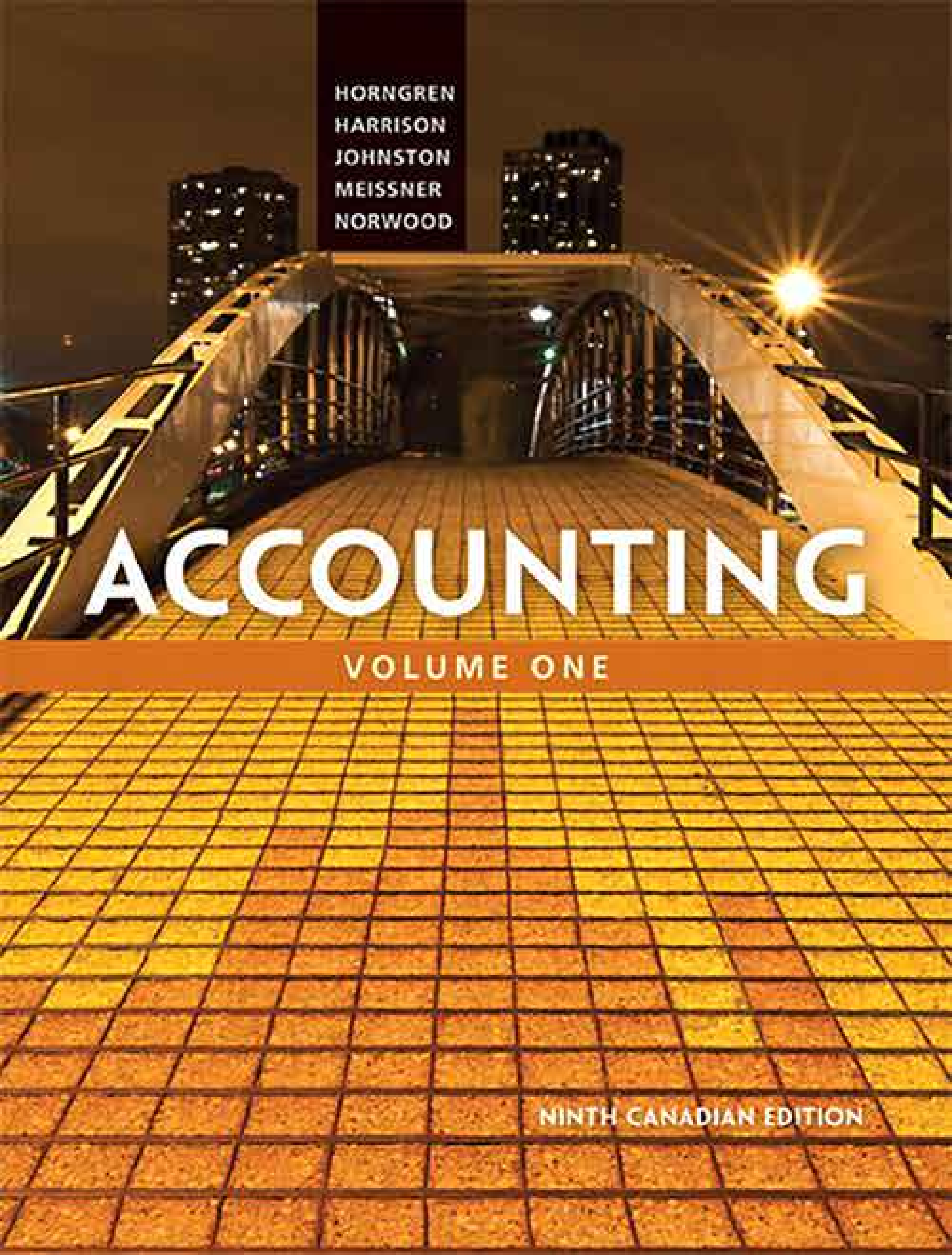
HORNGREN
HARRISON
JOHNSTON
MEISSNER
NORWOOD
ACCOUNTING
VOLUME ONE
NINTH CANADIAN EDITION

ACCOUNTING

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Stanford University

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BRIEF
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**Extending Your Knowledge includes Decision Problems, Financial Statement Cases, and, in select chapters, IFRS Mini-Cases.

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About the Authors

CHARLES T. HORNGREN was the Edmund W. Littlefield Professor of Accounting, Emeritus, at Stanford University. A graduate of Marquette University, the late Professor Horngren received his MBA from Harvard University and his PhD from the University of Chicago. He is also the recipient of honorary doctorates from Marquette University and DePaul University.

A Certified Public Accountant, Horngren served on the Accounting Principles Board for six years, the Financial Accounting Standards Board Advisory Council for five years, and the Council of the American Institute of Certified Public Accountants for three years. For six years, he served as a trustee of the Financial Accounting Foundation, which oversees the Financial Accounting Standards Board and the Government Accounting Standards Board. Horngren is a member of the Accounting Hall of Fame.

A member of the American Accounting Association, Horngren has been its President and its Director of Research. He received its first annual Outstanding Accounting Educator Award. The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He is the first person to have received both awards. The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren. Horngren was named Accountant of the Year, Education, by the national professional accounting fraternity, Beta Alpha Psi.

Professor Horngren was also a member of the Institute of Management Accountants, from whom he received its Distinguished Service Award. He was also a member of the Institute's Board of Regents, which administers the Certified Management Accountant examinations.

Horngren is the author of other accounting books published by Pearson Prentice Hall: *Cost Accounting: A Managerial Emphasis*, Thirteenth Edition, 2008 (with Srikant Datar and George Foster); *Introduction to Financial Accounting*, Ninth Edition, 2006 (with Gary L. Sundem and John A. Elliott); *Introduction to Management Accounting*, Fourteenth Edition, 2008 (with Gary L. Sundem and William Stratton); *Financial & Managerial Accounting*, Second Edition, 2009 and *Financial Accounting*, Eighth Edition, 2009 (with Walter T. Harrison, Jr. and M. Suzanne Oliver).

Horngren was the Consulting Editor for the Charles T. Horngren Series in Accounting.

WALTER T. HARRISON, JR. is Professor Emeritus of Accounting at the Hankamer School of Business, Baylor University. He received his BBA from Baylor University, his MS from Oklahoma State University, and his PhD from Michigan State University.

Professor Harrison, recipient of numerous teaching awards from student groups as well as from university administrators, has also taught at Cleveland State Community College, Michigan State University, the University of Texas, and Stanford University.

A member of the American Accounting Association and the American Institute of Certified Public Accountants, Professor Harrison has served as Chairman of the Financial Accounting Standards Committee of the American Accounting Association, on the Teaching/Curriculum Development Award Committee, on the Program Advisory Committee for Accounting Education and Teaching, and on the Notable Contributions to Accounting Literature Committee.

Professor Harrison has lectured in several foreign countries and published articles in numerous journals, including *Journal of Accounting Research*, *Journal of Accountancy*, *Journal of Accounting and Public Policy*, *Economic Consequences of Financial Accounting Standards*, *Accounting Horizons*, *Issues in Accounting Education*, and *Journal of Law and Commerce*.

He is co-author of *Financial & Managerial Accounting*, Second Edition, 2009 and *Accounting*, Eighth Edition, 2009 (with Charles T. Horngren and M. Suzanne Oliver), published by Pearson Prentice Hall. Professor Harrison has received scholarships, fellowships, and research grants or awards from PriceWaterhouseCoopers, Deloitte & Touche, the Ernst & Young Foundation, and the KPMG Foundation.

JO-ANN L. JOHNSTON is a program head and instructor in the Accounting, Finance and Insurance Department at the British Columbia Institute of Technology (BCIT). She obtained her Diploma of Technology in Financial Management from BCIT, her Bachelor in Administrative Studies from British Columbia Open University, and her MBA from Simon Fraser University. She is also a Certified General Accountant and completed the Canadian Securities Course.

Prior to entering the field of education, Mrs. Johnston worked in public practice and industry for over ten years. She is a past member of the Board of Governors of the Certified General Accountants Association of British Columbia and has served on various committees for the Association. She was also a member of the Board of Directors for the BCIT Faculty and Staff Association, and served as Treasurer during that tenure. She currently serves as chair of the CGA Student Advisory Group and is a member of CGA-BC Education Foundation and the Strategic Planning Committee for the Certified General Accountants Association of British Columbia.

In addition to teaching duties and committee work for the British Columbia Institute of Technology, Mrs. Johnston is the financial officer for a family-owned business.

CAROL A. MEISSNER is a professor in the School of Business at Georgian College in Barrie, Ontario, where she is a member of several curriculum committees. She is also a professor and program coordinator for the Bachelor of Business (Automotive Management) degree at the Automotive Business School of Canada, which is part of Georgian's School of Business. She teaches in both degree and diploma programs, primarily in the areas of introductory financial accounting for non-majors and dealership financial analysis, both in class and online.

A self-professed "learning junkie," Professor Meissner holds a Bachelor of Commerce degree, a Master of Business Administration degree, a Master of Arts degree in Education (Community College concentration), and is a Certified General Accountant. She has also earned Georgian College's Professional Development Teaching Practice Credential and is a graduate of Georgian's Aspiring Leaders program in addition to attending numerous conferences related to teaching, accounting, and the automotive industry. She is currently a member of the National Association of Fleet Administrators Student Advisory Task Force.

Professor Meissner has always been a teacher. She started as a part-time College instructor when she completed her first degree and moved to full-time teaching in 2005. Her "real world" experience includes car dealership controllership, and self-employment as a part-time controller and consultant for a wide variety of businesses. Professor Meissner has recently worked on several online projects for publishers as a subject-matter expert.

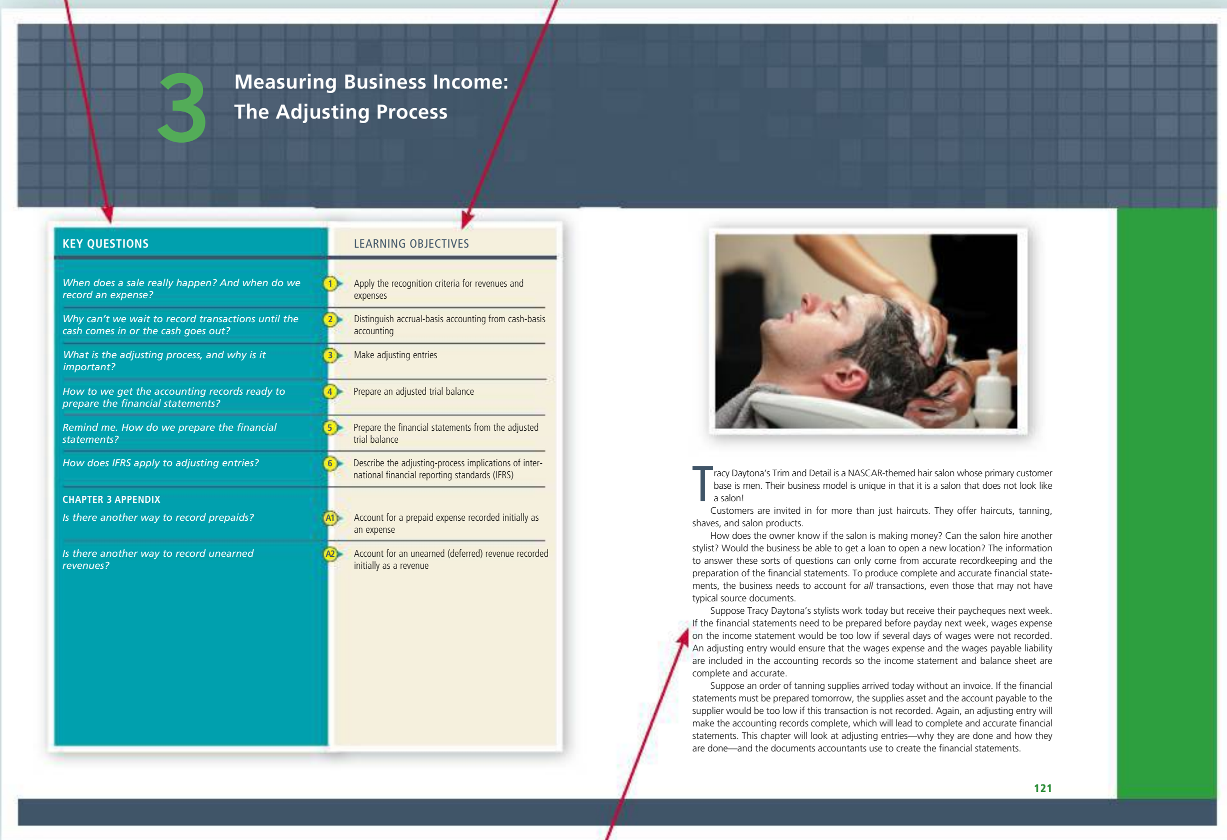
PETER R. NORWOOD is an instructor in accounting and coordinator of the Accounting program at Langara College in Vancouver. A graduate of the University of Alberta, he received his MBA from the University of Western Ontario. He is a Chartered Accountant, a Fellow of the Institute of Chartered Accountants of British Columbia, a Certified Management Accountant, and a Fellow of the Society of Management Accountants of Canada.

Before entering the academic community, Mr. Norwood worked in public practice and industry for over fifteen years. He is a Past President of the Institute of Chartered Accountants of British Columbia and Chair of the Chartered Accountants School of Business (CASB). He is also the Chair of the Chartered Accountants Education Foundation for the British Columbia Institute of Chartered Accountants, and has been active on many provincial and national committees, including the Board of Evaluators of the Canadian Institute of Chartered Accountants. Mr. Norwood is also a sessional lecturer in the Sauder School of Business, University of British Columbia.

Making Connections in *Accounting*

NEW
Key Questions are the important concepts in the chapter expressed in everyday language.

Learning Objectives are the important concepts in each chapter.



3 Measuring Business Income: The Adjusting Process

KEY QUESTIONS		LEARNING OBJECTIVES
When does a sale really happen? And when do we record an expense?	1	Apply the recognition criteria for revenues and expenses
Why can't we wait to record transactions until the cash comes in or the cash goes out?	2	Distinguish accrual-basis accounting from cash-basis accounting
What is the adjusting process, and why is it important?	3	Make adjusting entries
How to we get the accounting records ready to prepare the financial statements?	4	Prepare an adjusted trial balance
Remind me. How do we prepare the financial statements?	5	Prepare the financial statements from the adjusted trial balance
How does IFRS apply to adjusting entries?	6	Describe the adjusting-process implications of international financial reporting standards (IFRS)
CHAPTER 3 APPENDIX		
Is there another way to record prepaids?	A1	Account for a prepaid expense recorded initially as an expense
Is there another way to record unearned revenues?	A2	Account for an unearned (deferred) revenue recorded initially as a revenue

Tracy Daytona's Trim and Detail is a NASCAR-themed hair salon whose primary customer base is men. Their business model is unique in that it is a salon that does not look like a salon!

Customers are invited in for more than just haircuts. They offer haircuts, tanning, shaves, and salon products.

How does the owner know if the salon is making money? Can the salon hire another stylist? Would the business be able to get a loan to open a new location? The information to answer these sorts of questions can only come from accurate recordkeeping and the preparation of the financial statements. To produce complete and accurate financial statements, the business needs to account for *all* transactions, even those that may not have typical source documents.

Suppose Tracy Daytona's stylists work today but receive their paycheques next week. If the financial statements need to be prepared before payday next week, wages expense on the income statement would be too low if several days of wages were not recorded. An adjusting entry would ensure that the wages expense and the wages payable liability are included in the accounting records so the income statement and balance sheet are complete and accurate.

Suppose an order of tanning supplies arrived today without an invoice. If the financial statements must be prepared tomorrow, the supplies asset and the account payable to the supplier would be too low if this transaction is not recorded. Again, an adjusting entry will make the accounting records complete, which will lead to complete and accurate financial statements. This chapter will look at adjusting entries—why they are done and how they are done—and the documents accountants use to create the financial statements.

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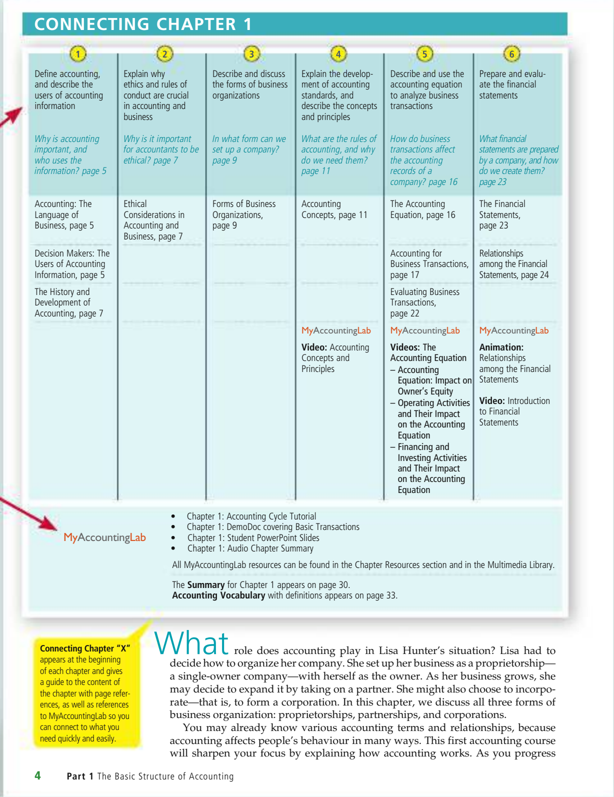
A **chapter-opening story** shows why the topics in the chapter are important to real companies and business people. We refer to this story throughout the chapter.

NEW

Connecting Chapter "X" appears at the beginning of each chapter. Don't read a chapter from the beginning to the end? Need to find a topic quickly when you're studying? This guide to the content of the chapter gives page references, as well as references to **MyAccountingLab** so you can connect to what you need quickly and easily.



CONNECTING CHAPTER 1

1	2	3	4	5	6
Define accounting, and describe the users of accounting information	Explain why ethics and rules of conduct are crucial in accounting and business	Describe and discuss the forms of business organizations	Explain the development of accounting standards, and describe the concepts and principles	Describe and use the accounting equation to analyze business transactions	Prepare and evaluate the financial statements
Why is accounting important, and who uses the information? page 5	*Why is it important for accountants to be ethical? page 7*	*In what form can we set up a company? page 9*	*What are the rules of accounting, and why do we need them? page 11*	*How do business transactions affect the accounting records of a company? page 16*	*What financial statements are prepared by a company, and how do we create them?* *page 23*
Accounting: The Language of Business, page 5	Ethical Considerations in Accounting and Business, page 7	Forms of Business Organizations, page 9	Accounting Concepts, page 11	The Accounting Equation, page 16	The Financial Statements, page 23
Decision Makers: The Users of Accounting Information, page 5				Accounting for Business Transactions, page 17	Relationships among the Financial Statements, page 24
The History and Development of Accounting, page 7				Evaluating Business Transactions, page 22	
			MyAccountingLab **Video:** Accounting Concepts and Principles	MyAccountingLab **Videos:** The Accounting Equation – Accounting Equation: Impact on Owner's Equity – Operating Activities and Their Impact on the Accounting Equation – Financing and Investing Activities and Their Impact on the Accounting Equation	MyAccountingLab **Animation:** Relationships among the Financial Statements **Video:** Introduction to Financial Statements

MyAccountingLab

- Chapter 1: Accounting Cycle Tutorial
- Chapter 1: DemoDoc covering Basic Transactions
- Chapter 1: Student PowerPoint Slides
- Chapter 1: Audio Chapter Summary

All MyAccountingLab resources can be found in the Chapter Resources section and in the Multimedia Library.

The **Summary** for Chapter 1 appears on page 30.
Accounting Vocabulary with definitions appears on page 33.

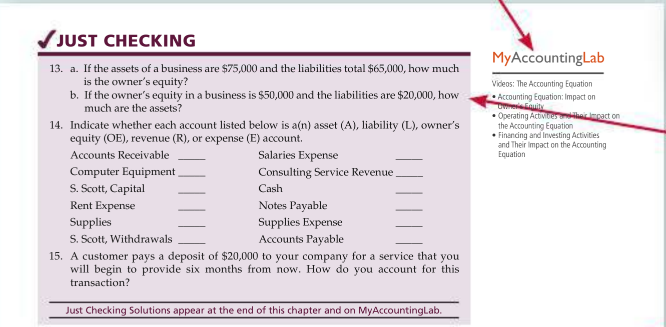
Connecting Chapter "X" appears at the beginning of each chapter and gives a guide to the content of the chapter with page references, as well as references to MyAccountingLab so you can connect to what you need quickly and easily.

What role does accounting play in Lisa Hunter's situation? Lisa had to decide how to organize her company. She set up her business as a proprietorship—a single-owner company—with herself as the owner. As her business grows, she may decide to expand it by taking on a partner. She might also choose to incorporate—that is, to form a corporation. In this chapter, we discuss all three forms of business organization: proprietorships, partnerships, and corporations.

You may already know various accounting terms and relationships, because accounting affects people's behaviour in many ways. This first accounting course will sharpen your focus by explaining how accounting works. As you progress

4 **Part 1** The Basic Structure of Accounting

MyAccountingLab references in the margin direct you to the special features on **MyAccountingLab**.



✓JUST CHECKING

13\. a. If the assets of a business are $75,000 and the liabilities total $65,000, how much is the owner's equity?
b. If the owner's equity in a business is $50,000 and the liabilities are $20,000, how much are the assets?

14\. Indicate whether each account listed below is a(n) asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E) account.

Accounts Receivable	____	Salaries Expense	____
Computer Equipment	____	Consulting Service Revenue	____
S. Scott, Capital	____	Cash	____
Rent Expense	____	Notes Payable	____
Supplies	____	Supplies Expense	____
S. Scott, Withdrawals	____	Accounts Payable	____

15\. A customer pays a deposit of $20,000 to your company for a service that you will begin to provide six months from now. How do you account for this transaction?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

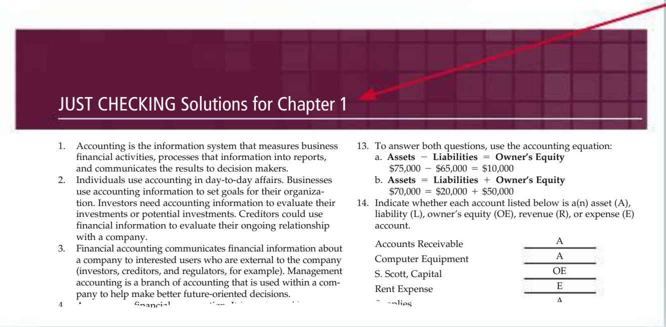
MyAccountingLab

Videos: The Accounting Equation
- Accounting Equation: Impact on Owner's Equity
- Operating Activities and Their Impact on the Accounting Equation
- Financing and Investing Activities and Their Impact on the Accounting Equation

Just Checking questions appear at the end of each Learning Objective. Test your mastery of the concepts in this Learning Objective before moving on.

NEW

The **Just Checking Solutions** appear at the end of the chapter and on **MyAccountingLab**.



JUST CHECKING Solutions for Chapter 1

1\. Accounting is the information system that measures business financial activities, processes that information into reports, and communicates the results to decision makers.

2\. Individuals use accounting in day-to-day affairs. Businesses use accounting information to set goals for their organization. Investors need accounting information to evaluate their investments or potential investments. Creditors could use financial information to evaluate their ongoing relationship with a company.

3\. Financial accounting communicates financial information about a company to interested users who are external to the company (investors, creditors, and regulators, for example). Management accounting is a branch of accounting that is used within a company to help make better future-oriented decisions.

13\. To answer both questions, use the accounting equation:
a. **Assets** − **Liabilities** = **Owner's Equity**
$75,000 − $65,000 = $10,000
b. **Assets** = **Liabilities** + **Owner's Equity**
$70,000 = $20,000 + $50,000

14\. Indicate whether each account listed below is a(n) asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E) account.

Accounts Receivable	A
Computer Equipment	A
S. Scott, Capital	OE
Rent Expense	E

These **margin items** highlight important details and show how real companies use the accounting concepts.

KEY POINTS

REAL WORLD EXAMPLE

NEW

Why It's Done This Way links "how" the accounting is done to "why it's done the way it's done" by connecting the chapter topic back to the basic principles of financial reporting described in Chapter 1.

WHY IT'S DONE THIS WAY

A primary focus in this chapter has been on various types of adjustments. You now know that these adjustments are all "non-cash" and they are recorded to provide more relevant financial statements to users. In terms of the accounting framework in Exhibit 1–6 in Chapter 1 (and on the back inside cover of this book), let's take a closer look at the role of adjustments.

A good example of this role can be found by examining prepaid accounts. Assume that a company has purchased its business insurance for the next year. If we look at ***Level 4*** of the accounting framework, we quickly realize that this transaction should be recognized as a financial transaction and we should measure the transaction at its cost. ***Level 3*** of the accounting framework tells us that the company would categorize this transaction as an asset, since there is future economic benefit to the company—the company has insurance coverage for the next year. Thus, we have now recognized an asset, which is prepaid insurance. By recording and measuring the transaction in this manner, we have provided information that is relevant and reliable at the time the insurance is purchased.

As the year goes along, however, we use up the prepaid asset. The insurance coverage will expire a year from the date it was purchased, so the value of the prepaid asset declines with the passage of time. If we were to prepare the financial statements five months after the insurance was purchased, would the balance sheet be relevant if it still showed the prepaid insurance at its original cost? The answer is no. Since the insurance policy only has seven months of coverage remaining, we need to adjust the value of the prepaid insurance by expensing the used-up portion. By completing the adjustment, our financial statements remain both reliable and relevant to users (***Level 2*** of the accounting framework) and the balance sheet and income statement will communicate useful information to users (***Level 1***).

Adjusting-Process Implications of International Financial Reporting Standards (IFRS)

LO 6 How does IFRS apply to adjusting entries?

The concept of accrual accounting is accepted around the world. The accounting guidelines for all countries recommend the use of accrual accounting. Consequently, the adjustment process that has been described in this chapter is applicable in all developed countries that provide standards for the preparation of financial statements.

The use of IFRS for publicly accountable enterprises has no direct impact on the adjusting process for these companies. Companies reporting under IFRS and ASPE go through the same adjusting process. In terms of the accrual journal entries we have seen in this chapter, the most significant difference between IFRS and ASPE is in the terms used in the amortization journal entries. IFRS specify that *depreciation* is the term to be used, whereas ASPE allow both *amortization* and *depreciation* to be used. Thus, you will see the terms *Accumulated Depreciation* and *Depreciation Expense* on IFRS financial statements for PPE. ASPE companies might choose to use the IFRS terms to be consistent with companies reporting under IFRS.

As we will see in future chapters, there is an impact on the way the financial statements are presented for companies reporting under IFRS versus ASPE. This topic will be discussed in Chapter 4.

✓JUST CHECKING

13. Do international financial reporting standards (IFRS) for publicly accountable enterprises in Canada have an impact on the adjusting process for these companies?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

International financial reporting standards (IFRS) is covered in the final Learning Objective in each chapter (except Chapter 1). How is IFRS different from accounting standards for private enterprises (ASPE)? Here is where we highlight the similarities and differences.

Summary Problem for Your Review

The unadjusted trial balance of Retail Employment Specialists pertains to November 30, 2014, which is the end of its year-long (fiscal) accounting period.

RETAIL EMPLOYMENT SPECIALISTS Unadjusted Trial Balance November 30, 2014		
Cash	$ 13,800	
Accounts receivable	10,000	
Supplies	2,000	
Furniture	20,000	
Accumulated amortization—furniture		$ 8,000
Building	100,000	
Accumulated amortization—building		60,000
Land	44,000	
Accounts payable		4,000
Salaries payable		0
Unearned service revenue		16,000
Gerry Barg, capital		64,000
Gerry Barg, withdrawals	50,000	

Summary Problem for Your Review pulls together the chapter concepts. It comes with hints and reminders for solving the problem, and full solutions.

Summary

1 Learning Objective 1: Apply the recognition criteria for revenues and expenses — Pg. 124

When does a sale really happen? And when do we record an expense?

- The *recognition criteria for revenues* tell one when to record revenue and the amount of revenue to record. The *matching objective* guides accounting for expenses. It directs accountants to match expenses against the revenues earned during a particular period of time.

2 Learning Objective 2: Distinguish accrual-basis accounting from cash-basis accounting — Pg. 126

Why can't we wait to record transactions until the cash comes in or the cash goes out?

- *Accrual-basis accounting:* Business events are recorded as they occur. This is part of GAAP, and, therefore, a basis for ASPE and IFRS.
- *Cash-basis accounting:* Only those events that affect cash are recorded. It omits important events such as purchases and sales of assets on account. It also distorts the financial statements by labelling as expenses those cash payments that have long-term effects, such as the purchases of buildings and equipment.

MyAccountingLab Video: Cash Basis versus Accrual Basis of Accounting

Summary appears at the end of each chapter, organized by Learning Objective. The point-form format with key diagrams and formulas keeps it concise. Page references help you find the topics you want to review.

SELF-STUDY QUESTIONS

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. The organization that formulates generally accepted accounting principles is the *(p. 12)*
   a. Ontario Securities Commission (OSC)
   b. Public Accountants Council of Canada
   c. Accounting Standards Board
   d. Canada Revenue Agency (CRA)
2. Which of the following forms of business organization is an "artificial person" and must obtain legal approval from the federal government or a province to conduct business? *(p. 10)*
   a. Law firm
   b. Proprietorship
   c. Partnership
   d. Corporation
3. You have purchased some T-shirts for $6,000 and can sell them immediately for $8,000. What accounting consideration, assumption, or characteristic governs the amount at which to record the goods you purchased? *(p. 15)*
   a. Economic-entity assumption
   b. Reliability characteristic
   c. Cost principle
   d. Going-concern assumption
4. The economic resources of a business are called *(p. 16)*
   a. Assets
   b. Liabilities
   c. Owner's equity
   d. Accounts payable
5. If the assets of a business are $200,000 and the liabilities are $90,000, how much is the owner's equity? *(p. 16)*
   a. $290,000
   b. $110,000
   c. $200,000
   d. $90,000
6. A business has assets of $160,000 and liabilities of $180,000. How much is its owner's equity? *(p. 16)*
   a. $0
   b. ($20,000)
   c. $160,000
   d. $340,000
7. If the owner's equity in a business is $70,000 and the liabilities are $35,000, how much are the assets? *(p. 16)*
   a. $35,000
   b. $70,000
   c. $105,000
   d. $45,000
8. Purchasing office supplies on account will *(p. 18)*
   a. Increase an asset and increase a liability
   b. Increase an asset and increase owner's equity
   c. Increase one asset and decrease another asset
   d. Increase an asset and decrease a liability
9. Performing a service for a customer or client and receiving the cash immediately will *(p. 19)*
   a. Increase one asset and decrease another asset
   b. Increase an asset and increase owner's equity
   c. Decrease an asset and decrease a liability
   d. Increase an asset and increase a liability
10. Paying an account payable will *(p. 20)*
    a. Increase one asset and decrease another asset
    b. Decrease an asset and decrease owner's equity
    c. Decrease an asset and decrease a liability
    d. Increase an asset and increase a liability
11. The financial statement that summarizes assets, liabilities, and owner's equity is called the *(p. 24)*
    a. Cash flow statement
    b. Balance sheet
    c. Income statement
    d. Statement of owner's equity
12. The financial statements that are dated for a time period (rather than for a specific point in time) are the *(pp. 24–25)*
    a. Balance sheet and income statement
    b. Balance sheet and statement of owner's equity
    c. Income statement, statement of owner's equity, and cash flow statement
    d. All financial statements are dated for a time period.

Answers to Self-Study Questions

1\. c 2. d 3. c 4. a 5. b 6. b 7. c 8. a 9. b 10. c 11. b 12. c

Self-Study Questions are multiple-choice questions with page references you can use to test your understanding. The **answers** are given.

ACCOUNTING VOCABULARY

Accounting period Time frame, or period of time, covered by financial statements and other reports *(p. 123)*.

Accrual-basis accounting Accounting that recognizes (records) the impact of a business event as it occurs, regardless of whether the transaction affected cash *(p. 126)*.

Accrued expense An expense that has been incurred but not yet paid in cash *(p. 135)*.

Accrued revenue A revenue that has been earned but not yet received in cash *(p. 136)*.

Accumulated amortization The cumulative sum of all amortization expense from the date of acquiring a capital asset *(p. 133)*.

Adjusted trial balance A list of all the ledger accounts with their adjusted balances *(p. 141)*.

Adjusting entry Entry made at the end of the period to assign revenues to the period in which they are earned and expenses to the period in which they are incurred. Adjusting entries help measure the period's income and bring the related asset and liability accounts to correct balances for the financial statements *(p. 129)*.

Amortization The term the *CICA Handbook* uses to describe the writing off to expense of the cost of capital assets; also called *depreciation* *(p. 132)*.

Carrying value (of property, plant, and equipment) The asset's cost less accumulated amortization *(p. 134)*.

Cash-basis accounting Accounting that records only transactions in which cash is received or paid *(p. 126)*.

Contra account An account that always has a companion account and whose normal balance is opposite that of the companion account *(p. 133)*.

Deferred revenue Another name for unearned revenue *(p. 137)*.

Intangible asset An asset with no physical form giving a special right to current and expected future benefits *(p. 132)*.

Matching objective The basis for recording expenses. Directs accountants to identify all expenses incurred during the period, measure the expenses, and match them against the revenues earned during that same span of time *(p. 125)*.

Prepaid expense A category of miscellaneous assets that is an advance payment of an expense that typically expires or gets used up in the near future. Examples include prepaid rent, prepaid insurance, and supplies *(p. 130)*.

Property, plant, and equipment (PPE) Long-lived tangible capital assets, such as land, buildings, and equipment, used to operate a business *(p. 132)*.

NEW

Accounting Vocabulary lists all the bolded terms in the chapter with **definitions** and page references. There is also a complete **Glossary** at the end of the book.

SIMILAR ACCOUNTING TERMS

Accounting period	Reporting period
Accrual-basis accounting	Accrual accounting
Adjusting the accounts	Making the adjusting entries; adjusting the books
Amortization	Depreciation; depletion
Carrying value	Book value
Deferred	Unearned
Property, plant, and equipment (PPE)	Capital asset; plant asset; fixed asset; tangible capital asset

Similar Accounting Terms link the accounting terms from the chapter with similar terms you may have heard outside the classroom. This may make new terms easier to remember.

All question numbers in red appear on **MyAccountingLab**.

Excel Spreadsheet Template appears in the margin when a spreadsheet is available to complete the question.

All questions come with a brief description and the Learning Objective(s) covered.

Check figures are given in the margin when appropriate so you can be sure you're "on track."

Business memos are formatted as follows:

Date:	(fill in)
To:	Supervisor
From:	(Student Name)
Subject:	Difference between the *unadjusted* and the *adjusted* amounts on an adjusted trial balance

Preparing the financial statements
5
Net income $55,000

Exercise 3–19

Refer to the adjusted trial balance in Exercise 3–16. Prepare Smith A income statement and statement of owner's equity for the month ended its balance sheet on that date. Draw the arrows linking the three stateme

Excel Spreadsheet Template
Recording prepaids in two ways
3 A1

***Exercise 3–20**

At the beginning of the year, supplies of $4,800 were on hand. During the paid $10,800 for more supplies. At the end of the year, the count of supplies of $3,400 on hand.

Required

1. Assume that the business records supplies by initially debiting Therefore, place the beginning balance in the Supplies T-account, and entries directly in the accounts without using a journal.
2. Assume that the business records supplies by initially debiting a Therefore, place the beginning balance in the Supplies Expense T-ac the above entries directly in the accounts without using a journal.
3. Compare the ending account balances under both approaches. Are they

Recording unearned revenues in two ways
3 A2
Unearned Service Revenue bal. $3,500

***Exercise 3–21**

At the beginning of the year, a business had a liability to customers of $ service revenue collected in advance. During the year, the business cash receipts of $20,000. At year end, the company's liability to custom unearned service revenue collected in advance.

Required

1. Assume that the company records unearned revenues by initially account. Open T-accounts for Unearned Service Revenue and Serv place the beginning balance in Unearned Service Revenue. Journalize and adjusting entries, and post their dollar amounts. As references label the balance, the cash receipt, and the adjustment.
2. Assume that the company records unearned revenues by initially account. Open T-accounts for Unearned Service Revenue and Service R the beginning balance in Service Revenue. Journalize the cash collec entries, and post their dollar amounts. As references in the T-accounts the cash receipt, and the adjustment.
3. Compare the ending balances in the two accounts. Explain why they are th

Recording prepaids as expenses and unearned revenues as revenues, adjusting entries
A1 A2
Supplies Expense Cr $700

***Exercise 3–22**

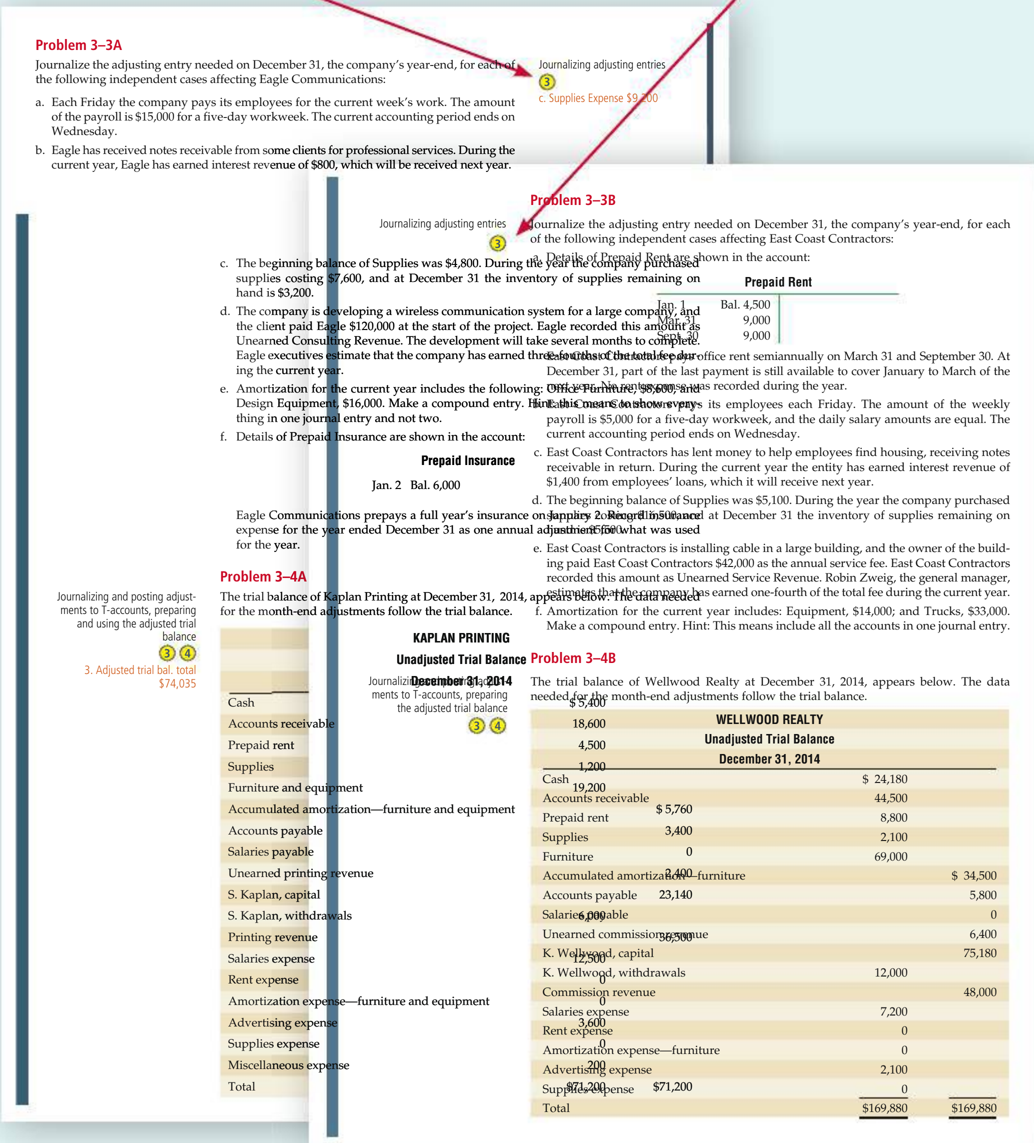
Fort Services initially records all prepaid expenses as expenses and all u as revenues. Given the following information, prepare the necessary a December 31, 2014, the company's year-end.

a. On January 3, 2014, the company's first day of operations, $2,500 of s chased. A physical count revealed $700 of supplies still on hand at De
b. On January 4, 2014, a $15,000 payment for insurance was made to ar for a 30-month policy.
c. On June 30, 2014, Fort Services received nine months' rent totalling $ from a tenant.

* These Exercises cover Chapter 3 Appendix topics.

Working Papers are available for purchase. They are a set of tear-out forms to use to solve all the Exercises and Problems in Volume 1. Avoid time-consuming set-up and focus on the accounting right away.

The **Group A Problems** have check figures in the margin, but the **Group B Problems** do not.



Problem 3–3B

Journalizing adjusting entries

Journalize the adjusting entry needed on December 31, the company's year-end, for each of the following independent cases affecting East Coast Contractors:

a. Details of Prepaid Rent are shown in the account:

Prepaid Rent		
Jan. 1	Bal. 4,500	
Mar. 31	9,000	
Sept. 30	9,000	

East Coast Contractors pays office rent semiannually on March 31 and September 30. At December 31, part of the last payment is still available to cover January to March of the next year. No rent expense was recorded during the year.

b. East Coast Contractors pays its employees each Friday. The amount of the weekly payroll is $5,000 for a five-day workweek, and the daily salary amounts are equal. The current accounting period ends on Wednesday.

c. East Coast Contractors has lent money to help employees find housing, receiving notes receivable in return. During the current year the entity has earned interest revenue of $1,400 from employees' loans, which it will receive next year.

d. The beginning balance of Supplies was $5,100. During the year the company purchased supplies costing $12,500, and at December 31 the inventory of supplies remaining on hand is $3,600.

e. East Coast Contractors is installing cable in a large building, and the owner of the building paid East Coast Contractors $42,000 as the annual service fee. East Coast Contractors recorded this amount as Unearned Service Revenue. Robin Zweig, the general manager, estimates that the company has earned one-fourth of the total fee during the current year.

f. Amortization for the current year includes: Equipment, $14,000; and Trucks, $33,000. Make a compound entry. Hint: This means include all the accounts in one journal entry.

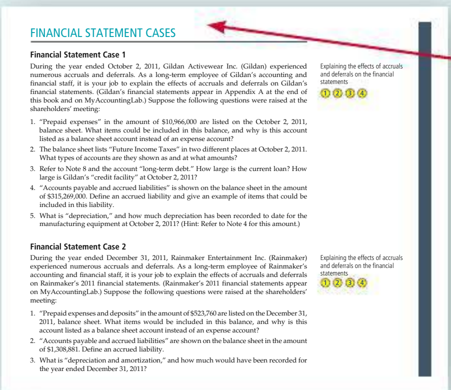
Problem 3–4B

Journalizing and posting adjustments to T-accounts, preparing the adjusted trial balance

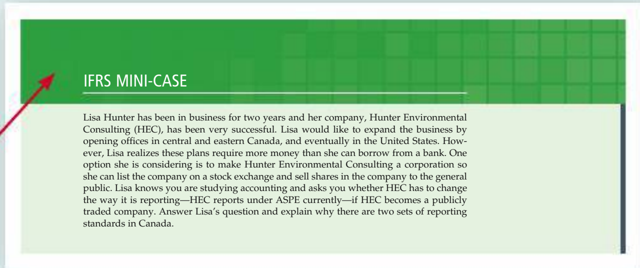
The trial balance of Wellwood Realty at December 31, 2014, appears below. The data needed for the month-end adjustments follow the trial balance.

WELLWOOD REALTY
Unadjusted Trial Balance
December 31, 2014

Cash	$ 24,180	
Accounts receivable	44,500	
Prepaid rent	8,800	
Supplies	2,100	
Furniture	69,000	
Accumulated amortization—furniture		$ 34,500
Accounts payable		5,800
Salaries payable		0
Unearned commission revenue		6,400
K. Wellwood, capital		75,180
K. Wellwood, withdrawals	12,000	
Commission revenue		48,000
Salaries expense	7,200	
Rent expense	0	
Amortization expense—furniture	0	
Advertising expense	2,100	
Supplies expense	0	
Total	$169,880	$169,880



Financial Statement Cases appear in almost every chapter, giving practice using real-company financial information.



IFRS MINI-CASE

Lisa Hunter has been in business for two years and her company, Hunter Environmental Consulting (HEC), has been very successful. Lisa would like to expand the business by opening offices in central and eastern Canada, and eventually in the United States. However, Lisa realizes these plans require more money than she can borrow from a bank. One option she is considering is to make Hunter Environmental Consulting a corporation so she can list the company on a stock exchange and sell shares in the company to the general public. Lisa knows you are studying accounting and asks you whether HEC has to change the way it is reporting—HEC reports under ASPE currently—if HEC becomes a publicly traded company. Answer Lisa's question and explain why there are two sets of reporting standards in Canada.

NEW

IFRS Mini-Cases appear in selected chapters and highlight the similarities and differences between ASPE and IFRS.

Supplements for Students and Instructors

The primary goal of the supplements that accompany *Accounting* is to help instructors deliver their course with ease, using any delivery method—traditional, self-paced, or online—and for students to learn and practice accounting in a variety of ways that meet their learning needs and study preferences.

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Study on the Go

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Instructor's Resources on the Online Catalogue at http://catalogue.pearsoned.ca

This password-protected site provides a collection of resources to help faculty with lecture preparation, presentation, and assessment. It contains the following supplements:

- **Instructor's Solutions Manual** Now provided in both Adobe PDF and MS Word format for ease of use.
- **Instructor's Resource Manual** Also provided in both Adobe PDF and MS Word format, the Instructor's Resource Manual includes Chapter Overviews and Outlines, Assignment Grids, Ten-Minute Quizzes, and other valuable teaching resources including how to integrate MyAccountingLab and MyAccountingCourse in your course. In addition, there is a new section describing all the supplements that come with *Accounting*, along with suggestions for how and when they can be used, written by an instructor who has used them all!
- **TestGen** This powerful and user-friendly computerized test bank includes well over 100 questions per chapter, ranging from True False, Multiple-Choice, and Matching to Problems and Critical Thinking Exercises.
- **PowerPoint Presentations** For instructors and students, we provide a comprehensive set of PowerPoint files with 40 to 60 slides per chapter.
- **Exhibits** We are pleased to provide the exhibits from the text in GIF format for use in the classroom and easy conversion to acetate format.
- **Adapting Your Lecture Notes** These detailed transition notes, including comparison of tables of content, chapter objectives, and chapter content, will facilitate your course preparation if you make the switch to *Accounting* from another introductory accounting text.

Other items include:

- **Group Projects**
- **Solutions to Group Projects**
- **Check Figures**
- **Excel Spreadsheet Templates**
- **Gildan Activewear Inc. 2011 Annual Report**
- **Rainmaker Entertainment Inc. 2011 Annual Report**

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We hope you enjoy *Accounting*!

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The Canadian Institute of Chartered Accountants, as the official promulgator of generally accepted accounting principles in Canada, and the *CICA Handbook*, are vital to the conduct of business and accounting in Canada. We have made every effort to incorporate the most current *Handbook* recommendations in this new edition of *Accounting* for both private enterprises (ASPE) and for publicly accountable enterprises subject to international financial reporting standards (IFRS).

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Peter R. Norwood

1 Accounting and the Business Environment

Key Questions are questions about the important concepts in the chapter expressed in everyday language.

Learning Objectives are a "roadmap" showing what will be covered and what is especially important in each chapter.

KEY QUESTIONS	LEARNING OBJECTIVES
Why is accounting important, and who uses the information?	1 Define accounting, and describe the users of accounting information
Why is it important for accountants to be ethical?	2 Explain why ethics and rules of conduct are crucial in accounting and business
In what form can we set up a company?	3 Describe and discuss the forms of business organizations
What are the rules of accounting, and why do we need them?	4 Explain the development of accounting standards, and describe the concepts and principles
How do business transactions affect the accounting records of a company?	5 Describe and use the accounting equation to analyze business transactions
What financial statements are prepared by a company, and how do we create them?	6 Prepare and evaluate the financial statements

Lisa Hunter graduated from university with a degree in environmental studies. She then went to work with an environmental consulting company and gained extensive experience in the area of environmental sustainability. Lisa soon came to realize that many businesses were starting to recognize the benefits of advancing their environmental performance and were seeing increasing opportunities to participate in the green economy. For these companies, the financial implications of "going green" were significant.

Lisa decided to go back to school to pursue an accounting designation. Within three years, she had successfully completed all the requirements and became designated as a professional accountant.

Lisa started her own consulting firm to combine her passion for environmental sustainability with her recently developed accounting skills. She named her new company "Hunter Environmental Consulting." She was now an entrepreneur! She realized she needed to develop a business plan, secure clients, set up an office, and hire staff.

Lisa's first year in business was stressful and successful. Her work in the first year was primarily in the area of energy efficiency, and how her clients could reduce their energy consumption and their energy costs.

"My previous training and experience gave me the confidence to know that I could be successful in this field. However, I did not realize how carefully you have to watch the books—costs can get out control in a hurry if you are not careful!"

A **chapter-opening story** shows why the topics in the chapter are important to real companies and business people. We refer to this story throughout the chapter.

CONNECTING CHAPTER 1

1	2	3	4	5	6
Define accounting, and describe the users of accounting information	Explain why ethics and rules of conduct are crucial in accounting and business	Describe and discuss the forms of business organizations	Explain the development of accounting standards, and describe the concepts and principles	Describe and use the accounting equation to analyze business transactions	Prepare and evaluate the financial statements
Why is accounting important, and who uses the information? page 5	*Why is it important for accountants to be ethical? page 7*	*In what form can we set up a company? page 9*	*What are the rules of accounting, and why do we need them? page 11*	*How do business transactions affect the accounting records of a company? page 16*	*What financial statements are prepared by a company, and how do we create them? page 23*
Accounting: The Language of Business, page 5	Ethical Considerations in Accounting and Business, page 7	Forms of Business Organizations, page 9	Accounting Concepts, page 11	The Accounting Equation, page 16	The Financial Statements, page 23
Decision Makers: The Users of Accounting Information, page 5				Accounting for Business Transactions, page 17	Relationships among the Financial Statements, page 24
The History and Development of Accounting, page 7				Evaluating Business Transactions, page 22	
			MyAccountingLab **Video:** Accounting Concepts and Principles	MyAccountingLab **Videos:** The Accounting Equation – Accounting Equation: Impact on Owner's Equity – Operating Activities and Their Impact on the Accounting Equation – Financing and Investing Activities and Their Impact on the Accounting Equation	MyAccountingLab **Animation:** Relationships among the Financial Statements **Video:** Introduction to Financial Statements

MyAccountingLab

- Chapter 1: Accounting Cycle Tutorial
- Chapter 1: DemoDoc covering Basic Transactions
- Chapter 1: Student PowerPoint Slides
- Chapter 1: Audio Chapter Summary

All MyAccountingLab resources can be found in the Chapter Resources section and in the Multimedia Library.

The **Summary** for Chapter 1 appears on page 30.
Accounting Vocabulary with definitions appears on page 33.

Connecting Chapter "X" appears at the beginning of each chapter and gives a guide to the content of the chapter with page references, as well as references to MyAccountingLab so you can connect to what you need quickly and easily.

What role does accounting play in Lisa Hunter's situation? Lisa had to decide how to organize her company. She set up her business as a proprietorship—a single-owner company—with herself as the owner. As her business grows, she may decide to expand it by taking on a partner. She might also choose to incorporate—that is, to form a corporation. In this chapter, we discuss all three forms of business organization: proprietorships, partnerships, and corporations.

You may already know various accounting terms and relationships, because accounting affects people's lives in many ways. This first accounting course will help you see this by explaining how accounting works. As you progress through this course, you will see how accounting helps people like Lisa Hunter—and you—achieve business goals.

Accounting: The Language of Business

LO 1 Why is accounting important, and who uses the information?

Learning Objectives in the margin signal the beginning of the section that covers the learning-objective topic. Look for the Learning Objective when you want to review this topic.

Accounting is the information system that measures business financial activities, processes that information into reports, and communicates the results to decision makers. For this reason it is called "the language of business." The better you understand the language, the better your decisions will be, and the better you can manage financial information. It is generally recognized that business managers believe it is more important for students to learn accounting than any other business subject. Decisions concerning personal financial planning, education expenses, loans, car payments, income taxes, and investments are based on the *information system* that we call accounting.

Financial statements are a key product of an accounting system and provide information that helps people make informed business decisions. Financial statements report on a business in monetary terms. Is my business making a profit? Should I hire assistants? Am I earning enough money to expand my business? Answering business questions like these requires a knowledge of financial statements.

Boldfaced words are new terms that are explained here and defined in the Accounting Vocabulary section at the end of this chapter and the Glossary at the end of the book.

Students sometimes mistake bookkeeping for accounting. *Bookkeeping* is a procedural element of accounting, just as arithmetic is a procedural element of mathematics (or just as skating is a procedural element of hockey). There are many accounting software packages that will handle detailed bookkeeping—in households, businesses, and organizations of all types. Exhibit 1–1 illustrates the role of accounting in business. The process starts and ends with people making decisions.

EXHIBIT 1–1 | The Accounting System: The Flow of Information

Exhibits summarize key ideas in a visual way.

Decision Makers: The Users of Accounting Information

Decision makers need information. The more important the decision, the greater the need for information. Virtually all businesses and most individuals keep accounting records to aid decision making. Here are some decision makers who use accounting information.

Individuals People use accounting information in day-to-day affairs to manage bank accounts, evaluate job prospects, make investments, and even in deciding whether to lease or buy a new car.

Businesses Business owners and managers use accounting information to set goals for their organizations. They evaluate their progress toward those goals, and they take corrective action when it is necessary. For example, Lisa Hunter makes decisions based on accounting information. She knows the amount of money that will be earned, since she and her client will agree on a fee for the consulting work she will perform. She needs to determine the scope of the work, how many consultants she will require, and how many hours it will take to complete the project. She needs to make sure that her costs do not exceed the fee she will receive from her client if she wants to make sure that she maintains a profitable business.

Investors Outside investors often provide the money a business needs to operate. To decide whether to invest, potential investors predict the amount of income to be earned on their investment. This evaluation means analyzing the financial statements of the business and keeping up with developments in the world of business.

Creditors Before lending money, creditors (lenders) such as banks evaluate the borrower's ability to make scheduled payments. This evaluation includes a report of the borrower's financial position and a prediction of future operations, both of which are based on accounting information.

Government Regulatory Agencies Most organizations face government regulation. For example, the provincial securities commissions, such as the British Columbia Securities Commission and the Ontario Securities Commission, dictate that businesses selling their shares to and borrowing money from the public disclose certain financial information to the investing public.

Taxing Authorities Provincial and federal governments levy taxes on individuals and businesses. Income tax is calculated by using accounting information as a starting point. A business's accounting system is required to keep track of provincial sales tax, goods and services tax, and harmonized sales tax that a company collects from its customers and pays to its suppliers. Businesses use these accounting records to help them determine their taxes that must be paid to the provincial and federal governments.

Not-for-profit Organizations Not-for-profit organizations such as churches, hospitals, government agencies, universities, and colleges, which operate for purposes other than to earn a profit, use accounting information to make decisions related to the organization in much the same way that profit-oriented businesses do.

Other Users Employees and labour unions may make wage demands based on the accounting information that shows their employer's reported income. Consumer groups and the general public are also interested in the amount of income that businesses earn. And newspapers may report "an improved profit picture'' of a major company as it emerges from economic difficulties. Such news, based on accounting information, relates to the company's health.

Financial Accounting and Management Accounting

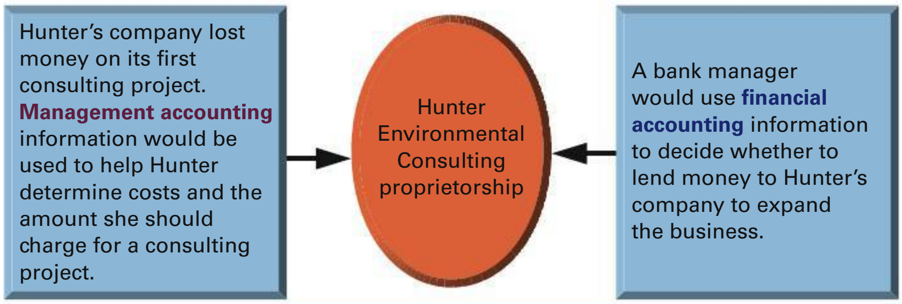
Users of accounting information are a diverse population, but they may be grouped as external users or internal users. This distinction allows us to classify accounting into two fields—financial accounting and management accounting.

Financial accounting provides information to people outside the company. Creditors and outside investors, for example, are not part of the day-to-day management of the company. Likewise, government agencies and the general public are external users of a company's accounting information. This book deals primarily with financial accounting.

Management accounting generates information for internal decision makers, such as company executives, department heads, university deans, and hospital administrators.

Exhibit 1–2 shows how financial accounting and management accounting are used by Hunter Environmental Consulting's internal and external decision makers.

EXHIBIT 1–2 How Financial Accounting and Management Accounting Are Used



The History and Development of Accounting

Accounting has a long history. Some scholars claim that writing arose in order to record accounting information. Accounting records date back to the ancient civilizations of China, Babylonia, Greece, and Egypt. The rulers of these civilizations used accounting to keep track of the cost of labour and materials used in building structures like the great pyramids. The need for accounting has existed as long as there has been business activity.

Accounting developed further as a result of the information needs of merchants in the city-states of Italy during the 1400s. In that busy commercial climate, the monk Luca Pacioli, a mathematician and friend of Leonardo da Vinci's, published the first known description of double-entry bookkeeping in 1494.

In the Industrial Revolution of the 19th century, the growth of corporations spurred the development of accounting. The corporation owners—the shareholders—were no longer necessarily the managers of their business. Managers had to create accounting systems to report to the owners and government how well their businesses were doing. Because managers want their performance to look good, society needs a way to ensure that the business information provided is reliable. To meet this need, generally accepted accounting principles were developed. These will be discussed in more detail shortly.

As required in other segments of society, accounting must be practised in an ethical manner. We look next at the ethical dimension of accounting.

✓ JUST CHECKING

1. What is accounting?
2. Name three decision makers that rely on financial information, and briefly describe how they use it.
3. What is the difference between financial accounting and management accounting?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

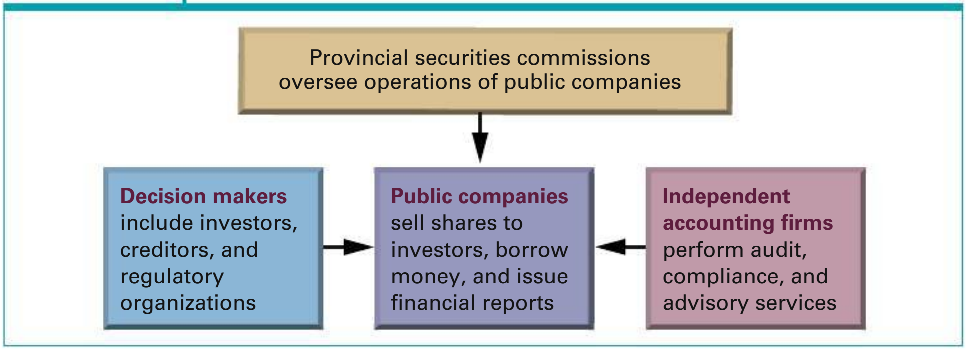
Just Checking questions appear at the end of each Learning Objective, allowing you to test your mastery of the concepts in this Learning Objective before moving on to the next one. The solutions appear at the end of the chapter and on MyAccountingLab.

Ethical Considerations in Accounting and Business

LO 2
Why is it important for accountants to be ethical?

Ethical considerations affect all areas of accounting and business. Investors, creditors, and regulatory bodies need relevant and reliable information about a company. Naturally, companies want to make themselves look as good as possible to attract investors, so there is a potential for conflict. An **audit** is a financial examination. Audits are conducted by independent accountants who express an opinion on whether or not the financial statements fairly reflect the economic events that occurred during the accounting period. It is vital that companies and their auditors behave in an ethical manner. Exhibit 1–3 illustrates the relationship among accounting and business entities that are public companies (companies that sell shares of stock to investors).

EXHIBIT 1–3 | Relationship among Accounting and Business Entities



Unfortunately for the accounting profession, accounting scandals involving both public companies and their auditors have made the headlines over the past fifteen years. At the turn of this century, Enron Corporation, which was the seventh-largest company in the United States, issued misleading financial statements. Enron was forced into bankruptcy and its auditors' actions were questioned. The impact of the Enron bankruptcy was felt by many different parties, including Enron shareholders, who saw their investments become worthless; employees who lost their jobs and their pensions; and the accounting profession, which lost some of its integrity and reputation as gatekeepers and stewards for the investing public. This situation shocked the business community and caused investors to question the reliability of financial information.

Since the financial health of a company is important to many different groups of users, these users must be confident that they can rely on the financial information they are given when they are making decisions. To increase users' confidence, the accounting profession and other interested stakeholder groups made important changes over the past decade to improve the quality of the financial information provided. We will describe these changes later in this chapter.

The Professional Accounting Bodies and Their Standards of Professional Conduct

The members of the four accounting organizations in Canada—Chartered Accountants (CAs), Certified General Accountants (CGAs), Certified Management Accountants (CMAs), and Chartered Professional Accountants (CPAs)—are all governed by rules of professional conduct created by their respective organizations. Many of the rules apply whether the members are public accountants working in public practice or private accountants working in industry or government. These rules concern the confidentiality of information the accountant is privy to, maintenance of the reputation of the profession, the need to perform accountancy work with integrity and due care, competence, refusal to be associated with false or misleading information, and compliance by the accountant with professional standards. Other rules are applicable only to those members in public practice, and deal with things like the need for independence, and how to advertise, seek clients, and conduct a practice.

The rules of professional conduct serve both the members of the accounting bodies and the public. The rules serve members by setting standards that they must meet, and providing a benchmark against which they will be measured by their peers. The public is served because the rules of professional conduct provide it with a list of the standards to which the members of the body adhere. This helps the public determine its expectations of members' behaviour. However, the rules of professional conduct should be considered a *minimum* standard of performance; ideally, the members should continually strive to exceed them.

Throughout this book, we provide several problems that allow you to consider ethical dilemmas. Consider them carefully. The perception that accountants follow the highest standard of professional conduct must also be the reality. In today's business climate, behaving in an ethical manner is crucial.

Codes of Business Conduct of Companies

Many companies have codes of conduct that apply to their employees in their dealings with each other and with the companies' suppliers and customers. Some of these companies mention their code in their annual report or on their website. For example, Vancouver City Savings Credit Union states on its website:

> **Our Values**
>
> **Integrity:** We act with courage, consistency and respect to do what is honest, fair and trustworthy.
>
> **Innovation:** We anticipate and respond to challenges and changing needs with creativity, enthusiasm and determination.
>
> **Responsibility:** We are accountable to our members, employees, colleagues and communities for the results of our decisions and actions.
>
> *Source:* From Vancouver City Savings Credit Union's website, www.vancity.com (accessed May 25, 2012)

The company indicates to its employees and to the general public how management expects employees to behave.

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4. What is an audit, and why is it important that it be performed by independent accountants?
5. Why do the professional accounting bodies establish rules of professional conduct for their members?
6. Refer to the Student Policies, Bylaws, and Codes of Conduct of your college or university. Why do these policies exist?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Forms of Business Organizations

LO 3
In what form can we set up a company?

A business can be organized as a

- Proprietorship
- Partnership
- Corporation

You should understand the differences among the three.

Proprietorship A **proprietorship** has a single owner, called the proprietor, who often manages the business. Proprietorships tend to be small retail stores, restaurants, and service businesses, but also can be very large. From an accounting

KEY POINTS

A proprietorship and a partnership (Ch. 12) are not legal entities separate from their owners, so the income from proprietorships and partnerships is taxable to their owners, not to the business. But in accounting, the owner and the business are considered separate entities, and separate records are kept for each. A corporation (Ch. 13) is a separate legal entity. The corporation is taxed on its income, and the owners are taxed on any income they receive from the corporation.

Key Points highlight important details from the text and are good tools for reviewing concepts.

viewpoint, each proprietorship is distinct from its owner. Thus, the accounting records of the proprietorship do not include the proprietor's personal accounting records. However, from a legal perspective, the business *is* the proprietor, so if the business cannot pay its debts, lenders can take the proprietor's personal assets (cash and belongings) to pay the proprietorship's debt. In this book, we start with a proprietorship because many students organize their first business that way.

Partnership A **partnership** joins two or more individuals together as co-owners. Each owner is a partner. Many retail stores and professional organizations of physicians, lawyers, and accountants are partnerships. Most partnerships are small and medium-sized, but some are quite large; there are public accounting firms and law firms in Canada with several hundred partners. Accounting treats the partnership as a separate organization distinct from the personal affairs of each partner. But again, from a legal perspective, a partnership *is* the partners in a manner similar to a proprietorship. If the partnership cannot pay its debts, lenders can take each partner's personal assets to pay the partnership's debts.

Corporation A **corporation** is a business owned by **shareholders**. These are the people or other corporations who own shares of ownership in the business. The corporation is the dominant form of business organization in Canada. Although proprietorships and partnerships are more numerous, corporations engage in more business and are generally larger in terms of total assets, income, and number of employees. In Canada, generally, corporations must have *Ltd.* or *Limited, Inc.* or *Incorporated,* or *Corp.* or *Corporation* in their legal name to indicate that they are incorporated. Corporations need not be large; a business with only a few assets and employees could be organized as a corporation.

From a legal perspective, a corporation is formed when the federal government or a provincial government approves its articles of incorporation. Unlike a proprietorship or a partnership, once a corporation is formed, it is a legal entity separate and distinct from its owners. The corporation operates as an "artificial person" that exists apart from its owners and that conducts business in its own name. The corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property. The corporation may enter into contracts and sue and be sued.

EXHIBIT 1–4

The Formation and Ownership of a Corporation

Since corporations are entities separate from their owners, they will prepare financial reports separate from their owners. Over the years, the accounting profession has developed accounting and reporting standards that corporations must follow when preparing their financial reports. We will examine them in greater detail in the next section of this chapter. Corporations differ significantly from proprietorships and partnerships in another way. If a proprietorship or partnership cannot pay its debts, lenders can take the owners' personal assets to satisfy the business's obligations. But if a corporation goes bankrupt, lenders cannot take the personal assets of the shareholders. This *limited personal liability* of shareholders for corporate debts explains why corporations are so popular compared to proprietorships and partnerships, which have *unlimited personal liability*. Exhibit 1–4 shows the formation and ownership of a corporation.

Another factor for corporations is the division of ownership into individual shares. Companies such as WestJet, Canadian Imperial Bank of Commerce, and Canadian Tire Corporation, Limited, have issued millions of shares of stock and have tens of thousands of shareholders. An investor with no personal relationship either to the corporation or to any other shareholder can become an owner by buying 30, 100, 5,000, or any number of shares of its stock. For most corporations, the investor may sell the shares at any time. It is usually harder to sell one's investment in a proprietorship or a partnership than to sell one's investment in a corporation.

Limited-Liability Partnership (LLP) A **limited-liability partnership (LLP)** is a partnership in which one partner cannot create a large liability for the other partners. Each partner is liable only for his or her own actions and those actions under his or her control.

Exhibit 1–5 summarizes the differences between proprietorships, partnerships, and corporations.

Accounting for corporations includes some unique complexities. For this reason, we initially focus on proprietorships. We cover partnerships in Chapter 12 and begin our discussion of corporations in Chapter 13.

EXHIBIT 1–5 | Comparison of the Three Forms of Business Organization

	Proprietorship	Partnership	Corporation
1. Owner(s)	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
2. Life of organization	Limited by owner's choice or death	Limited by owners' choices or death of one of the partners	Indefinite
3. Personal liability of owner(s) for business debts	Proprietor is personally liable	Partners are personally liable*	Shareholders are not personally liable
4. Legal status	The proprietorship is the proprietor	The partnership is the partners*	The corporation is separate from the shareholders (owners)

*Unless it is a limited-liability partnership (LLP)

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7. How does a partnership differ from a proprietorship?
8. How does a corporation differ from either a proprietorship or a partnership?
9. List two advantages of the corporate form of business over a proprietorship.

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Accounting Concepts

LO 4 What are the rules of accounting, and why do we need them?

Earlier in this chapter, we discussed the importance of financial information to various user groups. Users must be confident that they can rely on the financial information they are given when they are making decisions. To increase users' confidence, accounting practices need to follow certain guidelines. The rules that govern how accountants measure, process, and communicate financial information are known as **generally accepted accounting principles**, or **GAAP**. Accounting principles draw their authority from their acceptance in the business community. They are generally accepted by those people and organizations who need guidelines in accounting for their financial undertakings.

For the past eighty years, individual countries determined their own GAAP. Their goal was to provide accounting standards that could be used by companies in their countries to produce reliable, comparable financial statements. During this period of time, most companies did not compete in an international economy and most of a company's shareholders were residents of the country where the company was headquartered.

In the past twenty-five years, the circumstances under which companies compete for business, and where their shareholders and creditors reside have changed.