Chapter 1

The Nature and Purpose of Accounting

Most of the world's work is done through organizations—groups of people who work together to accomplish one or more objectives. In doing its work, an organization uses resources—labor, materials, various services, buildings, and equipment. These resources need to be financed, or paid for. To work effectively, the people in an organization need information about the amounts of these resources, the means of financing them, and the results achieved through using them. Parties outside the organization need similar information to make judgments about the organization. **Accounting** is a system that provides such information.

Organizations can be classified broadly as either for-profit or nonprofit. As these names suggest, a dominant purpose of organizations in the former category is to earn a profit, whereas organizations in the latter category have other objectives, such as governing, providing social services, and providing education. Accounting is basically similar in both types of organizations.

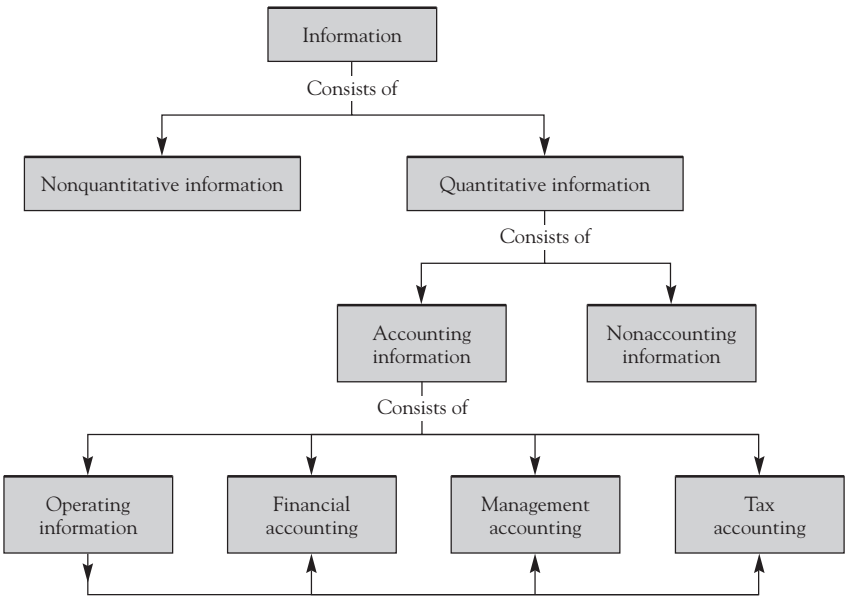
The Need for Information

In its details, information differs greatly among organizations of various types. But viewed broadly, the information needs of most organizations are similar. We shall outline and illustrate these general information needs by referring to Varsity Motors, Inc., an automobile dealership.

Varsity Motors seeks to earn a profit by selling new and used automobiles and parts and accessories, and by providing repair service. It is an organization of 52 people headed by Pat Voss, its president. It owns a building that contains the showroom, service shop, a storeroom for parts and accessories, and office space. It also owns a number of new and used automobiles, which it offers for sale; an inventory of spare parts, accessories, and supplies; and cash in the bank. These are examples of the resources the company needs to conduct its business.

Illustration 1–1 depicts the different types of information that might be useful to people interested in Varsity Motors. As shown in the illustration, information can be either quantitative or nonquantitative. Quantitative information is information that is expressed in numbers. Examples of nonquantitative information are visual impressions,

ILLUSTRATION 1–1
Types of Information



conversations, television programs, and newspaper stories. Accounting is primarily concerned with quantitative information.

Accounting is one of several types of quantitative information. Accounting information is distinguished from the other types in that it usually is expressed in *monetary* terms. Data on employees' ages and years of experience are quantitative, but they are not usually considered to be accounting information. The line here is not sharply drawn, however; nonmonetary information is often included in the notes to accounting reports when it will help the reader understand the report. For example, an accounting sales report for Varsity Motors would show not only the monetary amount of sales revenue, but also the number of automobiles sold, which is nonmonetary information.

What information is needed about the amounts and financing of the resources used in Varsity Motors and the results achieved by the use of these resources? This information can be classified into four categories: (1) operating information, (2) financial accounting information, (3) management accounting information, and (4) tax accounting information. Each is shown in the bottom section of Illustration 1–1.

Operating Information

A considerable amount of **operating information** is required to conduct an organization's day-to-day activities. For example, Varsity Motors' employees must be paid exactly the amounts owed them, and the government requires that records be maintained for each employee showing amounts earned and paid, as well as various deductions. The sales force needs to know what automobiles are available for sale and each one's cost and selling price. When an automobile is sold, a record must be made of that fact. The person in the stockroom needs to know what parts and accessories are on hand; and if the inventory of a certain part becomes depleted, this fact needs to be known so that an additional quantity can be ordered. Amounts owed by the company's customers need to be known; and if a customer does not pay a bill on time, this fact needs to be known so that appropriate action can be taken. The company needs to know the amounts it owes to others, when these amounts should be paid, and how much money it has in the bank.

Operating information constitutes by far the largest quantity of accounting information. As suggested by the arrows at the bottom of Illustration 1–1, operating information provides much of the basic data for management accounting, financial accounting, and tax accounting.

Financial Accounting Information

Financial accounting information is intended both for managers and also for the use of parties external to the organization, including shareholders (and trustees in nonprofit organizations), banks and other creditors, government agencies, investment advisers, and the general public. Shareholders who have furnished capital to Varsity Motors want information on how well the company is doing. If they should decide to sell their shares, they need information that helps them judge how much their investment is worth. Prospective buyers of these shares need similar information. If the company wants to borrow money, the lender wants information that will show that the company is sound and that there is a high probability that the loan will be repaid.

Only in rare instances can outside parties insist that an organization furnish information tailor-made to their specifications. In most cases, they must accept the information that the organization chooses to supply. They could not conceivably understand this information without knowing the ground rules that governed its preparation. Moreover, they cannot be expected to learn a new set of ground rules for each organization of interest to them, nor can they compare information about two organizations unless both sets of information are prepared according to common ground rules. These ground rules are the subject matter of financial accounting (also called **financial reporting**).

Management Accounting Information

Varsity Motors' president, vice president of sales, service manager, and other managers do not have the time to examine the details of the operating information. Instead, they rely on summaries of this information. They use these summaries, together with other information, to carry out their management responsibilities. The accounting information specifically prepared to aid managers is called **management accounting information.** This information is used in three management functions: (1) planning, (2) implementation, and (3) control.

Planning

Performed by managers at all levels, in all organizations, **planning** is the process of deciding what actions should be taken in the future. A plan may be made for any segment of the organization or for the entire organization. When Varsity Motors' service manager decides the order in which automobiles will be repaired and which mechanic will work on each of them, the service manager is engaged in planning in the same sense as, but on a smaller scale than, the president when the latter decides to build a new showroom and service facility.

An important form of planning is **budgeting.** Budgeting is the process of planning the overall activities of the organization for a specified period of time, usually a year. A primary objective of budgeting is to *coordinate* the separate plans made for various segments of the organization to ensure that these plans harmonize with one another. For example, Varsity's sales plans and service department capacity plans must be consistent. Also, budgeting helps managers determine whether the coming year's activities are likely to produce satisfactory results and, if not, what should be done. Even tiny organizations find budgeting useful; many persons prepare a budget for their household.

Planning involves making decisions. Decisions are arrived at by (1) recognizing that a problem or an opportunity exists, (2) specifying and ranking the criteria to be used to determine the best solution, (3) identifying alternative ways of addressing the problem or opportunity, (4) analyzing the consequences of each alternative, and (5) comparing

these consequences to each other and the decision criteria in order to decide which alternative is best. Accounting information is useful especially in the analysis step of the decision-making process.

Implementation

Making plans does not itself ensure that managers will implement the plans. In the case of the annual budget, each manager must take actions to provide the human and other resources that will be needed to achieve the planned results. Each manager also must make more detailed implementation plans than are encompassed in the budget; specific actions to be taken on a week-to-week and even day-to-day basis must be planned in advance.

The **implementation** of these very specific plans requires supervision on the part of the manager. Although much of this activity is routine, the manager also must react to events that were not anticipated when the budget was prepared. Indeed, a key managerial responsibility is to change previous plans appropriately to adjust for new conditions. If an unexpected situation impacts more than one part of the organization, the managers affected must coordinate their responses, just as their original plans were coordinated.

Control

In Varsity Motors most automobile sales are made by salespersons and most service work is done by mechanics. It is not the responsibility of Pat Voss and the other managers to do this work themselves. Rather, it is their responsibility to see that it is done, and done properly, by the employees of the organization. The process they use to ensure that employees perform properly is called **control.** Accounting information is used in the control process as a means of communication, motivation, attention getting, and appraisal.

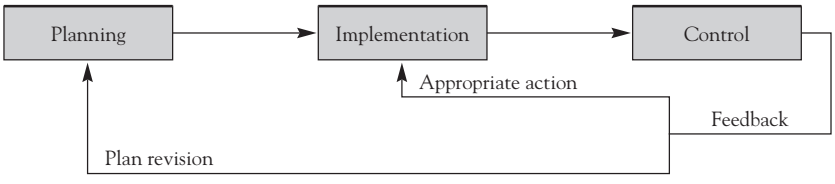
As a means of *communication,* accounting reports (especially budgets) can assist in informing employees about management's plans and in general about the types of action management wishes the organization to take. As a means of *motivation,* accounting reports can induce members of the organization to act in a way that is consistent with the organization's overall goals and objectives. As a means of *attention getting,* accounting information signals that problems may exist that require investigation and possibly action; this process is called **feedback.** As a means of *appraisal,* accounting helps show how well managers of the organization have performed, particularly with respect to the budgeted performance of the departments for which they are responsible. This provides a basis for a salary increase, promotion, corrective action of various kinds, or (in extreme cases) dismissal.

The relationship among the management functions of planning, implementation, and control is shown in Illustration 1–2. Chapter 15 will further introduce management accounting and contrast it with financial reporting.

Tax Accounting Information

Varsity Motors must file tax returns with the taxing authorities. As we will see later, in the United States for all companies and increasingly around the world for stock-exchange-listed companies, tax accounting rules can differ from financial accounting rules. Varsity Motors therefore must keep separate **tax accounting** records for tax purposes in those areas where it has elected to use different accounting rules for tax accounting and financial accounting.

ILLUSTRATION 1–2
Relationship of Management Functions



Definition of Accounting

Accounting is related to all of the activities described above, and in all of them the emphasis is on using accounting information in the process of *making decisions.* Both managers within an organization and interested outside parties use accounting information in making decisions that affect the organization. Thus, of the several available definitions of accounting, the one developed by an American Accounting Association committee is perhaps the best because of its focus on accounting as an aid to decision making. This committee defined accounting as *the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.*

The Profession of Accounting

In most organizations the accounting group is the largest staff unit, that is, the largest group other than the "line" activities of production and marketing. The accounting group consists essentially of two types of people: (1) bookkeepers and other data-entry employees who maintain the detailed operating records and (2) staff accountants who decide how items should be reported, prepare the reports, interpret these reports, prepare special analyses, design and operate the systems through which information flows, and ensure that the information is accurate.

All publicly owned companies and many other organizations have their accounting reports audited by an independent public accounting firm. These firms also perform other services for clients. Some of these firms are very large with tens of thousands of employees and hundreds of offices around the world, with annual revenues totaling billions of dollars. They are far larger than any law firm, medical group practice, or other professional firm. At the other extreme, thousands of independent public accountants practice as individuals.

Most independent public accountants are licensed by their state and are designated as Certified Public Accountants (CPAs). The professional organization of CPAs is the American Institute of Certified Public Accountants (AICPA). Many accountants employed by industry belong to the Institute of Management Accountants (IMA). The IMA administers the Certified Management Accountant (CMA) program. Some accountants in industry also are Certified Internal Auditors (CIA). Many college and university accounting faculty members belong to the American Accounting Association (AAA).

CPAs that audit public companies are subject to the oversight of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). The SEC was created by the Securities Act of 1934. Its mission is to protect investors; maintain fair, orderly, and efficient securities markets; and facilitate capital formation. PCAOB is a five-person board appointed by the SEC to oversee the auditors of public companies in order to protect the interests of investor and further the public interest in the preparation of informative, fair, and independent audit reports. PCAOB has the power to set auditing standards and discipline auditors who fail to follow their standards.

Although accounting is a staff function performed by accounting professionals within an organization, the ultimate responsibility for the generation of accounting information—whether financial or managerial—rests with *management.* Management's responsibility for accounting is the reason that one of the top officers of many businesses is the **controller.** Within the division of top management's duties, the controller is the person responsible for satisfying other managers' needs for management accounting information and for complying with the requirements of financial reporting and tax accounting. To these ends the controller's office employs accounting

professionals in management, financial, and tax accounting. These accountants design, install, and operate the information systems required to generate financial and managerial reports and tax returns.

Our Approach to Accounting

Accounting can be approached from either of two directions: from the viewpoint of the accountant or from the viewpoint of the user of accounting information. The former approach emphasizes the concepts and techniques that are involved in collecting, summarizing, and reporting accounting information; the latter emphasizes what the user needs to know about accounting. We focus on the latter approach. The difference between these two approaches is only one of emphasis. Accountants need to know how information is to be used because they should collect and report information in a form that is most helpful to those who use it. Users need to know what the accountant does; otherwise, they are unlikely to understand the real meaning of the information that is provided.

The approach to accounting taken here is something like that used by an airplane pilot in learning to use flight instruments. The pilot needs to know the meaning of the message conveyed by each of the instruments—for example, that a needle on a certain gauge going above a given point probably means that a certain component is not functioning properly. The word *probably* is used because, for one reason or another, an instrument may not always give the reading that it is supposed to give. As the user of the instrument, the pilot must realize this and also must understand something of the likelihood of, and the reason for, these abnormalities. On the other hand, the pilot does not need to know how to design, construct, calibrate, or repair airplane instruments. Specialists are available for these important functions.

Similarly, those who use accounting information must understand what a given accounting figure probably means, what its limitations are, and the circumstances in which it may mean something different from the apparent "signal" that it gives. They do not, however, need to know how to design, construct, operate, or check on the accuracy of an accounting system. They can rely on accountants for these important functions.

Preconceptions about Accounting

Readers of this book have already been exposed to a great deal of accounting information. Cash register or credit card receipts, checks written or (preferably) received, bank statements, merchants' and utilities' bills—all these are parts of accounting systems. Newspapers report about the profit (or losses) of a company or an industry, about dividends, or about money being spent to build new buildings; this information comes from accounting systems. Even before beginning a formal study of the subject, therefore, the reader has accumulated a number of ideas about accounting.

The trouble is that some of these ideas probably are incorrect. For example, it seems intuitively reasonable that accounting should report what a business is "worth." But accounting does not, in fact, do this, nor does it even attempt to do so. As another example, there is a general notion that the word *asset* refers to valuable things, good things to have. But the skills and abilities of an organization's employees are not assets in the accounting sense, even though they may be a key determinant of the organization's success.

Thus, as with many other subjects, students of accounting must be wary of preconceptions. They will discover that accounting *as it really is* may be different in important respects from what they had surmised it to be. They will find that there are sound reasons for these differences, and it is important that they understand these reasons. To achieve such an understanding, users need to know enough about accounting concepts

and techniques to understand the nature and limitations of the accounting information. They do not, however, need the detailed knowledge that the accountant must have.

Plan of the Book

We described above four types of accounting information: operating information, financial accounting information, management accounting information, and tax accounting information. Since our viewpoint is that of the current and potential *users* (as opposed to preparers) of accounting information, we shall not describe operating and tax accounting information in any great detail. The book is therefore divided into two approximately equal parts, the first on financial accounting and the second on management accounting.

The discussion of financial accounting comes first because the structure of financial accounting underlies *all* accounting. This structure consists of a few basic principles and concepts, a set of relationships among the elements comprising the accounting system, a terminology, and a number of rules and guidelines for the application of the principles and concepts to specific situations. We shall describe the financial accounting structure in a general way in Chapters 2, 3, and 4; and we shall then go over the same ground again in more detail in Chapters 5 through 14.

The second half of the book discusses the nature and use of management accounting information. The management of an organization can establish whatever ground rules it wishes for the accounting information collected for its own use. Thus, although the principles of financial accounting are applicable to all organizations, the rules of management accounting are tailor-made to meet the needs of the management of a specific organization.

Nevertheless, a similarity exists in both financial accounting practices and management accounting practices in most organizations. There are obvious economies in using financial accounting information wherever possible for management accounting purposes rather than devising two completely different systems for the two purposes.

The Financial Accounting Framework

Suppose you were asked to keep track of what was going on in an organization in order to provide useful information for management. One way of carrying out this assignment would be to write down a narrative of important events in a log similar to that kept by the captain of a ship.

After some experience with your log, you would gradually develop a set of rules to guide your efforts. For example, since it would be impossible to write down every action of every person in the organization, you would develop rules to guide you in choosing between those events that were important enough to record and those that should be omitted. You also would find that your log would be more valuable if you standardized certain terms. People who studied it would then have a clearer understanding of what you meant. Furthermore, if you standardized terms and their definitions, you could turn the job of keeping the log over to someone else and have some assurance that this person's report of events would convey the same information that you would have conveyed had you been keeping the log yourself.

In devising these rules of keeping a log, you would necessarily be somewhat arbitrary. There might be several ways of describing a certain event, all equally good. But in order to have a common basis of understanding, you would select just one of these for use in your recordkeeping system.

All these considerations were actually involved in the development of the accounting process. Accounting has evolved over a period of many centuries, and during this time certain terminology, rules, and conventions have come to be accepted as useful. If you are to understand accounting reports—the end products of an accounting system—you must be familiar with the rules and conventions lying behind these reports.

Accounting as a Language

Accounting is aptly called the *language of business.* The task of learning accounting, very similar to the task of learning a new language, is complicated by the fact that many words used in accounting mean almost but not quite the same thing as the identical words mean in everyday nonaccounting usage. Accounting is not exactly a foreign language; the problem of learning it is more like that of an American learning to speak English as it is spoken in Great Britain. For example, the grain that Americans call *wheat* is called *corn* by the British; and the British use the word *maize* for what Americans call *corn.* Unless they are careful, Americans will fail to recognize that some words are used in Great Britain in a different sense from that used in America.

Similarly, some words are used in a different sense in accounting from their colloquial meanings. For example, accountants often use the term *net worth* to describe an amount that appears on accounting reports. The commonsense interpretation is that this amount refers to what something is worth, what its value is. However, such an interpretation is incorrect, and misunderstandings can arise if the user of an accounting statement does not understand what accountants mean by net worth. (The correct meaning, somewhat technical in nature, will be given in Chapter 2.)

Accounting also resembles a language in that some of its rules are definite, whereas others are not. There are differences of opinion among accountants about how a given event should be reported, just as grammarians differ on many matters of sentence structure, punctuation, and word choice. Nevertheless, just as many practices are clearly poor English, many practices are definitely poor accounting. In the following chapters we describe the elements of good accounting and indicate areas in which there are differences of opinion about what constitutes good practice.

Finally, languages evolve in response to the changing needs of society, and so does accounting. The rules described here are currently in use, but some of them will probably be modified to meet the changing needs of organizations and their constituencies.

Different Formats

The communication and understanding of accounting information may be further complicated by the use of different financial statement presentation formats. As far as financial reporting data are concerned, the statement user problems caused by presentational difference has been mitigated by the development and adoption of eXtensible Business Reporting Language (XBRL). XBRL is a digital business language designed to help companies communicate financial statement data internally and externally. XBRL codes every element of a set of financial statements using a simple, universal, plain-language tag. The tag allows companies to consistently communicate financial statement data originally prepared in many different forms, and it allows statement users to extract information rapidly and reliably. XBRL does not adjust data for differences in accounting principles. Its principal purpose is to adjust presentational differences. The SEC permits companies to file financial statements using XBRL.

Nature of Principles

The rules and basic concepts of accounting are commonly referred to as *principles.* The word **principle** is here used in the sense of a general law or rule that is to be used as a

guide to action. This means that accounting principles do not prescribe exactly how each event occurring in an organization should be recorded. Consequently, there are many matters in accounting practice that differ from one organization to another. Most of these differences are inevitable because a single detailed set of rules could not conceivably apply to every organization. In part, the differences reflect that, within "generally accepted accounting principles," management has some latitude in which to express its own ideas about the best way of recording and reporting a specific event.

Readers should realize, therefore, that they cannot know the precise meaning of a number of the items in an accounting report unless they know which of several equally acceptable possibilities has been selected by the person who prepared the report. The meaning intended in a specific situation requires knowledge of the context.

Criteria

Accounting principles are established by humans. Unlike the principles of physics, chemistry, and the other natural sciences, accounting principles were not deduced from basic axioms, nor can they be verified by observation and experiment. Instead, they have evolved. This evolutionary process is going on constantly; accounting principles are not eternal truths.

The general acceptance of an accounting principle usually depends on how well it meets three criteria: relevance, objectivity, and feasibility. A principle has **relevance** to the extent that it results in information that is meaningful and useful to those who need to know something about a certain organization. A principle has **objectivity** to the extent that the resulting information is not influenced by the personal bias or judgment of those who furnish it. Objectivity connotes reliability, trustworthiness. It also connotes verifiability, which means that there is some way of finding out whether the information is correct. A principle has **feasibility** to the extent that it can be implemented without undue complexity or cost.

These criteria often conflict with one another. In some cases the most relevant solution may be the least objective and the least feasible. Often, in this situation a less relevant but more objective and more feasible solution may be selected.

Example

The development of a new product may have a significant effect on a company's real value—"miracle" drugs and personal computer chips being spectacular examples. Information about the value of new products is most useful to the investor; it is indeed relevant. But the best estimate of the value of a new product is likely to be that made by management, and this is a highly subjective estimate. Accounting therefore does not attempt to record such values. Accounting sacrifices relevance in the interests of objectivity.

The measure of the value of the owners' interest or equity in a biotechnology firm such as Genentech, Inc., obtained from the stock market quotations (i.e., multiplying the price per share of stock times the number of shares outstanding) is a much more accurate reflection of the true value than the amount listed as owners' equity that appears in the corporation's financial statements. The marketplace gave this value as $26.4 billion; the accounting records gave it as $6.8 billion. The difference does not indicate an error in the accounting records. It merely illustrates the fact that accounting does not attempt to report firm market values.

In developing new principles, the essential problem is to strike the right balance between relevance on the one hand and objectivity and feasibility on the other. Failure to appreciate this problem often leads to unwarranted criticism of accounting principles. It is easy to criticize accounting on the grounds that accounting information is not as relevant as it might be; but the critic often overlooks the fact that proposals to increase

relevance almost always involve a sacrifice of objectivity and feasibility. On balance, such a sacrifice may not be worthwhile.

Source of Accounting Principles

The foundation of accounting consists of a set of **generally accepted accounting principles,** or **GAAP** for short. Currently, these principles are established by the Financial Accounting Standards Board (FASB). Current information about the FASB's activities can be obtained by accessing the FASB's website (http://www.fasb.org). The FASB consists of seven members with diverse accounting backgrounds who work full time on developing new or modified principles. The board is supported by a professional staff that does research and prepares a discussion memorandum on each problem that the board addresses. The board acts only after interested parties have been given an opportunity to suggest solutions to problems and to comment on proposed pronouncements. The FASB is a nongovernmental organization.[1]

It is important to note that the acronym "GAAP" when used in practice (and this text) refers to accounting standards applicable in the United States, where the acceptability of the FASB pronouncements rests on their general acceptability. In most other countries, the authority of accounting standards is based on laws enacted by the national governing bodies.

Each of the *Standards* of the FASB deals with a specific topic.[2] Collectively, they do not cover all the important topics in accounting. If an authoritative pronouncement has not been made on a given topic, accountants can treat that topic in the way they believe most fairly presents the situation.

Companies are not legally required to adhere to GAAP as established by the FASB. As a practical matter, however, there are strong pressures for them to do so. The accounting reports of most companies are audited by certified public accountants who are members of the American Institute of Certified Public Accountants (AICPA). Although the AICPA (http://www.aicpa.org) does not require its members to force companies to adhere to FASB standards, it does require that if the CPA finds that the company has not followed FASB standards, the difference must be called to public attention. Since companies usually do not like to go counter to the FASB—even though they may feel strongly that the FASB principle is not appropriate in their particular situation—they almost always conform to the FASB pronouncements.

The FASB has established a 14-member group called the Emerging Issues Task Force (EITF). As its name suggests, the EITF publishes guides, referred to as *consensuses,* on accounting issues that need to be resolved in a timely manner. Typically, these consensuses are adopted where appropriate by corporations.

Another source of pressure to conform to GAAP is the U.S. Securities and Exchange Commission (SEC). This agency, which exists to protect the interests of investors, has jurisdiction over any corporation with a class of securities listed on a national stock exchange or, if traded over the counter, with 500 or more shareholders and $10 million or more total assets. The SEC requires these companies to file accounting reports prepared in accordance with GAAP. In its *Regulation S–X,* its

[1] Financial accounting and reporting standards for state and local governments and government-owned entities, such as colleges and universities, are set by the Government Accounting Standards Board.

[2] Authoritative pronouncements consist of *Statements* and interpretations of the Financial Accounting Standards Board and certain pronouncements of predecessor bodies established by the AICPA. We shall refer to these earlier pronouncements as *Accounting Research Bulletins* and *Opinions.*

Financial Reporting Series Releases, and its *Staff Accounting Bulletins,* the SEC spells out acceptable accounting principles in more detail than, but generally consistent with, the pronouncements of the FASB. Legally, the Securities Exchange Act of 1934 gave the SEC the authority to promulgate GAAP; but over the years, for the most part the SEC has relied on the FASB and its predecessors for carrying out the standard-setting process.

In its past, the AICPA has issued pronouncements called *Statements of Position* (SOP) for accounting in a number of industries, including finance companies, government contractors, and real estate investment trusts. Although these pronouncements do not have the force of FASB *Standards,* organizations have followed them. Recently, the FASB has made it clear that AICPA pronouncements are not GAAP. It has asked the AICPA to cease issuing these pronouncements.

Various regulatory bodies also prescribe accounting rules for the companies they regulate. Among those subjected to such rules are banks and other financial institutions, insurance companies, and public utilities. These rules are not necessarily consistent with the principles of the FASB, although there has been a tendency in recent years for regulatory agencies to change their accounting rules so that they do conform.

The authority of the FASB and the other agencies discussed so for exists, of course, only in the United States of America. Accounting principles in other countries differ in some respects from American GAAP, but in general there is a basic similarity throughout the world. There is a major effort to codify a set of accounting principles that would apply internationally, and over 40 statements known as International Accounting Standards (IAS) have been published by the International Accounting Standards Committee (IASC)—now reorganized as the International Accounting Standards Board (IASB)—located in London, England. While retaining the name IAS for standards issued by its predecessor, standards issued by the IASB (http://www.iasb.org) are known as International Financial Reporting Standards (IFRS).

The IASB does not have the power to enforce its pronouncements. Their adoption by companies and accounting standard setters is voluntary. Neverthless, impressed by the potential value of a global set of accounting principles, the FASB and the IASB have initiated a joint-program to converge GAAP and IFRS. This effort is supported by the SEC, which has proffered a timetable for potential mandatory adoption of IFRS for SEC registered companies beginning in 2014. Currently, over 100 countries have either adopted IFRS in whole or part or are considering IFRS adoption.

Readers of this text can assume, unless noted otherwise, the accounting for a particular transaction or event described in the text is essentially this same under both GAAP and IFRS.

A complete compilation of GAAP—FASB Accounting Standards Codification™—can be found on the FASB website. It is the single official source of authoritative, nongovernmental GAAP issued by the FASB. Guidance issued by the SEC is also incorporated in the site's materials.

Principles Vs. Rules

A major controversy in accounting is the extent to which accounting standards should be expressed in the form of broad principles versus detailed rules. IFRS tend to be stated in the form of broad principles. In contrast, much of GAAP tends to be stated in the form of bright-line rules. For example, as you will learn later, under GAAP if a term of a lease is equal to 75 percent of the economic life of the leased property, the lease will be accounted for as a capital lease.[3] On the other hand, if the lease term is

[3] "Accounting for Leases," *FASB Statement No. 13.*

equal to 74 or less percent of the leased property's economic life, the lease will be accounted for as an operating lease. IFRS takes a different approach. It makes the distinction between a capital and an operating lease based on which party—the lessor or the lessee—substantially bears the risks and rewards of owership.[4]

The distinction between the principle-based and rule-based accounting standards is important. Under a principle-based standards model, the accounting for transactions is more likely to reflect the substance of the transaction. Under a rule-based standards model, the accounting for a transaction is more likely to reflect the form of the transaction.

As GAAP and IFRS converge, it is anticipated that GAAP will become more principle based.

Financial Statements

The end product of the financial accounting process is a set of reports that are called **financial statements.** Generally accepted accounting principles require that three such reports be prepared: (1) a statement of financial position, which is generally referred to as a balance sheet; (2) an income statement; and (3) a statement of cash flows.[5] As we examine the details of the financial accounting process, it is important to keep in mind the objective toward which the process is aimed: the preparation of these three financial statements.

Most reports, in any field, can be classified into one of two categories: (1) **stock,** or **status, reports** and (2) **flow reports.** The amount of water in a reservoir at a given moment of time is a measure of stock, whereas the amount of water that moves through the reservoir in a day is a measure of flow. Reports of stocks are always as of a specified *instant* in time; reports of flow always cover a specified *period* of time. Reports of stocks are like snapshots; reports of flows are more like motion pictures. One of the accounting reports, the balance sheet, is a report of stocks. It shows information about the resources and obligations of an organization at a specified moment of time. The other two reports, the income statement and the cash flow statement, are reports of flows. They report activities of the organization for a period of time, such as a quarter or a year.

Companies listed on stock exchanges publish annual and quarterly financial reports. These reports can be obtained either directly from the company or from the Securities and Exchange Commission (SEC). Typically, these reports are also available directly from companies through the Internet.

For example, the Coca-Cola Company's home page (http://www.cocacola.com) contains information about Coca-Cola's products, history, and financial performance and position. (You might want to access this site to get a sense of a complete set of financial statements. After completing the financial reporting section of this book, you should be able to read and interpret these reports with confidence that you understand them.)[6]

[4] "Leases," *IAS No. 17*.

[5] Company financial reports also may include other financial displays, such as changes in owners' equity. This display will be explained in Chapter 10.

[6] The home pages of other well-known companies you might want to access are General Electric (http://www.ge.com), Microsoft (http://www.microsoft.com), General Motors (http://www.gm.com), Walmart (http://www.walmart.com), and IBM (http://www.ibm.com).

Listed company financial reports are also available electronically through the Securities and Exchange Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. All companies registered with the SEC use EDGAR to transmit their required filings to the SEC (http://www.sec.gov).

In this chapter we will give a brief introduction to the balance sheet and income statement. The definitions provided should be considered as only working definitions for the purposes of this introductory chapter. The next nine chapters describe more precisely and in greater detail the balance sheet and income statement. We shall defer a description of the statement of cash flows until Chapter 11. Because this report is derived from data originally collected for the other two reports, it is inappropriate to defer the discussion of the cash flow statement until after the balance sheet and income statement have been thoroughly explained.

The Balance Sheet

Illustration 1–3 presents the December 31, 2010, balance sheet of the Holden Company. (Do not worry if you do not know what all of the account titles mean. They will be discussed in later chapters.)

The Holden balance sheet is a snapshot of the financial position of the company. It has two sides: the left, Assets, and the right, Liabilities and Owners' Equity. We will give working descriptions of each side. (More precise descriptions will be provided in Chapter 2.)

Assets

An entity needs cash, equipment, and other resources in order to operate. These resources are its assets. **Assets** are valuable resources owned by the entity. The left side of the balance sheet shows the amounts of these assets as of a certain date. For example, the amount of Cash that Holden Company owned on December 31, 2010, was $1,449,000.

Assets are resources **owned** by Holden Company. Its employees, although perhaps its most valuable resource, are not assets in accounting, because the company does not own its employees.

Liabilities and Owners' Equity

The right side of the balance sheet shows the sources that provided the entity's assets. As the heading indicates, there are two general types of sources, Liabilities and Owners' Equity.

Liabilities are obligations of the entity to outside non owner parties who have furnished resources. These parties are generally called **creditors** because they have extended credit to the entity. As Illustration 1–3 indicates, suppliers have extended credit in the amount of $5,602,000, as indicated by Accounts Payable.

Creditors have a **claim** against the assets in the amount shown as the liability. For example, a bank has loaned $1,000,000 to Holden Company, and therefore has a claim of this amount, as indicated by Bank Loan Payable.

Because an entity will use its assets to pay off its claims, those claims are against assets. They are claims against *all* the assets, not any particular assets.

The other source of the funds that an entity uses to acquire its assets is called **Owners' Equity.** There are two sources of equity funds: (1) the amount provided directly by equity investors, which is called **Total Paid-In Capital;** and (2) the amount retained from profits (or earnings), which is called **Retained Earnings.**

Creditors can sue the entity if the amounts due them are not paid. Equity investors have only a *residual claim;* that is, if the entity is dissolved, they get whatever is left

ILLUSTRATION 1–3
The Balance Sheet

HOLDEN COMPANY
Balance Sheet
As of December 31, 2010
(000 omitted)

Assets		Liabilities and Owners' Equity	
Current assets:		*Current liabilities:*	
Cash	$ 1,449	Accounts payable	$ 5,602
Marketable securities	246	Bank loan payable	1,000
Accounts receivable, net	9,944	Accrued liabilities	876
Inventories	10,623	Estimated tax liability	1,541
Prepaid expenses	389	Current portion of long-term debt	500
Total current assets	22,651	Total current liabilities	9,519
Noncurrent assets:		*Noncurrent liabilities:*	
Property, plant, equipment at cost	26,946	Long-term debt, less current portion	2,000
Less: Accumulated depreciation	13,534	Deferred income taxes	824
Property, plant, equipment—net	13,412	Total liabilities	12,343
Investments	1,110	*Owners' equity:*	
Patents and trademarks	403	Common stock	1,000
Goodwill	663	Additional paid-in capital	11,256
		Total paid-in capital	12,256
		Retained earnings	13,640
		Total owners' equity	25,896
Total assets	$38,239	Total liabilities and owners' equity	$38,239

after the liabilities have been paid, which may be nothing. Liabilities therefore are a stronger claim against the assets than equity.

We can describe the right-hand side of the balance sheet in two somewhat different ways: (1) as the amount of funds supplied by creditors and equity investors and (2) as the claims of these parties against the assets. Use whichever way is more meaningful to you.

Dual-Aspect Concept

The assets that remain after the liabilities are taken into account will be claimed by the equity investors. If an entity has assets that total $10,000 and liabilities that total $4,000, its owners' equity must be $6,000.

Because (1) any assets not claimed by creditors will be claimed by equity investors and (2) the total amount of claims (liabilities + owners' equity) cannot exceed what there is to be claimed, it follows that the total amount of assets will always be equal to the total amount of liabilities plus owners' equity.

The fact that total assets must equal, or **balance,** total liabilities plus owners' equity is why the statement is called a *balance sheet.* This equality tells nothing about the entity's financial condition; it always exists unless the accountant has made a mistake.

This fact leads to what is called the **dual-aspect concept.** The two aspects that this concept refers to are (1) assets and (2) liabilities plus owners' equity. The concept states that these two aspects are always equal. (This equality exists even if liabilities are greater than assets. For example, if assets in an unprofitable business were $100,000 and liabilities were $120,000, owners' equity would be a *negative* amount of $20,000.)

The dual-aspect concept is 1 of 11 basic accounting concepts we shall describe in Chapters 2 and 3. The dual-aspect concept can be written as an equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

This equation is fundamental. It governs all accounting. We can write a similar equation in a form that emphasizes the fact that owners' equity is a residual interest:

$$\text{Assets} - \text{Liabilities} = \text{Owners' equity}$$

For example, if the assets of Violet Company total $19,000 and its liabilities total $3,000, its owners' equity must total $16,000.

The term *net assets* is sometimes used instead of owners' equity. It refers to the fact that owners' equity is always the difference between assets and liabilities.

Every accounting transaction can be described in terms of its effect on this fundamental accounting equation. For example, the Violet Company spends $15,000 cash for a new car. The company's accountant would record a reduction in the asset Cash (−$15,000) and an increase in the asset Cars (+$15,000). After recording this transaction, the fundamental equation is still in balance. Similarly, if the company had bought the car on credit rather than for cash, the equation would be in balance because the liability Accounts Payable would have increased (+$15,000) and the asset Cars would have increased by a like amount (+$15,000).

The amounts of an entity's assets and liabilities will change from day to day. Any balance sheet reports the amounts of assets, liabilities, and owners' equity at one point in time. The balance sheet therefore must be dated. (From here on we shall sometimes use the term *20x1* to refer to the first year, *20x2* for the next year, and so on. Thus, a balance sheet as of December 31 of the first year is dated "as of December 31, 20x1." It refers to the close of business on that day.)

Returning to Illustration 1–3, if the Holden Company prepared a balance sheet as of the beginning of business the next day, January 1, 2011, it would be the same as the one in Illustration 1–3 because nothing changes between the close of business on one day and the beginning of business on the next day.

The Income Statement

Illustration 1–4 shows the Holden Company's 2010 income statement. The amount added to Retained Earnings as a result of profitable operations during a period is the **income** of the period. An income statement explains how this income was earned. There is no standard format for an income statement. Illustration 1–4 shows one common format. (The income statement is discussed in greater detail in Chapter 3.)

The basic income statement equation is

$$\text{Revenues} - \text{Expenses} = \text{Net income}$$

The first item on this income statement is Sales Revenue, which is the amount of products (i.e., goods and services) sold or delivered to customers during the period.

The item on the second line is labeled Cost of Sales. It reports the cost of the goods or services whose revenue is reported on the first line.

The difference between sales and cost of sales is called *gross margin.* Thus,

$$\text{Gross margin} = \text{Sales revenue} - \text{Cost of sales}$$

ILLUSTRATION 1–4
The Income Statement

HOLDEN COMPANY Income Statement For the Year 2010 (000 omitted)	
Sales revenue	$75,478
Less cost of sales	52,227
Gross margin	23,251
Less operating expenses	10,785
Income before taxes	12,466
Provision for income taxes	6,344
Net income	$ 6,122

Operating expenses are subtracted from gross margin, leaving **income before taxes.** These expenses include costs related to the current period and costs that do not benefit future periods.

The next item in Illustration 1–4, provision for income taxes, is shown separately because it is an especially important expense.

The final item (the bottom line) on an income statement is called **net income** (or **net loss,** if expenses were larger than revenues).

"Package" of Financial Reports

Illustration 1–5 is a "package" of financial reports for the Holden Company consisting of two balance sheets and an income statement. (A complete package of financial reports also would include a cash flow statement.) The illustration shows how the balance sheet, statement of retained earnings, and income statement relate to each other through the Retained Earnings account.

An income statement is a summary of certain changes in Retained Earnings that have taken place during an accounting period. In other words, an income statement reports certain changes in Retained Earnings that have taken place between two balance sheet dates.

Thus, a useful accounting "report package" consists of a balance sheet *at the beginning of* the accounting period, an income statement *for* the period, and a balance sheet *at the end of* the period.

The statement of retained earnings at the bottom of Illustration 1–5 shows that the Retained Earnings on December 31, 2009, was $13,640,000. During 2010 profitable operations resulted in net income of $6,122,000, which increased Retained Earnings by this amount. (Net income is the bottom line on the income statement.) Retained Earnings was decreased by $4,390,000, representing a distribution to the shareholders in the form of dividends. As a result, the total Retained Earnings on December 31, 2010, was $15,372,000 ($13,640,000 + $6,122,000 − $4,390,000).

Dividends are deducted from Retained Earnings because dividends are a distribution of earnings to owners. Dividends are *not* an expense.

Financial Statement Objectives

We indicated earlier that financial accounting statements, while also of use to management, are intended primarily to provide relevant information to parties external to the business. The Financial Accounting Standards Board (FASB) issued a formal statement of financial reporting objectives. The entire statement is too lengthy to describe here in detail. We will simply highlight the key objectives. (The numbering is ours, not that of the FASB.)

ILLUSTRATION 1–5
A "Package" of Accounting Reports

HOLDEN COMPANY
(000 OMITTED)

Condensed Balance Sheet
As of December 31, 2009

Assets	
Current assets	$22,651
Buildings and equipment	13,412
Other assets	2,176
Total assets	$38,239
Liabilities and Owners' Equity	
Liabilities	$12,343
Owners' equity:	
Paid-in capital	12,256
Retained earnings	13,640
Total liabilities and owners' equity	$38,239

Condensed Balance Sheet
As of December 31, 2010

Assets	
Current assets	$24,062
Buildings and equipment	14,981
Other assets	3,207
Total assets	$42,250
Liabilities and Owners' Equity	
Liabilities	$14,622
Owners' equity:	
Paid-in capital	12,256
Retained earnings	15,372
Total liabilities and owners' equity	$42,250

Income Statement
For the Year 2010

Sales revenue	$75,478
Less cost of sales	52,127
Gross margin	23,351
Less operating expenses	10,885
Income before taxes	12,466
Provision for income taxes	6,344
Net income, 2010	$ 6,122

Statement of Retained Earnings

Retained earnings, 12/31/09	$13,640
Add net income	6,122
	19,762
Less dividends	4,390
Retained earnings, 12/31/10	$15,372

Financial reporting should provide information that

1. Is useful to present and potential investors and creditors in making rational investment and credit decisions.
2. Is comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
3. Is about the economic resources of an enterprise, the claims to those resources, and the effects of transactions and events that change resources and claims to those resources.
4. Is about an enterprise's financial performance during a period.
5. Helps users assess the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale or redemption of securities or loans.

Objectives 1 and 2 apply to all financial accounting information. Note that the intended users are expected to have attained a reasonable level of sophistication in using the statements; the statements are not prepared for uninformed persons. Objective 3 is related to the balance sheet, objective 4 to the income statement, and objective 5 to the cash flow statement. As the five objectives collectively suggest, financial statements provide information about the *past* to aid users in making predictions and decisions related to the *future* financial status and flows of the business.

Sarbanes-Oxley Act

In July 2002 the U.S. president signed into law the Sarbanes-Oxley Act. It requires chief executives and chief financial officers of public companies to certify that their company's financial statements filed with the SEC are materially accurate and complete, and that in all material respects they present fairly the financial condition and results of operations of the issuer. These certifications subject the signers to potential civil and criminal liability for false certifications.

Income Tax Reporting

The Internal Revenue Service (IRS) specifies the ways in which taxable income is calculated for the purpose of assessing income taxes. Because the tax laws' purposes differ from the objectives of financial reporting, the IRS accounting regulations differ in some respects from GAAP. These differences mean that the amount of pretax income or loss shown on the taxpayer's income statement prepared according to GAAP will probably not be equal to the taxable income or loss shown on the taxpayer's income tax return.[7] How GAAP handles this difference will be covered in Chapter 10.

Thus, in the United States, financial accounting, management accounting, and income tax accounting are essentially separate processes. GAAP provides the principles for financial accounting; top management for management accounting; and the IRS and Congress for income tax accounting. The underlying operating information that is the basic data for all three processes is the same. The pieces or building blocks of operating information simply are put together in different ways for these three different processes. Though differences among the three processes do exist, in practice the similarities are greater than the differences.

Summary

An organization has four types of accounting information: (1) operating information, which has to do with the details of operations; (2) management accounting information, which is used internally for planning, implementation, and control; (3) financial accounting information, which is used both by management and by external parties; and (4) tax accounting information, which is used to file tax returns with taxing authorities.

Financial accounting is governed by ground rules that in America are referred to as generally accepted accounting principles. Outside the United States, there rules are increasingly most likely to be IFRS, rather than local standards. In either case, these ground rules may be different from what the reader believes them to be, based on previous exposure to accounting information. There rules attempt to strike a balance between the criterion of relevance on the one hand and the criteria of objectivity and feasibility on the other.

The end products of the financial accounting process are three financial statements: the balance sheet, the income statement, and the cash flow statement. The balance sheet is a

[7] In contrast to the United States, the governments of many countries require a company's financial accounting and tax accounting to be identical. This is changing. In many countries public companies listed on stock exchanges and, in some cases, unlisted companies are now being allowed or required to use IASB standards in reports to stockholders that differ from the local tax accounting rules.

report of status or stocks as of a moment of time, whereas the other two statements summarize flows over a period of time.

In the United States, calculating taxable income for income tax purposes differs from the process of calculating income for the financial accounting income statement.

The basic accounting equation is

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

Problems

Problem 1–1.

As of December 31, Charles Company had $12,000 in cash, held $95,000 of inventory, and owned other items that originally cost $13,000. Charles Company also had borrowed $40,000 from First City Bank. Prepare a balance sheet for Charles Company as of December 31. Be sure to label each item and each column with appropriate terms.

Problem 1–2.

Selected balance sheet items are shown for the Microtech Company. Compute the missing amounts for each of the four years. What basic accounting equation did you apply in making your calculations?

	Year 1	Year 2	Year 3	Year 4
Current assets	$113,624	$?	$ 85,124	$?
Noncurrent assets	?	198,014	162,011	151,021
Total assets	$524,600	$?	$?	$220,111
Current liabilities	$ 56,142	$ 40,220	$?	$?
Noncurrent liabilities	?	?	60,100	30,222
Paid-in capital	214,155	173,295	170,000	170,000
Retained earnings	13,785	(3,644)	1,452	2,350
Total liabilities and owners' equity	$524,600	$288,456	$?	$220,111

Problem 1–3.

Selected income statement items are shown for Astrotech Company. Compute the missing amounts for each of the four years. What basic accounting equation did you apply in making your calculations?

(*Hint:* To *estimate* the Year 4 missing numbers, compute the typical percentage each expense item is of sales for Years 1 to 3 and apply the percentage figure for each expense item to Year 4's sales.)

	Year 1	Year 2	Year 3	Year 4
Sales	$12,011	$?	$11,545	$10,000
Cost of goods sold	3,011	2,992	?	?
Gross margin	?	8,976	8,659	?
Other expenses	6,201	6,429	?	?
Profit before taxes	2,799	?	2,363	?
Tax expense	?	1,019	945	?
Net income	$ 1,679	$1,528	$ 1,418	?

Problem 1–4.

An analysis of the transactions made by Acme Consulting for the month of July is shown below.

	Cash	+	Accounts Receivable	+	Supplies Inventory	+	Equipment	=	Accounts Payable	+	Owners' Equity	Description of Transaction
1.	+$20,000										+$20,000	Investment
2.	−$ 5,000						+$7,000		+$2,000			
3.	−$ 1,000				+$1,000							
4.	−$ 4,500										−$ 4,500	Salaries
5.	+$ 5,000		+$5,000								+$10,000	Revenues
6.	−$ 1,500								−$1,500			
7.	+$ 1,000		−$1,000									
8.	−$ 750										−$ 750	Rent
9.	−$ 500										−$ 500	Utilities
10.									+$ 200		−$ 200	Travel
11.					−$ 200						−$ 200	

Required:

a. Explain each transaction.
b. List the changes in the company's balance sheet during the month of July.
c. Prepare an income statement for the month (ignore taxes).
d. Explain the changes in the Cash account.
e. Explain why the change in the Cash account and the month's income are not the same.

Problem 1–5.

During the month of June, Bon Voyage Travel recorded the following transactions:

1. Owners invested $25,000 in cash to start the business. They received common stock.
2. The month's rent of $500 was prepaid in cash.
3. Equipment costing $8,000 was bought on credit.
4. $500 was paid for office supplies.
5. Advertising costing $750 was paid for with cash.
6. Paid $3,000 employee salaries in cash.
7. Earned travel commissions of $10,000 of which $2,000 was received in cash.
8. Paid $5,000 of the $8,000 owed to the equipment supplier.
9. Used $100 of the office supplies.
10. Charged $1,000 of miscellaneous expenses on the corporate credit card.

Required:

a. Prepare an analysis of the month's transactions using the same tabular format as shown in Problem 1–4 (ignore taxes).
b. Explain how the transactions during the month changed the basic accounting equation (Assets = Liabilities + Owners' equity) for the company.
c. Prepare an income statement for the month.
d. Explain the changes in the Cash account.
e. Explain why the change in the Cash account and the month's income are not the same.

Cases

Case 1–1

Ribbons an' Bows, Inc.

In January 2010, Carmen Diaz, a recent arrival from Cuba, decided to open a small ribbon shop in the Coconut Grove section of Miami, Florida. During the month, she put together a simple business plan, which she took to several relatives whom she believed would be interested in helping her finance the new venture. Two of her cousins agreed to loan the business $10,000 for one year at a 6 percent interest rate. For her part, Carmen agreed to invest $1,000 in the equity of the business.

On March 1, 2010, with the help of an uncle who practiced law, Carmen formally incorporated her business, which she named "Ribbons an' Bows." Normally, the uncle would have charged a fee of $600 for handling the legal aspects of a simple incorporation, but, since Carmen was family, he waived the fee.

As soon as the new business was incorporated, Carmen opened a bank account and deposited the cousins' $10,000 loan and her $1,000 equity contribution. The same day, she signed an agreement to rent store space for $600 per month, paid on the last day of the month. The agreement was for an 18-month period beginning April 1. The agreement called for a prepayment of the last two months' rent, which Carmen paid out of the company bank account at the signing.

Over the next few weeks, Carmen was actively engaged in getting ready to open the store for business on April 1. Fortunately for Carmen, the previous tenant had left counters and display furniture that Carmen could use at no cost to her. In addition, the landlord agreed to repaint the store at no cost, using colors of Carmen's choice. For her part, Carmen ordered, received, and paid for the store's opening inventory of ribbons and ribbon accessories; acquired for free a simple cash register with credit-card processing capabilities from the local credit-card charge processing company after paying a refundable deposit; signed service agreements with the local phone and utility companies; ordered, received, and paid for some store supplies; and placed and paid for advertising announcing the store opening in the April 2 edition of the local paper. In addition, she bought and paid for a used desktop computer with basic business software already installed to keep track of her business transactions and correspondence.

On March 31, before opening for business the next day, Carmen reviewed the activity in the company's cash bank account. Following the deposit of the loans and equity contribution, the following payments were made.

1. Last two months' rent	$1,200
2. Opening merchandise inventory	$3,300
3. Cash register deposit	$ 250
4. Store supplies	$ 100
5. April 2 edition advertising	$ 150
6. Used computer purchase	$2,000

After reviewing her cash transaction records, Carmen prepared a list of Ribbons an' Bows assets and sources of its capital (see Exhibit 1).

EXHIBIT 1 Carmen's March 31, 2010, Ribbons an' Bows Assets and Capital Sources List

	Assets		Sources of Capital
Cash	$ 4,000		
Inventory	3,300		
Supplies	100		
Prepaid rent	1,200		
Prepaid advertising	150		
Computer/ software	2,000	Cousin's loan	$10,000
Cash register deposit	250	Carmen's equity	1,000
	$11,000		$11,000

Carmen eventually decided to expand her business by selling custom-designed ribbon table arrangements for weddings and other special events. This decision led to the purchase of a used commercial sewing machine for $1,800 cash on May 1.

Later, at a family Fourth of July celebration, one of Carmen's cousins reminded her that she had promised to send the cousins a financial report covering the four-month period from March 1 to June 30.

The next day, Carmen reviewed the following Ribbons an' Bows information she had gathered over the last four months.

1. Customers had paid $7,400 cash for ribbons and accessories, but she was still owed $320 for ribbon arrangements for a large wedding delivered to the customer on June 30.
2. A part-time employee had been paid $1,510 but was still owed $90 for work performed during the last week of June.
3. Rent for the three-month period had been paid in cash at the end of each month, as stipulated in the rental agreement.
4. Inventory replenishments costing $2,900 had been delivered and paid for by June 30. Carmen estimated the June 30 merchandise inventory on hand had cost $4,100.
5. The small opening office supplies inventory was nearly all gone. She estimated supplies costing $20 had not been used.

Carmen believed that the initial three months of business had been profitable, but she was puzzled by the fact that the cash in the company's June 30 bank account was $3,390, which was less than the April 1 balance of $4,000.

Carmen also was concerned about how she should reflect the following in her financial report:

1. No interest had been paid on the cousins' loan.
2. The expenditures made for the desktop computer and its related software and the commercial sewing machine. She believed these expenditures would be beneficial to the business long after June 30. At the time she purchased the commercial sewing machine, Carmen estimated that it would be used for about five years from its May 1 purchase date, when it would then have to be replaced. Similarly, on March 31, she had estimated the desktop computer and its software would have to be replaced in two years' time. Carmen believed the sewing machine and the computer along with its software would have no resale value at the end of their useful lives.
3. The free legal work performed by her uncle and the free cash register provided by the local credit-card charge processor.
4. Carmen had not paid herself a salary or dividends during the four months of operations. If cash was available, she anticipated that sometime in July she would pay herself some compensation for the four months spent working in the business. Before starting her business, Carmen had worked for $1,300 a month as a cashier in a local grocery store.

Questions

1. How would you report on the three-month operations of Ribbons an' Bows, Inc., through June 30? Was the company profitable? (Ignore income taxes.) Why did its cash in the bank decline during the three-month operating period?
2. How would you report the financial condition of the business on June 30, 2010?
3. Do you believe Carmen's first three months of operation could be characterized as "successful"? Explain your answer.

Case 1–2

Kim Fuller*

In the early fall of 2010, Kim Fuller was employed as a district sales engineer for a large chemical firm. During a routine discussion with plant chemists, Fuller learned that the company had developed a use for the recycled material, in pulverized form, made from plastic soft drink bottles. Because the state had mandatory deposits on all beverage bottles, Fuller realized that a ready supply of this material was available. All that was needed was an organization to tap that bottle supply, grind the bottles, and deliver the pulverized plastic to the chemical company. It was an opportunity Fuller had long awaited—a chance to start a business.

In November 2010, Fuller began checking into the costs involved in setting up a plastic bottle grinding business. A used truck and three trailers were acquired to pick up the empty bottles. Fuller purchased one

* © Professor Robert N. Anthony.

used grinding machine but had to buy a second one new; supplies and parts necessary to run and maintain the machines also were purchased. Fuller also purchased a personal computer with the intention of using it to keep company records. These items used $65,000 of the $75,000 Fuller had saved and invested in the company.

A warehouse costing $162,000 was found in an excellent location for the business. Fuller was able to interest family members enough in this project that three of them—two sisters and a brother—invested $30,000 each. These funds gave Fuller the $50,000 down payment on the warehouse. The bank approved a mortgage for the balance on the building. In granting the mortgage, however, the bank official suggested that Fuller start from the beginning with proper accounting records. He said these records would help not only with future bank dealings but also with tax returns and general management of the company. He suggested Fuller find a good accountant to provide assistance from the start, to get things going on the right foot.

Fuller's neighbor, Marion Zimmer, was an accountant with a local firm. When they sat down to talk about the new business, Fuller explained, "I know little about keeping proper records." Zimmer suggested Fuller should buy an "off-the-shelf" accounting system software package from a local office supply retailer. Zimmer promised to help Fuller select and install the package as well as learn how to use it. In order to select the right package for Fuller's needs, Zimmer asked Fuller to list all of the items purchased for the business, all of the debts incurred, and the information Fuller would need to manage the business. Zimmer explained that not all of this information would be captured by the accounting records and displayed in financial statements. Based on what Fuller told Zimmer, Zimmer promised to create files to accommodate accounting and nonaccounting information that Fuller could access through the company's personal computer. As Fuller's first lesson in accounting, Zimmer gave Fuller a brief lecture on the nature of the balance sheet and income statement and suggested Fuller draw up an opening balance sheet for the company.

Confident now that the venture was starting on solid ground, Kim Fuller opened the warehouse, signed contracts with two local bottling companies, and hired two grinding machine workers and a truck driver. By February 2011 the new firm was making regular deliveries to Fuller's former employer.

Questions

1. What information will Fuller need to manage the business? Classify this information in two categories: accounting information and nonaccounting information.
2. See what you can do to draw up a beginning-of-business list of the assets and liabilities of Fuller's company making any assumptions you consider useful. How should Fuller go about putting a value on the company's assets? Using your values, what is the company's opening owners' equity?
3. Now that Fuller has started to make sales, what information is needed to determine "profit and loss"? What should be the general construction of a profit and loss analysis for Fuller's business? How frequently should Fuller do such an analysis?
4. What other kinds of changes in assets, liabilities, and owners' claims will need careful recording and reporting if Fuller is to keep in control of the business?

Case 1–3

Baron Coburg*

Once upon a time many, many years ago, there lived a feudal landlord in a small province of Western Europe. The landlord, Baron Coburg, lived in a castle high on a hill. He was responsible for the well-being of many peasants who occupied the lands surrounding his castle. Each spring, as the snow began to melt, the Baron would decide how to provide for all his peasants during the coming year.

One spring, the Baron was thinking about the wheat crop of the coming growing season. "I believe that 30 acres of my land, being worth five bushels of wheat per acre, will produce enough wheat for next winter," he mused, "but who should do the farming? I believe

* *Source:* Academic Note "Another Implorable Occurrence," W. T. Andrews, ACCOUNTING HORIZONS, Vol. 9-No.3, April 1974, pp. 369–370. © American Accounting Association.

I'll give Ivan and Frederick the responsibility of growing the wheat." Whereupon Ivan and Frederick were summoned for an audience with Baron Coburg.

"Ivan, you will farm on the 20-acre plot of ground and Frederick will farm the 10-acre plot," the Baron began. "I will give Ivan 20 bushels of wheat for seed and 20 pounds of fertilizer. (Twenty pounds of fertilizer are worth two bushels of wheat.) Frederick will get 10 bushels of wheat for seed and 10 pounds of fertilizer. I will give each of you an ox to pull a plow, but you will have to make arrangements with Feyador the Plowmaker for a plow. The oxen, incidentally, are only three years old and have never been used for farming, so they should have a good 10 years of farming ahead of them. Take good care of them because an ox is worth 40 bushels of wheat. Come back next fall and return the oxen and the plows along with your harvest."

Ivan and Frederick genuflected and withdrew from the Great Hall, taking with them the things provided by the Baron.

The summer came and went, and after the harvest Ivan and Frederick returned to the Great Hall to account to their master for the things given them in the spring. Ivan said, "My Lord, I present you with a slightly used ox, a plow, broken beyond repair, and 223 bushels of wheat. I, unfortunately, owe Feyador the Plowmaker three bushels of wheat for the plow I got from him last spring. And, as you might expect, I used all the fertilizer and seed you gave me last spring. You will also remember, my Lord, that you took 20 bushels of my harvest for your own personal use."

Frederick spoke next. "Here, my Lord, is a partially used ox, the plow, for which I gave Feyador the Plowmaker 3 bushels of wheat from my harvest, and 105 bushels of wheat. I, too, used all my seed and fertilizer last spring. Also, my Lord, you took 30 bushels of wheat several days ago for your own table. I believe the plow is good for two more seasons."

"You did well," said the Baron. Blessed with this benediction, the two peasants departed.

After they had taken their leave, the Baron began to contemplate what had happened. "Yes," he thought, "they did well, but I wonder which one did better?"

Questions

1. For each farm, prepare balance sheets as of the beginning and end of the growing season and an income statement for the season. (Do not be concerned that you do not have much understanding of what a balance sheet and income statement are; just use your intuition as best you can.)
2. Which peasant was the better farmer?

Chapter 2

Basic Accounting Concepts: The Balance Sheet

This chapter describes 5 of the 11 basic concepts from which principles of accounting are derived. Also described, in a preliminary way, are the nature of the balance sheet and the principal categories of items that appear in it. Finally, the chapter shows how amounts that appear in the balance sheet are changed to reflect events that affect an organization's resources.

The material presented here should be regarded as an overview. Each of the topics introduced will be discussed in more depth in later chapters.

Basic Concepts

Accounting principles are built on a foundation of a few basic concepts. These concepts are so basic that most accountants do not consciously think of them; they are regarded as self-evident. Nonaccountants will not find these concepts to be self-evident, however. Accounting could be constructed on a foundation of quite different concepts; indeed, some accounting theorists argue that certain of the present concepts are wrong and should be changed. Nevertheless, in order to understand accounting as it now exists, one must understand the underlying concepts currently used.

The Financial Accounting Standards Board (FASB) has adopted a number of *Statements of Financial Accounting Concepts*. These statements are intended to provide the FASB with explicit conceptual criteria to help resolve future accounting issues, rather than trying to deal with each issue on an ad hoc basis. The concept statements themselves do not establish generally accepted accounting principles (GAAP). Other groups, including the International Accounting Standards Board, have published statements of basic accounting concepts. These publications are similar in many respects to the FASB's concept statements.

The concepts we shall use in this book, while not identical to those listed by other authors or groups, reflect concepts that are widely accepted and applied in practice by

accountants in the United States. These 11 concepts are as follows:

1. Money measurement
2. Entity
3. Going concern
4. Cost
5. Dual aspect
6. Accounting period
7. Conservatism
8. Realization
9. Matching
10. Consistency
11. Materiality

The first five are discussed below, and the other six are discussed in Chapter 3.

The Money Measurement Concept

In financial accounting, a record is made only of information that can be expressed in monetary terms. The advantage of such a record is that money provides a common denominator by means of which heterogeneous facts about an entity can be expressed as numbers that can be added and subtracted.

Example

Although it may be a fact that a business owns $30,000 of cash, 6,000 pounds of raw material, six trucks, 50,000 square feet of building space, and so on, these amounts cannot be added together to produce a meaningful total of what the business owns. Expressing these items in monetary terms—$30,000 of cash, $9,000 of raw material, $150,000 of trucks, and $4,000,000 of buildings—makes such an addition possible. Thus, despite the old cliché about not adding apples and oranges, it *is* easy to add them if both the apples and the oranges are expressed in terms of their respective monetary values.

Despite its advantage, the money measurement concept imposes a severe limitation on the scope of an accounting report. Accounting does not report the state of the president's health, that the sales manager is not on speaking terms with the production manager, that a strike is beginning, or that a competitor has placed a better product on the market. Accounting therefore does not give a complete account of the happenings in an organization or a full picture of its condition. It follows, then, that the reader of an accounting report should not expect to find therein all of the facts, or perhaps even the most important ones, about an organization.

Money is expressed in terms of its value at the time an event is recorded in the accounts. Subsequent changes in the purchasing power of money do not affect this amount. Thus, a machine purchased in 2010 for $200,000 and land purchased 20 years earlier for $200,000 are each listed in the 2010 accounting records at $200,000, although the purchasing power of the dollar in 2010 was much less than it was 20 years earlier. It is sometimes said that accounting assumes that money is an unvarying yardstick of value, but this statement is inaccurate. Accountants know full well that the purchasing power of the dollar changes. They do not, however, attempt to reflect such changes in the accounts.[1]

[1] In countries with high inflation rates, accountants initially record events in terms of their monetary value and then in subsequent periods adjust any remaining balances upward to reflect the changes in the purchasing power of the currency. For example, if the annual inflation rate is 100 percent, land bought for $10,000 at the beginning of the year would be reported at $20,000 one year later ($10,000 * 200 ÷ 100).

The Entity Concept

Accounts are kept for entities, as distinguished from the persons who are associated with these entities. An **entity** is any organization or activity for which accounting reports are prepared. Although our examples tend to be drawn from business companies, accounting entities include governments, churches, universities, and other nonbusiness organizations.

In recording events in accounting, the important question is, how do these events affect the entity? How they affect the persons who own, operate, or otherwise are associated with the entity is irrelevant. For example, suppose that the owner of a clothing store removes $100 from the store's cash register for his or her personal use. The real effect of this event on the owner as a person may be negligible; although the cash has been taken out of the business's "pocket" and put into the owner's pocket, in either pocket the cash belongs to the owner. Nevertheless, because of the entity concept, the accounting records show that the business has less cash than it had previously.

It is sometimes difficult to define with precision the entity for which a set of accounts is kept. Consider the case of a married couple who own and operate an unincorporated retail store. In *law* there is no distinction between the financial affairs of the store and those of its owners. A creditor of the store can sue and, if successful, collect from the owners' personal resources as well as from the resources of the business. In *accounting,* by contrast, a set of accounts is kept for the store as a separate business entity, and the events reflected in these accounts must be those of the store. The nonbusiness events that affect the couple must not be included in these accounts. In accounting, the *business* owns the resources of the store, even though the resources are legally owned by the couple, and debts owed by the business are kept separate from personal debts owed by the couple. The expenses of operating the store are kept separate from the couple's personal expenses for food, clothing, housing, and the like.

The necessity for making such a distinction between the entity and its owners can create problems. Suppose, for example, that the couple lives on the same premises as the business. How much of the rent, electric bill, and property taxes associated with these premises is properly an expense of the business, and how much is personal expense of the family? Answers to questions like these are often difficult to ascertain, and are indeed somewhat arbitrary.

For a *corporation* the distinction is often quite easily made. A corporation is a legal entity, separate from the persons who own it, and the accounts of many corporations correspond exactly to the scope of the legal entity. There may be complications, however. In the case of a group of legally separate corporations that are related to one another by shareholdings, the whole group may be treated as a single entity for financial reporting purposes, giving rise to what are called *consolidated* accounting statements. Conversely, within a single corporation, a separate set of accounts may be maintained for each of its principal operating units. For example, General Electric Company maintains separate accounts for each of its many business units (appliances, lighting, aircraft engines, capital services, and others).

One entity may be part of a larger entity. Thus, a set of accounts may be maintained for an individual elementary school, another set for the whole school district, and still another set for all the schools in a particular state. There even exists a set of accounts, called the *national income accounts,* for the entire economic activity of the United States. In general, detailed accounting records are maintained for entities at the lowest level in the hierarchy, and reports for higher levels are prepared by summarizing the detailed data of these low-level entities.

The Going-Concern Concept

Unless there is good evidence to the contrary, accounting assumes that an entity is a **going concern**—that it will continue to operate for an indefinitely long period in the future. The significance of this assumption can be indicated by contrasting it with a

possible alternative, namely, that the entity is about to be liquidated. Under the latter assumption, accounting would attempt to measure at all times what the entity's resources are currently worth to potential buyers. Under the going-concern concept, by contrast, there is no need to constantly measure an entity's worth to potential buyers, and it is not done. Instead, it is assumed that the resources currently available to the entity will be used in its future operations.

Example

At any given moment, a blue jeans manufacturer has jeans in various stages of the production process. If the business were liquidated today, these partially completed jeans would have little if any value. Accounting does not attempt to value these jeans at what they are currently worth. Instead, accounting assumes that the manufacturing process will be carried through to completion, and therefore that the amount for which the partially completed jeans could be sold if the company were liquidated today is irrelevant.

If, however, the accountant has good reason to believe that an entity *is* going to be liquidated, then its resources would be reported at their liquidation value. Such circumstances are uncommon.

The Cost Concept

The economic resources of an entity are called its **assets.** They consist of *nonmonetary* assets, such as land, buildings, and machinery, and other similar assets whose cash value is not fixed by contract, and *monetary assets,* such as money and marketable securities and other similar assets whose cash value is fixed by contract as will be described in Chapter 5. A fundamental concept of accounting, closely related to the going-concern concept, is that an asset is ordinarily entered initially in the accounting records at the price paid to acquire it—at its cost.[2] In the case of nonmonetary assets, the cost concept extends to their accounting subsequent to acquisition; cost continues to be the basis for all subsequent accounting for the asset. This is not true for most monetary assets. Subsequent to acquisition, they are accounted for at their fair value. *Fair value* is the amount at which an asset could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

While IFRS favors the cost concept for nonmonetary assets, it does permit as an acceptable alternative treatment the revaluation of land and buildings to their fair value subsequent to their initial recognition at cost.

Nonmonetary Assets

Since, for a variety of reasons, the real worth of an asset may change with the passage of time, the accounting measurement of nonmonetary assets does not necessarily—indeed, does not ordinarily—reflect what assets are worth, except at the moment they are acquired. There is therefore a considerable difference between the way in which nonmonetary assets are measured in accounting after their acquisition and the everyday, nonaccounting notion that assets are measured at what they are worth.

In accounting, all assets are initially recorded at their cost. (For emphasis, this is also referred to as an asset's *historical* cost.) In the case of nonmonetary assets, this amount is ordinarily unaffected by subsequent changes in the value of the asset. By contrast, in ordinary usage, the "value" of an asset usually means the amount for which it currently could be sold.

[2] APB *Opinion No. 20* requires that donated assets be recorded at their fair value at the date of receipt.

Example

If a business buys a plot of land (a nonmonetary asset), paying $250,000 for it, this asset would be recorded in the accounts of the business at the amount of $250,000. If a year later the land could be sold for $275,000, or if it could be sold for only $220,000, no change would ordinarily be made in the accounting records to reflect this fact.

Thus, the amounts at which nonmonetary assets are shown in an entity's accounts do *not* indicate the fair values of these assets. Probably the most common mistake made by uninformed persons reading accounting reports is that of believing there is a close correspondence between the amount at which a nonmonetary asset appears in these reports and the fair value of the asset. The amounts reported for land, building, equipment, and similar nonmonetary assets have no necessary relationship to what these items are currently worth. In general, it is safe to say that the longer a nonmonetary asset has been owned by an entity, the less likely it is that the amount at which the asset appears on the accounting records corresponds to its current fair value.

To emphasize the distinction between accounting's cost concept as it is applied to nonmonetary assets and the ordinary meaning of value, the term *book value* is used for historical cost amounts shown in accounting records.

Rationale for the Cost Concept

The cost concept as it is applied to nonmonetary assets provides an excellent illustration of the problem of applying the three basic criteria used to judge the acceptability of an accounting principle discussed in Chapter 1: relevance, objectivity, and feasibility. If the only criterion were relevance, then the application of the cost concept to the accounting for nonmonetary assets subsequent to their acquisition would not be defensible. Clearly, investors and other financial statement users are more interested in what the business and its individual assets are actually worth today than in what the assets cost originally.

The cost concept, by contrast, provides a relatively objective foundation for nonmonetary asset accounting. It is not purely objective, as we shall see, for judgments are necessary to apply it. It is much more objective, however, than the alternative of attempting to estimate fair values. A market value or current worth concept would be difficult and costly because it would require that the accountant attempt to keep track of the ups and downs through appraisals of the fair value of each nonmonetary asset during each accounting period. The cost concept leads to a much more feasible system of accounting for nonmonetary assets. As a result, readers of an accounting report must recognize that it is based in part on the cost concept, and they must arrive at their own estimate of current values partly by analyzing the information in the report and partly by using nonaccounting information.

The cost concept does not mean that all nonmonetary assets remain on the accounting records at their original purchase price for as long as the entity owns them. The cost of a nonmonetary asset that has a long but nevertheless limited life is systematically reduced over that life by the process called *amortization,* as discussed in Chapter 7. The purpose of the amortization process is to remove systematically the cost of the asset from the asset accounts and to show it as a cost of operations. Amortization has no necessary relationship to changes in market value or in the real worth of the asset.

In summary, adherence to the cost concept when accounting for nonmonetary assets indicates a willingness on the part of the accounting profession to sacrifice some degree of relevance in exchange for greater objectivity and greater feasibility.

Monetary Assets

Monetary assets are initially recorded at their cost and, in the case of most monetary assets, subsequently accounted for at their fair value. This practice raises an important

accounting issue: How should the unrealized changes in a monetary asset's fair value be treated for accounting purposes? As will be explained in later chapters, if a monetary asset's carrying amount is changed at the end of each accounting period to reflect its current fair value, the offsetting adjustment is accounted for in several different ways, depending on the nature of the monetary asset.

Rationale for Fair Value

The use of fair value to account for most monetary assets subsequent to their acquisition satisfies the three basic criteria of relevance, objectivity, and feasibility used to judge the acceptability of an accounting principle. Clearly a monetary asset's fair value is relevant to readers of accounting reports, and the fair value of many monetary assets can readily be determined objectively and at a low cost.

Example

A company has invested surplus cash in 100,000 shares of the common stock of General Electric. On June 12, 2010, the management wants to determine the fair value of its investment. To achieve this objective, the management need only wait until the close of the New York Stock Exchange and then refer to one of several different stock price reporting services. Each of these would show that General Electric's common stock closed at $30 per share. Then by simple multiplication, the fair value of the investment could be determined to be $3.0 million.

But who knows what a business is worth today? Any estimate of current value is just that—an estimate—and informed people will disagree on what the estimate should be. For example, on the same day, some people believe that the shares of stock of a given company are overpriced and they should therefore sell the stock; others believe that the shares are underpriced and they buy. Furthermore, accounting reports are prepared by an organization's management. If these reports contained estimates of what the entity is actually worth (including its "goodwill"), these would be management's estimates. It is quite possible that such estimates would be biased.

Goodwill

It follows from the cost concept that if an entity pays *nothing* for an item it acquires (other than as a donation), this item will usually not appear on the accounting records as an asset. Thus, factors that contribute to the value of a company—such as the knowledge and skills that are built up as a business operates, the teamwork that exists within the organization, the importance of a favorable location, the good reputation a company has with its customers, and the trade names developed by the company—do not appear as assets in the accounts of the company.

On some accounting reports, the term *goodwill* appears. Reasoning from the everyday definition of the word, one might conclude that it represents the accountant's appraisal of what the company's intellectual capital, market power, name, and reputation are worth. This is not so. Goodwill appears in the accounts of a company only when the company has purchased another company—as discussed in Chapter 12, when one company buys another company and pays more than the fair value of its net assets (the sum of the fair value of individual assets less the sum of the fair value of individual liabilities). The amount by which the purchase price exceeds the fair value of the acquired company's net assets is called *goodwill,* representing the value of the name, reputation, clientele, or similar intangible resources of the purchased company. Unless a business has actually purchased such intangibles through a business acquisition, however, no item for goodwill is shown in its accounts. If the item does appear, the amount shown initially is the purchase price, even though the management may believe that the real value is considerably higher.

Example

When Philip Morris Incorporated paid $5.8 billion to acquire the General Foods Corporation, $2.8 billion of the purchase price was allocated to the purchased "goodwill," which included the value of the General Foods organization and its various brand names (e.g., Jell-O, Good Seasons, Kool-Aid, Maxwell House). This $2.8 billion was recorded in the Philip Morris accounts as goodwill. It had never been recognized as an asset by General Foods.

The Dual-Aspect Concept

The economic resources of an entity are called *assets.* The claims of various parties against these assets are called **equities.** There are two types of equities: (1) **liabilities,** which are the claims of creditors (that is, everyone other than the owners of the business), and (2) **owners' equity,** which is the claims of the owners of the business. (Owners' equity for an incorporated business is commonly called **shareholders' equity.**) Since all of the assets of a business are claimed by someone (either by its owners or by its creditors) and since the total of these claims cannot exceed the amount of assets to be claimed, it follows that

$$\text{Assets} = \text{Equities}$$

This is the **fundamental accounting equation** expressed in its general form. It is the formal expression of the dual-aspect concept. As we shall see, all accounting procedures are derived from this equation. To reflect the two types of equities, the expanded version of the equation is

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

Events that affect the numbers in an entity's accounting records are called **transactions.** Although it is certainly not self-evident to a beginning accounting student, every transaction has a *dual impact* on the accounting records. Accounting systems are set up to record both of these aspects of a transaction; this is why accounting is called a **double-entry system.**

To illustrate the dual-aspect concept, suppose that Ms. Jones starts a business and that her first act is to open a bank account in which she deposits $40,000 of her own money. The dual aspect of this transaction is that the business now has an asset, cash, of $40,000, and Ms. Jones, the owner,[3] has a claim, also of $40,000, against this asset. In other words,

$$\text{Assets (cash), } \$40{,}000 = \text{Equities (owner's), } \$40{,}000$$

If, as its next transaction, the business borrowed $15,000 from a bank, the business accounting records would change in two ways: (1) They would show a $15,000 increase in cash, making the amount $55,000, and (2) they would show a new claim against the assets, the bank's claim, in the amount of $15,000. At this point, the accounting records of the business would show the following:

Cash	$55,000	Owed to bank	$15,000
		Owner's equity	40,000
Total assets	$55,000	Total equities	$55,000

[3] Recall from the entity concept that the accounts of the business are kept separate from those of Ms. Jones as an individual.

To repeat, every transaction recorded in the accounts affects at least two items. There is no conceivable way that a transaction can result in only a single change in the accounts.

The Balance Sheet

The financial position of an accounting entity as of a specified moment in time is shown by a **balance sheet.** Its more formal name is a **statement of financial position.** More specifically, the balance sheet reports the assets and equities (liabilities and owners' equity) of the entity at a specified moment in time.[4] Because the balance sheet is a snapshot as of an instant in time, it is a status report (rather than a flow report).

A simplified balance sheet for a corporation is shown in Illustration 2–1. Before considering its details, first examine this balance sheet in terms of the basic concepts already described. Note that the amounts are *expressed in money* and reflect only those

ILLUSTRATION 2–1

GARSDEN CORPORATION ← Name of entity
Balance Sheet ← Name of statement
As of December 31, 2010 ← Moment of time

Assets			Liabilities and Shareholders' Equity		
Current assets:			*Current liabilities:*		
Cash	$ 3,448,891		Accounts payable	$ 6,301,442	
Marketable securities	246,221		Taxes payable	1,672,000	
Accounts receivable	5,954,588		Accrued expenses	640,407	
Inventories	12,623,412		Deferred revenues	205,240	
Prepaid expenses	377,960		Current portion of long-term debt	300,000	
Total current assets		$22,651,072	Total current liabilities		$ 9,119,089
Property, plant, and equipment:			*Long-term debt*		3,000,000
Land		642,367	Total liabilities		$12,119,089
Buildings and equipment, at cost	$26,303,481				
Less: Accumulated depreciation	13,534,069	12,769,412	*Shareholders' equity:*		
Net property, plant, and equipment		$13,411,779	Paid-in capital	$5,000,000	
			Retained earnings	19,116,976	
			Total shareholders' equity		$24,116,976
Other assets:					
Investments	$110,000				
Intangible assets	63,214	173,214			
Total assets		$36,236,065	Total liabilities and shareholders' equity		$36,236,065

[4] A balance sheet dated December 31 is implicitly understood to mean "at the close of business on December 31."

matters that can be measured in monetary terms. The *entity* involved is the Garsden Corporation, and the balance sheet pertains to that entity rather than to any of the individuals associated with it. The statement assumes that Garsden Corporation is a *going concern.* The nonmonetary asset amounts stated are governed by the *cost concept.* Many of the monetary assets are recorded at their fair value. The *dual-aspect concept* is evident from the fact that the assets listed on the left-hand side of this balance sheet are equal in total to the liabilities and shareholders' equity listed on the right-hand side.

Because of the dual-aspect concept, the two sides of the balance sheet necessarily add up to the same total. This equality does not tell anything about the company's financial health. The label *balance sheet* can give the impression that there is something significant about the fact that the two sides balance. This is not so; the two sides always balance.

In the Garsden Corporation balance sheet, assets are listed on the left and equities on the right.[5] (Normally, the dollar amounts would be rounded to the nearest thousand dollars. We have not done this to emphasize the fact that assets equal equities precisely.)

An Overall View

The balance sheet is the fundamental accounting statement in the sense that *every* accounting transaction can be analyzed in terms of its dual impact on the balance sheet. To understand the information a balance sheet conveys and how economic events affect the balance sheet, the reader must be absolutely clear as to the meaning of its two sides. They can be interpreted in either of two ways, both of which are correct.

Resources and Claims View

One interpretation, the resources and claims view, has already been described. The items listed on the asset side are the economic resources of the entity as of the date of the balance sheet. The amounts stated for each asset are recorded in accordance with the basic concepts described above. Liabilities and owners' equity are claims against the entity as of the balance sheet date. Liabilities are the claims of outside parties—amounts that the entity owes to banks, vendors, employees, and other creditors. Owners' equity shows the claims of the owners.

However, an entity's owners do not have a claim in the same sense that the creditors do. In the Garsden Corporation illustration, it can be said with assurance that governmental taxing authorities had a claim of $1,672,000 as of December 31, 2010—that the corporation owed them $1,672,000, neither more nor less. It is more difficult to interpret as a claim the amount shown as shareholders' equity, $24,116,976. *If* the corporation were liquidated as of December 31, 2010, *if* the assets were sold for their book value, and *if* the creditors were paid the $12,119,089 owed them, then the shareholders would get what was left, which would be $24,116,976. However, these "if" conditions are obviously unrealistic. According to the going-concern concept, the corporation is not going to be liquidated; and according to the cost concept, the nonmonetary assets are not shown at their liquidation values.

The shareholders' equity (or owners' equity) might be worth considerably more or less than $24,116,976. The shareholders' equity of a healthy, growing company is usually worth considerably more than its "book value"—the amount shown on the balance sheet. On the other hand, if a company is not salable as a going concern and is liquidated with the assets being sold piecemeal, the owners' proceeds are often only a small fraction of the amount stated for shareholders' equity on the balance sheet. Often when

[5] Outside the United States, other balance sheet formats are often used. A common format is to list assets at the top of the page and to list equities beneath them. This format is called the *report form.* The balance sheet format used by the Garsden Corporation is called the *account form.*

a bankrupt company's assets are liquidated, the proceeds are inadequate to satisfy 100 percent of the creditors' claims, in which case the owners receive nothing.

The resources and claims view of the balance sheet has some shortcomings. We have already pointed out the difficulty of interpreting shareholders' equity as a claim. Also, the notion of "claiming" assets is rather legalistic, and has the most meaning if a company is being liquidated in bankruptcy—which is inconsistent with the going-concern concept. Therefore, the second way of interpreting the balance sheet has considerable merit. It is described in the next section.

Sources and Uses of Funds View

In this alternative view, the left-hand side of the balance sheet is said to show the forms in which the entity has used, or *invested,* the funds provided to it as of the balance sheet date. These investments have been made in order to help the entity achieve its objectives, which in a business organization include earning a satisfactory profit. The right-hand side shows the *sources of the funds* that are invested in the assets—it shows how the assets were *financed.* The several liability items describe how much of that financing was obtained from trade creditors (accounts payable), from lenders (long-term debt), and from other creditors. The owners' equity section shows the financing supplied by the owners. (The two ways in which the owners of a business corporation provide it with funds—paid-in capital and retained earnings—will be explained later in the chapter.)

Thus, with the sources and uses of funds view, the fundamental accounting equation, Assets = Liabilities + Owners' equity, has this interpretation: Every dollar invested in the entity's assets was supplied either by the entity's creditors or by its owners; and every dollar thus supplied is invested in some asset.

Both ways of interpreting the balance sheet are correct. In certain circumstances, the resources and claims view is easier to understand. In analyzing the balance sheet of a going concern, however, the sources and uses of funds view usually provides a more meaningful interpretation.

Account Categories

Although each individual asset or equity—each building, piece of equipment, bank loan, and so on—could conceivably be listed separately on the balance sheet, it is more practicable and more informative to summarize and group related items into classifications or **account categories.** There is no fixed pattern as to the number of such categories or the amount of detail reported. Rather, the format is governed by management's opinion about the most useful way of presenting significant information on the status of the entity.

As in any classification scheme, the categories are defined so that (1) the individual items included in a category resemble one another in significant respects and (2) the items in one category are essentially different from those in all other categories. Although the items included in a category are similar to one another, they are not identical.

Example

The category labeled *cash* usually includes money on deposit in interest-paying accounts as well as money on deposit in checking accounts. These two types of money are *similar* in that they are both in highly liquid form, but they are not *identical* because certain restrictions may apply to withdrawals from interest-paying accounts that do not apply to checking accounts.

The balance sheet in Illustration 2–1 gives a minimum amount of detail. The terms used on this balance sheet are common ones, and they are described briefly below. More detailed descriptions are given in Chapters 5 through 9.

Note that the amounts in Illustration 2–1 are rounded to the nearest dollar. Cents are rarely shown; and in a large company, the amounts are usually rounded to thousands or

even millions of dollars. Although rounding is done in preparing financial statements, the underlying detailed records are maintained to the cent.

Assets

We shall now supersede the short definition of *assets* given in the preceding section by the following more exact statement: **Assets** are economic resources that are controlled by an entity and whose cost (or fair value) at the time of acquisition could be objectively measured. The four key points in this definition are (1) an asset must be acquired in a transaction, (2) an asset must be an *economic resource,* (3) the resource must be *controlled* by the entity, and (4) its cost (or fair value) at the time of acquisition must be *objectively measurable.*

A resource is an *economic* resource if it provides *future benefits* to the entity. Resources provide future benefits under any of three conditions: (1) They are cash or can be converted to cash, (2) they are goods that are expected to be sold and cash received for them, or (3) they are items expected to be used in future activities that will generate cash inflows to the entity. Thus, economic resources are either cash or items that will eventually result in cash inflows.

Example

Garsden Corporation is a manufacturing company. The cash that it has on deposit in banks is an asset because it is money that can be used to acquire other resources. Amounts owed by customers are assets that when collected will generate cash. The goods Garsden has manufactured and still has on hand are assets because they are expected to be sold. The equipment and other manufacturing facilities it owns are assets because it is expected that they will be used to produce additional goods. However, merchandise that cannot be sold because it is damaged or obsolete is not an asset, even though it is owned by the business, because it will not generate cash.

Control is an accounting concept similar to, but not quite the same as, the legal concept of ownership. When a business buys an automobile on an installment loan (e.g., it pays $575 a month for 36 months), the business may not own the car in the legal sense because title to the car does not pass to the buyer until the last installment has been paid. Nevertheless, if the business has the full use of the car, the automobile is regarded as being fully controlled by the business and is an asset. Possession or temporary control is not enough to qualify the item as an asset, however.

Example

Office space leased on an annual basis is not an asset, nor is an automobile or other piece of equipment that is leased for a relatively short time. In both cases, the entity's control over the use of the item is only temporary. On the other hand, if a business leases a building or an item of equipment for a period of time that equals or almost equals its useful life, such an item is an asset even though the entity does not own it.

The *objective measurability* test is usually clear-cut, but in some instances it is difficult to apply. If the resource was purchased for cash or for the promise to pay cash, it is an asset. If the resource was manufactured or constructed by the business, then money was paid for the costs of manufacture or construction, and it is an asset. If the resource was acquired by trading in some other asset or by issuing shares of the company's stock, it is an asset. If the resource was donated and it has future benefit, then the resource is an asset. On the other hand, as already pointed out, a valuable reputation is not an asset if it arose gradually over a period of time rather than being acquired in a transaction at an objectively measurable cost.

On most business balance sheets, assets are listed in decreasing order of their liquidity, that is, in order of the promptness with which they are expected to be converted into cash.[6]

Assets are customarily grouped into categories. Current assets are almost always reported in a separate category. All noncurrent assets may be reported together or in various groupings such as "property, plant, and equipment" and "other assets," as shown on the Garsden Corporation balance sheet.

Current Assets

Cash and other assets that are expected to be realized in cash or sold or consumed during the normal operating cycle of the entity or within one year, whichever is longer, are called **current assets.** Although the usual time limit is one year, exceptions occur in companies whose normal operating cycle is longer than one year. Tobacco companies and distilleries, for example, include their inventories as current assets even though tobacco and liquor remain in inventory for an aging process that lasts two years or more.

Cash consists of funds that are readily available for disbursement. Most of these funds are on deposit in interest-paying accounts and checking accounts in banks, and the remainder are in cash registers or petty cash boxes on the entity's premises.

Marketable securities are investments that are both readily marketable and expected to be converted into cash within a year. These investments are made in order to earn some return on cash that otherwise would be temporarily idle.

Accounts receivable are amounts owed to the entity by its customers. Accounts receivable are reported on the balance sheet as the amount owed less an allowance for that portion that probably will not be collected. (Methods of estimating this "allowance for doubtful accounts" are described in Chapter 5.) Amounts owed the entity by parties other than customers would appear under the heading **notes receivable** or **other receivables** rather than as accounts receivable. If the amounts owed to the company are evidenced by written promises to pay, they are listed as notes receivable.

Inventories are the aggregate of those items that are either (1) held for sale in the ordinary course of business, (2) in process of production for such sale, or (3) soon to be consumed in the production of goods or services that will be available for sale. Note that inventory relates to goods that will be sold in the ordinary course of business. A truck offered for sale by a truck dealer is inventory. A truck used by the dealer to make service calls is not inventory; it is an item of equipment, which is a noncurrent asset.

Prepaid expenses represent certain assets, usually of an intangible nature, whose usefulness will expire in the near future. An example is an insurance policy. A business pays for insurance protection in advance. Its right to this protection is an asset—an economic resource that will provide future benefits. Since this right will expire within a fairly short period of time, it is a current asset. The amount on the balance sheet is the amount of the unexpired cost of the future benefit.

Example

If on January 1, 2010, Garsden Corporation paid $250,000 for insurance protection for two years, the amount of prepaid insurance expense on the December 31, 2010, balance sheet would be $125,000, which is the cost of the one year of protection then remaining.

Property, Plant, and Equipment

This category consists of assets that are tangible and relatively long-lived. The term **fixed assets** is also used for this category. The entity has acquired these assets in order to use them to produce goods and services that will generate future cash inflows. If such assets are instead held for resale, they are classified as inventory, even though in a sense they are long-lived assets. (They will be long-lived to their purchaser, but they are not expected to be held long term by their seller.)

[6] Outside the United States, on some balance sheets, the order is reversed and the least liquid assets are listed first.

In the balance sheet shown in Illustration 2–1, the first item of property, plant, and equipment is land, which is reported at its cost, $642,367. Land is shown separately because it is not depreciated, as are buildings and equipment. The first amount shown for buildings and equipment, $26,303,481, is the *original cost* of all the items of tangible long-lived property other than land—the amounts paid to acquire these items. The next item, accumulated depreciation, means that a portion of the original cost of the buildings and equipment, amounting to $13,534,069, has been written off, allocated as a cost of doing business. Depreciation will be discussed in detail in Chapter 7.

Other Assets

Another type of noncurrent asset is **investments.** These are securities of one company owned by another either in order to control the other company or in anticipation of earning a long-term return from the investment. They are therefore to be distinguished from marketable securities, which are a current asset reflecting the short-term use of excess cash.

Intangible assets include goodwill (briefly described earlier), patents, copyrights, trademarks, franchises, and similar valuable but nonphysical things controlled by the business. They are distinguished from prepaid expenses (intangible *current* assets) in that they have a longer life span than prepaid expenses.

Liabilities

In general, **liabilities** are obligations to transfer assets or provide services to outside parties arising from events that have already happened. (A few complicated items that may appear in the liabilities section of the balance sheet do not fit this definition; they will be discussed in later chapters.) Liability obligations exist as a result of *past* transactions or events. Thus, on December 31, wages not yet paid to an employee who worked from December 27 to December 31 are a liability; but that person's wages to be earned next week (the first week in January) are not a liability as of December 31.[7]

Liabilities are claims against the entity's assets. Unless otherwise noted, an individual liability is not a claim against any *specific* asset or group of assets. Thus, although accounts payable typically arise from the purchase of items for inventory, accounts payable are claims against the assets in general and not specifically against inventories. If a liability *is* a claim against a specific asset, its title indicates that fact, as in a *mortgage* loan or *secured* long-term debt.

With minor exceptions, a liability is reported at the amount that would be required to satisfy the obligation as of the balance sheet date.[8] For a loan, this includes the principal that is owed as well as any interest earned by the lender but unpaid as of the balance sheet date. (Often this interest payable or "accrued" interest is shown separately from the principal owed.) Thus, if the December 31 balance sheet showed $100,000 for a loan payable and $1,000 interest payable on that loan, a $101,000 payment to the lender would be required to satisfy the loan liability obligation as of December 31. Note that the total amount needed to satisfy the obligation is reported, not just the portion of that total that is due and payable as of the balance sheet date. The $100,000 loan is a liability even though there may be no principal payment due for another five years.

Current Liabilities

Liabilities that are expected to be satisfied or extinguished during the normal operating cycle or within one year, whichever is longer, are called **current liabilities.**

[7] Although, in a sense, employees are not outside parties, in accounting they are considered such to the extent that they are not owners of the entity. Only owners of the entity are inside parties.

[8] We shall describe an alternative interpretation of the amount of a liability in Chapter 8.

Accounts payable represent the claims of suppliers arising from their furnishing goods or services to the entity for which they have not yet been paid. (Such suppliers often are called **vendors.**) Usually these claims are unsecured. Amounts owed to financial institutions (which are suppliers of funds rather than of goods or services) are called **notes payable** or **short-term loans** (or some other name that describes the nature of the debt instrument) rather than accounts payable.

Taxes payable shows the amount that the entity owes government agencies for taxes. It is shown separately from other obligations both because of its size and because the amount owed may not be precisely known as of the date of the balance sheet. Often the liability for federal and state income taxes is shown separately from other tax liabilities, such as property taxes.

Accrued expenses represent amounts that have been earned by outside parties but have not yet been paid by the entity. Usually there is no invoice or similar document submitted by the party to whom the money is owed. Interest earned by a lender but not yet paid by the entity is an accrued expense. Another example is the wages and salaries owed to employees for work they have performed but for which they have not yet been paid. The term *accrued expenses,* although frequently used as a balance sheet category, is not as descriptive as the names used in the detailed records for specific accrued expenses, such as **interest payable** and **wages payable.**

Deferred revenues (also called **unearned revenues**) represent the liability that arises because the entity has received advance payment for a service it has agreed to render in the future. An example is unearned subscription revenues, which represent magazine subscription payments received in advance, for which the publishing company agrees to deliver issues of its magazine during some future period.

Current portion of long-term debt represents that part of a long-term loan that is due within the next 12 months. It is reported separately from the noncurrent portion so that current liabilities will give a complete picture of the entity's short-term obligations.

Other Liabilities

Those obligations that do not meet the criteria for being classified as current liabilities are simply called **other liabilities.** They are also sometimes called **noncurrent liabilities** or **long-term debt.**

Example

Garsden Corporation has a $3,300,000 loan outstanding. Of this amount, $300,000 is due within the next year and is therefore a current liability. The remaining $3 million is due in some future period (or periods) beyond the next year (i.e., after December 31, 2010) and is thus shown as long-term debt.

Owners' Equity

The **owners' equity** section of the balance sheet shows the amount the owners have invested in the entity. The terminology used in this section varies with different forms of organization. In a corporation, the ownership interest is evidenced by shares of stock, and the owners' equity section of its balance sheet is therefore usually labeled **shareholders' equity** or **stockholders' equity.**

Paid-In Capital

The shareholders' equity of the Garsden Corporation's balance sheet is divided into two main categories.[9] The first category, called **paid-in capital** or **contributed capital,** is the amount the owners have invested directly in the business by purchasing shares of stock as these shares were issued by the corporation. Paid-in capital in most

[9] A third section, called *other comprehensive income,* may be included in the owners' equity section of some balance sheets. It is discussed in Chapter 10.

corporations is further subdivided into **capital stock** and **additional paid-in capital.** Each share of stock has a stated or "par" value; capital stock shows this value per share times the number of shares outstanding.[10] If investors actually paid more to the corporation than the stated value (as is almost always the case) for their shares, the excess is shown separately as additional paid-in capital.

Example

Garsden Corporation has outstanding 1 million shares of common stock with a par value of $1 per share. Investors actually paid into the corporation $5 million for these shares. The balance sheet in Illustration 2–1 could be modified to show:

Paid-in capital:		
Common stock at par	$1,000,000	
Additional paid-in capital	4,000,000	
Total paid-in capital		$5,000,000

Retained Earnings

The second category of shareholders' equity is labeled *retained earnings.* The owners' equity increases through *earnings* (i.e., the results of profitable operations) and decreases when earnings are paid out in the form of dividends. **Retained earnings** is the difference between the *total* earnings of the entity *from its inception* to date and the *total* amount of dividends paid out to its shareholders *over its entire life.* That is, the difference represents that part of the total earnings that have been retained for use in—*reinvested* in—the business.[11] If the difference is negative, the item usually is labeled **deficit** rather than retained earnings.

Note that the amount of retained earnings on a given date is the *cumulative* amount that has been retained in the business from the beginning of the corporation's existence up to that date. The amount shown for Garsden Corporation means that *since the company began operations,* the total amount of its earnings reinvested in the business after paying out dividends is $19,116,976.

Note also that the amount of retained earnings does not indicate the *form* in which the retained earnings have been reinvested. They may be invested in *any* of the resources that appear on the assets side of the balance sheet. (This is true of all liabilities and items of owners' equity, not just retained earnings.) There is a common misconception that there is some connection between the amount of a company's retained earnings and the amount of cash it holds. There is no such connection. This should be apparent from the fact that the Garsden Corporation balance sheet shows over $19 million of retained earnings but only $3.4 million of cash.

Net worth is a synonym for the term *owners' equity* that is frequently used in articles and conversation. *Net worth* can be a misleading term because it implies that the amount indicates what the owners' interest is "worth," which, as has been emphasized, is erroneous. For this reason, the use of the term *net worth* in financial statements is frowned upon.

[10] Par value is a dollar amount printed on the face of common stock certificates. It seldom has any significance today. A stockholder who paid less to the issuing company than the par value of the common stock received could be held liable in bankruptcy for the difference between the stock's par value and the amount paid for it. To guard against this possibility, the par value is set at a nominal amount and the selling price is higher than the par value.

[11] Shareholders' equity also can be affected by events other than the issuance of common stock and the accumulation of earnings and the distribution of these earnings as dividends. Some of these events will be discussed in later chapters.

Owners' equity is also sometimes called **net assets,** since the amount shown for owners' equity is always equal to assets net of (i.e., minus) liabilities. Similarly, the Financial Accounting Standards Board defines owners' equity simply as "the residual interest in the assets of an entity that remains after deducting its liabilities."[12] The use of the word *residual* reflects the fact that in law, owners' claims rank below creditors' claims. For the same reason, common stock is sometimes referred to as a "residual security."

Unincorporated Businesses

In unincorporated businesses, different terminology is used in the owners' equity section. In a **proprietorship**—a business owned by one person—the owner's equity is customarily shown as a single number with a title such as "Lee Jones, capital," rather than making a distinction between the owner's initial investment and the accumulated earnings retained in the business.

In a **partnership,** which is an unincorporated business owned jointly by several persons, there is a capital account for each partner. For example:

Jane Davis, capital	$75,432	
Wayne Smith, capital	75,432	
Total partners' capital		$150,864

A proprietorship or partnership balance sheet also may show a reconciliation of the beginning and ending balance in each owner's capital account. An owner's capital is increased by her or his share of the entity's earnings during the period and is decreased by the owner's **drawings.** (Drawings in an unincorporated firm are analogous to a corporation's dividends.) For example, a proprietorship's 2010 year-end balance sheet might show the following:

Lee Jones, capital, as of January 1, 2010	$180,000
Add: 2010 earnings	45,000
Deduct: 2010 drawings	(40,000)
Lee Jones, capital, as of December 31, 2010	$185,000

The reader may have heard the terms *partnership accounting* and *corporation accounting* and thus may have formed the impression that different accounting systems are used for different forms of business organizations. This is not so. The treatment of assets and liabilities is generally the same in all forms of business organizations: Differences occur principally in the owners' equity (capital) section, as noted above.[13]

Having explained the two principal components of owners' equity in a corporation, we can now expand the fundamental accounting equation to read

$$\text{Assets} = \text{Liabilities} + \text{Paid-in capital} + \text{Retained earnings}$$

[12] FASB, *Statement of Financial Accounting Concepts No. 6.*

[13] Nonbusiness organizations do treat certain items differently than businesses, but these differences are beyond the scope of this book.

Ratios

In using financial statement information, it often is helpful to express certain important relationships as ratios or percentages. Some of these ratios will be introduced at appropriate places throughout the book and they will be summarized in Chapter 13. A **ratio** is simply one number expressed in terms of another. It is found by dividing one number, the base, into the other. Since Garsden Corporation (Illustration 2–1) had current assets of $22,651,072 and current liabilities of $9,119,089, the ratio of its current assets to its current liabilities is $22,651,072 ÷ $9,119,089, or 2.5 to 1.

Current Ratio

The ratio of current assets to current liabilities is called the **current ratio.** It is an important indication of an entity's ability to meet its current obligations because if current assets do not exceed current liabilities by a comfortable margin, the entity may be unable to pay its current bills. This is because most current assets are expected to be converted into cash within a year or less, whereas most current liabilities are obligations expected to use cash within a year or less. As a rough rule of thumb, a current ratio of at least 2 to 1 is believed to be desirable in a typical manufacturing company. Garsden's current ratio of 2.5 to 1 is therefore satisfactory. (The "to 1" part of the ratio is usually not explicitly stated; Garsden's current ratio is simply 2.5.)

Balance Sheet Changes

At the moment an entity begins, its financial status can be recorded on a balance sheet. From that time on, events occur that change the numbers on this first balance sheet, and the accountant records these transactions in accordance with the concepts given earlier in this chapter. Accounting systems accumulate and summarize these changes as a basis for preparing new balance sheets at prescribed intervals, such as the end of a quarter or a year. Each balance sheet shows the financial condition of the entity as of the date it was prepared, after giving effect to all of these changes.

Although in practice a balance sheet is prepared only at prescribed intervals, in learning the accounting process it is useful to consider the changes one by one. This makes it possible to study the effect of individual events without getting entangled with the mechanisms used to record these transactions. The following examples show the effects of a few transactions on the balance sheet. For simplicity, they are assumed to occur on successive days.

Original Capital Contribution

Jan. 1 John Smith starts an incorporated CD and tape store called Music Mart, Inc. He does this by depositing $25,000 of his own funds in a bank account that he has opened in the name of the business entity and taking $25,000 of stock certificates in return. He is the sole owner of the corporation. The balance sheet of Music Mart, Inc., will then be as follows:

MUSIC MART
Balance Sheet
As of January 1

Assets		Liabilities and Owner's Equity	
Cash	$25,000	Paid-in capital	$25,000

Bank Loan

Jan. 2 Music Mart borrows $12,500 from a bank; the loan is evidenced by a legal document called a *note.* This transaction increases the asset, cash, and the business incurs a liability to the bank called *notes payable.* The balance sheet after this transaction will appear thus:

MUSIC MART
Balance Sheet
As of January 2

Assets		Liabilities and Owner's Equity	
Cash	$37,500	Notes payable	$12,500
		Paid-in capital	25,000
Total	$37,500	Total	$37,500

Purchase of Merchandise

Jan. 3 The business buys inventory (merchandise it intends to sell) in the amount of $5,000, paying cash. This transaction decreases cash and increases another asset, inventory. The balance sheet will now be as follows:

MUSIC MART
Balance Sheet
As of January 3

Assets		Liabilities and Owner's Equity	
Cash	$32,500	Notes payable	$12,500
Inventory	5,000	Paid-in capital	25,000
Total	$37,500	Total	$37,500

Sale of Merchandise

Jan. 4 For $750 cash, the store sells merchandise that costs $500. The effect of this transaction is to decrease inventory by $500, increase cash by $750, and increase owner's equity by the difference, or $250. The $250 is the profit on this sale. To distinguish it from the paid-in capital portion of owner's equity, it is recorded as retained earnings. The balance sheet will then look like this:

MUSIC MART
Balance Sheet
As of January 4

Assets		Liabilities and Owner's Equity	
Cash	$33,250	Notes payable	$12,500
Inventory	4,500	Paid-in capital	25,000
		Retained earnings	250
Total	$37,750	Total	$37,750

Concluding Comment

At this point, readers should not be alarmed if they do not yet fully understand some of the topics in this chapter. In subsequent chapters, we shall expand considerably on the concepts, categories, and terms introduced here. We shall describe modifications and qualifications to some of the basic concepts, and we shall introduce many additional terms that are used on balance sheets. We shall not, however, discard the basic structure that was introduced in this chapter; it was based on the equation Assets = Liabilities + Owners' equity. Furthermore, it is important to remember that *every* accounting transaction can be recorded in terms of its effect on the balance sheet. The reader should be able to relate all the new material to this basic structure.

Summary

The basic concepts discussed in this chapter may be briefly summarized as follows:

1. *Money measurement.* Accounting records only those facts that can be expressed in monetary terms.
2. *Entity.* Accounts are kept for entities as distinguished from the persons associated with those entities.
3. *Going concern.* Accounting assumes that an entity will continue to exist indefinitely and that it is not about to be liquidated.
4. *Cost.* Nonmonetary and monetary assets are ordinarily entered in the accounts at the amount paid to acquire them. This cost, rather than current fair value, is the basis for subsequent accounting for nonmonetary assets. Most monetary assets are accounted for at fair value following their acquisition.
5. *Dual aspect.* Every transaction affects at least two items and preserves the fundamental equation: Assets = Liabilities + Owners' equity.

The balance sheet shows the financial condition of an entity as of a specified moment in time. It consists of two sides. The assets side shows the economic resources controlled by the entity that are expected to provide future benefits to it and that were acquired at objectively measurable amounts. The equities side shows the liabilities, which are obligations of the entity, and the owners' equity, which is the amount invested by the owners. In a corporation, owners' equity is subdivided into paid-in capital and retained earnings.

Problems

Problem 2–1.

a. If assets equal $95,000 and liabilities equal $40,000, then owners' equity equals _____.
b. If assets equal $65,000 and owners' equity equals $40,000, then liabilities equal _____.
c. If current assets equal $25,000, liabilities equal $40,000, and owners' equity equals $55,000, the noncurrent assets equal _____.
d. If the current ratio is 2.2:1, current assets are $33,000, and noncurrent assets equal $55,000, then owners' equity is _____. (Assume that all liabilities are current.)
e. What is the current ratio if noncurrent assets equal $60,000, total assets equal $95,000, and owners' equity equals $70,000? (Assume that all liabilities are current.)

Problem 2–2.

Prepare a balance sheet as of June 30, for the J. L. Gregory Company, using the following data:

Accounts payable	$ 241,000	Cash	$ 89,000
Accounts receivable	505,000	Equipment (at cost)	761,000
Accrued expenses	107,000	Estimated tax liability	125,000
Accumulated depreciation on buildings	538,000	Inventories	513,000
		Investment in the Peerless Company	320,000
Accumulated depreciation on equipment	386,000	Land (at cost)	230,000
Bonds payable	700,000	Marketable securities	379,000
Buildings (at cost)	1,120,000	Notes payable	200,000
Capital stock	1,000,000	Retained earnings	?

Problem 2–3.

Indicate the net effect on assets, liabilities, and owners' equity resulting from each of the following transactions:

1. Capital stock was issued for $100,000 cash.
2. Bonds payable of $25,000 were refunded with capital stock.
3. Depreciation on plant and equipment equaled $8,500 for the year.
4. Inventory was purchased for $15,900 cash.
5. $9,400 worth of inventory was purchased on credit.
6. Inventory costing $4,500 was sold for $7,200 on credit.
7. $3,500 in cash was received for merchandise sold on credit.
8. Dividends of $3,000 were declared.
9. The declared dividends of $3,000 were paid.
10. The company declared a stock split, and replaced each outstanding share with two new shares.

Problem 2–4.

D. Carson and F. Leggatt formed a partnership on June 1 to operate a shoe store. Carson contributed $50,000 cash and Leggatt contributed $50,000 worth of shoe inventory. During the month of June, the following transactions took place:

1. Additional shoe inventory was purchased at a cost of $24,000 cash.
2. Total cash sales for the month were $31,000. The inventory that was sold had a cost of $15,500.
3. Carson withdrew $6,200 of cash drawings. Leggatt withdrew only $3,700 of cash drawings.
4. The partnership borrowed $50,000 from the Third National Bank.
5. Land and a building were purchased at a cash cost of $25,000 and $50,000, respectively.

Required:

a. Prepare a balance sheet as of June 1.
b. Prepare a reconciliation of the beginning and ending balances for each owner's capital account.
c. Prepare a balance sheet as of June 30.

Problem 2–5.

The January 1 balance sheet of the Marvin Company, an unincorporated business, is as follows:

MARVIN COMPANY
Balance Sheet
As of January 1

Assets		Liabilities and Owners' Equity	
Cash	$25,000	Notes payable	$20,000
Inventory	50,000	Capital	55,000
Total	$75,000	Total	$75,000

The following transactions took place in January:

Jan. 4 Merchandise was sold for $12,000 cash that had cost $7,000.
6 To increase inventory, Marvin placed an order with Star Company for merchandise that would cost $7,000.
8 Marvin received the merchandise ordered from Star and agreed to pay the $7,000 in 30 days.
11 Merchandise costing $1,500 was sold for $2,500 in cash.
16 Merchandise costing $2,000 was sold for $3,400 on 30-day open account.
26 Marvin paid employees for the month $4,200 in cash.
29 Purchased land for $20,000 in cash.
31 Marvin purchased a two-year insurance policy for $2,800 in cash.

Required:

Describe the impact of each transaction on the balance sheet, and prepare a new balance sheet as of January 31.

Problem 2–6.

As of December 31, Brian Company had the following account balances:

Accounts payable	$5,000	Long-term investments	$1,500
Accounts receivable	7,000	Marketable securities	3,500
Bonds payable	8,000	Plant and equipment	8,500
Cash	2,000	Wages payable	1,500
Current portion of bonds payable	2,000		

Required:

a. What was the current ratio?
b. Explain what the current ratio measures.

Cases

Case 2–1

Maynard Company (A)*

Diane Maynard made the following request of a friend:

> My bookkeeper has quit, and I need to see the balance sheets of my company. He has left behind a book with the numbers already entered in it. Would you be willing to prepare balance sheets for me? Also, any comments you care to make about the numbers would be appreciated. The Cash account is healthy, which is a good sign, and he has told me that the net income in June was $19,635.

The book contained a detailed record of transactions, and from it the friend was able to copy off the balances at the beginning of the month and at the end of the month as shown in Exhibit 1. Diane Maynard owned all the stock of Maynard Company. At the end of June, Diane Maynard paid herself an $11,700 dividend and used the money to repay her loan from the company.

* © Professor Robert N. Anthony.

Questions

1. Prepare balance sheets as of June 1 and as of June 30, in proper format.
2. Make comments about how the financial condition as of the end of June compared with that at the beginning of June.
3. Why do retained earnings not increase by the amount of June net income?
4. As of June 30, do you feel that Maynard Company is worth the amount in Shareholder's Equity, $619,446? Explain.

EXHIBIT 1 Account Balances

	June 1	June 30
Accounts payable	$ 8,517	$ 21,315
Accounts receivable	21,798	26,505
Accrued wages payable	1,974	2,202
Accumulated depreciation on building	156,000	157,950
Accumulated depreciation on equipment	5,304	5,928
Bank notes payable	8,385	29,250
Building	585,000	585,000
Capital stock	390,000	390,000
Cash	34,983	66,660
Equipment (at cost)	13,260	36,660
Land	89,700	89,700
Merchandise inventory	29,835	26,520
Note receivable, Diane Maynard	11,700	0
Other noncurrent assets	4,857	5,265
Other noncurrent liabilities	2,451	2,451
Prepaid insurance	3,150	2,826
Retained earnings	221,511	229,446
Supplies on hand	5,559	6,630
Taxes payable	5,700	7,224

Case 2–2

Music Mart, Inc.*

On a sheet of paper, set up in pencil the balance sheet of Music Mart, Inc., as it appears after the last transaction described in the text (January 4), leaving considerable space between each item. Record the effect, if any, of the following events on the balance sheet, either by revising existing figures (cross out, rather than erase) or by adding new items as necessary. At least one of these events does not affect the balance sheet. The basic equation, Assets = Liabilities + Owners' equity, must be preserved at all times. Errors will be minimized if you make a separate list of the balance sheet items affected by each transaction and the amount (+ or −) by which each is to be changed.

After you have recorded these events, prepare a balance sheet in proper form. Assume that all these transactions occurred in January and that there were no other transactions in January.

1. The store purchased and received merchandise for inventory for $5,000, agreeing to pay within 30 days.
2. Merchandise costing $1,500 was sold for $2,300, which was received in cash.
3. Merchandise costing $1,700 was sold for $2,620, the customers agreeing to pay $2,620 within 30 days.
4. The store purchased a three-year fire insurance policy for $1,224, paying cash.
5. The store purchased two lots of land of equal size for a total of $24,000. It paid $6,000 in cash and gave a 10-year mortgage for $18,000.
6. The store sold one of the two lots of land for $12,000. It received $3,000 cash, and in addition, the buyer assumed $9,000 of the mortgage; that is, Music Mart, Inc., became no longer responsible for this half.
7. Smith received a bona fide offer of $33,000 for the business; although his equity was then only $26,970, he rejected the offer. It was evident that the store had already acquired goodwill of $6,030.
8. Smith withdrew $1,000 cash from the store's bank account for his personal use.
9. Smith took merchandise costing $750 from the store's inventory for his personal use.
10. Smith learned that the individual who purchased the land (No. 6 above) subsequently sold it for $14,000. The lot still owned by Music Mart, Inc., was identical in value with this other plot.
11. The store paid off $6,000 of its note payable (disregard interest).
12. Smith sold one-third of the stock he owned in Music Mart, Inc., for $11,000 cash.
13. Merchandise costing $850 was sold for $1,310, which was received in cash.

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Case 2–3

Lone Pine Cafe (A)*

On March 31, 2010, the partnership that had been organized to operate the Lone Pine Cafe was dissolved under unusual circumstances, and in connection with its dissolution, preparation of a balance sheet became necessary.

The partnership was formed by Mr. and Mrs. Henry Antoine and Mrs. Sandra Landers, who had become acquainted while working in a Portland, Oregon, restaurant. On November 1, 2009, each of the three partners contributed $16,000 cash to the partnership and agreed to share in the profits proportionally to

* Based on a case decided by the Supreme Court of the State of Oregon (216 P.2d 1005). © Professor Robert N. Anthony, Harvard Business School.

their contributed capital (i.e., one-third each). The Antoines' contribution represented practically all of their savings. Mrs. Landers' payment was the proceeds of her late husband's insurance policy.

On that day also the partnership signed a one-year lease to the Lone Pine Cafe, located in a nearby recreational area. The monthly rent on the cafe was $1,500. This facility attracted the partners in part because there were living accommodations on the floor above the restaurant. One room was occupied by the Antoines and another by Mrs. Landers.

The partners borrowed $21,000 from a local bank and used this plus $35,000 of partnership funds to buy out the previous operator of the cafe. Of this amount, $53,200 was for equipment and $2,800 was for the food and beverages then on hand. The partnership paid $1,428 for local operating licenses, good for one year beginning November 1, and paid $1,400 for a new cash register. The remainder of the $69,000 was deposited in a checking account.

Shortly after November 1, the partners opened the restaurant. Mr. Antoine was the cook, and Mrs. Antoine and Mrs. Landers waited on customers. Mrs. Antoine also ordered the food, beverages, and supplies, operated the cash register, and was responsible for the checking account.

The restaurant operated throughout the winter season of 2009–2010. It was not very successful. On the morning of March 31, 2010, Mrs. Antoine discovered that Mr. Antoine and Mrs. Landers had disappeared. Mrs. Landers had taken all her possessions, but Mr. Antoine had left behind most of his clothing, presumably because he could not remove it without warning Mrs. Antoine. The new cash register and its contents were also missing. No other partnership assets were missing. Mrs. Antoine concluded that the partnership was dissolved. (The court subsequently affirmed that the partnership was dissolved as of March 30.)

Mrs. Antoine decided to continue operating the Lone Pine Cafe. She realized that an accounting would have to be made as of March 30 and called in Donald Simpson, an acquaintance who was knowledgeable about accounting.

In response to Mr. Simpson's questions, Mrs. Antoine said that the cash register had contained $311 and that the checking account balance was $1,030. Ski instructors who were permitted to charge their meals had run up accounts totaling $870. (These accounts subsequently were paid in full.) The Lone Pine Cafe owed suppliers amounts totaling $1,583. Mr. Simpson estimated that depreciation on the assets amounted to $2,445. Food and beverages on hand were estimated to be worth $2,430. During the period of its operation, the partners drew salaries at agreed-upon amounts, and these payments were up to date. The clothing that Mr. Antoine left behind was estimated to be worth $750. The partnership had also repaid $2,100 of the bank loan.

Mr. Simpson explained that in order to account for the partners' equity, he would prepare a balance sheet. He would list the items that the partnership owned as of March 30, subtract the amounts that it owed to outside parties, and the balance would be the equity of the three partners. Each partner would be entitled to one-third of this amount.

Questions

1. Prepare a balance sheet for the Lone Pine Cafe as of November 2, 2009.
2. Prepare a balance sheet as of March 30, 2010.
3. Disregarding the marital complications, do you suppose that the partners would have been able to receive their proportional share of the equity determined in Question 2 if the partnership was dissolved on March 30, 2010? Why?