HORNGREN
HARRISON
JOHNSTON
MEISSNER
NORWOOD

ACCOUNTING

VOLUME TWO

NINTH CANADIAN EDITION

ACCOUNTING

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NINTH CANADIAN EDITION

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PEARSON

BRIEF
Contents

Part 1 The Basic Structure of Accounting

1 Accounting and the Business Environment *2*
2 Recording Business Transactions *58*
3 Measuring Business Income: The Adjusting Process *120*
4 Completing the Accounting Cycle *184*
5 Merchandising Operations and the Accounting Cycle *256*
6 Accounting for Merchandise Inventory *342*
7 Accounting Information Systems *394*

Part 2 Accounting for Assets and Liabilities

8 Internal Control and Cash *462*
9 Receivables *520*
10 Property, Plant, and Equipment; Goodwill; and Intangible Assets *578*
11 Current Liabilities and Payroll *636*

Part 3 Accounting for Partnerships and Corporate Transactions

12 Partnerships *752*
13 Corporations: Share Capital and the Balance Sheet *808*
14 Corporations: Retained Earnings and the Income Statement *860*
15 Long-Term Liabilities *916*
16 Investments and International Operations *988*

Part 4 Analysis of Accounting Information

17 The Cash Flow Statement *1050*
18 Financial Statement Analysis *1126*

Contents

Part 3 Accounting for Partnerships and Corporate Transactions 752

12 Partnerships 752

Characteristics of a Partnership 756
Types of Partnerships 759
Partnership Financial Statements 759
Forming a Partnership 761
Sharing Partnership Profits and Losses 762
Partner Withdrawals (Drawings) of Cash and Other Assets 767
Admission of a Partner 768
Withdrawal of a Partner from the Business 772
Death of a Partner 775
Liquidation of a Partnership 776
The Impact on Partnerships of International Financial Reporting Standards (IFRS) 780
Summary Problem for Your Review 780
Summary 782
Assignment Material* 785
Extending Your Knowledge** 803

13 Corporations: Share Capital and the Balance Sheet 808

Corporations: An Overview 810
Shareholders' Equity Basics 814
Issuing Shares 816
Ethical Considerations in Accounting for the Issuance of Shares 823
Organization Costs 823
Accounting for Cash Dividends 824
Different Values of Shares 828
Evaluating Operations 831
The Impact on Share Capital of International Financial Reporting Standards (IFRS) 833
Summary Problem for Your Review 834
Summary 836
Assignment Material 840
Extending Your Knowledge 857

*In each chapter, Assignment Material includes Questions, Starters, Exercises (including Serial and Challenge Exercises), Beyond the Numbers, and Ethical Issue, and Problems (Group A and B, and Challenge Problems).
**Extending Your Knowledge includes Decision Problems, Financial Statement Cases, and, in select chapters, IFRS Mini-Cases.

14 Corporations: Retained Earnings and the Income Statement 860

Retained Earnings 863
Stock Dividends 864
Stock Splits 867
Similarities and Differences between Stock Dividends and Stock Splits 868
Repurchase of Its Shares by a Corporation 869
Ethical and Legal Issues for Share Transactions 873
The Corporate Income Statement—Analyzing Earnings 873
Statement of Retained Earnings 879
Statement of Shareholders' Equity 880
Accounting for Errors and Changes in Accounting Policy or Circumstances 883
Restrictions on Retained Earnings 884
The Impact of IFRS on the Income Statement and the Statement of Shareholders' Equity 885
Summary Problem for Your Review 888
Summary 889
Assignment Material 893
Extending Your Knowledge 911

15 Long-Term Liabilities 916

Bonds: An Introduction 919
Issuing Bonds to Borrow Money 924
Amortization of a Bond Discount and a Bond Premium 928
Reporting Liabilities and Bonds Payable 932
Adjusting Entries for Interest Expense 935
Retirement of Bonds 938
Convertible Bonds and Notes 939
Advantages and Disadvantages of Issuing Bonds versus Shares 940
Mortgages and Other Long-Term Liabilities 942
Lease Liabilities 943
The Effects on Long-Term Liabilities of International Financial Reporting Standards (IFRS) 947
Summary Problem for Your Review 948
Summary 950
Assignment Material 955
Extending Your Knowledge 974
Chapter 15 Appendix 976

16 Investments and International Operations 988

Share Investments: An Overview 991
Accounting for Short-Term Investments 993
Accounting for Long-Term Share Investments 996
Consolidated Financial Statements 1004
Investments in Bonds and Notes 1010
Foreign-Currency Transactions 1014
The Impact on Accounting for Investments of International Financial Reporting Standards (IFRS) 1019
Summary Problems for Your Review 1020
Summary 1021
Assignment Material 1025
Extending Your Knowledge 1044
Comprehensive Problem for Part 3 1045

Part 4 Analysis of Accounting Information 1050

17 The Cash Flow Statement 1050

The Cash Flow Statement: Basic Concepts 1054
Purpose of the Cash Flow Statement 1055
Operating, Investing, and Financing Activities 1056
Noncash Investing and Financing Activities 1059
Measuring Cash Adequacy: Free Cash Flow 1060
Format of the Cash Flow Statement 1060
The Cash Flow Statement: The Direct Method 1062
Computing Individual Amounts for the Cash Flow Statement 1067
The Cash Flow Statement: The Indirect Method 1076
The Impact on the Cash Flow Statement of International Financial Reporting Standards (IFRS) 1082
Summary Problem for Your Review 1083
Summary 1085
Assignment Material 1087
Extending Your Knowledge 1119

18 Financial Statement Analysis 1126

The Objectives of Financial Statement Analysis 1129
Methods of Analysis 1130
Horizontal Analysis 1130
Vertical Analysis 1134
Common-Size Statements 1136
Benchmarking 1137
Using Ratios to Make Decisions 1139
Limitations of Financial Analysis 1150
Efficient Markets, Nonfinancial Reports, and Investor Decisions 1151
The Impact on Financial Statement Analysis of International Financial Reporting Standards (IFRS) 1155
Summary Problem for Your Review 1156
Summary 1157
Assignment Material 1162
Extending Your Knowledge 1190
Comprehensive Problem for Part Four 1194
Appendix A Gildan Activewear Inc. 2011 Annual Report 1198
Appendix B Present-Value Tables and Future-Value Tables 1238
Appendix C Typical Charts of Accounts for Service Proprietorships and Service Partnerships (ASPE) and Merchandising Corporations (IFRS) 1244

Glossary 1246
Index 1250

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).

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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 Certified Public Accountant, 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 inter-national 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.

121

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

✓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.

WHY IT'S DONE THIS WAY

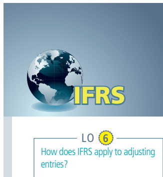
A primary focus in this chapter has been on various types of adjustments. You now know that these adjustments are all "non-cash" and they are recorded to provide more relevant financial statements to users. In terms of the accounting framework in Exhibit 1–6 in Chapter 1 (and on the back inside cover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

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.



LO 6 How does IFRS apply to adjusting entries?

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

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		
	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.	Pg. 124
2	Learning Objective 2: Distinguish accrual-basis accounting from cash-basis accounting		
	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.	Pg. 126
		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*).

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 an 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 $3 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 c 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 c 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 an 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 2. 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 3–3A

Journalizing adjusting entries

(3)

c. Supplies Expense $9,200

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

a. Each Friday the company pays its employees for the current week's work. The amount of the payroll is $15,000 for a five-day workweek. The current accounting period ends on Wednesday.

b. Eagle has received notes receivable from some clients for professional services. During the current year, Eagle has earned interest revenue of

c. The beginning
supplies costi
hand is $3,200

d. The company
the client paid
Unearned Co
Eagle executiv
ing the curren

e. Amortization
Design Equip
thing in one j

f. Details of Pre

Eagle Commu
expense for th
for the year.

Problem 3–4A

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

(3) (4)

3. Adjusted trial bal. total $74,035

The trial balance
for the month-en

Cash
Accounts receiv
Prepaid rent
Supplies
Furniture and e
Accumulated a
Accounts payal
Salaries payabl
Unearned print
S. Kaplan, capi
S. Kaplan, with
Printing revenu
Salaries expens
Rent expense
Amortization e
Advertising ex
Supplies expen
Miscellaneous
Total

Problem 3–3B

Journalizing adjusting entries

(3)

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 $16,500, and at December 31 the inventory of supplies remaining on hand is $5,500.

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

(3) (4)

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

Financial Statement Case 1

Explaining the effects of accruals and deferrals on the financial statements

(1) (2) (3) (4)

During the year ended October 2, 2011, Gildan Activewear Inc. (Gildan) experienced numerous accruals and deferrals. As a long-term employee of Gildan's accounting and financial staff, it is your job to explain the effects of accruals and deferrals on Gildan's financial statements. (Gildan's financial statements appear in Appendix A at the end of this book and on MyAccountingLab.) Suppose the following questions were raised at the shareholders' meeting:

1. "Prepaid expenses" in the amount of $10,966,000 are listed on the October 2, 2011, balance sheet. What items could be included in this balance, and why is this account listed as a balance sheet account instead of an expense account?
2. The balance sheet lists "Future Income Taxes" in two different places at October 2, 2011. What types of accounts are they shown as and at what amounts?
3. Refer to Note 8 and the account "long-term debt." How large is the current loan? How large is Gildan's "credit facility" at October 2, 2011?
4. "Accounts payable and accrued liabilities" is shown on the balance sheet in the amount of $315,269,000. Define an accrued liability and give an example of items that could be included in this liability.
5. What is "depreciation," and how much depreciation has been recorded to date for the manufacturing equipment at October 2, 2011? (Hint: Refer to Note 4 for this amount.)

Financial Statement Case 2

Explaining the effects of accruals and deferrals on the financial statements

(1) (2) (3) (4)

During the year ended December 31, 2011, Rainmaker Entertainment Inc. (Rainmaker) experienced numerous accruals and deferrals. As a long-term employee of Rainmaker's accounting and financial staff, it is your job to explain the effects of accruals and deferrals on Rainmaker's 2011 financial statements. (Rainmaker's 2011 financial statements appear on MyAccountingLab.) Suppose the following questions were raised at the shareholders' meeting:

1. "Prepaid expenses and deposits" in the amount of $523,760 are listed on the December 31, 2011, balance sheet. What items would be included in this balance, and why is this account listed as a balance sheet account instead of an expense account?
2. "Accounts payable and accrued liabilities" are shown on the balance sheet in the amount of $1,308,881. Define an accrued liability.
3. What is "depreciation and amortization," and how much would have been recorded for the year ended December 31, 2011?

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

NEW

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

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.

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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 practise accounting in a variety of ways that meet their learning needs and study preferences.

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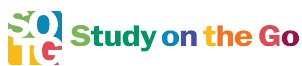

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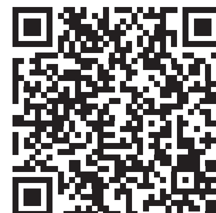

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Instructor's Resources on the Online Catalogue at http://catalogue.pearsoned.ca

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.
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- **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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Brad Witt, Humber College

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Thanks are extended to Gildan Activewear Inc. and Rainmaker Entertainment Inc. for permission to use their annual reports in Volumes 1 and 2 of this text and on MyAccountingLab. We acknowledge the support provided by the websites of various news organizations, and by the annual reports of a large number of public companies.

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

12 Partnerships

KEY QUESTIONS		LEARNING OBJECTIVES
What are the characteristics of a partnership?	1	Identify the characteristics of a partnership
How do we account for partners' investments in a partnership?	2	Account for partners' initial investments in a partnership
How can we allocate profits and losses to the partners?	3	Allocate profits and losses to the partners by different methods
How do we account for a new partner?	4	Account for the admission of a new partner
How do we account for the withdrawal of a partner?	5	Account for the withdrawal of a partner
How do we account for the ending of a partnership?	6	Account for the liquidation of a partnership
How does IFRS affect partnerships?	7	Identify the impact on partnerships of international financial reporting standards (IFRS)

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In this chapter, we will explain the partnership form of business organization and examine many of the issues that affect partnerships.

[1] From the Osler, Hoskin & Harcourt website www.osler.com/AboutUs/, accessed August 9, 2012.

CONNECTING CHAPTER 12

1	2	3	4	5	6	7
Identify the characteristics of a partnership	Account for partners' initial investments in a partnership	Allocate profits and losses to the partners by different methods	Account for the admission of a new partner	Account for the withdrawal of a partner	Account for the liquidation of a partnership	Identify the impact on partnerships of international financial reporting standards (IFRS)
What are the characteristics of a partnership? page 756	*How do we account for partners' investments in a partnership? page 761*	*How can we allocate profits and losses to the partners? page 762*	*How do we account for a new partner? page 768*	*How do we account for the withdrawal of a partner? page 772*	*How do we account for the ending of a partnership? page 776*	*How does IFRS affect partnerships? page 780*
Characteristics of a Partnership, page 756	Forming a Partnership, page 761	Sharing Partnership Profits and Losses, page 762	Admission of a Partner, page 768	Withdrawal of a Partner from the Business, page 772	Liquidation of a Partnership, page 776	The Impact on Partnerships of International Financial Reporting Standards (IFRS), page 780
Types of Partnerships, page 759		Partner Withdrawals (Drawings) of Cash and Other Assets, page 766		Death of a Partner, page 775		
Partnership Financial Statements, page 759						

MyAccountingLab

- Chapter 12: DemoDoc covering Partnerships
- Chapter 12: Student PowerPoint Slides
- Chapter 12: Audio Chapter Summary

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

The **Summary** for Chapter 12 appears on page 782.
Accounting Vocabulary with definitions appears on page 784.

The partnership form of business introduces some complexities that a proprietorship avoids:

- How much cash should a new partner contribute to the business?
- How should the partners divide profits and losses?
- How should a partner who leaves the firm be compensated for her or his share of the business?

A **partnership** is an association of two or more persons who co-own a business for profit. This definition is common to the various provincial partnership acts, which tend to prescribe similar rules with respect to the organization and operation of partnerships in their jurisdictions.

Forming a partnership is easy. It requires no permission from government authorities and involves no legal procedures, with the exception that most provinces require most partnerships to register information such as the names of the

partners and the name under which the business will be conducted.[2] When two people decide to go into business together, a partnership is automatically formed.

A partnership combines the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. As the chapter-opening story illustrates, this is an important characteristic of a partnership. Osler, Hoskin & Harcourt LLP is successful because it is able to combine the skills of its very specialized lawyers and provide its clients with a complete roster of legal services. It is unlikely a lawyer operating as a proprietorship could offer the same level of expertise.

Partnerships come in all sizes. Many partnerships have fewer than 10 partners. Some medical practices may have 10 or more partners, while some of the largest law firms in Canada have more than 300 partners. The largest accounting firm in Canada has more than 500 partners.[3] Exhibit 12–1 lists the 10 largest public accounting firms in Canada. The majority of them are partnerships.

EXHIBIT 12–1 | The Ten Largest Accounting Firms in Canada

Rank 2011	Firm	Revenue (Millions)	Number of Partners/Principals
1	Deloitte & Touche LLP	$1,505	538
2	PricewaterhouseCoopers LLP	1,180	420
3	KPMG LLP	1,138	429
4	Ernst & Young LLP	870	331
5	Grant Thornton Canada (includes Grant Thornton LLP and Raymond Chabot Grant Thornton (Quebec))	515	416
6	BDO Canada LLP	426	382
7	MNP LLP	374	283
8	Collins Barrow National Co-operative	143	177
9	RSM Richter	84	76
10	Mallette	53	59

Source: "Canada's Accounting Top 30," *The Bottom Line*, April 2012, online at www.thebottomlinenews.ca/documents/Canadas_Accounting_Top_30.pdf, accessed August 15, 2012. Courtesy of *The Bottom Line*.

WHY IT'S DONE THIS WAY

Beginning with this chapter, you will learn more about the different types of organization structures that were first mentioned in Chapter 1. To this point, proprietorships were studied extensively. This chapter covers partnerships and the remaining chapters after this focus on corporations.

The good news is that the principles and concepts in the accounting framework described in Chapter 1 (and repeated on the back inside cover of this book) apply equally to all types of organizations, including partnerships. Accounting differences among types of organizations only relate to the equity section of the balance sheet. Therefore, the ***Level 4*** recognition and measurement criteria and constraints apply equally to partnerships as well as proprietorships and corporations. The ***Level 3*** elements of financial statements are the same for the three types of organizations except for an expansion in the partnership's equity section (and further expansion in the corporation's equity section). For partnerships, the ***Level 2*** qualitative characteristics of accounting information are the same as for proprietorships and corporations, and the ***Level 1*** objective of financial reporting continues to be to communicate useful information to users of partnership financial information.

[2] Smyth, J.E., D.A. Soberman, A.J. Easson, and S.S. McGill, *The Law and Business Administration in Canada*, 13th edition (Toronto: Pearson Canada Inc., 2013), pp. 598–602.

[3] "Canada's Accounting Top 30," *The Bottom Line*, April 2012, online at www.thebottomlinenews.ca/documents/Canadas_Accounting_Top_30.pdf, accessed August 15, 2012.

Characteristics of a Partnership

LO 1
What are the characteristics of a partnership?

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner (unless existing partners vote and the majority accept the new partner). The following characteristics distinguish partnerships from proprietorships and from corporations.

The Written Partnership Agreement

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. However, there can still be disagreements even when there is a written agreement.

A business partnership is somewhat like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates, partners should draw up a **partnership agreement**. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[4]

The partnership agreement should specify the following points:

1. Name, location, and nature of the business
2. Name, capital investment, and duties of each partner
3. Procedures for admitting a new partner
4. Method of sharing profits and losses among the partners
5. Withdrawals of assets allowed to the partners
6. Procedures for settling disputes among the partners
7. Procedures for settling with a partner who withdraws from the firm
8. Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
9. Procedures for liquidating the partnership—selling the assets, paying the liabilities, and giving any remaining cash to the partners

As partners enter and leave the business, the old partnership is dissolved and a new partnership is formed. Drawing up a new agreement for each new partnership may be expensive and time-consuming.

Limited Life

A partnership has a limited life. If one partner withdraws from the business, the partnership dissolves and its books are closed. If the remaining partners want to continue as partners in the same business, they form a new partnership with a new set of books. **Dissolution** is the ending of a partnership and does not require liquidation; that is, the assets need not be sold to outside parties for a new partnership to be created. Often the new partnership continues the former partnership's business, and the new partnership may choose to continue to use the dissolved partnership's name. Large partnerships such as PricewaterhouseCoopers retain the firm name even after partners resign from the firm.

[4] Smyth, J.E., D.A. Soberman, A.J. Easson, and S.A. McGill, *The Law and Business Administration in Canada*, 13th edition (Toronto: Pearson Canada Inc., 2013), pp. 598–618.

Mutual Agency

Mutual agency means that every partner is a mutual agent of the firm. Any partner can bind the business to a contract within the scope of the partnership's regular business operations. If a partner enters into a contract with a person or another business to provide a service, then the firm—not just the partner who signed the contract—is bound to provide that service. If the partner signs a contract to buy her own car, however, the partnership is not liable because the car is a personal matter. It is not within the scope of the regular business operations of the partnership.

The following example shows the impact mutual agency can have on a partnership. Richard Harding and Simon Davis formed a partnership to deal in lumber and other building material. The partners agreed that their company should not handle brick or any stone materials and that neither partner had the right to purchase these commodities. While Harding was away during the summer, Davis purchased a quantity of these materials for the company because he could buy them at a cheap price. Two months later, when Harding returned, business was very slow, and brick and stone were selling at a price lower than Davis had paid for them. Harding, therefore, refused to abide by the contract Davis had made with the brick and stone supplier, and refused to accept any more deliveries under the contract. Harding argued that Davis had no authority to buy these goods since the partnership was not organized to deal in brick and stone. The supplier of the brick and stone said that he did not know the partnership was not in the brick and stone business. In fact, he believed that it did handle these goods since all of the other lumber companies in the town bought or sold brick and stone. Because the supplier acted in good faith, he claimed that Harding and Davis should abide by the contract and accept the remaining deliveries of brick and stone. Who was correct? Under normal circumstances, the brick-and-stone supplier is correct because the mutual agency characteristic of a partnership allows partners to bind each other in business contracts. The agreements made within the partnership would not be known by an outside party like the supplier, so the supplier would have a solid case and could sue the partnership to abide by the contract.[5]

Unlimited Liability

Each partner has **unlimited personal liability** for the debts of the business. When a partnership cannot pay its debts with business assets, the partners must pay with their personal assets. (There are exceptions, which are described in the next section, Types of Partnerships.) Proprietors also have unlimited personal liability for the debts of their business.

Suppose the partnership of Willis & Jones cannot pay a $20,000 business debt that Jones created. Willis and Jones each become personally liable (must pay this amount with their personal assets) because each partner has *unlimited liability* for their business debts. If either partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment.

Unlimited liability and mutual agency are closely related. A dishonest partner or a partner with poor judgment may commit the partnership to a contract under which the business loses money. In turn, creditors may force *all* the partners to pay the debt from their personal assets. Hence, a business partner should be chosen with great care. This was shown in the Harding and Davis partnership described above.

[5] This case is based on the scenario described on http://chestofbooks.com/business/law/Case-Method/B-Apparent-Scope-Of-Authority.html#ixzz1qimHxY2o, accessed on August 14, 2012.

KEY POINTS

A personal investment of assets in a partnership becomes the joint property of all the partners.

Co-ownership of Property

Any asset—cash, inventory, machinery, computers, and so on—that a partner invests into the partnership becomes the joint property of all the partners. The partner who invested the asset is no longer its sole owner.

No Partnership Income Tax

A partnership pays no income tax on its business income. Instead, the net income of the partnership is divided and flows through to become the taxable income of the partners. Suppose the Willis & Jones partnership earned net income of $150,000, shared equally by the two partners. The partnership would pay no income tax *as a business entity*. However, each partner would pay income tax *as an individual* on his or her $75,000 share of partnership income.

Partners' Equity Accounts

Recall from Chapter 1, page 16, that owner's equity for a proprietorship has only one account, entitled "Capital." Accounting for a partnership is much like accounting for a proprietorship. We record buying and selling goods and services, collecting and paying cash for a partnership just as we do for a proprietorship. But, because a partnership has more than one owner, the partnership must have a separate owner's equity account for each partner. For example, the equity account for Leslie Willis is "L. Willis, Capital." Just as a proprietor has a drawings or withdrawal account (a temporary account), each partner in a partnership has a withdrawal account, such as "L. Willis, Withdrawals."

Exhibit 12–2 lists the advantages and disadvantages of partnerships (compared with proprietorships and corporations). Most features of a proprietorship also apply to a partnership, most importantly

- Limited life
- Unlimited liability
- No business income tax

EXHIBIT 12–2 | Advantages and Disadvantages of Partnerships

Partnership Advantages	Partnership Disadvantages
Versus Proprietorships: 1. A partnership can raise more capital since capital comes from more than one person. 2. A partnership brings together the abilities of more than one person. 3. Partners working well together can achieve more than by working alone: 1 + 1 > 2 in a good partnership. *Versus Corporations:* 4. A partnership is less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government. 5. A partnership is subject to fewer governmental regulations and restrictions than is a corporation.	1. A partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement. 2. Relationships among partners may be fragile. 3. Mutual agency and unlimited liability create personal obligations for each partner.

Types of Partnerships

There are two basic types of partnerships: general and limited.

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partner is a co-owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business. The partnership *reports* its income to the government tax authority (Canada Revenue Agency, or CRA), but the partnership pays *no* income tax. The profits and losses of the partnership pass through the business to the partners, who then pay personal income tax on their income. All the other features just covered also apply to a general partnership.

Limited Partnerships

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership.* A **limited partnership** has at least two classes of partners. There must be at least one *general partner,* who takes primary responsibility for the management of the business. The general partner also takes most of the risk of failure if the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships, such as real-estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after the limited partners get their share of the income.

Since all partners are personally liable for any debt of the business, it is extremely important to choose a partner carefully. This is one reason some investors/partners prefer the *limited partnership* form of business organization.

The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Limited partners have limited liability similar to the limited liability that shareholders in a corporation have. Usually, the limited partners have invested the bulk of the partnership's assets and capital. They, therefore, usually have the first claim to partnership profits and losses, but only up to a specified limit. In exchange for their limited liability, their potential for profits usually has a limit as well.

Most professionals, such as doctors, lawyers, and most public accounting firms in Canada—including almost all of those in Exhibit 12–1—are now organized as **limited liability partnerships (LLPs)**. An LLP can only be used by eligible professions—accounting is an eligible profession—and is designed to protect innocent partners from negligence damages that result from another partner's actions. This means that each partner's personal liability for other partners' negligence is limited to a certain dollar amount, although liability for a partner's own negligence is still unlimited. The LLP must carry an adequate amount of malpractice insurance or liability insurance to protect the public.

Partnership Financial Statements

Partnership financial statements are much like those of a proprietorship. However, a partnership income statement includes a section showing the division of net income to the partners. A partnership balance sheet reports a separate Capital account for each partner in the section now called Partners' Equity. Large partnerships may show one balance, the total for all partners. For example, the Willis & Jones partnership of Leslie Willis and Andrew Jones might report its financial statements for the year ended December 31, 2014, as shown in Panel A of Exhibit 12–3 on the next page. A proprietorship's financial statements are presented in Panel B for comparison.

EXHIBIT 12–3 | Financial Statements of a Partnership and a Proprietorship (all amounts in thousands of dollars)

PANEL A—PARTNERSHIP			PANEL B—PROPRIETORSHIP	
WILLIS & JONES			**WILLIS CONSULTING**	
Income Statement			**Income Statement**	
For the Year Ended December 31, 2014			**For the Year Ended December 31, 2014**	
Revenues		$460	Revenues	$460
Expenses		(270)	Expenses	(270)
Net income		$190	Net income	$190
Allocation of net income:				
To Leslie Willis	$114			
To Andrew Jones	76	$190		
WILLIS & JONES			**WILLIS CONSULTING**	
Statement of Owners' Equity*			**Statement of Owner's Equity**	
For the Year Ended December 31, 2014			**For the Year Ended December 31, 2014**	
	Willis	**Jones**	Capital, January 1, 2014	$ 90
Capital, January 1, 2014	$ 50	$40	Additional investments	10
Additional investments	10	—	Net income	190
Net income	114	76	Subtotal	290
Subtotal	174	116	Withdrawals	(120)
Withdrawals	(72)	(48)	Capital, December 31, 2014	$170
Capital, December 31, 2014	$102	$68		
WILLIS & JONES			**WILLIS CONSULTING**	
Balance Sheet			**Balance Sheet**	
December 31, 2014			**December 31, 2014**	
Assets			**Assets**	
Cash and other assets		$170	Cash and other assets	$170
Partners' Equity				
Leslie Willis, capital		**$102**		
Andrew Jones, capital		**68**	**Owner's Equity**	
Total equity		$170	Leslie Willis, capital	$170

*This statement could also be called a Statement of Partners' Equity.

✓JUST CHECKING

1. John Richards and Patricia Quinn would like to form a partnership to open up a night club—Endelay's. They each have $100,000 and have decided that since they have been life-long friends, they do not need a written partnership agreement. Detail the contents of a partnership agreement and explain the importance of a written agreement to Richards and Quinn.
2. Suppose you were giving the friends in the previous question advice on their decision to form a partnership. Detail the advantages and disadvantages of their decision.
3. Richards and Quinn may, at some point, want to bring in a partner who does not want any day-to-day responsibility for managing the operations; he or she may simply want to receive a return on his or her investment. Describe the type of partner this person would be.

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

Forming a Partnership

LO 2
How do we account for partners' investments in a partnership?

Let's examine the start up of a partnership. Partners in a new partnership may invest assets and their related liabilities in the business. These contributions are journalized in the same way as for proprietorships, by debiting the assets and crediting the liabilities at their agreed-upon values. Each person's net contribution—assets minus liabilities—is credited to the equity account for that person. Often the partners hire an independent firm to appraise their assets and liabilities at current market value at the time a partnership is formed. This outside evaluation assures an objective valuation for what each partner brings into the business.

Suppose Katie Zheng and Dan Chao form a partnership on June 1, 2014 to develop and sell computer software. The partners agree on the following values based on an independent appraisal:

Zheng's contributions

- Cash, $10,000; inventory, $40,000; and accounts payable, $80,000 (The appraiser believes that the current market values for these items equal Zheng's book values.)
- Computer equipment: cost, $800,000; accumulated amortization, $200,000; current market value, $450,000

Chao's contributions

- Cash, $5,000
- Computer software: cost, $50,000; current market value, $100,000

There is a way for a partner to allow the partnership to use a personal asset, such as a car or money, without losing his or her claim to that asset. The partner could lease the car to the partnership. If the partnership were liquidated, the car would have to be returned to its owner. The partner could also lend money to the partnership instead of investing it. Upon liquidation, the partnership would have to repay the loan to the lending partner before any distribution of capital to the partners.

The partnership records receipts of the partners' initial investments at the current market values of the assets and liabilities because, in effect, the partnership is buying the assets and assuming the liabilities at their current market values. The partnership entries are as follows:

Zheng 's investment

2014			
Jun. 1	Cash	10,000	
	Inventory	40,000*	
	Computer Equipment	450,000*	
	Accounts Payable		80,000*
	Katie Zheng, Capital		420,000
	To record Zheng's investment in the partnership ($500,000 – $80,000).		

Chao's investment

2014			
Jun. 1	Cash	5,000	
	Computer Software	100,000*	
	Dan Chao, Capital		105,000
	To record Chao's investment in the partnership.		

*The assets were appraised and their current market values were used.

The major difference in accounting for a proprietorship versus a partnership is the number of Capital and Withdrawal accounts. The partnership balance sheet shows a separate Capital account for each partner, and there is a separate Withdrawals account for each partner. The asset and liability sections on the balance sheet and the income statement are the same for a proprietorship and a partnership.