATION ▶ *How do these financial statements help Jenny Mullin, as owner of Keep-Fit Center, measure progress toward the company's two main financial goals of profitability and liquidity? What additional financial statement information would be useful?*

LEARNING OBJECTIVES

LO 1 **Define *accounting*, and explain the concepts underlying accounting measurement.**

LO 2 **Define *financial position*, and state the accounting equation.**

LO 3 **Identify the four basic financial statements and their interrelationships.**

LO 4 **Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.**

LO 5 **Identify the users of accounting information, and identify business goals, activities, and performance measures.**

LO 6 **Explain the importance of ethics in financial reporting.**


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SECTION 1 CONCEPTS

CONCEPTS

- Accounting measurement
- Business transactions
- Money measure
- Separate entity
- Assets
- Liabilities
- Owner's equity

RELEVANT LEARNING OBJECTIVES

LO 1 Define *accounting* and explain the concepts underlying accounting measurement.

LO 2 Define *financial position*, and state the accounting equation.

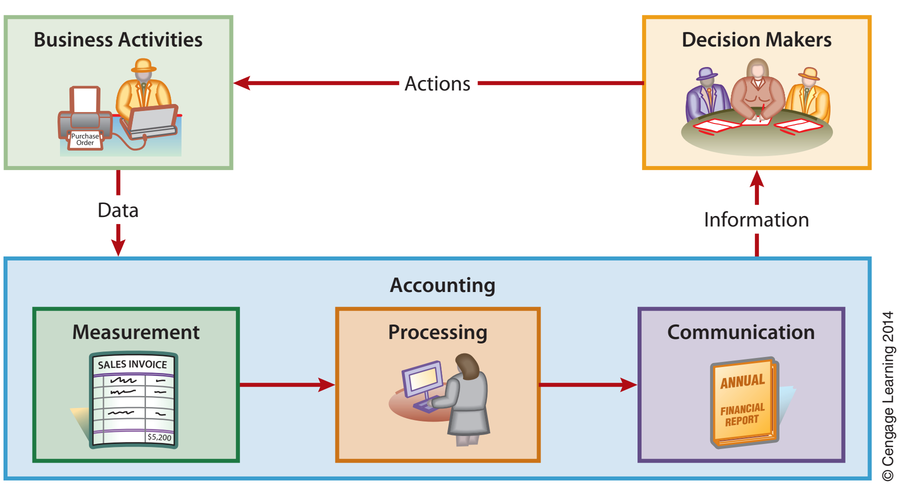
LO 1 Concepts Underlying Accounting Measurement

Accounting is an information system that measures, processes, and communicates financial information about a business.[1] Accountants focus on the needs for financial information, whether the decision makers are inside or outside a business or other economic entity. An **economic entity** is a unit that exists independently, such as a business, hospital, or a governmental body. Accountants supply the information decision makers need to make "reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities."[2] As shown in Exhibit 1, accounting is a link between business activities and decision makers.

- Accounting measures business activities by recording data about them for future use.
- The data are stored until needed and then processed to become useful information.
- The information is communicated through reports to decision makers.
- Based on information from accounting, decision makers take actions that affect subsequent business activities.

In other words, data about business activities are the input to the accounting system, and useful information for decision makers is the output.

Exhibit 1
Accounting as an Information System



Financial and Managerial Accounting

Accounting's role of measuring, processing, and communicating financial information is usually divided into financial accounting and managerial accounting. Although the functions of financial accounting and managerial accounting overlap, they can be distinguished by the principal users of their information.

Financial Accounting *External* decision makers use **financial accounting** to evaluate how well the business has achieved its goals. These reports, called **financial statements**, are a central feature of accounting. **CVS**, whose stock is traded on the New York Stock Exchange, sends its financial statements to its owners (called *stockholders*), its banks and other creditors, and government regulators. Financial statements report on a business's financial performance and are used extensively both inside and outside a business to evaluate its financial success.

It is important to distinguish accounting from bookkeeping and management information systems.

- **Bookkeeping** is the process of recording financial transactions and keeping financial records. It is mechanical and repetitive, yet an important part of accounting that is usually handled by computers.
- **Management information systems (MIS)** consist of the interconnected subsystems, including accounting, that provide the information needed to run a business.

Managerial Accounting *Internal* decision makers use information provided by **managerial accounting** about operating, investing, and financing activities. Managers and employees need information about how they have done in the past and what they can expect in the future. For example, **Gap, Inc.**, a retail clothing business, needs an operating report that tells how much was sold at each store and what costs were incurred, and it needs a budget that projects each store's sales and costs for the next year.

Accounting Measurement

To make an *accounting measurement*, the accountant must answer four basic questions:

- What is measured?
- When should the measurement be made?
- What value should be placed on what is measured?
- How should what is measured be classified?

Accountants debate the answers to these questions constantly, and the answers change as new knowledge and practice require. But the basis of today's accounting practice rests on a number of widely accepted concepts and conventions. We begin by focusing on the first question: What is measured? We discuss the other three questions in the next chapter.

Business Transactions **Business transactions** are economic events that affect a business's financial position. Businesses can have hundreds or even thousands of transactions every day. These transactions are the raw material of accounting reports.

A transaction can be an exchange of value (a purchase, sale, payment, collection, or loan) between two or more parties. A transaction also can be an economic event that does not involve an exchange. Some examples of nonexchange transactions are losses from fire, flood, explosion, and theft; physical wear and tear on machinery and equipment; and the day-by-day accumulation of interest.

To be recorded, a transaction must relate directly to a business entity. Suppose a customer buys toothpaste from **CVS** but buys shampoo from a competing store because CVS is out of shampoo. The transaction in which the toothpaste was sold is entered in CVS's records. However, the purchase of the shampoo is not entered in CVS's records because, even though it indirectly affects CVS economically (by losing a sale), it does not involve a direct exchange of value between CVS and the customer.

Money Measure All business transactions are recorded in terms of money. This concept is called **money measure**. Of course, nonfinancial information may also be recorded, but a business's transactions and activities are measured through the recording of monetary amounts. Money is the only factor common to all business transactions, and thus it is the only unit of measure capable of producing financial data that can be compared. The monetary unit a business uses depends on the country in which the business resides. For example, in the United States, the basic unit of money is the dollar. In China, it is the yuan; in Japan, the yen; in the European Union (EU), the euro; and in the United Kingdom, the pound. In international transactions, exchange rates must be used to translate from one currency to another. An **exchange rate** is the value of one currency in terms of another. For example, a British person purchasing goods from a U.S. company like **CVS** and paying in U.S. dollars must exchange British pounds for U.S. dollars before making payment. In effect, currencies are goods that can be bought and sold.

Exhibit 2 illustrates the exchange rates for several currencies in dollars. It shows the exchange rate for British pounds as $1.59 per pound on a particular date. Like the prices of many goods, currency prices change daily according to supply and demand. For example, a year and a half earlier, the exchange rate for British pounds was $1.63.

Exhibit 2
Examples of Foreign Exchange Rates

Country	Price in $U.S.	Country	Price in $U.S.
Australia (dollar)	1.07	Hong Kong (dollar)	0.13
Brazil (real)	0.58	Japan (yen)	0.012
Britain (pound)	1.59	Mexico (peso)	0.08
Canada (dollar)	1.00	Russia (ruble)	0.03
European Union (euro)	1.32	Singapore (dollar)	0.79

Source: The Wall Street Journal, February 18, 2012.

STUDY NOTE: *For accounting purposes, a business is always separate and distinct from its owners, creditors, and customers.*

Separate Entity For accounting purposes, a business organization is a **separate entity**, distinct not only from its creditors and customers but also from its owners. It should have its own set of financial records, and its records and reports should refer only to its own affairs.

For example, Just Because Flowers Company should have a bank account separate from the account of Molly Dar, the owner. Molly Dar may own a home, a car, and other property, and she may have personal debts; but these are not the resources or debts of Just Because Flowers. Molly Dar may own another business, say a stationery shop. If she does, she should have a completely separate set of records for each business.

Forms of Business Organization

The three basic forms of business organization recognized as separate entities are the sole proprietorship, the partnership, and the corporation.

Sole Proprietorship A **sole proprietorship** is a business owned by one person.* The owner takes all the profits or losses of the business and is liable for all its obligations. As Exhibit 3 shows, sole proprietorships represent the largest number of businesses in the United States, but typically they are the smallest in size.

STUDY NOTE: *A key disadvantage of a partnership is the unlimited liability of its owners. Unlimited liability can be avoided by organizing the business as a corporation or, in some states, by forming what is known as a limited liability partnership (LLP).*

Partnership A **partnership** is like a sole proprietorship in most ways, but it has two or more owners. The partners share the profits and losses of the business according to a prearranged formula. Generally, any partner can obligate the business to another party, and the personal resources of each partner can be called on to pay the obligations. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies. If the business is to continue as a partnership after this occurs, a new partnership must be formed.

Corporation Both the sole proprietorship and the partnership are convenient ways of separating the owners' commercial activities from their personal activities. Legally,

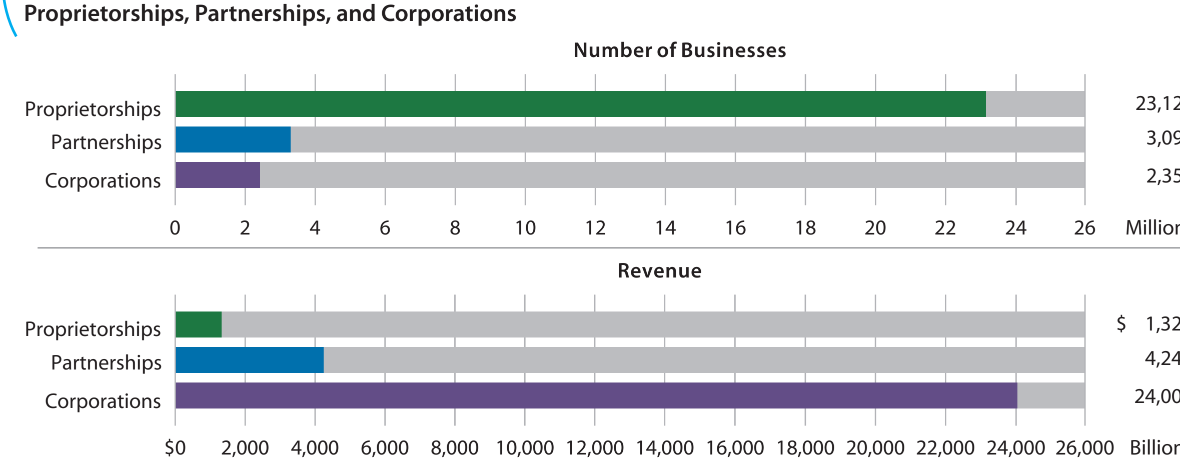
*Accounting for a sole proprietorship is simpler than accounting for a partnership or corporation. For that reason, we focus on the sole proprietorship in the early part of this book. At critical points, however, we call attention to the essential differences between accounting for a sole proprietorship and accounting for a partnership or corporation.

Because this surf shop is a partnership, the owners share the profits and losses of the business, and their personal resources can be called on to pay the obligations of the business.

however, there is no economic separation between the owners and the businesses. A **corporation**, on the other hand, is a business unit chartered by the state and legally separate from its owners (the stockholders). The **stockholders**, whose ownership is represented by shares of stock, do not directly control the corporation's operations. Instead, they elect a board of directors to run the corporation for their benefit. In exchange for their limited involvement in the corporation's operations, stockholders enjoy **limited liability**; that is, their risk of loss is limited to the amount they paid for their shares. Thus, stockholders are often willing to invest in risky, but potentially profitable, activities. Also, because stockholders can sell their shares without dissolving the corporation, the life of a corporation is unlimited and not subject to the whims or health of a proprietor or a partner.

The characteristics of corporations make them very efficient in amassing capital, which enables them to grow extremely large. As Exhibit 3 shows, even though corporations are fewer in number than sole proprietorships and partnerships, they contribute much more to the U.S. economy in monetary terms. For example, in 2011, **ExxonMobil** generated more revenues than all but 28 of the world's countries.[3]

Exhibit 3
Number and Receipts (Revenues) of U.S. Proprietorships, Partnerships, and Corporations



Source: U.S. Treasury Department, Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2012.

Business Perspective

Are Most Corporations Big or Small Businesses?

Most people think of corporations as large national or global companies whose shares of stock are held by thousands of people and institutions. Indeed, corporations can be huge and have many stockholders. However, of the approximately 4 million corporations in the United States, only about 15,000 have stock that is publicly bought and sold. The vast majority of corporations are small businesses privately held by a few stockholders. Illinois alone has more than 250,000 corporations. Thus, the study of corporations is just as relevant to small businesses as it is to large ones.

APPLY IT!

Match each description with the appropriate term. (*Hint*: Terms may be used more than once.)

1. Owners have limited liability
2. Requires an exchange of value between two or more parties
3. Owned by only one person
4. Multiple co-owners
5. An amount associated with a business transaction
6. Management appointed by board of directors
7. Distinct from customers, lenders, and owners
8. Biggest segment of the economy

a. Business transactions
b. Corporation(s)
c. Money measure
d. Partnership
e. Sole proprietorship
f. Separate entity

SOLUTION

1. b; 2. a; 3. e; 4. d; 5.c; 6. b; 7. f; 8. b

TRY IT! SE1, SE2, E1A, E2A, E3A, E12A, E1B, E2B, E3B, E12B

LO2 Concepts Underlying Financial Position

Financial position refers to a company's economic resources, such as cash, inventory, and buildings, and the claims against those resources at a particular time. Another term for claims is *equities*.

Every company has two types of equities: creditors' equities, such as bank loans, and owner's equity. The sum of these equities equals a company's resources:

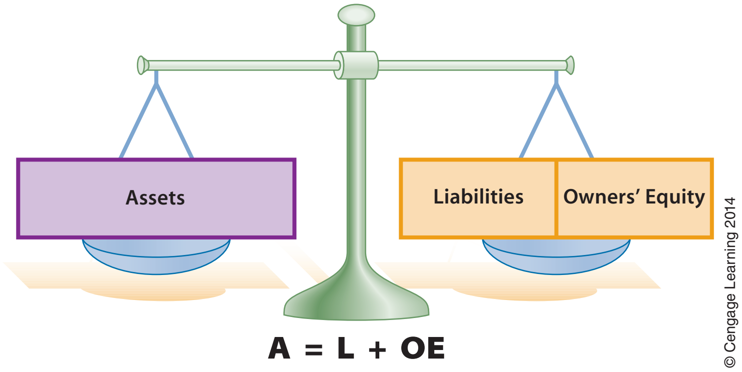
Economic Resources = Creditors' Equities + Owner's Equity

In accounting terminology, economic resources are called *assets* and creditors' equities are called *liabilities*. So the equation can be written like this:

Assets = Liabilities + Owner's Equity

This equation is known as the **accounting equation (A = L + OE)**. The two sides of the equation must always be equal, or "in balance," as shown in Exhibit 4. To evaluate the financial effects of business activities, it is important to understand their effects on this equation.

Exhibit 4
The Accounting Equation



Assets

Assets are the economic resources that are expected to benefit the company's future operations. Certain kinds of assets—for example, cash and money that customers owe to the company (called *accounts receivable*)—are monetary items. Other assets—inventories (goods held for sale), land, buildings, and equipment—are nonmonetary, physical items. Still other assets—the rights granted by patents, trademarks, and copyrights—are nonphysical.

Liabilities

Liabilities are a business's present obligations to pay cash, transfer assets, or provide services to other entities in the future. Among these obligations are amounts owed to suppliers for goods or services bought on credit (called *accounts payable*), borrowed money (e.g., money owed on bank loans), salaries and wages owed to employees, taxes owed to the government, and services to be performed.

Liabilities are claims recognized by law. That is, the law gives creditors the right to force the sale of a company's assets if the company fails to pay its debts. Creditors have rights over owners and must be paid before the owners receive anything, even if the payment of debt uses up all the assets.

Owner's Equity

Owner's equity represents the claims by the owner of a business to the assets of the business. Theoretically, owner's equity is what would be left if all liabilities were paid, and it is sometimes said to equal **net assets**. By rearranging the accounting equation, we can define owner's equity this way:

$$\text{Owner's Equity} = \text{Assets} - \text{Liabilities}$$

Owner's equity is affected by the owner's investments in and withdrawals from the business and by the business's revenues and expenses.

- **Owner's investments** are assets that the owner puts into the business (e.g., by transferring cash from a personal bank account to the business's bank account). In this case, the assets (cash) of the business increase, and the owner's equity in those assets also increases.
- **Withdrawals** are assets that the owner takes out of the business (e.g., by transferring cash from the business's bank account to a personal bank account). In this case, the assets of the business decrease, as does the owner's equity in the business.

Simply stated, **revenues** and **expenses** are the increases and decreases in owner's equity that result from operating a business.

▲ For example, the amounts customers pay (or agree to pay in the future) to Keep-Fit Center for its exercise service are revenues for Keep-Fit. Keep-Fit's assets (cash or accounts receivable) increase, as does its owner's equity in those assets.

▼ On the other hand, the amount Keep-Fit must pay out (or agree to pay out) for rent and wages to instructors so that it can provide its service are expenses. In this case, the assets (cash) decrease or the liabilities (accounts payable) increase, and the owner's equity decreases.

Generally, a company is successful if its revenues exceed its expenses.

▲ When revenues exceed expenses, the difference is called **net income**.

▼ When expenses exceed revenues, the difference is called **net loss**.

In summary, owner's equity is the accumulated net income (revenues − expenses) minus withdrawals over the life of the business.

APPLY IT!

Stevenson Company had assets of $140,000 and liabilities of $60,000 at the beginning of the year, and assets of $200,000 and liabilities of $70,000 at the end of the year. During the year, $20,000 was invested in the business, and withdrawals of $24,000 were made. What amount of net income did the company earn during the year?

Beginning of the year					
Assets	=	Liabilities	+	Owner's Equity	
$140,000	=	$60,000	+	**$ 80,000**	
During the year					
		Investment	+	20,000	
		Withdrawals	−	24,000	
		Net income		?	
End of year					
$200,000	=	$70,000	+	**$130,000**	

SOLUTION

Net income = $54,000

Start by finding the owner's equity at the beginning of the year: $140,000 − $60,000 = $80,000

Then find the owner's equity at the end of the year: $200,000 − $70,000 = $130,000

Then determine net income by calculating how the transactions during the year led to the owner's equity amount at the end of the year: $80,000 + $20,000 − $24,000 + net income = $130,000; net income = $54,000

TRY IT! SE3, SE4, SE5, SE6, E4A, E5A, E4B, E5B

SECTION 2 ACCOUNTING APPLICATIONS

ACCOUNTING APPLICATIONS

- Describe the income statement
- Describe the statement of owner's equity
- Describe the balance sheet
- Describe the statement of cash flows

RELEVANT LEARNING OBJECTIVES

LO 3 Identify the four basic financial statements and their interrelationships.

LO 4 Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.

LO 3 Financial Statements

Financial statements are the primary means of communicating accounting information about a business to those who have an interest in the business. These statements model the business enterprise in financial terms. As is true of all models, however, financial statements are not perfect pictures of the real thing. Four major financial statements are used to communicate accounting information: the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. Exhibit 5 presents an overview of these four financial statements and their interrelationships. The following sections examine them in more detail.

Income Statement

The **income statement** summarizes the revenues earned and expenses incurred by a business over an accounting period. Many people consider it the most important financial report because it shows whether a business achieved its profitability goal—that is, whether it earned an acceptable income. Exhibit 6 shows that Roland Consultancy had revenues of $14,000. From this amount, total expenses of $5,600 were deducted to arrive at net income of $8,400. To show the period to which the statement applies, it is dated "For the Month Ended December 31, 2014."

Statement of Owner's Equity

The **statement of owner's equity** shows the changes in owner's equity over an accounting period. In Exhibit 7, beginning owner's equity is zero because Roland Consultancy began operations in this period. During the month, the owner, Tom Roland, invested $200,000 in the business, and the company earned an income (as shown on the income statement) of $8,400. Withdrawals of $2,400 by the owner are deducted from this amount, leaving an ending balance of $206,000.

Balance Sheet

The purpose of a **balance sheet** is to show the financial position of a business on a certain date, usually the end of the month or year. For this reason, it often is called the *statement of financial position*. It's important to note that the date on the balance sheet is a single date, whereas the dates on the other three statements cover a period of time, such as a month, quarter, or year. The balance sheet presents a view of the business as the holder of resources, or assets, that are equal to the claims against those assets. The claims consist of the company's liabilities and the owner's equity. Exhibit 8 shows that Roland Consultancy has several categories of assets, which total $208,400. These assets equal the total liabilities of $2,400 plus the owner's equity of $206,000. Notice that the amount of the owner's capital account on the balance sheet comes from the ending balance on the statement of owner's equity.

Exhibit 5
Financial Statement Relationships

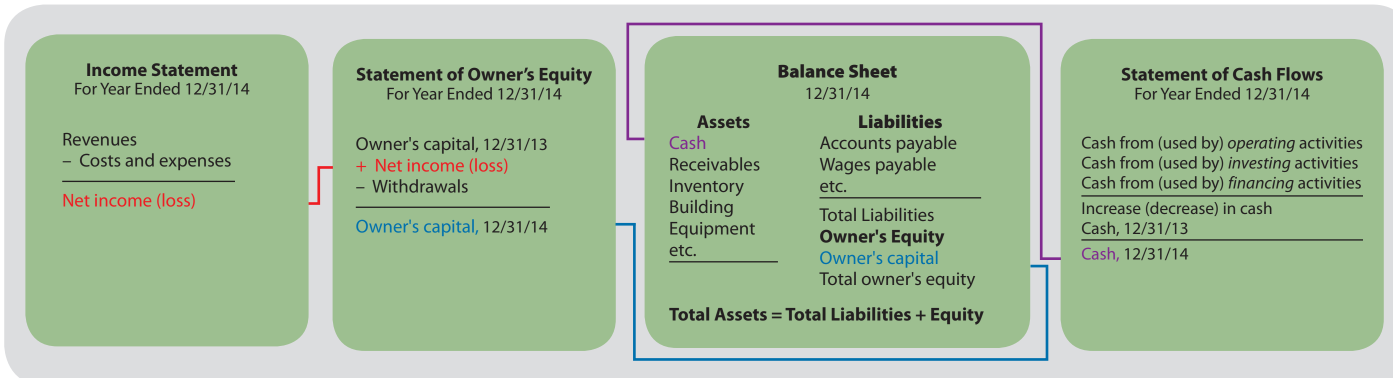


Exhibit 6
Income Statement for Roland Consultancy

Roland Consultancy
Income Statement
For the Month Ended December 31, 2014

Revenues:		
Consulting fees earned		$14,000
Expenses:		
Equipment rental expense	$2,800	
Wages expense	1,600	
Utilities expense	1,200	
Total expenses		5,600
Net income		$ 8,400

Exhibit 7
Statement of Owner's Equity for Roland Consultancy

Roland Consultancy
Statement of Owner's Equity
For the Month Ended December 31, 2014

T. Roland, capital, December 1, 2014	$ 0
Investment by T. Roland	200,000
Net income for the month	8,400
Subtotal	$208,400
Less withdrawals	2,400
T. Roland, capital, December 31, 2014	$206,000

Exhibit 8
Balance Sheet for Roland Consultancy

Roland Consultancy
Balance Sheet
December 31, 2014

Assets		Liabilities	
Cash	$ 62,400	Accounts payable	$ 2,400
Accounts receivable	4,000	Total liabilities	$ 2,400
Supplies	2,000		
Land	40,000	**Owner's Equity**	
Buildings	100,000	T. Roland, capital	206,000
Total assets	$208,400	Total liabilities and owner's equity	$208,400