Chapter 3

Accounting Concepts

**BASICS**

Accounting centers on the business entity. An entity is simply the unit for which we wish to account. Entities frequently exist within a larger entity. An entity can be a department, or a project, or a firm. For example, Joe’s Chili Dog Stand is a firm that is an entity. However, if it is not a corporation and Joe owns it solely, the Internal Revenue Service considers it to be part of the larger entity, Joe. That larger entity includes Joe’s salary, other investments, and various other sources of income in addition to the chili dog stand.

From an accounting point of view there are two crucial aspects of the entity concept. First, once we have defined the entity we are interested in, we shouldn’t commingle the resources and obligations of that entity with those of other entities. If we are interested in Joe’s Chili Dog Stand as an accounting entity, we mustn’t confuse the cash that belongs to Joe’s Chili Dog Stand with the other cash that Joe has.

Second, we should view all financial events from the entity’s point of view. For example, consider that the Chili Dog Stand buys chili dog rolls “on account.” A transaction on account gives rise to an obligation or account payable on the part of the buyer and an account receivable on the part of the seller. In order for both the buyer and seller to keep their financial records, or “books,” straight, each must record the event from their own viewpoint. They must determine whether they have a payable or a receivable.

We assume throughout this book that the firm you work for is the entity. Once we establish the entity we want to account for, we can begin to keep track of its financial events as they happen. There is a restriction, however, on the way in which we keep track of these events. We must use a monetary denominator for recording all financial events that affect the firm. Even if no cash is involved, we describe an event in terms of amounts of currency. In the United States, accounting revolves around dollars; elsewhere the local currency is used.

This restriction is an important one for purposes of communication. The financial accountant not only wants to keep track of what has happened to the firm but also wants to be able to communicate the firm’s history to others after it has happened. Conveying information about the financial position of the firm and the results of its operations would be cumbersome at best without this monetary restriction. Imagine trying to list and describe each building, machine, parcel of land, desk, chair, and so on owned by the firm. The financial statement would be hundreds if not thousands of pages long.

Yet, don’t be too comfortable with the monetary restriction either, because currencies are not stable vis-a-vis one another, nor are they internally consistent over time. During periods of inflation or deflation, the assignment of a dollar value creates its own problems. For example, the values of inventory, buildings, and equipment constantly change as a result of inflation or deflation. This problem will be discussed in [Chapter 21](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap21.xhtml).

### ASSETS

The general group of resources owned by the firm represents the firm’s assets. An asset is anything with economic value that can somehow help the firm provide its goods and services to its customers, either directly or indirectly. The machine that makes the firm’s product is clearly an asset. The desk in the chief executive’s office is also an asset, however indirect it may be in generating sales.

Assets may be either tangible or intangible. Tangible assets have physical form and substance and are generally shown on the financial statements. Intangible assets don’t have any physical form. They consist of such items as a good credit standing, skilled employees, and patents, copyrights, or trademarks developed by the firm. It is difficult to precisely measure the value of intangible assets. As a result, accountants usually do not allow these assets to be recorded on the financial statements.

An exception to this rule occurs if the intangible asset has a clearly measurable value. For example, if we purchase that intangible from someone outside of the firm, then the price we pay puts a reasonable minimum value on the asset. It may be worth more, but it can’t be worth less or we, as rational individuals, wouldn’t have paid as much as we did. Therefore the accountant is willing to allow the intangible to be shown on the financial statement for the amount we paid for it.

If you see a financial statement that includes an asset called goodwill, it is an indication that a merger has occurred at some time in the past. The firm paid more for the company it acquired than could be justified based on the market value of the specific tangible assets of the acquired firm. The only reason a firm would pay more than the tangible assets themselves are worth is because the firm being acquired has valuable intangible assets. Otherwise the firm would have simply gone out and duplicated all of the specific tangible assets instead of buying the firm.

After the merger, the amount paid in excess of the market value of the specific tangible assets is called goodwill. It includes the good credit standing the firm has with suppliers, the reputation for quality and reliability with its customers, the skilled set of employees already working for the firm, and any other intangible benefits gained by buying an ongoing firm rather than by buying the physical assets and attempting to enter the industry from scratch.

The implication of goodwill is that a firm may be worth substantially more than it is allowed to indicate on its own financial statements. Only if the firm is sold will the value of all of its intangibles be shown on a financial statement. Thus we should exercise care in evaluating how good financial statements are as an indication of the true value of the firm.

### LIABILITIES

Liabilities, from the word liable, represent the obligations that a firm has to outside creditors. Although there generally is no one-on-one matching of specific assets with specific liabilities, the assets taken as a whole represent a pool of resources available to pay the firm’s liabilities. The most common liabilities are money owed to suppliers, employees, financial institutions, bondholders, and the government (taxes).

### OWNERS’ EQUITY

Equity represents the value of the firm to its owners. For a firm owned by an individual proprietor we refer to this value as owner’s equity. For a partnership we speak of this value as partners’ equity. For a corporation we talk of this value as shareholders’ or stockholders’ equity. A not-for-profit organization refers to this as net assets. Governments call it the fund balance. This book commonly uses the term stockholders’ equity whenever the equity of the owners is meant.

The stockholders’ equity of a firm is often referred to as the “net worth” of the firm or its “total book value.” Book value per share is simply the total book value divided by the number of shares of stock outstanding.

The equity of the owners of the firm is quite similar to the equity commonly referred to with respect to home ownership. If you were to buy a house for $400,000 by putting down $80,000 of your own money and borrowing $320,000 from a bank, you would say that your equity in the $400,000 house was $80,000.

If the house were a factory building owned by a firm, the $400,000 purchase price could be viewed as the value of the factory building asset, the $320,000 loan as the firm’s liability to an outside creditor, and the $80,000 difference as the stockholders’ equity, or the portion of the value of the building belonging to the owners.

### THE ACCOUNTING EQUATION

The relationship among the assets, liabilities, and stockholders’ equity is shown in the following equation and provides a framework for all of financial accounting.

ASSETS = LIABILITIES + OWNERS’ EQUITY

The left side of this equation represents the firm’s resources. The right side of the equation gives the sources of the resources. Another way to think about this equation is that the right side represent the claims on the resources. The liabilities represent the legal claims of the firm’s creditors. The owners’ equity is the owners’ claim on any resources not needed to meet the firm’s liabilities.

The right side of the equation is frequently referred to as the equity side of the equation because the liabilities and owners’ equity both represent legal claims on the firm’s assets. Therefore, both can be thought of in an equity sense. Frequently the entire equation is referred to as the firm’s assets and equities.

By definition, this equation is true for any entity. Once the firm’s assets and liabilities have been defined, the value of ownership or stockholders’ equity is merely a residual value. The owners own all of the value of the assets not needed to pay off obligations to creditors. Therefore, the equation need not ever be imbalanced because there is effectively one term in the equation, owners’ equity, that changes automatically to keep the equation in balance. We refer back to this basic equation of accounting throughout this book.

### KEY TERMS

Entity—the unit for which we wish to account. This unit can be a person, department, project, division, or firm. Avoid commingling the resources of different entities.

Monetary denominator—All resources are assigned values in a currency such as dollars in order to simplify communication of information regarding the firm’s resources and obligations.

Assets—the resources owned by the firm.

1. Tangible assets—assets having physical substance or form.
2. Intangible assets—assets having no physical substance or form; result in substantial valuation difficulties.

Liabilities—obligations of the firm to outside creditors.

Owners’ equity—the value of the firm to its owners, as determined by the accounting system. This is the residual amount left over when liabilities are subtracted from assets.

Fundamental equation of accounting—Assets = Liabilities + Owners’ Equity

**QUESTIONS FOR REVIEW**

1. What is an accounting entity?
2. Define the following:
	1. Asset
	2. Liability
	3. Owners’ Equity
3. What is the equation that provides a framework for financial accounting?