

# ACCOUNTING PRINCIPLES

THIRTEENTH EDITION

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# Accounting Principles

Thirteenth Edition

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Enid, Merlynn, and Donna, for their love,  
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\* Available in WileyPLUS and Wiley Custom.

# From the Authors

Dear Student,

**WHY THIS COURSE?** Remember your biology course in high school? Did you have one of those “invisible man” models (or maybe something more high-tech than that) that gave you the opportunity to look “inside” the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.

“Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening.”

**WHY THIS TEXT?** Your instructor has chosen this text for you because of the authors’ trusted reputation. The authors have worked hard to write a text that is engaging, timely, and accurate.

**HOW TO SUCCEED?** We’ve asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: “Do the homework.” This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this text provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the text itself, WileyPLUS also offers various support resources.

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

**Jerry J. Weygant**  
**Paul D. Kimmel**  
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# Author Commitment



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# Hallmark Features

*Accounting Principles, Thirteenth Edition*, provides a simple and practical introduction to the fundamentals of accounting. It explains the concepts you need to know. This edition continues this approach by offering even more explanations, illustrations, and homework problems to help students get a firm understanding of the accounting cycle.

## DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

**DO IT! 3 | Correcting Entries**

Sanchez Company discovered the following errors made in January 2020.

- A payment of Salaries and Wages Expense of \$600 was debited to Supplies and credited to Cash, both for \$600.
- A collection of \$3,000 from a client on account was debited to Cash \$200 and credited to Service Revenue \$200.
- The purchase of supplies on account for \$860 was debited to Supplies \$680 and credited to Accounts Payable \$680.

Correct the errors without reversing the incorrect entry.

**Solution**

1. Salaries and Wages Expense	600		
Supplies		600	
2. Service Revenue	200		
Cash	2,800		
Accounts Receivable			3,000

**ACTION PLAN**

- Compare the incorrect entry with correct entry.
- After comparison, make an entry to correct the accounts.

## Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

**Practice Brief Exercises**

Prepare the current assets section of a balance sheet.

**3. (LO 4) Financial Statement** The balance sheet debit column of the worksheet for Miguel Company includes the following accounts: Accounts Receivable \$25,000, Prepaid Insurance \$7,000, Cash \$8,000, Supplies \$11,000, and Stock Investments (short-term) \$14,000. Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

**Solution**

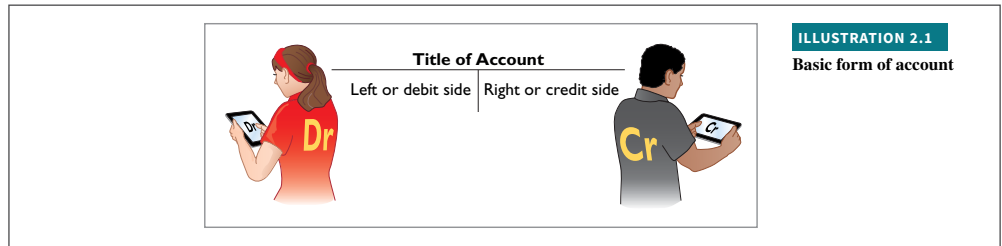
3.

Miguel Company	
Partial Balance Sheet	
Current assets	
Cash	\$ 8,000
Stock investments	14,000
Accounts receivable	25,000
Supplies	11,000
Prepaid insurance	7,000
Total current assets	\$65,000



# Infographic Learning


Over half of the text is visual, providing students alternative ways of learning about accounting. In addition, a new interior design promotes accessibility.



# Real-World Decision-Making

Real-world examples that illustrate interesting situations in companies and how accounting information is used are integrated throughout the text, such as in the opening Feature Story as well as the Insight boxes.

People, Planet, and Profit Insight



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**Regaining Goodwill**

After falling to unforeseen lows amidst scandals, recalls, and economic crises, the American public's positive perception of the reputation of corporate America is on the rise. Overall corporate reputation is experiencing rehabilitation as the American public gives high marks overall to corporate America, specific industries, and the largest number of individual companies in a dozen years. This is according to the findings of a *Harris Interactive RQ Study*, which measures the reputations of the 60 most visible companies in the United States.

The survey focuses on six reputational dimensions that influence reputation and consumer behavior. Four of these dimensions, along with the five corporations that ranked highest within each, are as follows.

- **Social Responsibility:** (1) Whole Foods Market, (2) Johnson & Johnson, (3) Google, (4) The Walt Disney Company, (5) Procter & Gamble Co.
- **Emotional Appeal:** (1) Johnson & Johnson, (2) Amazon.com, (3) UPS, (4) General Mills, (5) Kraft Foods
- **Financial Performance:** (1) Google, (2) Berkshire Hathaway, (3) Apple, (4) Intel, (5) The Walt Disney Company
- **Products and Services:** (1) Intel Corporation, (2) 3M Company, (3) Johnson & Johnson, (4) Google, (5) Procter & Gamble Co.

**Source:** [www.harrisinteractive.com](http://www.harrisinteractive.com).

Name two industries today which are probably rated low on the reputational characteristics of “being trusted” and “having high ethical standards.” (Go to WileyPLUS for this answer and additional questions.)

# Additional Guidance

Throughout the text, marginal notes, such as **Helpful Hints**, **Alternative Terminology**, and **Ethics Notes**, are provided as additional guidance. In addition, more than 100 new solution walkthrough videos are now available in WileyPLUS.

Correcting Entries—An Avoidable Step

Unfortunately, errors may occur in the recording process. Companies should correct errors, **as soon as they discover them**, by journalizing and posting **correcting entries**. If the accounting records are free of errors, no correcting entries are needed.

You should recognize several differences between correcting entries and adjusting entries. First, adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records are error-free. Second, companies journalize and post adjustments **only at the end of an accounting period**. In contrast, companies make correcting entries **whenever they discover an error** (see **Ethics Note**). Finally, adjusting entries always affect at least one balance sheet account and one income statement account. In

**ETHICS NOTE**

When companies find errors in previously released income statements, they restate those numbers. Perhaps because of the increased scrutiny caused by Sarbanes-Oxley, in a recent year companies filed a record 1,195 restatements

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# Accounting in Action

The **Chapter Preview** describes the purpose of the chapter and highlights major topics.

## Chapter Preview

The following Feature Story about **Columbia Sportswear Company** highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.

## Feature Story

### Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need to know accounting?” Well, consider this quote from Harold Geneen, the former chairman of **IT&T**: “To be good at your business, you

have to know the numbers—cold.” In business, accounting and financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle’s family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat

Company. In 1971, Gert's husband, who was then running the company, died suddenly of a heart attack. The company was in the midst of an aggressive expansion, which had taken its sales above \$1 million for the first time but which had also left the company financially stressed. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of \$1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail. Gert still heads up the Board of Directors, and Tim is the company's President and CEO.

Columbia doesn't just focus on financial success. The company is very committed to corporate, social, and environmental responsibility. For example, several of its factories

have participated in a project to increase health awareness of female factory workers in developing countries. Columbia was also a founding member of the Sustainable Apparel Coalition, which is a group that strives to reduce the environmental and social impact of the apparel industry. In addition, it monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address issues including forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, in this textbook you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results.

The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.

## Chapter Outline

### LEARNING OBJECTIVES

<b>LO 1</b> Identify the activities and users associated with accounting.	<ul style="list-style-type: none"> <li>• Three activities</li> <li>• Who uses accounting data</li> </ul>	<b>DO IT! 1</b> Basic Concepts
<b>LO 2</b> Explain the building blocks of accounting: ethics, principles, and assumptions.	<ul style="list-style-type: none"> <li>• Ethics</li> <li>• GAAP</li> <li>• Measurement principles</li> <li>• Assumptions</li> </ul>	<b>DO IT! 2</b> Building Blocks of Accounting
<b>LO 3</b> State the accounting equation, and define its components.	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Owner's equity</li> </ul>	<b>DO IT! 3</b> Owner's Equity Effects
<b>LO 4</b> Analyze the effects of business transactions on the accounting equation.	<ul style="list-style-type: none"> <li>• Accounting transactions</li> <li>• Transaction analysis</li> <li>• Summary of transactions</li> </ul>	<b>DO IT! 4</b> Tabular Analysis
<b>LO 5</b> Describe the four financial statements and how they are prepared.	<ul style="list-style-type: none"> <li>• Income statement</li> <li>• Owner's equity statement</li> <li>• Balance sheet</li> <li>• Statement of cash flows</li> </ul>	<b>DO IT! 5</b> Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.

Visit WileyPLUS with ORION for additional tutorials and practice opportunities.

# Accounting Activities and Users

## LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by **Nike** founder Phil Knight, **Home Depot** co-founder Arthur Blank, former acting director of the **Federal Bureau of Investigation (FBI)** Thomas Pickard, and numerous members of Congress? Accounting.<sup>1</sup> Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

**Accounting** consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

*Essential terms are printed in blue when they first appear, and are defined in the end-of-chapter Glossary Review.*

## Three Activities

As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, the provision of cell phone services by **AT&T**, and the payment of wages by **Facebook**.

Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

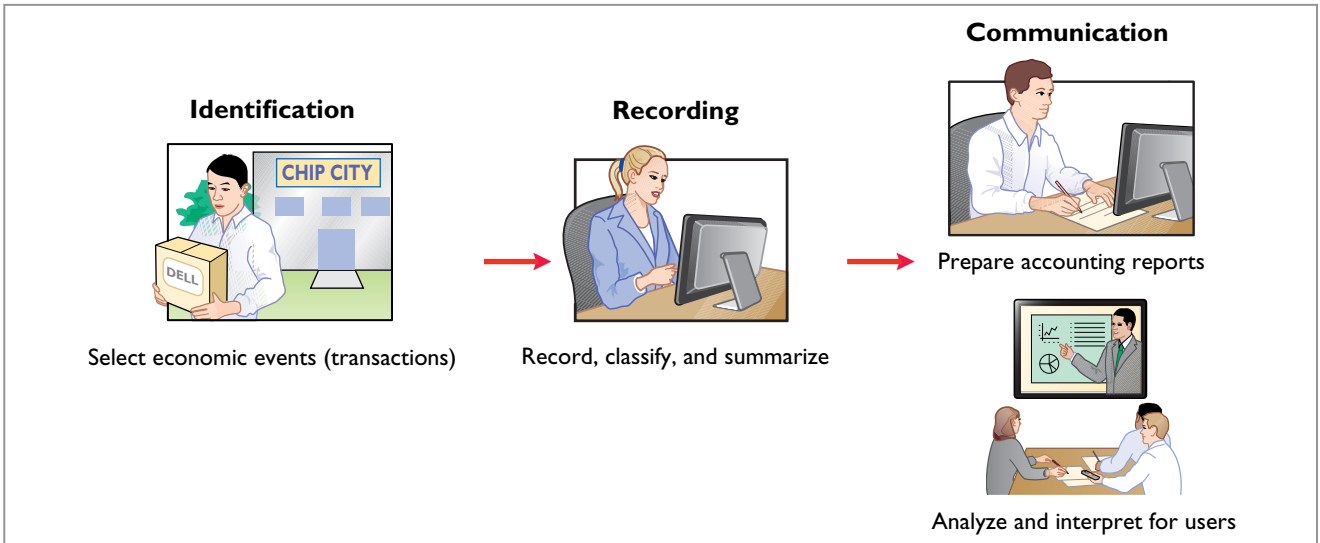
Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**. Appendices A–E show the financial statements of **Apple Inc.**, **PepsiCo Inc.**, **The Coca-Cola Company**, **Amazon.com, Inc.**, and **Wal-Mart Stores, Inc.**, respectively. (In addition, in the *A Look at IFRS* section at the end of each chapter, the French company **Louis Vuitton Moët Hennessy** is analyzed.) We refer to these statements at various places throughout the textbook. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

<sup>1</sup>The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

**Illustration 1.1** summarizes the activities of the accounting process.

**ILLUSTRATION 1.1** The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**<sup>2</sup>

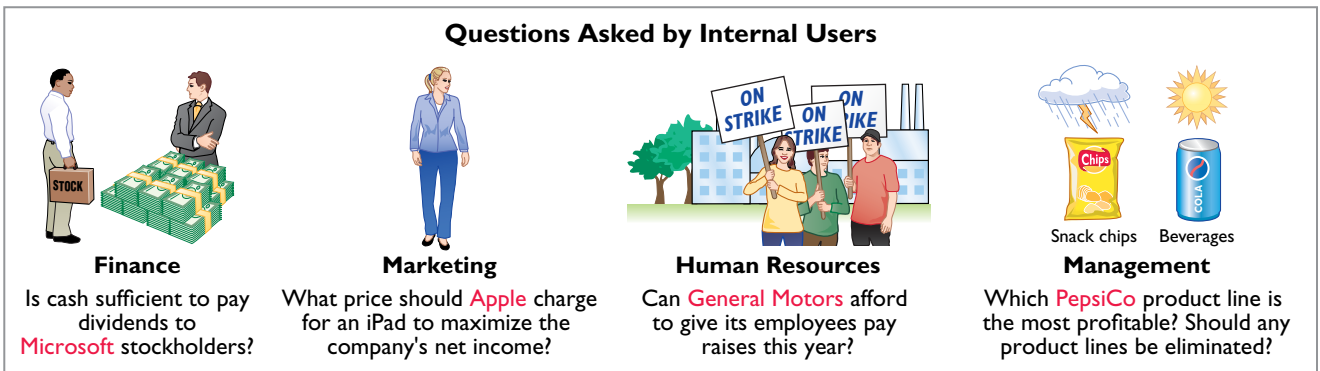
## Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

### Internal Users

**Internal users** of accounting information are the managers who plan, organize, and run a business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in **Illustration 1.2**.

**ILLUSTRATION 1.2** Questions that internal users ask



<sup>2</sup>The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

## Accounting Across the Organization Clif Bar & Company



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### Owning a Piece of the Bar

The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor's Breakaway Brands®. One of **Clif Bar & Company's** proudest moments was the creation of an employee stock own-

ership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

**What are the benefits to the company and to the employees of making the financial statements available to all employees? (Go to WileyPLUS for this answer and additional questions.)**

*Accounting Across the Organization boxes demonstrate applications of accounting information in various business functions.*

## External Users

**External users** are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. **Illustration 1.3** shows some questions that investors and creditors may ask.

### ILLUSTRATION 1.3 Questions that external users ask

#### Questions Asked by External Users

**Investors**

Is **General Electric** earning satisfactory income?

**Investors**

How does **Disney** compare in size and profitability with **Time Warner**?

**Creditors**

Will **United Airlines** be able to pay its debts as they come due?

**Financial accounting** answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws. **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like **Tesla Motors** will continue to honor product warranties and support its product lines. **Labor unions**, such as the **Major League Baseball Players Association**, want to know whether the owners have the ability to pay increased wages and benefits.



The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the **Action Plan** necessary to complete the exercise, and they show a **Solution**.

## DO IT! 1 | Basic Concepts

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

### Solution

1. True 2. False. Bookkeeping involves only the recording step. 3. False. Accountants analyze and interpret information in reports as part of the communication step. 4. False. The two most common types of external users are investors and creditors. 5. True.

Related exercise material: **DO IT! 1.1, E1.1, and E1.2.**

### ACTION PLAN

- Review the basic concepts discussed.
- Develop an understanding of the key terms used.

## The Building Blocks of Accounting

### LEARNING OBJECTIVE 2

Explain the building blocks of accounting: ethics, principles, and assumptions.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

## Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think prices are rigged. At one time, the financial press was full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG**. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals (see **Ethics Note**). As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

### ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

*Ethics Notes help sensitize you to some of the ethical issues in accounting.*

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this textbook:

1. A number of the *Feature Stories* and other parts of the textbook discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in **Illustration 1.4**.

#### ILLUSTRATION 1.4 Steps in analyzing ethics cases and situations



##### 1. Recognize an ethical situation and the ethical issues involved.

Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

##### 2. Identify and analyze the principal elements in the situation.

Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

##### 3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.

Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

*Insight* boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions as well as additional questions are available in **WileyPLUS**.

### Ethics Insight Dewey & LeBoeuf LLP



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#### I Felt the Pressure—Would You?

“I felt the pressure.” That’s what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- “I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate.”

- “I intentionally gave the auditors incorrect information in the course of the audit.”

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

**Source:** Ashby Jones, “Guilty Pleas of Dewey Staff Detail the Alleged Fraud,” *Wall Street Journal* (March 28, 2014).

**Why did these employees lie, and what do you believe should be their penalty for these lies? (Go to WileyPLUS for this answer and additional questions.)**

**INTERNATIONAL NOTE**

Over 115 countries use international standards (called IFRS). For example, all companies in the European Union follow IFRS. The differences between U.S. and international standards are not generally significant.

*International Notes highlight differences between U.S. and international accounting standards.*

## Generally Accepted Accounting Principles

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)** (see **International Note**).

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. This process is referred to as **convergence**. As a result of these convergence efforts, someday there may be a single set of high-quality accounting standards that are used by companies around the world. Because convergence is such an important issue, we highlight any major differences between GAAP and IFRS in *International Notes* (as shown in the margin here) and provide a more in-depth discussion in the *A Look at IFRS* section at the end of each chapter.

### International Insight



Toru-Hanai-Pool/Getty Images, Inc.

#### The Korean Discount

If you think that accounting standards don't matter, consider these events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

**Source:** Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

**What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (Go to WileyPLUS for this answer and additional questions.)**

**HELPFUL HINT**

*Relevance and faithful representation are two primary qualities that make accounting information useful for decision-making.*

*Helpful Hints further clarify concepts being discussed.*

## Measurement Principles

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation (see **Helpful Hint**). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

### Historical Cost Principle

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if **Best Buy** purchases land for \$300,000, the company initially reports

it in its accounting records at \$300,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to \$400,000? Under the historical cost principle, it continues to report the land at \$300,000.

## Fair Value Principle

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market price information is usually readily available for these types of assets. In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

## Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

### Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to applying the historical cost principle.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money.

### Economic Entity Assumption

**An economic entity can be any organization or unit in society.** It may be a company (such as **Crocs, Inc.**), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities (see **Ethics Note**). To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the business. Similarly, **J. Crew** and **Gap Inc.** are segregated into separate economic entities for accounting purposes.

**Proprietorship.** A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

**Partnership.** A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to

#### ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving **Adelphia**. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over \$2 billion of loans to the founding family.

be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants).

**Corporation.** A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**. The holders of the shares (stockholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Stockholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest companies in the United States—for example, **Exxon-Mobil, Ford, Wal-Mart Stores, Inc., Citigroup, and Apple**—are corporations.

## Accounting Across the Organization



Josef Volavka/iStockphoto

### Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include:

**General management:** Managers at **Ford Motors**, Massachusetts General Hospital, California State University—Fullerton, a **McDonald's** franchise, and a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.

**Marketing:** Marketing specialists at **Procter & Gamble** must be sensitive to costs and benefits, which accounting helps them quantify

and understand. Making a sale is meaningless unless it is a profitable sale.

**Finance:** Do you want to be a banker for **Citicorp**, an investment analyst for **Goldman Sachs**, or a stock broker for **Merrill Lynch**? These fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

**Real estate:** Are you interested in being a real estate broker for **Prudential Real Estate**? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

**How might accounting help you? (Go to WileyPLUS for this answer and additional questions.)**

## DO IT! 2 | Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.
2. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

### ACTION PLAN

- Review the discussion of ethics and financial reporting standards.
- Develop an understanding of the key terms used.

**Solution**

1. True. 2. True. 3. False. The historical cost principle dictates that companies record assets at their cost. Under the historical cost principle, the company must also use cost in later periods. 4. False. Faithful representation, not relevance, means that financial information matches what really happened; the information is factual. 5. True.

Related exercise material: **DO IT! 1.2, E1.3, and E1.4.**

## The Accounting Equation

### LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **Alphabet Inc.** has total assets of approximately \$167.5 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, Alphabet has \$167.5 billion of claims against its \$167.5 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **owner's equity**. Alphabet has liabilities of \$28.5 billion and owners' equity of \$139.0 billion.

We can express the relationship of assets, liabilities, and owner's equity as an equation, as shown in **Illustration 1.5**.

<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Owner's Equity</b>
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### ILLUSTRATION 1.5

The basic accounting equation

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and owner's equity. Liabilities appear before owner's equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as **PepsiCo**. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

## Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Campus Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza are tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

## Liabilities

**Liabilities** are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.