UNIT 1. INTRODUCTION TO ACCOUNTING AND BUSINESS

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1.1 INTRODUCTION

We live in the ***information age***-a time of communication, and a time when information is a vital resource. Businesses that have better access to information and that process information more quickly and accurately do the best. But to take advantage of these, we need knowledge of information systems.

An information system is the collecting, processing, and reporting of information to decision makers. Understanding and processing information is the core of ***accounting***.

The kind of information processed in accounting is financial i.e. of a monetary nature. Providing information about what businesses own, what they owe, and how they perform is the aim of accounting. Accounting is, an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization's (a business's) economic activities.

Therefore, a study of accounting helps people make better and informed decisions about assessing opportunities, products, investments, and social and community responsibilities.

This course discusses the ***fundamental principles*** involved in processing accounting information of ***business enterprises***.

In this chapter we explain the fundamentals of financial reporting, which underpins how a financial phenomenon is identified, recorded, and disclosed to the users of financial statements. We will also look at the bodies responsible for issuing accounting standards. We will discuss the judgment process that is necessary to make good accounting decisions. In addition to this, we will also discuss the contents of the four basic financial statements that report the results of those decisions.

1.2 Definition, Importance and Users of Accounting Information

1.2.1 Accounting Defined

accounting is an information system. It records and measures business activities, processes data into information, and communicates this information to decision makers who make decisions that will have an impact on business activities. Indeed, accounting is "the language of business."

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

Three Activities

1. 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 cosmetics and snacks by Shoa supermarket, the providing of telephone services by ethio Telecom, and the manufacture of motor vehicles by Toyota Motors.

2. Once a company 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 monetary units. In recording, a company also classifies and summarizes economic events.

3. Finally, communicates the collected information to interested users by means of accounting reports. These reports are called financial statements. To make the reported financial information meaningful, a company reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, Shoa supermarket accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. 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.

Accounting as a language of business

Accounting is the universal language of business. This is because accounting is the means by which businesses' financial information is communicated to users. The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties.

So, who needs to be familiar with this language? Those who run a business? Shareholders? Well anyone who makes any business decision needs to be familiar with accounting. Accounting is the language of communication in all businesses. The better our understanding of this language, the better we can understand our finances, our businesses, or our investments!

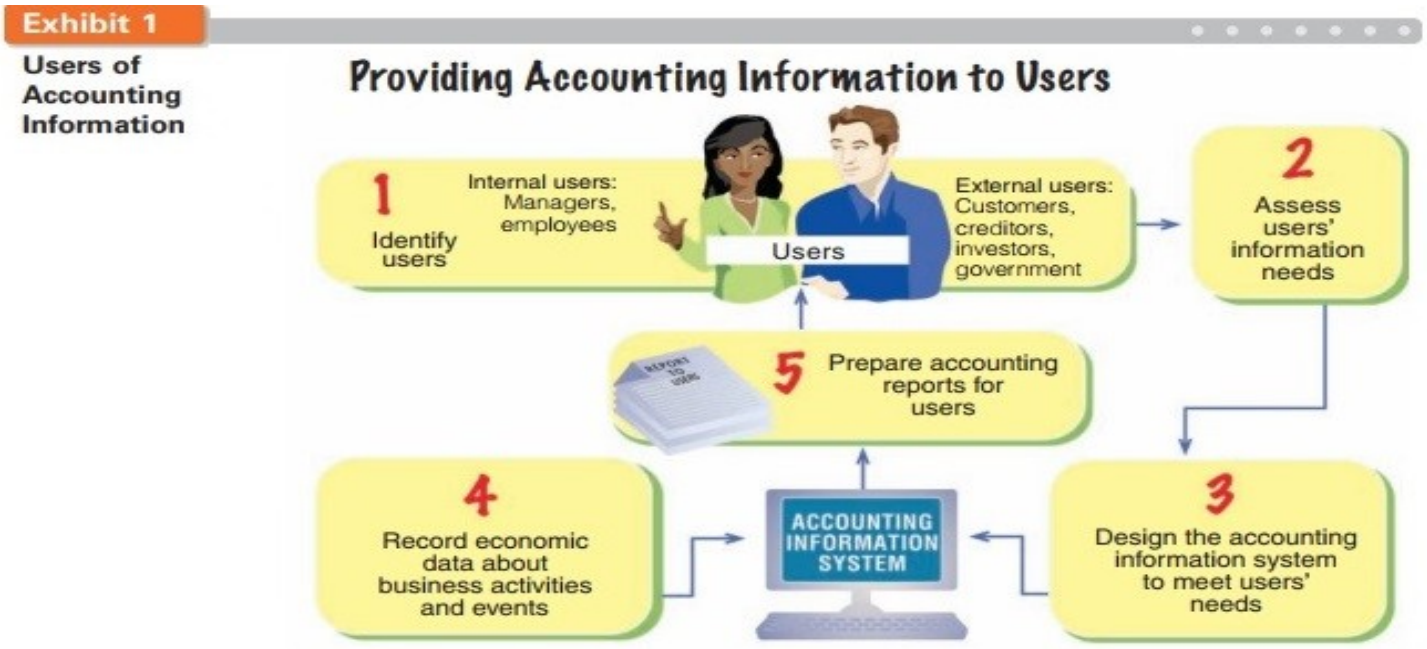
1.2.2 Accounting as information system

What is the role of accounting in business? The simplest answer is that accounting provides information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

Thus, accounting can be defined as an information system that provides reports to users about the economic activities and condition of a business. You may think of accounting as the "language of business." This is because accounting is the means by which businesses' financial information is communicated to users.

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users' information needs.
3. Design the accounting information system to meet users' needs.
4. Prepare accounting reports for users.

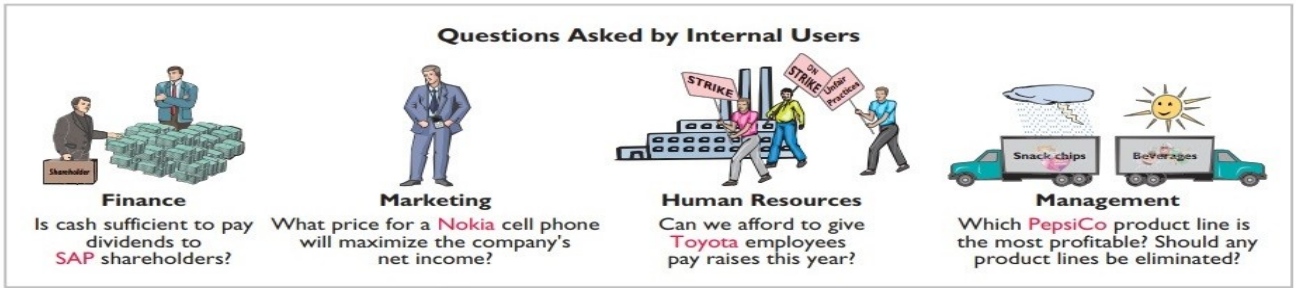


1.2.3 Users of Accounting Information.

The specific financial information that a user needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

INTERNAL USERS

Internal users of accounting information are managers and employees which include marketing managers, production supervisors, finance directors, and company officers who plan, organize, and run the business. These users are directly involved in managing and operating the business. The area of accounting that provides internal users with information is called management accounting. The objective of managerial accounting is to provide relevant and timely information for managers' and employees' decision-making needs. Often times, such information is sensitive and is not distributed outside the business. Examples of sensitive information might include information about customers, prices, and plans to expand the business. Managerial accountants employed by a business are employed in private accounting.

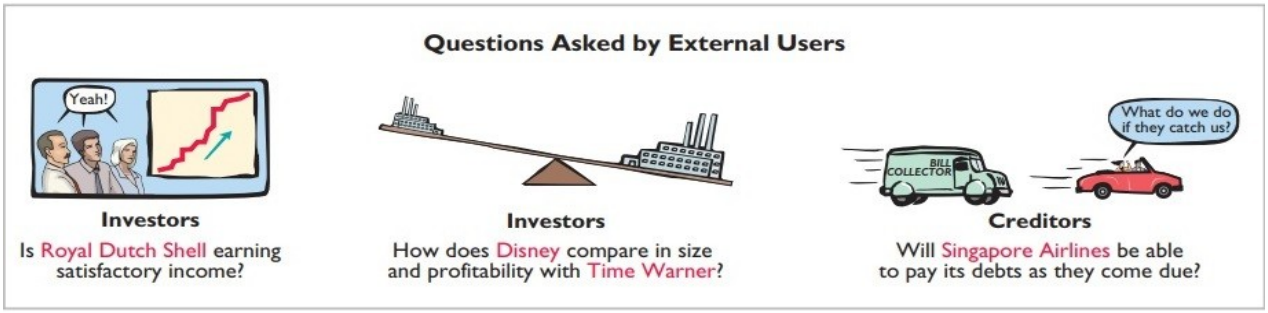


To answer these and other questions, internal users need detailed information on a timely basis. Managerial accounting provides internal reports to help users make decisions about their companies. **Managerial accounting** is the process of identifying, analyzing, and communicating financial information needed by management to plan, control, and evaluates a company's operations. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of future cash needs.

EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. External users include investors, customers, Labor unions, creditors, government and the media. Investors (owners) use accounting information to make decisions 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. Taxing authorities, such as the Ethiopian revenue and customs authority (ERCA), want to know whether the company complies with tax laws. Customers are interested in whether a company continues to honor product warranties and support its product lines. Labor unions, want to know whether the companies have the ability to pay increased salaries and benefits to employees. These users are not directly involved in managing and operating the business.

The area of accounting that provides external users with information is called financial accounting. The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business. For example, financial reports on the operations and condition of the business are useful for banks and other creditors in deciding whether to lend money to the business. General-purpose financial statements are one type of financial accounting report that is distributed to external users.



To answer these and other questions, external users need detailed information on a timely basis. Financial accounting answers these questions. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.

1.2.4 The Role (Importance) of Accounting Information in Business.

The main purpose of accounting is to provide financial information to be used for decision-making. For instance, Business executives and managers need the financial information provided by the accounting system to help them plan and control the activities of the business. Outsiders such as bankers, potential investors, and labor unions and others also need accounting in formation.

In short the goal of the accounting system is to provide useful information to decision makers. Thus, accounting is the connecting link between decision makers and business operations.

What is the role of accounting in business? The simplest answer is that accounting provides information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

Why is so much time and money spent on the development of accounting information? To fairly answer these questions, one must think broadly. Investors and creditors have limited resources and seek to place those resources where they will generate the best returns. Accounting information is the nexus of this capital allocation decision process. Without good information, misallocation of capital would occur and result in inefficient production and shortages.

1.2.5 Qualitative Characteristics of Accounting Information

Accounting information is general purpose and should be designed to serve the information needs of all types of interested parties. To be useful, information should be helpful in assessing an entity's economic resources, claims against resources, and what causes changes in resources and claims.

The following qualities help to make accounting useful.

Fundamental Qualities

Conceptual Framework of IFRS suggests that if financial information is to be useful, it must first be relevant and it must faithfully represent what it purports to represent—these are the "fundamental qualitative characteristics."

Relevancy - Information should be timely and bear on the decision-making process by possessing predictive or confirmatory value.

To be relevant, information must be capable of making a difference to the decision maker. Typically, this happens when financial information is used to help users in making their own predictions of future outcomes (predictive value) or in assessing previous evaluations (confirmatory value).

To be relevant, information must be capable of making a difference to the decision maker. The degree of relevance may be influenced by the materiality of the information. Materiality means that the information must be important enough to the user to make a difference to his or her decision if it were omitted or erroneously declared.

Faithful Representation **-** Information must be truthful; complete, neutral, and free from error.

Financial statements represent economic phenomena, i.e., resources, claims to resources, and changes in resources and claims, in words and numbers.

Completeness means that the financial reports should include all necessary information for a user to understand the economic phenomenon being depicted, including all necessary descriptions and explanations. Neutrality means that the information must be depicted without bias. It is supported by the concept of prudence, i.e., the exercise of caution when making judgments under conditions of uncertainty. Freedom from error means that there are no erroneous depictions of economic phenomenon nor any omission. If you were to discover that Ethio Telecom's total expenses in 2010 were not complete or were riddled with errors, you would not rely on its financial statements.

Enhancing Qualities

Information that is relevant and faithfully represented may be further enhanced if it is comparable, verifiable, timely, and understandable—these are the "enhancing qualitative characteristics." Enhancing qualitative characteristics will never make information that is not relevant become relevant, and similarly, will not make information that is not faithfully representative be so.

Comparability- Even though different companies may use different accounting methods, there is still sufficient basis for valid comparison.

Users usually compare financial statements of an entity over a period to identify trends in its financial position and performance. Thus, it is important that the basis of preparation and presentation remains comparable over time. For example, the comparison between Shoa supermarket's sales in 2016 and 2015 only makes sense if you know that there has been no material change in the way sales are recognized in the financial statements. Similarly, you may want to compare Shoa supermarket's performance to another retailer, and before drawing any conclusions you would want to be sure that net sales are derived in the same way for both companies.

Consistency **-** Deviations in measured outcomes from period to period should be the result of deviations in underlying performance (not accounting quirks).

Verifiability **-** Different knowledgeable and independent observers reach similar conclusions.

Verifiability helps assure users that information faithfully represents the economic phenomenon it purports to represent. It means that given the same economic phenomenon and its depiction, two different knowledgeable and independent parties can come to a consensus that the depiction is a faithful representation of the economic phenomenon.

Timeliness **-** Available in sufficient time to be capable of influence.

Timeliness means that the information must be made available to users early enough to help them make decisions, thus, making the information more relevant to their needs. By providing information about its financial position and performance to the users of the financial statement in a timely manner, Shoa supermarket allows investors to readily make decisions about their investments in the company.

Understandability **-** Clear and concise to those with reasonable business knowledge.

Understandability means that financial information must be classified, characterized, and presented clearly and concisely. The framework assumes that users have a reasonable knowledge of business, economic activities and accounting, and a willingness to study the information with reasonable diligence. Thus, whilst you may not have the knowledge right now, by the end of this course you will be able to understand the accounting vocabulary and use financial information for decision making.

1.3 Profession of accountancy

Numerous career opportunities are available for students majoring in accounting. Currently, the demand for accountants exceeds the number of new graduates entering the job market. This is partly due to the increased regulation of business caused by the accounting and business frauds. Also, more and more businesses have come to recognize the importance and value of accounting information.

Here are three of the major professions in accounting.

- Public Accounting
- Private Accounting or
- Not – for – profit Accounting

i) Public accounting

Accountants and their staff who provide services on a fee basis are said to be employed in public accounting. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public Accountants offer expert service to the general public in much the same way that a doctor serves patients and a lawyer serves clients. Public accountants who have met a state's education, experience, and examination requirements may become Certified Public Accountants (CPAs). CPAs generally perform general accounting, audit, or tax services to examine the financial statements of companies and expresses opinion as to the fairness of presentation. When presentation is fair, users consider the statements to be reliable.

A major portion of public accounting practice is involved with Auditing. Management consulting is another area of public accounting. In this case, the accountant consults the management generally about the growth and development of the business enterprise.

ii) Private Accounting

Instead of working in public accounting, an accountant may be an employee of a business enterprise. In private accounting, you would be involved in one of the following activities:

1. **Cost Accounting**: Determining the cost of producing specific products.
2. **Budgeting:** Assisting management in quantifying goals concerning revenues, costs of goods sold, and operating expenses.
3. **General Accounting**: recording daily transactions and preparing financial statements and related information.
4. **Accounting information systems**: designing both manual and computerized data processing systems.
5. **Tax Accounting**: preparing tax returns (-forms to be filled by a company and returned to a taxing authority) and engaging in tax planning for the company.
6. **Internal Auditing**: reviewing a company's operations to determine compliance with management policies and evaluating efficiency of operations.

iii) Not for Profit Accounting

Like businesses that exist to make a profit, not - for-profit organizations also need sound financial reporting and control. Donors to such organizations want information about how well the organization has met its objectives and whether continued support is justified. In each of these cases, accounting expertise is highly valued. Not-for-profit accounting is used for government agencies, hospitals, churches and synagogues, and schools. Accountants for these organizations prepare budgets and maintain records of revenues and

expenses. Local, state, and federal government bodies employ vast numbers of people in accounting positions.

Accounting Career Track	Description	Career Options	Annual Starting Salaries[1]	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	$34,875	
		Payroll clerk	$33,500	Certified Payroll Professional (CPP)
		General accountant	$40,750	
		Budget analyst	$42,875	
		Cost accountant	$42,125	Certified Management Accountant (CMA)
		Internal auditor	$46,375	Certified Internal Auditor (CIA)
		Information technology auditor	$54,625	Certified Information Systems Auditor (CISA)
Public Accounting	Accountants employed individually or within a public accounting firm in tax or audit services.	Local firms	$43,625	Certified Public Accountant (CPA)
		National firms	$52,500	Certified Public Accountant (CPA)

1.4 ACCOUNTING AND PROFESSIONAL ETHICS:

The objective of accounting is to provide relevant, fairful & timely information for user decision making. Accountants must behave in an ethical manner so that the information they provide will be trustworthy and, thus, useful for decision making. A doctor follows certain standards in treating a patient's illness. An architect follows certain standards in designing a building. Managers and employees must also behave in an ethical manner in managing and operating a business. An accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept must be at work—ethical behavior. Imagine trying to carry on a business or invest money in a company 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.

The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are Ethics. Effective financial reporting depends on sound ethical behavior. Otherwise, no one will be willing to invest in or loan money to the business. **Ethics** are moral principles that guide the conduct of individuals. **Ethics** are shaped by our cultural, socioeconomic, and religious backgrounds. Ethical training starts at home and continues throughout our lives. It is reinforced by the teaching that we receive in our churches or mosques; by the schools we attend; and by the persons we associate with and the company we work. Remember that while making accounting decisions do not leave your ethics at the door.

Unfortunately, business managers and accountants sometimes behave in an unethical manner. Ethical violations lead to fines, firings, and lawsuits. In some cases, managers were criminally prosecuted, convicted, and sent to prison. In addition, checks and balances via the audit process, government oversight, and the ever vigilant "plaintiff's attorney" all serve a vital role in providing additional safeguards against the errant accountant. If you are preparing to enter the accounting profession, you should do so with the intention of behaving with honor and integrity.

Here are the examples for some of the ethical violations that can happen in everyday business.

Failure of Individual Character. An ethical manager and accountant are honest and fair. However, managers and accountants often face pressures from high level managers to meet company and investor expectations. In many cases managers and accountants justify small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.

Culture of Greed and Ethical Indifference. By their behavior and attitude, senior managers set the company culture. Senior managers sometimes create a culture of greed and indifference to the truth.

Because investors and creditors place great reliance on financial statements in making their investment and credit decisions, it is imperative that the financial reporting process be truthful and dependable. Accountants are expected to behave in an entirely ethical fashion. To help insure integrity in the reporting process, the profession has adopted a code of ethics to which its licensed members must adhere.

What are the factors that influence business and accounting decisions, and how should these factors be weighed? Generally, three factors influence accounting decisions: economic, legal, and ethical.

The *economic* factor states that the decision being made should benefit the decision maker economically. Based on most economic theories, every rational person faced with a decision will choose the course of action that maximizes his or her own welfare, without regard to how that decision impacts others.

The *legal* factor involves legal analysis applying the relevant laws to each decision and then choosing the action that complies with those laws.

The *ethical* factor states that while certain actions might be both economically profitable and legal, they may still not be right. Therefore, most companies, and many individuals, have established standards for themselves to enforce a higher level of conduct than that imposed by law. These standards govern how we treat others and the way in which we restrain our selfish desires. This behavior and its underlying beliefs are the essence of ethics.

The fundamental principles for ethical behavior.

A professional accountant shall comply with the following fundamental principles:

(a)Integrity

The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

(b)Objectivity

The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest, or the undue influence of others.

(c) Professional Competence and Due Care

The principle of professional competence and due care imposes an obligation on all professional accountants to maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service and to act diligently in accordance with applicable technical and professional standards when performing professional activities or providing professional services.

(d) Confidentiality

The principle of confidentiality imposes an obligation on all professional accountants to refrain from disclosing confidential information, acquired as a result of professional and business relationships, outside the firm without proper and specific authority or consent, or unless there is a legal or professional right or duty to disclose the information. They should also refrain from using the confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

(e) Professional Behavior

The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that may discredit the profession.

1.5 Accounting Principles and practices, IFRS conceptual framework, ABBE Overview

In this section we explain the guiding general standards of financial reporting, which underpins how a financial phenomenon is identified, recorded, and communicated/disclosed/ to the users of financial statements. We will also look at the bodies responsible for issuing accounting standards. In addition to this,

we will also discuss the contents of the four basic financial statements that report the results of those decisions.

Accounting Standards

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard setting bodies. Presently, there are two primary accounting standard-setting bodies—the Financial Accounting Standards Board (FASB) which issued standards referred to as generally accepted accounting principles (GAAP) and the International Accounting Standards Board (IASB) which issued standards referred to as International Financial Reporting Standards (IFRS). The IASB is formed in 2001 headquartered in London, with its 15 board members drawn from around the world with the objective of developing a single set of high-quality and understandable, accounting standards to help users of accounting information make economic decisions.

These standards are now being used by most countries around the world. According to the IFRS Foundation, 86% of 192 jurisdictions (countries and territories) around the world either require or permit the use of IFRS for financial reporting, especially for listed companies. Other major economies, including the United States, Japan, India, and China, are working towards IFRS convergence.

A revolution is therefore occurring in financial reporting. A single set of rules, called International Financial Reporting Standards (IFRS), which is now being used by over 155 countries. It is estimated that as many as 310 of the 500 largest global companies are using IFRS. IFRS are considered to be more "principles-based" than U.S. GAAP, which is considered to be more "rules-based." For example, U.S. GAAP consists of approximately 17,000 pages, which include numerous industry-specific accounting rules. In contrast, IFRS allow more professional judgment in deciding how business transactions are recorded. Many believe that the strong regulatory and litigation environment in the United States is the cause for the more rules-based GAAP approach. Regardless, IFRS and GAAP share many common principles.

GAAP - referred to as being **rules -based**

Provides a rule for every situation

More prescriptive

Body of knowledge too large and complicated

Although more guidance is good, it becomes difficult to ensure that the standards are all consistent.

IFRS - referred to as being **principles-based**

They are more loosely framed, allowing for professional judgment to be applied

More flexible to deal with unique economic and business circumstances

IFRS puts greater emphasis on the importance of judgment in determining the appropriate accounting recognition, measurement, and presentation. But some argue that allowing professional judgment introduces bias

The need for High-Quality Standards IFRS

Accounting standards are necessary because without them, users of financial statements would have to learn the basis of accounting for each company, making comparisons to other companies' financial statements difficult.

Many countries like the United States, the United Kingdom, Japan, Germany, Australia, etc., used to follow their own version of professional frameworks for measurement and disclosure of financial information, usually called **generally accepted accounting principles (GAAP).**

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 IFRS and U.S. GAAP. This process is referred to as convergence. As a result of these convergence efforts, it is likely that someday there will be a single set of high-quality accounting standards that are used by companies around the world.

Advantages of adopting IFRS

The advantages of adopting one common set of standards are clear. Companies in countries that have mandated the use of IFRS, such as Australia, Hong Kong, the United Arab Emirates, Europe, and Japan will have financial statements that are more comparable with each other. It will be far easier for investors and other financial statement users to evaluate the information of various companies across the globe, and companies will only have to prepare one set of financial statements, instead of multiple versions. Thus, in the long run, the global use of IFRS should reduce the costs of doing business globally. A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Globalization demands a single set of high-quality international accounting standards.

Here are some of the advantages:

1. Single set of high-quality accounting standards established by a single standard setting body.
2. Consistency in application and interpretation.
3. Common disclosures.
4. Common high-quality auditing standards and practices.

5. Common approach to corporate governance, legal frameworks, regulatory review and enforcement.
6. Common Business Reporting Language.
7. Common approach to around the world.

1.6.1 Measurement Principles

IFRS 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.

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 Gazprom (a Russian company) purchases land for 300,000, the company initially reports it in its accounting records at 300,000. But what does Gazprom 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 value 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, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to fair value, 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.

1.6.2 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 measured and 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.

ECONOMIC ENTITY ASSUMPTION

An economic entity can be any organization or unit in society. It may be a company, a governmental unit, a municipality, a school, or a church. 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. To illustrate, Ato abebe, owner of Sunshine Boutique, must keep his personal living costs separate from the expenses of the boutique.

1.6 Forms of Business Organizations

A business generally takes one of the following forms:

1. Proprietorship
2. Partnership
3. Corporation

1. Proprietorship. A business owned by one person is generally called a proprietorship. The owner is often the manager/operator of the business. Proprietorships tend to be Small service-type businesses and small retail stores (shops, beauty salons, clothing stores, and book stores). 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. Almost every single big company you see today started business created and owned by a single person which is the manager just like Facebook (initially created and owned by Mark Zuckerburg), Apple (initially created and owned by Steve Jobs), and Alibaba (initially created and owned by Jack Ma). Legally, the proprietor is personally liable for all the business's debts. But for accounting purposes, a proprietorship is

a distinct entity, separate from its proprietor. Thus, the business records should not include the proprietor's personal finances.

2. Partnership. A partnership has two or more parties as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. Income and loss of the partnership "flows through" to the partners and they recognize it based on their agreed upon percentage interest in the business. In general, a partnership is not a taxpaying entity. Instead, each partner takes a proportionate share of the entity's taxable income and pays tax according to that partner's individual or corporate rate. Many retail establishments, professional service firms (law, accounting, etc.), real estate, and oil and gas exploration companies operate as partnerships. Partnerships are governed by agreement, usually spelled out in writing in the form of a contract between the partners. **General partnerships** have mutual agency and unlimited liability, meaning that each partner may conduct business in the name of the entity and can make agreements that legally bind all partners without limit for the partnership's debts. Therefore, partnerships are quite risky because an irresponsible partner can create large debts for the other general partners without their knowledge or authorization. This feature of general partnerships has spawned the creation of limited-liability partnerships (LLPs).

   A **limited-liability partnership (LLPs)** is one in which a partner cannot create a large liability for the other partners. In LLPs, each partner is liable for partnership debts only up to the extent of his or her investment in the partnership, plus his or her proportionate share of the liabilities. Each LLP, however, must have one general partner with unlimited liability for all partnership debts. Many of the accounting firms, such as the "Big 3" accounting firms (Deloitte, Earnst&Young, KPMG are now organized as LLPs.
3. Corporation. A corporation is a business owned by the shareholders, who own shares representing ownership in the corporation. One of the major advantages of doing business in the corporate form is the ability to raise capital from issuance of shares to the public. In 1999, Jack Ma founded Alibaba with a mere US$60,000—this was an initial investment from friends and close ones. Mark Zuckerberg and other Facebook founders incorporated their company in late 2004 and received initial investments from a group of people; all types of entities (individuals, partnerships, corporations, or other types) may be shareholders in a corporation. Even though proprietorships and partnerships are more numerous, corporations transact much more business and are larger in terms of assets, income, and number of employees. Most well-known companies, such as the Samsung Group, Google, and Toyota are corporations.

   Unlike proprietorships and partnerships, a corporation is legally distinct from its owners. The corporation is like an artificial person and possesses many of the same rights that a person has. The shareholders have no personal obligation for the corporation's debts and have limited liability. Ultimate

control of a corporation rests with the shareholders, who generally get one vote for each share they own. In general, shareholders elect the board of directors, which sets policy and appoints management then the management hires employees and let the business flow.

Exhibit 1-2 | The Various Forms of Business Organization

	Proprietorship	Partnership	Corporation
1. *Owner(s)*	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
2. *Personal liability of owner(s) for business debts*	Proprietor is personally liable	General partners are personally liable; limited partners are not	Shareholders are *not* personally liable

1.8 Nature of Business and Accounting

A business is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. The objective of most businesses is to earn a profit. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services.

Types of Businesses

Three types of businesses operated for profit include service, merchandising, and manufacturing businesses.

Each type of business and some examples are described below.

Service businesses provide services rather than products to customers.

Ethiopian Air Lines (transportation services)
Ehio telecom (telcom Service Company)
The Walt Disney Company (entertainment services)

Merchandising businesses sell products they purchase from other businesses to customers.

Shoa supermarket (general merchandise)

Amazon.com (Internet books, music, videos)

Manufacturing businesses change basic inputs into products that are sold to customers.

General Motors Corporation (cars, trucks, vans)

Dell Inc. (personal computers)