

Organized as a Proprietorship

ENCORE MUSIC CHART OF ACCOUNTS

General Ledger

Balance Sheet Accounts

- (100) ASSETS
 - 110 Cash
 - 120 Petty Cash
 - 130 Accounts Receivable—Kids Time
 - 140 Accounts Receivable—Learn N Play
 - 150 Supplies
 - 160 Prepaid Insurance
- (200) LIABILITIES
 - 210 Accounts Payable—Ling Music Supplies
 - 220 Accounts Payable—Sullivan Office Supplies

- (300) OWNER'S EQUITY
 - 310 Barbara Treviño, Capital
 - 320 Barbara Treviño, Drawing
 - 330 Income Summary

Income Statement Accounts

- (400) REVENUE
 - 410 Sales
- (500) EXPENSES
 - 510 Advertising Expense
 - 520 Insurance Expense
 - 530 Miscellaneous Expense
 - 540 Rent Expense
 - 550 Supplies Expense
 - 560 Utilities Expense

The chart of accounts for Encore Music is illustrated above for ready reference as you study Cycle 1 of this textbook.

1 Starting a Proprietorship

AFTER STUDYING CHAPTER 1, YOU WILL BE ABLE TO:

1. Define accounting terms related to starting a service business organized as a proprietorship.
2. Identify accounting concepts and practices related to starting a service business organized as a proprietorship.
3. Classify accounts as assets, liabilities, or owner's equity and demonstrate their relationships in the accounting equation.
4. Analyze how transactions related to starting a service business organized as a proprietorship affect accounts in an accounting equation.
5. Prepare a balance sheet for a service business organized as a proprietorship from information in an accounting equation.

TERMS PREVIEW

accounting
accounting system
accounting records
service business
proprietorship
asset
equities
liability
owner's equity
accounting equation
transaction
account
account title
account balance
capital
balance sheet

WHAT IS ACCOUNTING?

Planning, recording, analyzing, and interpreting financial information is called **accounting**. A planned process for providing financial information that will be useful to management is called an **accounting system**. Organized summaries of a business's financial activities are called **accounting records**.

Accounting is the language of business. Many individuals in a business complete accounting forms and prepare accounting reports. Owners, managers, and accounting personnel use their knowledge of accounting to understand the information provided in the accounting reports. Regardless of their responsibilities within an organization, individuals can perform their jobs more efficiently if they know the language of business—accounting.

Inaccurate accounting records often contribute to business failure and bankruptcy. Failure to understand accounting information can result in poor business decisions for both businesses and nonprofit organizations. Understanding accounting helps managers and owners make better business decisions.

In addition, nearly everyone in the United States earns money and must submit income tax reports to the federal and state governments. Everyone, personally or for a business, must plan ways to keep spending within available income.

ACCOUNTING IN YOUR CAREER

THE JOB INTERVIEW

Robert Walker had a job interview today. He has just finished his first year of college but is undecided about what he should major in for the rest of his program. He cannot depend on his family to finance his college education, so he is prepared to continue his education as a part-time student and get a full-time job to pay tuition. He has been considering majoring in business, maybe even accounting, but he knows very little about the realities of the business world. Although he knows that completing college as a part-time student will take longer, he feels comfortable with his decision because of the practical experience he will gain from working.



Robert is looking for an office job as an administrative assistant. He can key 60 words per minute and has taken courses in word processing and spreadsheets.

Robert was interviewed by Paula Humphries, who operates a plumbing contractor business in town. At the end of the interview she said to Robert:

Robert, you've got a good academic record. My company is growing rapidly, and I need people I can count on to help it grow. You don't have enough experience to be an administrative assistant, but I would like to start you as a general office assistant, which is an entry-level position. You would do some typing of bids, invoices, purchase orders, and correspondence, set appointments, file, and manage the telephones. You would be required to take an accounting course, which the company will pay for, but you will have to do it on your own time and get a good grade. I am offering you an opportunity to grow with my company. With a good performance record and the additional education, it wouldn't be too long before I could consider promoting you to administrative assistant.

Critical Thinking:

1. Why would Ms. Humphries want Robert to take an accounting course?
2. Should Robert reject this offer and hold out for an administrative assistant position?

1-1 The Accounting Equation



Barbara Treviño
Proprietor

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Tampa, FL 33601

In 1989, Barbara Treviño started Encore Music. After several years of teaching at a local university, Barbara decided to start her own business so that she could have a more flexible schedule. After only two months, she had made all the arrangements and scheduled her first lessons. She has never looked back.

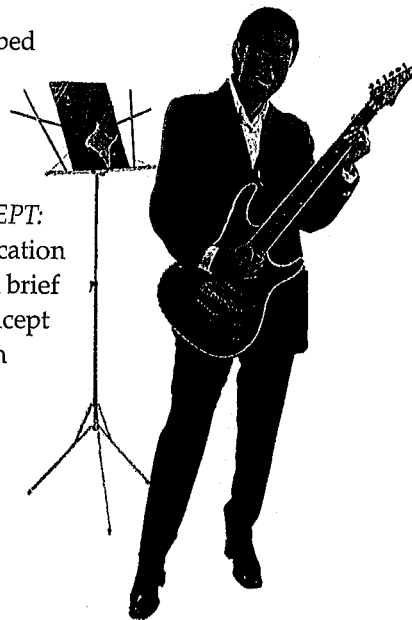
Barbara gets tremendous satisfaction from teaching music. Nothing matches the thrill of hearing a student master an instrument. She also really enjoys being her own boss. She gets a different kind of satisfaction from keeping her own accounting records and seeing that she is making money every month.

THE BUSINESS—ENCORE MUSIC

A business that performs an activity for a fee is called a **service business**. Barbara Treviño decided to start her own business, giving music lessons. A business owned by one person is called a **proprietorship**. A proprietorship is also referred to as a sole proprietorship. Ms. Treviño named her new proprietorship *Encore Music*. Encore Music will rent office space and the instruments used to teach music lessons.

Since Encore Music is a new business, Ms. Treviño must design the accounting system that will be used to keep Encore Music's accounting records. Ms. Treviño must be careful to keep Encore Music's accounting records separate from her own personal financial records. For example, Ms. Treviño owns a house and a personal car. Encore Music's financial records must *not* include information about Ms. Treviño's house, car, or other personal belongings. Ms. Treviño must use one checking account for her personal expenses and another checking account for Encore Music. The accounting concept, *Business Entity*, is applied when a business's financial information is recorded and reported separately from the owner's personal financial information. (**CONCEPT: Business Entity**)

Accounting concepts are described throughout this textbook when an application of a concept first occurs. When additional applications occur, a concept reference, such as (**CONCEPT: Business Entity**), indicates an application of a specific accounting concept. A brief description of each accounting concept used in this text is also provided in Appendix A.



THE ACCOUNTING EQUATION

Assets	=	Liabilities + Owner's Equity
Left side amount		Right side amounts
\$0	=	\$0 + \$0

Encore Music will own items such as cash and supplies that will be used to conduct daily operations. Anything of value that is owned is called an **asset**. Assets have value because they can be used to acquire other assets or be used to operate a business. For example, Encore Music will use cash to buy supplies for the business. Encore Music will then use the asset, supplies, in the operation of the music lesson business.

Financial rights to the assets of a business are called **equities**. A business has two types of equities. (1) Equity of those to whom money is owed. For example, Encore Music may buy some supplies and agree to pay for the supplies at a later date. The business from whom supplies are bought will have a right to some of Encore Music's assets until Encore Music pays for the supplies. An amount owed by a business is called a **liability**. (2) Equity of the owner. Ms. Treviño will own Encore Music and invest in the assets of

the business. Therefore, she will have a right to decide how the assets will be used. The amount remaining after the value of all liabilities is subtracted from the value of all assets is called **owner's equity**.

The relationship among assets, liabilities, and owner's equity can be written as an equation. An equation showing the relationship among assets, liabilities, and owner's equity is called the **accounting equation**. The accounting equation is most often stated as:

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

The accounting equation must be in balance to be correct. Thus, the total of the amounts on the left side of the equation must always equal the total of the amounts on the right side. Before Ms. Treviño actually starts the business, Encore Music's accounting equation would show all zeros.

INTRODUCTION TO BUSINESS ETHICS

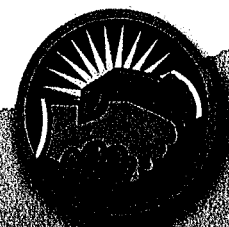
The principles of right and wrong that guide an individual in making decisions are called **ethics**. The use of personal ethics in making business decisions is called **business ethics**.

Throughout this textbook you will have the opportunity to analyze the ethics of common business situations by using the following three-step checklist as a guide in collecting relevant information regarding an action.

1. *Is the action illegal? Does the action violate any laws?* Obeying the law is in your best interest and the best interest of your business.
2. *Does the action violate company or professional standards?* Public laws often set only minimum standards of behavior. Many busi-

nesses and professions set even higher standards of behavior. Thus, an action may be legal, yet still violate standards of the business or profession. Violating these standards may affect your job security and professional certification.

3. *Who is affected, and how, by the action?* If an action is legal and complies with business and professional standards, you must rely on your principles of right and wrong to determine if the action is ethical. Determining how the action affects individuals and groups—including business employees and owners, customers, the local community, and society—will help you decide if an action is ethical.



PROFESSIONAL BUSINESS ETHICS

TERMS REVIEW

accounting	asset
accounting system	equities
accounting records	liability
service business	owner's equity
proprietorship	accounting equation

AUDIT YOUR UNDERSTANDING

1. What is accounting?
2. Give two examples of service businesses.
3. What is a proprietorship?
4. State the accounting equation.

WORK TOGETHER

Completing the accounting equation

Write the answers to the following problem in the *Working Papers*. Your instructor will guide you through the following example.

5. For each line, fill in the missing amount to complete the accounting equation:

Assets	=	Liabilities	+	Owner's Equity
?		3,000		8,000
10,000		?		6,000
63,000		35,000		?

ON YOUR OWN

Completing the accounting equation

Write the answers to the following problem in the *Working Papers*. Work this problem independently.

6. For each line, fill in the missing amount to complete the accounting equation:

Assets	=	Liabilities	+	Owner's Equity
23,000		?		13,000
?		70,000		30,000
48,000		25,000		?

1-2

How Business Activities Change the Accounting Equation

RECEIVING CASH

	Assets	=	Liabilities	+	Owner's Equity
	Cash	=			Barbara Treviño, Capital
Beginning Balances	\$0		\$0		\$0
Received cash from owner as an investment	+10,000				+10,000
New Balances	\$10,000		\$0		\$10,000

Business activities change the amounts in the accounting equation. A business activity that changes assets, liabilities, or owner's equity is called a **transaction**. For example, a business that pays cash for supplies is engaging in a transaction. After each transaction, the accounting equation must remain in balance.

The accounting concept, *Unit of Measurement*, is applied when business transactions are stated in numbers that have common values; that is, using a common unit of measurement. (*CONCEPT: Unit of Measurement*) For example, in the United States, business transactions are recorded in dollars. In Ghana, business transactions are recorded in *cedis*. The unit of measurement concept is followed so that the financial reports of businesses can be clearly stated and understood in numbers that have comparable values.

Received Cash from Owner as an Investment

Ms. Treviño uses \$10,000.00 of her own money to invest in Encore Music. Encore Music should only be concerned with the effect of this transaction on Encore Music's records. The business should not be concerned about Ms. Treviño's personal records. (*CONCEPT: Business Entity*)

Transaction 1 August 1. Received cash from owner as an investment, \$10,000.00.

A record summarizing all the information pertaining to a single item in the accounting equation is called an **account**. The name given to an account is called an **account title**. Each part

of the accounting equation consists of one or more accounts. For example, one of the asset accounts is titled **Cash**. The cash account is used to summarize information about the amount of money the business has available.

In the accounting equation shown above, the asset account, **Cash**, is increased by \$10,000.00, the amount of cash received by the business. This increase is on the left side of the accounting equation. The amount in an account is called the **account balance**. Before the owner's investment, the account balance of **Cash** was zero. After the owner's investment, the account balance of **Cash** is \$10,000.00.

The account used to summarize the owner's equity in a business is called **capital**. The capital account is an owner's equity account. Encore Music's capital account is titled **Barbara Treviño, Capital**. In the accounting equation shown above, the owner's equity account, **Barbara Treviño, Capital**, is increased by \$10,000.00. This increase is on the right side of the accounting equation. Before the owner's investment, the account balance of **Barbara Treviño, Capital** was zero. After the owner's investment, the account balance of **Barbara Treviño, Capital** is \$10,000.00.

The accounting equation has changed as a result of the receipt of cash as the owner's investment. However, both sides of the equation are changed by the same amount, \$10,000.00. The \$10,000.00 increase on the left side of the equation equals the \$10,000.00 increase on the right side of the equation. Therefore, the accounting equation is still in balance.

PAYING CASH

	Assets			= Liabilities + Owner's Equity	
	Cash	+ Supplies	+ Prepaid Insurance	=	Barbara Treviño, Capital
Balances	\$10,000	\$0	\$0		\$10,000
Paid cash for supplies	-1,577	+1,577			
Balances	\$8,423	\$1,577	\$0		\$10,000
Paid cash for insurance	-1,200		+1,200		
New Balances	\$7,223	\$1,577	\$1,200		\$10,000

Encore Music pays cash for supplies and insurance.

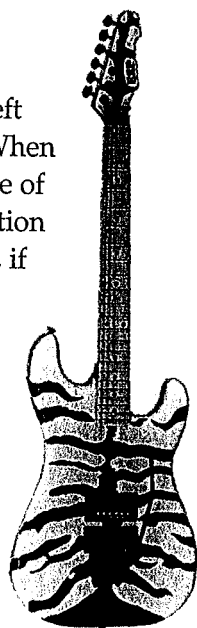
Paid Cash for Supplies

Encore Music needs supplies to operate the business. Barbara Treviño uses some of Encore Music's cash to buy supplies.

Transaction 2 August 3. Paid cash for supplies, \$1,577.00.

In this transaction, two asset accounts are changed. One asset, cash, has been exchanged for another asset, supplies. The asset account, Cash, is decreased by \$1,577.00, the amount of cash paid out. This decrease is on the left side of the accounting equation. The asset account, Supplies, is increased by \$1,577.00, the amount of supplies bought. This increase is also on the left side of the accounting equation.

For this transaction, two assets are changed. Therefore, the two changes are both on the left side of the accounting equation. When changes are made on only one side of the accounting equation, the equation must still be in balance. Therefore, if one account is increased, another account on the same side of the equation must be decreased. After this transaction, the new account balance of Cash is \$8,423.00. The new account balance of Supplies is \$1,577.00. The sum of the amounts on the left side is \$10,000.00 (Cash,



\$8,423.00 + Supplies, \$1,577.00). The amount on the right side is also \$10,000.00. Therefore, the accounting equation is still in balance.

Paid Cash for Insurance

Insurance premiums must be paid in advance. For example, Encore Music pays a \$1,200.00 insurance premium for future insurance coverage.

Transaction 3 August 4. Paid cash for insurance, \$1,200.00.

In return for this payment, Encore Music is entitled to insurance coverage for the length of the policy. The insurance coverage is something of value owned by Encore Music. Therefore, the insurance coverage is an asset. Because insurance premiums are paid in advance, or *prepaid*, the premiums are recorded in an asset account titled Prepaid Insurance.

In this transaction, two assets are changed. One asset, cash, has been exchanged for another asset, prepaid insurance. The asset account, Cash, is decreased by \$1,200.00, the amount of cash paid out. The asset account, Prepaid Insurance, is increased by \$1,200.00, the amount of insurance bought.

After this transaction, the new account balance of Cash is \$7,223.00. The new account balance of Prepaid Insurance is \$1,200.00. The sum of the amounts on the left side is \$10,000.00 (Cash, \$7,223.00 + Supplies, \$1,577.00 + Prepaid Insurance, \$1,200.00). The amount on the right side is also \$10,000.00. Therefore, the accounting equation is still in balance.

TRANSACTIONS ON ACCOUNT

	Assets			= Liabilities + Owner's Equity	
	Cash	+ Supplies	+ Prepaid Insurance	Accts. Pay.— Ling Music Supplies	+ Barbara Treviño, Capital
Balances	\$7,223	\$1,577	\$1,200	\$0	\$10,000
Bought supplies on account		+2,720		+2,720	
New Balances	\$7,223	\$4,297	\$1,200	\$2,720	\$10,000
Paid cash on account	-1,360			-1,360	
New Balances	\$5,863	\$4,297	\$1,200	\$1,360	\$10,000

Bought Supplies on Account

Encore Music needs to buy additional supplies. The supplies are obtained from Ling Music Supplies, which is located in a different city. It is a common business practice to buy items and pay for them at a future date. Another way to state this activity is to say that these items are bought *on account*.

Transaction 4 August 7. Bought supplies on account from Ling Music Supplies, \$2,720.00.

In this transaction, one asset and one liability are changed. The asset account, Supplies, is increased by \$2,720.00, the amount of supplies bought. Ling Music Supplies will have a claim against some of Encore Music's assets until Encore Music pays for the supplies bought. Therefore, Accounts Payable—Ling Music Supplies is a liability account. The liability account, Accounts Payable—Ling Music Supplies, is increased by \$2,720.00, the amount owed for the supplies.

After this transaction, the new account balance of Supplies is \$4,297.00. The new account balance of Accounts Payable—Ling Music Supplies is \$2,720.00. The sum of the amounts on the left side is \$12,720.00 (Cash, \$7,223.00 + Supplies, \$4,297.00 + Prepaid Insurance, \$1,200.00). The sum of the amounts on the right side is also \$12,720.00 (Accounts Payable—Ling Music Supplies, \$2,720.00 + Barbara Treviño, Capital, \$10,000.00). Therefore, the accounting equation is still in balance.

Paid Cash on Account

Since Encore Music is a new business, Ling Music Supplies has not done business with Encore Music before. Ling Music Supplies allows Encore Music to buy supplies on account but requires Encore Music to send a check for one half of the amount immediately. Encore Music will pay the remaining liability at a later date.

Transaction 5 August 11. Paid cash on account to Ling Music Supplies, \$1,360.00.

In this transaction, one asset and one liability are changed. The asset account, Cash, is decreased by \$1,360.00, the amount of cash paid out. After this payment, Encore Music owes less money to Ling Music Supplies. Therefore, the liability account, Accounts Payable—Ling Music Supplies, is decreased by \$1,360.00, the amount paid on account.

After this transaction, the new account balance of Cash is \$5,863.00. The new account balance of Accounts Payable—Ling Music Supplies is \$1,360.00. The sum of the amounts on the left side is \$11,360.00 (Cash, \$5,863.00 + Supplies, \$4,297.00 + Prepaid Insurance, \$1,200.00). The sum of the amounts on the right side is also \$11,360.00 (Accounts Payable—Ling Music Supplies, \$1,360.00 + Barbara Treviño, Capital, \$10,000.00). Therefore, the accounting equation is still in balance.

REMEMBER

The left side of the accounting equation must always equal the right side.

TERMS REVIEW

transaction
account
account title
account balance
capital

AUDIT YOUR UNDERSTANDING

1. What must be done if a transaction increases the left side of the accounting equation?
2. How can a transaction affect only one side of the accounting equation?
3. To what does the phrase *on account* refer?

WORK TOGETHER

Determining how transactions change an accounting equation

Write the answers to the following problem in the *Working Papers*. Your instructor will guide you through the following example.

Trans. No.	Assets	=	Liabilities	+ Owner's Equity
1.				

4. For each transaction, place a plus (+) in the appropriate column if the classification is increased. Place a minus (-) in the appropriate column if the classification is decreased.

Transactions:

- | | |
|---|-----------------------------|
| 1. Bought supplies on account. | 3. Paid cash for insurance. |
| 2. Received cash from owner as an investment. | 4. Paid cash on account. |

ON YOUR OWN

Determining how transactions change an accounting equation

Write the answers to the following problem in the *Working Papers*. Work this problem independently.

Trans. No.	Assets	=	Liabilities	+ Owner's Equity
1.				

5. For each transaction, place a plus (+) in the appropriate column if the classification is increased. Place a minus (-) in the appropriate column if the classification is decreased.

Transactions:

- | | |
|--|--------------------------------|
| 1. Received cash from owner as investment. | 4. Bought supplies on account. |
| 2. Paid cash for supplies. | 5. Paid cash on account. |
| 3. Paid cash for insurance. | |

BALANCE SHEET

Periodically a business reports details about its assets, liabilities, and owner's equity. The financial details about assets, liabilities, and owner's equity could be found on the last line of the accounting equation. However, most businesses prepare more formal financial statements that may be copied and sent to interested persons. A financial statement that reports assets, liabilities, and owner's equity on a specific date is called a **balance sheet**.

When a business is started, it is expected that the business will continue to operate indefinitely. For example, Barbara Treviño



assumes that she will own and operate Encore Music for many years. When she retires, she expects to sell Encore Music to someone else who will continue its operation. The accounting concept, *Going Concern*, is applied when financial statements are prepared with the expectation that a business will remain in operation indefinitely. (**CONCEPT: Going Concern**)

Body of a Balance Sheet

A balance sheet has three major sections. (1) *Assets* are on the left side of the accounting equation. Therefore, Encore Music lists its assets on the left side of the balance sheet. (2) *Liabilities* are on the right side of the accounting equation. Therefore, Encore Music lists its liabilities on the right side of the balance sheet. (3) *Owner's equity* is also on the right side of the accounting equation. Therefore, Encore Music lists its owner's equity on the right side of the balance sheet.

PROFESSIONAL ORGANIZATIONS

Professional organizations provide important social and economic benefits to their members. For example, the National Association of Black Accountants is a professional organization. Members of this association are CPAs, accountants, and accounting students. The organizational purpose is to unite accountants and accounting students who have similar interests and ideals. Members must be committed to professional and academic excellence. They must possess a sense of professional and civic

responsibility. They must also be concerned with enhancing opportunities for minorities in the accounting profession.

Activities of the National Association of Black Accountants are diverse. They include free income tax preparation, student scholarships, high school and university career seminars, regional student conferences, and technical seminars and lectures. Other services of the organization include a speakers' bureau, a placement service, and publications of a journal and newsletter.



**CULTURAL
DIVERSITY**

PREPARING A BALANCE SHEET

Assets			= Liabilities + Owner's Equity		
Cash	+ Supplies	+ Insurance	Prepaid	Accts. Pay.— Ling Music Supplies	+ Barbara Treviño, Capital
Balances	\$5,863	\$4,297	\$1,200	\$1,360	\$10,000

1. Write the heading.

2. Prepare the assets section.

3. Prepare the liabilities section.

4. Prepare the owner's equity section.

5. Add amounts and compare the totals.

6. Rule single lines.

7. Write the totals.

8. Rule double lines.

1

2

3

4

5

6

7

8

Encore Music

Balance Sheet

August 11, 20--

Assets					Liabilities						
Cash	5	8	6	3	0	A/P—Ling Music Supplies	1	3	6	0	0
Supplies	4	2	9	7	0	Owner's Equity					
Prepaid Insurance	1	2	0	0	0	Barbara Treviño, Capital	1	0	0	0	0
Total Assets	1	1	3	6	0	Total Liab. and Owner's Eq.	1	1	3	6	0

S Preparing a balance sheet

T
E
P
S

1. Write the *heading* centered on three lines at the top of the balance sheet: the name of the business, the name of the report, and the date of the report.
2. Because assets are on the LEFT side of the accounting equation, prepare the *assets section* on the LEFT side. Center the word *Assets* on the first line of the wide column. Under this heading, write each asset account title and amount.
3. Because liabilities are on the RIGHT side of the accounting equation, prepare the *liabilities section* on the RIGHT side. Center the word *Liabilities* on the first line of the wide column. Under this heading, write each liability account title and amount.
4. Because owner's equity is also on the RIGHT side of the accounting equation, prepare the *owner's equity section* on the RIGHT side. Center the words *Owner's Equity* on the next blank line. Under this heading, write the owner's equity account title and amount.
5. Add all the asset amounts. Add the liabilities and owner's equity amounts. If the totals equal, the balance sheet is *in balance*. If the totals do not equal, find the errors before completing any more work. Prepare a new balance sheet without errors.
6. Rule a single line across each amount column. A single line means that amounts are to be added or subtracted.
7. On the next line on the left side, write *Total Assets* and write the total asset amount under the single rule. On the right side, write *Total Liabilities and Owner's Equity* and write the total liabilities and owner's equity amount under the single rule.
8. Rule double lines below the amount column totals. Double rules mean that the totals have been verified as correct.

TERM REVIEW

balance sheet

AUDIT YOUR UNDERSTANDING

1. List the three sections of a balance sheet.
2. What kinds of accounts are listed on the left side of a balance sheet?
3. What kinds of accounts are listed on the right side of a balance sheet?
4. What should be done if a balance sheet is not in balance?

WORK TOGETHER

Preparing a balance sheet from information in an accounting equation

Write the answers to the following problem in the *Working Papers*. Your instructor will guide you through the following example.

On October 31 the Hess Company's accounting equation indicated the following account balances.

Trans. No.	Assets			=	Liabilities	+	Owner's Equity		
	Cash	+	Supplies	+	Prepaid Insurance	=	Accts. Pay.— Hulett Company	+	Jim Hess, Capital
New Bal.	2,400		300		600		250		3,050

5. Using the October 31 balances in the accounting equation, prepare a balance sheet for the Hess Company.

ON YOUR OWN

Preparing a balance sheet from information in an accounting equation

Write the answers to the following problem in the *Working Papers*. Work this problem independently.

On July 31 the Goldstein Company's accounting equation indicated the following account balances.

Trans. No.	Assets			=	Liabilities	+	Owner's Equity		
	Cash	+	Supplies	+	Prepaid Insurance	=	Accts. Pay.— Heino Company	+	Mary Goldstein, Capital
New Bal.	2,500		800		1,200		500		4,000

6. Using the July 31 balances in the accounting equation, prepare a balance sheet for the Goldstein Company.

After completing this chapter, you can

1. Define important accounting terms related to starting a service business organized as a proprietorship.
2. Identify accounting concepts and practices related to starting a service business organized as a proprietorship.
3. Classify accounts as assets, liabilities, or owner's equity and demonstrate their relationships in the accounting equation.
4. Analyze how transactions related to starting a service business organized as a proprietorship affect accounts in an accounting equation.
5. Prepare a balance sheet for a service business organized as a proprietorship from information in an accounting equation.

EXPLORE ACCOUNTING

WHAT IS GAAP?

The standards and rules that accountants follow while recording and reporting financial activities are commonly referred to as generally accepted accounting principles, or GAAP. These rules have not been developed by any one group of rule makers, but have instead evolved over time and from many sources.

By law, the Securities and Exchange Commission (SEC) has the authority to establish GAAP. The SEC, however, has allowed a series of private organizations to determine GAAP. Currently the organization that has the authority to set accounting standards is the Financial Accounting

Standards Board (FASB), which was established in 1973.

The standard-setting process includes getting input and feedback from many sources. FASB listens to this feedback and considers all sides of each issue.

WHY IS GAAP NECESSARY?

Users of financial statements rely on the information those statements contain. If the preparers of financial statements were allowed to follow *any* measurement, recording, and reporting rules, the users of the statements would have no way to determine if the financial statements present fairly the

financial position of the business.

By requiring the financial statement preparers to follow consistently certain standards and rules—such as GAAP—the users are able to compare the financial statements of several companies and to track the results of one company over several time periods.

Discussion: Why would a group of people disagree with a proposed accounting standard?

Research: Using your local library or the Internet, find additional information about the FASB. Write a one-page report on your findings.

