

# INTRODUCTORY FINANCIAL ACCOUNTING

Third Edition

Gerhard G. Mueller

UNIVERSITY OF WASHINGTON

and

Lauren Kelly

UNIVERSITY OF WASHINGTON



#### Library of Congress Cataloging-in-Publication Data

Mueller, Gerhard G.
Introductory financial accounting.—3rd ed./Gerhard G. Mueller and Lauren Kelly.
p. cm.—(Prentice Hall series in accounting)
Rev. ed. of: A new introduction to financial accounting/Robert G. May, Gerhard G. Mueller, Thomas H. Williams.
Includes index.
ISBN 0-13-485616-3
1. Accounting. I. Kelly, Lauren. II. May, Robert G.
New introduction to financial accounting. III. Title. IV. Series.
HF5635.M92 1991
657'.48—dc20 90-42939
CIP

Acquisitions editor: Joseph Heider Production editor: Anne Pietropinto Interior design by: Penelope Linskey Cover design by: Bruce Kenselaar

Cover photo by: Loyd C. Heath, Professor of Accounting Manufacturing buyers: Trudy Pisciotti and Bob Anderson



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This is a revised edition of *A New Introduction* to Financial Accounting by Robert G. May, Gerhard G. Mueller, and Thomas H. Williams.

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Printed in the United States of America 10 9 8 7 6 5 4 3 2 1

#### IZBN 0-13-485616-3

Prentice-Hall International (UK) Limited, London Prentice-Hall of Australia Pty. Limited, Sydney Prentice-Hall Canada Inc., Toronto Prentice-Hall Hispanoamericana, S.A., Mexico Prentice-Hall of India Private Limited, New Delhi Prentice-Hall of Japan, Inc., Tokyo Simon & Schuster Asia Pte. Ltd., Singapore Editora Prentice-Hall do Brasil, Ltda., Rio de Janeiro

# Preface

The 1990's have brought renewed challenges to the structure and effectiveness of accounting education. In 1971, the Price Waterhouse Foundation-sponsored Study Group on Introductory Accounting issued its report. The first and second editions of this book, *A New Introduction to Financial Accounting*, were written by Professor Robert G. May (University of Texas), Gerhard G. Mueller (University of Washington), and Thomas H. Williams (University of Wisconsin) in response to the concepts and recommendations of the Study Group. This third edition follows closely on that tradition and addresses directly recent challenges to the traditional technical approach typically characterizing the first course in accounting.

In 1985, the AAA Bedford Committee concluded, "Accounting education as it is currently approached requires major reorientation between now and the year 2,000." In 1989, the chief executives of the (then) eight largest public accounting firms issued a report stating, "Individuals seeking to be successful in the diverse world of public accounting must be able to use creative problemsolving skills in a consultative process. They must be able to solve diverse and unstructured problems in unfamiliar settings." The growing admonitions to reexamine accounting education led to the establishment of the Accounting Education Change Commission in 1989. Its purpose is to foster substantive change in the education of future accounting professionals. This book responds to the need for a new approach to accounting education at the introductory level.

The first course in accounting is traditionally taught from the procedural perspective of double entry bookkeeping. Under this approach, students learn techniques to account for numbers representing economic events and transactions. Even though students may become good technicians, they frequently fail

<sup>&</sup>lt;sup>1</sup> AAA Bedford Committee, Future Accounting Education: Preparing for the Expanding Profession, Special Report of the American Accounting Association Committee on the Future Structure, Content, and Scope of Accounting Education, 1985.

<sup>&</sup>lt;sup>2</sup> Perspectives on Education: Capabilities for Success in the Accounting Profession.

to understand why the double entry paradigm is used and what the resulting financial statements mean. This book uses a decision-making approach as the foundation for explaining the need for and role of accounting information in a modern economy. The use of financial accounting information in making investment decisions is the focus from which the concepts and processes involved in preparing financial statements are explained.

The book is comprised of four parts. Part One contains Chapters One and Two. The first chapter introduces the role of accounting information in making decisions about business enterprises. Chapter Two describes the use of the present value model for making investment decisions.

Part Two contains five chapters devoted to the basic accounting framework. Chapter Three concerns the accrual basis, income determination, and preparation of the income statement. In Chapter Four, preparation of the balance sheet is addressed by developing an understanding of its major components: assets, liabilities, and owners' equity. The statement of cash flows is covered in Chapter Five, using the framework of cash flows from operating, investing, and financing activities. Chapter Six addresses limitations of the historical cost assumption in financial accounting and considers general price-level adjustments and current costs as alternative measurement bases. In Chapter Seven, accounting information systems and the debt/credit mechanism are described.

Part Three contains four chapters elaborating upon the theoretical and technical issues that arise in applying the financial accounting framework. Chapter Eight addresses revenue recognition topics such as long-term contracts and credit sales. Complex measurement issues relating to inventory and long-lived assets are the topic of Chapter Nine. Chapter Ten concerns the accounting for liabilities such as leases, income taxes, and pensions. Accounting for ownership issues relating to corporate shareholders and intercorporate investments is described in Chapter Eleven.

Part Four addresses professional issues related to the provision and use of accounting information. In Chapter Twelve, the financial accounting policy-making process is described, with particular attention to the role of accounting information in the functioning of market economics. Chapter Thirteen covers the traditional use of accounting information in financial statement analysis. The auditing profession and its importance to the credibility of the financial reporting system are addressed in Chapter Fourteen.

These four parts have been constructed such that each is freestanding and can be used in combination with any other part. Instructors of a one-quarter first introduction to accounting may choose to omit Part Three, with no loss of continuity. Schools where the introductory course is taught in one semester or two quarters would have sufficient time to cover some of the more detailed topics addressed in Part Three. The institutional topics in Part Four can be deleted entirely. Alternatively, these chapters can be used as the initial chapters covered by instructors who prefer to establish more depth regarding the social and professional roles of financial accounting before addressing the workings of the accounting system.

Users of the second edition of this book will observe that the length has been shortened from 18 to 14 chapters. Great attention has been given to making the text more readable. Significantly shorter chapters and a simplified writing style make for more efficient and effective learning. Throughout, the goal was to create a concise exposition without overwhelming technical details. A logical

sequence of material has been followed, reducing the amount of mechanical or rote learning required. All technical aspects covered have been completely updated to current standards.

The intrinsic idea of this edition is consistent with the concept originated by the Price Waterhouse Study Group. We owe a special debt of gratitude to Professors May and Williams for their role in translating the Study Group report into a viable textbook—and later refining the sequence of subject matter and exposition of the text from the first to the second editions.

Our colleagues, Professors Judith Requist and William Wells at the University of Washington, gave us many specific suggestions on the manuscript that we were able to use. Colleagues at other universities reviewed the manuscript for this book and provided much appreciated, helpful comment. The group of reviewers includes Dean Robert Carver, Jr. (Southern Illinois University at Edwardsville) and Professors Jay D. Cook, Jr. (Ohio State University), William T. Geary (College of William and Mary), James K. Loebbecke (University of Utah), Maryanne Mowen (Oklahoma State University), Mohamed Onsi (Syracuse University), Alan K. Ortegren (Southern Illinois University at Edwardsville), Shahrokh Saudagaran (Santa Clara University), Edmund Scribner (New Mexico State University), and P. van Essen (Higher School of Economics, The Hague, Netherlands). Quite a number of informal comments were received from Ph.D. students using this text in sophomore classes—this source of help is thankfully acknowledged.

Mss. Irene Childs, Kelly Foy, Debbie Malestky, and Diane Robinette at the University of Washington provided invaluable assistance in producing useable copies of this manuscript through the many stages during which it was being tested in actual classroom settings. Messrs. Andrew Boyd and Ali Salama provided significant help with the problem and solution material.

As is customary for projects of this type, the co-authors accept full responsibility for all errors of commission and omission. We invite feedback from colleagues who have an opportunity to use this book.

Gerhard G. Mueller Lauren Kelly

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# The Role of Accounting

#### CHAPTER ONE

This book is an introduction to the role of financial accounting in society. To place the topic in its proper context, Chapter One begins with a general discussion of the uses of accounting information. The focus then narrows to financial accounting, or the use of information about business enterprises by parties external to these enterprises. Sections of Chapter One describe how people make decisions, the characteristics of business enterprises, and decision making in relation to the business entity.

#### WHAT IS ACCOUNTING?

Accounting is frequently described as the language of business. It is used to communicate financial and other information to people, organizations, and governments who need to make decisions.

**Accounting.** The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action.<sup>1</sup>

In this definition, information is knowledge helpful in reaching a conclusion. Accounting information is used in many sectors of society. To illustrate, the uses

<sup>&</sup>lt;sup>1</sup> American Institute of Certified Public Accountants, *Statement of the Accounting Principles Board No.* 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: AICPA, 1970), paragraph 40.

of accounting information about individuals, business enterprises, nonbusiness organizations, social programs, and units of government are discussed below.

#### Information About Individuals

Accounting information about individuals is used in the following cases. Individual credit is typically extended only after the prospective borrower has furnished an accounting of his or her private financial affairs. For example, banks evaluating applications for home mortgages or other forms of consumer credit need this type of information. Scholarship committees of colleges and universities use accounting data when they evaluate the financial needs of student applicants. Candidates for political office make public their income and property owned. Income tax collectors need accounting information since a large share of tax revenues collected by state and federal governments comes from individuals.

### Information About Business Enterprises

Owners of businesses, creditors, suppliers, management, taxing authorities, employees, and customers need accounting information about business enterprises. For example, owners may examine accounting information to determine if they should expect to receive dividend payments from a firm. Users with indirect concerns about business enterprises include financial analysts and advisors, stock exchanges, lawyers, regulatory and registration authorities, financial press and reporting agencies, trade associations, labor unions, and the public at large. These parties continually evaluate business firms and make decisions about them or on their behalf; for example, in helping the business raise funds.

# Information About Nonbusiness Organizations

Nonbusiness organizations such as churches, hospitals, the United Way, the Boy Scouts of America, the Red Cross, political parties, and trade or professional associations also must provide financial information. The general public needs enough information about the financial status of these organizations to determine whether to make private contributions to them and, if so, in what amount.

# Information About Social Programs

Similarly, administrators of social programs must adequately report on the success of their programs. For example, day care centers which receive business, community, and governmental support need to account for how their funding is used. All such programs must provide an assessment of resources spent and program benefits achieved.

# Information About Units of Government

The leaders of governmental units use a wide variety of accounting information. Tax policy at all levels of government cannot be formulated without accounting information about present and potential tax bases within the particular jurisdiction. National income data are needed to measure the productivity of the total economy and the distribution of economic resources. This type of information

supports the formulation of national economic, monetary supply, foreign trade, and investment policies.

Although accounting information is used extensively throughout society, it is only one part of all the information needed by decision makers. Few decisions are or should be made on the basis of accounting information alone. At the same time, most decisions with financial or economic implications can be improved with the use of accounting information.

### FOCUS ON FINANCIAL ACCOUNTING

Accounting has been described as providing information about various types of entities to facilitate economic decision making. This broad scope cannot be adequately covered in a single textbook. Thus the focus of this book is narrowed to one category of information users: those parties external to the accounting entity.

**External Users of Information.** External users of information concerning an accounting entity are those interested parties whose decisions relate to the entity, but who are not employed by the entity to direct its activities or utilize its resources.

External users of information include investors, customers, suppliers, and taxing authorities; that is, interested parties who are not employees of the enterprise. The entity these individuals are evaluating is the subject of the accounting information.

**Accounting Entity.** An accounting entity is any individual or organization that (1) uses economic resources to achieve a purpose; (2) has an identity of its own; and (3) is of interest to one or more individuals for decision-making purposes.

All the parties in the previous section can be considered accounting entities. The key characteristic of such organizations is that they are of decision interest in and of themselves, and that their activities can be distinguished from the activities of other entities. This includes a vast number of decision-relevant parties. In this text we narrow the focus to the business enterprise as the accounting entity of interest. Business entities dominate our economy, as they control the bulk of productive resources. They are also the most frequent focus of decisions by external parties. By narrowing the focus to external users of information about the business entity, we are limiting ourselves to the subject matter of financial accounting.

**Financial Accounting.** Financial accounting provides a continual history quantified in money terms of economic resources and obligations of a business enterprise and of economic activities that change those resources and obligations.<sup>2</sup>

#### DECISION MAKING

Information is primarily used to facilitate decisions regarding the allocation of scarce resources. Society is faced with virtually unlimited wants and needs. However, our resources, the means to satisfy those wants and needs, are in limited

<sup>&</sup>lt;sup>2</sup> AICPA, Statement of the Accounting Principles Board No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: 1970), paragraph 41.

supply. We can classify the resources available to satisfy wants and needs as (1) land, or natural resources; (2) labor, or the capacity of the individual for mental or physical output; (3) capital, or any implement, technology, or learned technique that increases the output of our resources; and (4) entrepreneurial ability, or the creative and leadership capacity to organize other individuals and resources to produce products and services.

Members of society must continually make decisions to resolve the conflict between unlimited wants and needs, and limited means to satisfy those wants and needs.

**Decision Making.** Decision making is the process of choosing from among alternative courses of action using criteria adopted by the decision maker.

We can depict the decision-making process in stages similar to those illustrated in Exhibit 1–1. Each of these stages will be discussed separately and illustrated by an individual making a career decision. The role of accounting is to provide information for use in this decision-making process.

### Identifying the Problem

The decision-making process begins when an individual feels the need to take a course of action. The problem must then be identified. In defining the problem, the decision maker states the criteria that will determine the choice of one action over another for satisfying a need. These criteria can be formulated as objectives.

**Statement of Objectives.** A statement of objectives is an expression of the decision maker's preferences in terms of the consequences of potential courses of action.

For example, an individual may decide he or she would like to become a professional. This is a statement of objectives. Two courses of action might achieve this goal: attending law school to become a lawyer or attending business school to get an MBA. However, the individual has limited financial resources available for tuition. Thus a constraint on the action taken is the cost of attending school. In this manner, the set of constraints and the statement of objectives provide a framework for the evaluation of alternatives leading to a choice, as well as prescribing what information will be useful to the decision maker.

#### Evaluation of Alternatives

As in the example of the aspiring professional, the decision maker may face two or more alternatives, each of which possesses different desirable attributes. In such cases, it is useful to define a common denominator to evaluate the alternatives.

EXHIBIT 1-1 Stages in the Decision-making Process

Need Problem Sought about Felt Identified Alternatives Alternatives   Conclusion   Action   Reviewed;   Felt Identified Alternatives   Selected   Appropriate   Evaluated   Selected   Appropriate   Emerge   Emerge	<del> </del>		· · · · · · · · · · · · · · · · · · ·		<del></del>			Λ
	Need Felt	Problem Identified	Information Sought about Alternatives	Alternatives Evaluated	or Action	Taken if	Reviewed; New Needs	\ 

Different decision outcome attributes can then be translated into this common denominator for greater ease of comparison. The decision is thus simplified to a selection of the alternative that scores highest on the common denominator. Thus if the individual who wants to become a professional decides maximization of earnings is a criterion for choosing a career, the starting salaries of lawyers and MBAs would be a common basis upon which to evaluate the alternatives.

#### The Role of Information

After defining the problem, the decision maker should have some idea regarding what aspects of the alternative courses of action might affect the constraints and attainment of objectives. Usually the outcomes from the alternative courses of action cannot be predicted exactly. This gives rise to uncertainty in the decision setting.

**Uncertainty.** Uncertainty is the condition of not knowing at the time of decision precisely what the outcomes of relevant future events will be; that is, not knowing precisely the consequences of alternatives courses of action.

For example, our ambitious professional is uncertain as to what future employment opportunities and salaries will be upon graduation. Uncertainty can never be eliminated altogether, but it can be lessened by information. A more formal definition of information can now be given.

Information. Information is data that improves the decision maker's understanding and predictions of the outcomes of uncertain future events.

The decision maker is essentially interested in the results or consequences of the different decision alternatives. With greater information, the knowledge about the outcomes from a decision usually increases. However, this does not mean that more facts are always better, since the decision maker may be confused by additional data. Defining a problem indicates what features and characteristics about each alternative must be investigated to make the best choice. Thus a particular problem definition prescribes what information is relevant.

**Decision Relevance.** Information is relevant with respect to a specific decision situation if it will improve predictions regarding future events related to the decision.

For example, the individual choosing between law school and business school would obtain information about the cost of tuition, potential number of jobs, average starting salaries, and the like.

Decision making is not simply a matter of choosing the most desirable alternative. Rather it is the process of finding the best combination of the expected outcome and the amount of resources needed to follow a specific course of action. Information improves the expected outcome of a decision. But information is costly. Fortunately there are individuals (such as accountants) who can produce the information needed by decision makers at a cost lower than producing it on their own. These persons are called information specialists.

Information Specialist. An information specialist is an individual who deviates resources to producing decision-relevant information for use by others.

The need for an information specialist arises when large numbers of individuals make decisions involving similar courses of action. For example, business newspapers such as *The Wall Street Journal* contain articles about specific corporations that are of interest to many investors. Information produced by a specialist has value to many decision makers, provided it is decision relevant. Since the specialist can provide information at a lower cost than would be incurred by others individually gathering the same facts, decision makers often pay for such services. Thus decision makers oftentimes use more information at a lower cost and make decisions with greater expected benefits. The role of the information specialist to enable the functioning of an economy is served by accountants.

#### THE BUSINESS ENTERPRISE

This book focuses on the role of accounting in supplying information to decision makers concerned about the business enterprise. To understand the characteristics of these decision makers, their common decision problems and the information they need, the role of the business enterprise in the free enterprise, or market, system is reviewed next.

### The Enterprise Function

Entrepreneurs are individuals who provide products and services in response to demand by potential customers. They organize factors of production such as natural resources and labor to produce specific goods and services. They also take the risk that the price they receive for the goods or services may not exceed the cost of production. Presumably, entrepreneurs are motivated by the expectation that sales prices will exceed costs by a sufficient amount to justify the effort expended and the risks taken. In performing their dual role of organizing and risk taking, entrepreneurs usually structure themselves as a business enterprise.

**Business Enterprise.** A business enterprise is an organization comprised of one or more individuals, capital goods, and other resources, whose purpose is to produce specific products or services for sale.

Thus the business enterprise is a means of coordinating the activities of individuals engaged in production processes, often of a fairly large scale involving a high degree of division of labor and specialization. Additionally, the business enterprise is a means of dividing or sharing among many individuals the enterprise function itself by obtaining funds to finance the business. When an entrepreneur sees an opportunity for profit in the production of a product or service, the necessary factors of production must be secured first. Then these factors must be organized and used to produce and sell the product or service to others. Significant resources are needed to accomplish these steps. Before the sale of products or services starts to bring in cash, the enterpriser may have to pay for buildings, equipment, and other capital goods, as well as for materials and wages. Even after starting a business, there is a time lag before the sale of products and services brings in cash. This requires the ongoing commitment of money capital.

**Money Capital.** Money capital is the cash or cash equivalent of other resources committed to a business enterprise to enable it to procure and meet its obligations to pay for capital goods, labor, material, and other factors of production.

A central part of the enterprise function involves the provision of money capital and the acceptance of the attendant risk that the sales proceeds may not cover the costs of production. Individual enterprisers may not possess adequate funds and thus may borrow money in exchange for fixed interest payments, or arrange for other persons to share the enterprise function with them as owners. However it is financed, the business organization provides a means of breaking down a large opportunity for profit into a number of smaller individual opportunities.

### Kinds of Business Enterprises

There are three traditional kinds of business enterprises: proprietorships, partnerships, and corporations. All are recognized by accountants as economic units or entities with an existence separate from that of their owners. They differ from each other in legal status, ownership and management relationships, extent of ownership risk or liability, duration of life and dissolution, and transferability of ownership interest. Exhibit 1–2 summarizes these differences.

*Proprietorship.* A proprietorship is a personal business, formed unilaterally by a single individual. It exists as an organization devoted to production activities, and it separates those activities and the resources devoted to them from the entrepreneur's private life. Legally, however, a proprietorship does not constitute a separate entity. It is identical with the owner and therefore cannot be involved in any legal relationship or action except in the name of the owner. If, in the

EXHIBIT 1-2 Comparative Features of Types of Business Enterprises

Type of Business Enterprise	Proprietorship	Partnership	Corporation	
Legal Status of Business Entity	Not a separate legal entity	Not a separate legal entity	Separate legal entity	
Owner-Management Relationship	Separation only by owner choice	Separation only by partnership agreement	Separation; owners influence management indirectly	
Risk of Ownership	Owner's personal fortune at stake	At least one part- ner's personal for- tune at stake	Limited to loss of interest in benefits of ownership	
Duration of Life	Expires by choice or death of owner	Expires by with- drawal or death of a partner	Indefinite life span; possibly un- limited	
Transferability of Ownership Interest	If sold by the proprietor, the business is reconstituted under new ownership	Partnership share cannot be sold without agreement of other partners; new partnership is formed	Usually transferable	