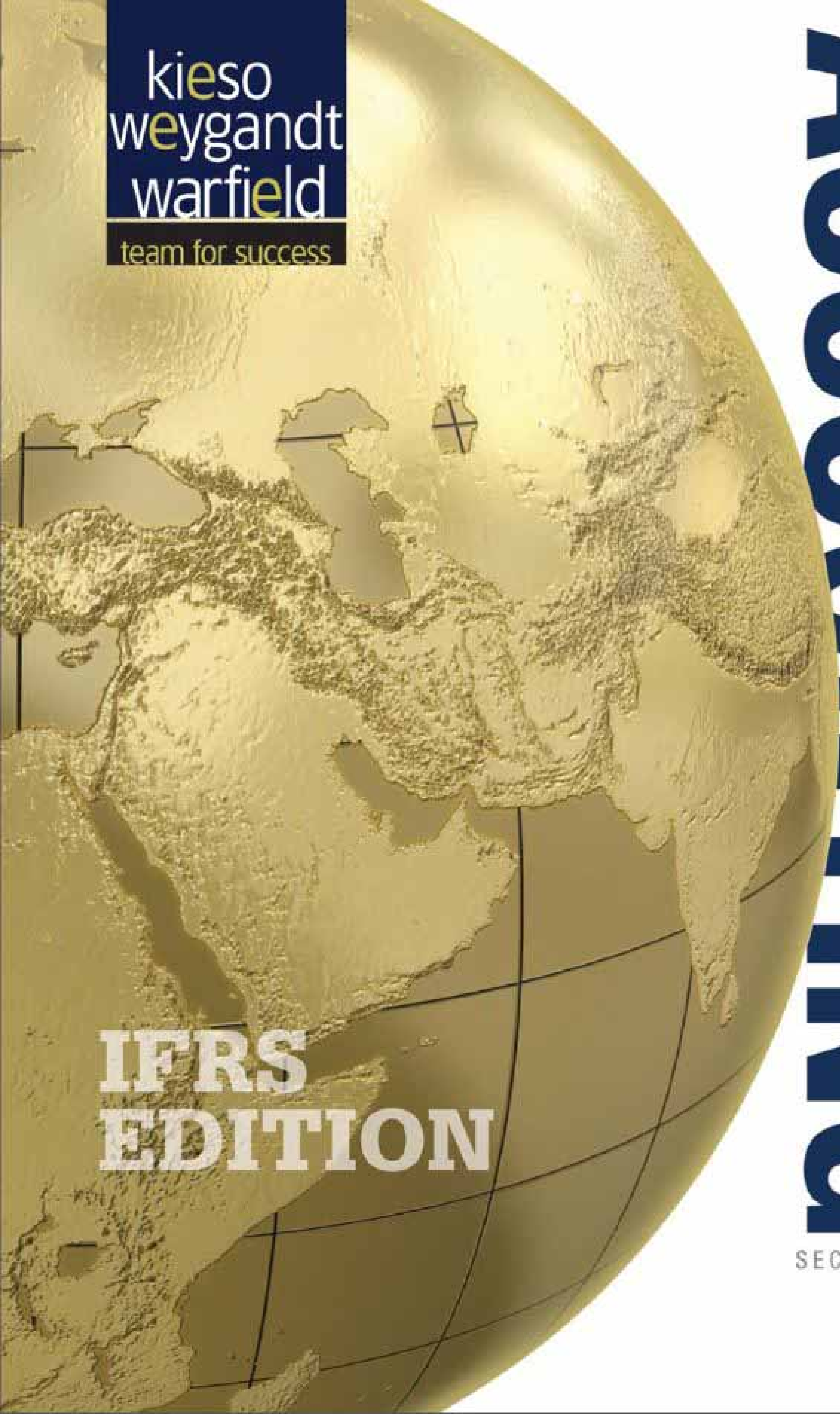

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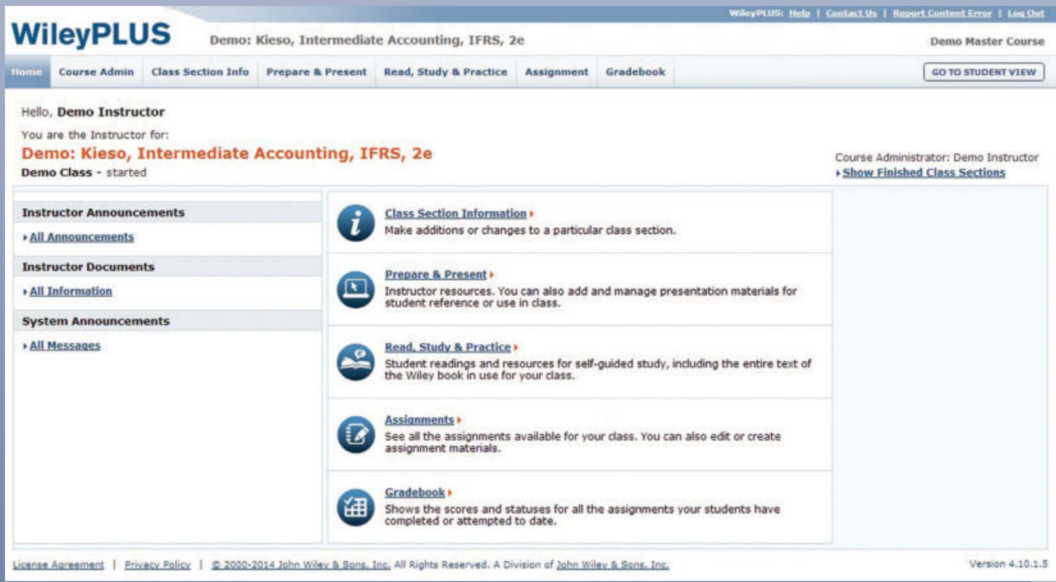

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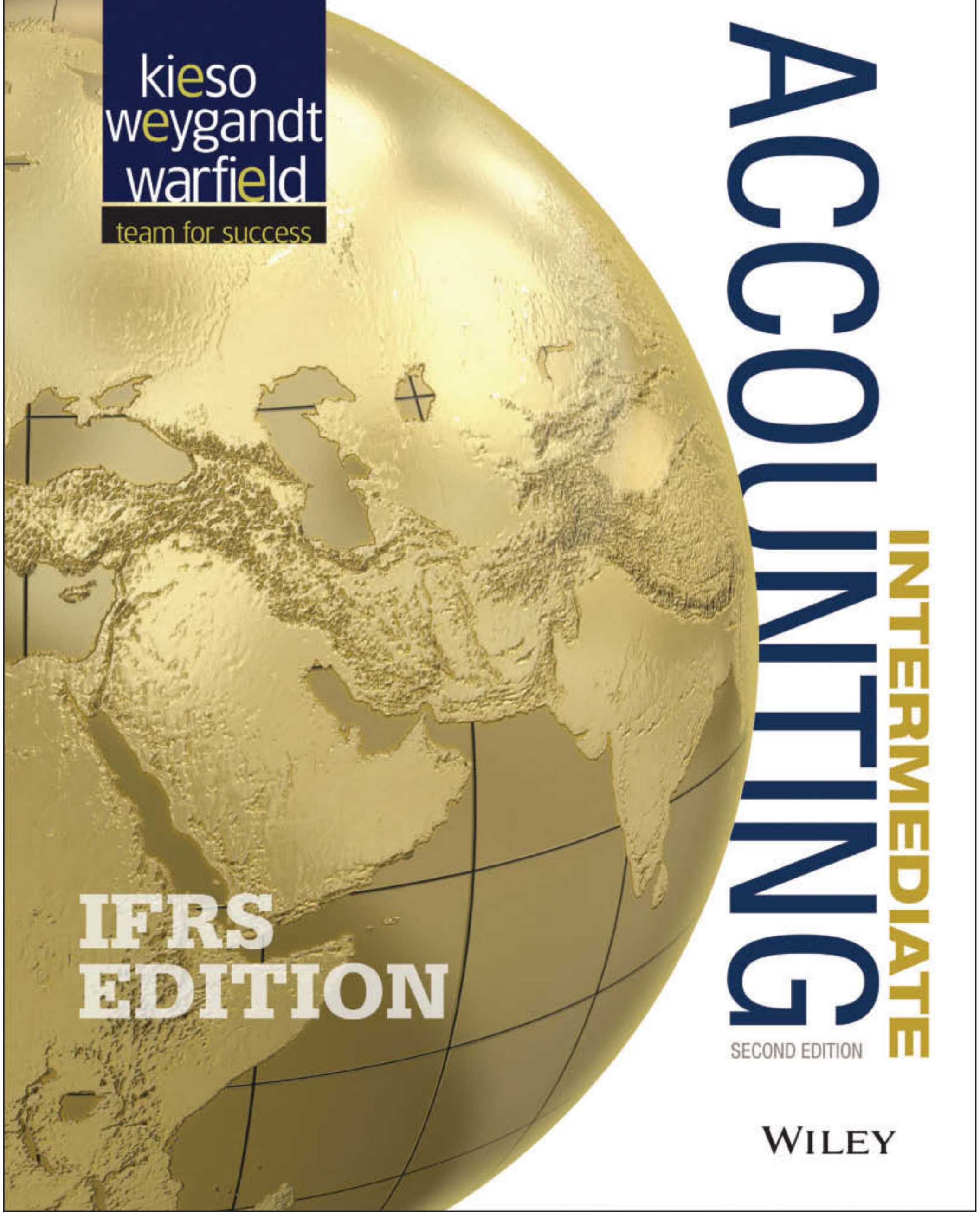

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our wives, ***Donna, Enid, and Mary,***
for their love,
support, and encouragement

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ISBN-13 978-1-118-44396-5

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Brief Contents

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Jerry J. Weygandt, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Accountancy,* and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the Accounting Review; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001, he received the American Accounting Association's Outstanding Educator Award.

Terry Warfield

Terry D. Warfield, PhD, is the PwC Professor in Accounting at the University of Wisconsin—Madison. He received a B.S. and M.B.A. from Indiana University and a Ph.D. in accounting from the University of Iowa. Professor Warfield's area of expertise is financial reporting, and prior to his academic career, he worked for five years in the banking industry. He served as the Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission in Washington, D.C. from 1995–1996. Professor Warfield's primary research interests concern financial accounting standards and disclosure policies. He has published scholarly articles in *The Accounting Review, Journal of Accounting and Economics, Research in Accounting Regulation,* and *Accounting Horizons,* and he has served on the editorial boards of *The Accounting Review, Accounting Horizons,* and *Issues in Accounting Education*. He has served as president of the Financial Accounting and Reporting Section, the Financial Accounting Standards Committee of the American Accounting Association (Chair 1995–1996), and on the AAA-FASB Research Conference Committee. He also served on the Financial Accounting Standards Advisory Council of the Financial Accounting Standards Board. He currently serves as a trustee on the Financial Accounting Foundation. Professor Warfield has received teaching awards at both the University of Iowa and the University of Wisconsin, and he was named to the Teaching Academy at the University of Wisconsin in 1995. Professor Warfield has developed and published several case studies based on his research for use in accounting classes. These cases have been selected for the AICPA Professor-Practitioner Case Development Program and have been published in *Issues in Accounting Education*.

From the Authors

Globalization is occurring rapidly. As economic and other interactions increase among countries, capital markets must provide high-quality financial information. A need therefore exists for high-quality financial reporting standards that meet this objective. Fortunately, **International Financial Reporting Standards (IFRS)** has broad international acceptance, being used in some form by more than 115 countries around the world. One securities regulator noted that IFRS is best positioned to serve as the single set of high-quality accounting standards.

Change Is the Only Constant

Most countries want rapid action related to the acceptance of IFRS. A number of countries have already switched from their own version of accounting standards to IFRS. Students and instructors need educational materials related to IFRS in order to meet this new challenge. Our objective in revising *Intermediate Accounting*, IFRS Edition, was therefore to continue to provide the tools needed to understand what IFRS is and how it is applied in practice. The emphasis on fair value, the proper accounting for financial instruments, and the new developments related to leasing, revenue recognition, and financial statement presentation are examined in light of current practice. In addition, given the rapid changes taking place, we provide and discuss the new Conceptual Framework to understand how these issues will likely be resolved in the future.

> "If this textbook helps you appreciate the challenges, worth, and limitations of financial reporting, if it encourages you to evaluate critically and understand financial accounting concepts and practice, and if it prepares you for advanced study, professional examinations, and the successful and ethical pursuit of your career in accounting or business in a global economy, then we will have attained our objectives."

A Look at Global Accounting

While IFRS has achieved broad acceptance, not all countries have adopted it. For example, U.S. companies still follow U.S. generally accepted accounting principles (U.S. GAAP) in preparing their financial statements. In fact, the differences between IFRS and U.S. GAAP may provide certain companies with a competitive advantage, so understanding these differences may be important in analyzing company performance. In addition, the IASB and the FASB are working together to converge their standards as appropriate. Accordingly, we have included a **Global Accounting Insights** section at the end of selected chapters, to highlight the important differences that remain between IFRS and U.S. GAAP, as well as the ongoing joint convergence efforts to resolve them. As a result, students truly gain a global accounting education by studying this textbook.

Intermediate Accounting Works

Intermediate Accounting, Fifteenth Edition (based on U.S. GAAP) is the market-leading textbook in providing the tools needed to understand what U.S. GAAP is and how it is applied in practice. With this IFRS Second Edition, we strive to continue to provide the material needed to understand this subject area using IFRS. The book is comprehensive and up-to-date, and provides the instructor with flexibility in the topics to cover. We also include proven pedagogical tools, designed to help students learn more effectively and to answer the changing needs of this course.

We are excited about *Intermediate Accounting,* IFRS Second Edition. We believe it meets an important objective of providing useful information to educators and students interested in learning about IFRS. Suggestions and comments from users of this textbook will be appreciated. Please feel free to e-mail any one of us at *AccountingAuthors@yahoo.com*.

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What's New?

The Second Edition expands our emphasis on student learning and improves upon a teaching and learning package that instructors and students have rated the highest in customer satisfaction. We have developed a number of new pedagogical features and content changes, designed both to help students learn more effectively and to answer the changing needs of the course.

Evolving Issues

As we continue to strive to reflect the constant changes in the accounting environment, we have added a new feature to the Second Edition, **Evolving Issue** boxes, which highlight and discuss areas in which the profession may be encountering controversy or nearing resolution. Our hope is that these high-interest boxes will increase student engagement, as well as serve as classroom discussion points. For another source of high-interest material, see the **What Do the Numbers Mean?** boxes, most of which are new to this edition.

Global Accounting Insights

We have updated the end-of-chapter section, **Global Accounting Insights** (previously known as the Convergence Corner), throughout the textbook. In addition, we now present *Similarities* as well as *Differences* between U.S. GAAP and IFRS to increase student understanding.

Major Content Revisions

In response to the changing environment, we have significantly revised several chapters.

Chapter 2 Conceptual Framework for Financial Reporting

- Updated discussion on the IASB's guidance related to the use of fair value in financial statements, including the establishment of the fair value hierarchy.
- New illustration on the five steps of revenue recognition.
- Revised Constraints section, as now only cost constraint is included in the Conceptual Framework.

Chapter 4 Income Statement and Related Information

- New sections on the one statement and two statement formats for reporting components of other comprehensive income.
- Rewrote the Allocating to Non-Controlling Interest section to increase student understanding.

Chapter 18 Revenue Recognition

- Completely new chapter reflecting the very recent IFRS on revenue recognition.
- Numerous new illustrations providing case examples for correctly applying the new IFRS on revenue recognition.

Chapter 20 Accounting for Pensions and Postretirement Benefits

- New sections on the net defined benefit obligations and how to report changes for it.
- Updated section on past service cost, including discussion of curtailments.

Chapter 23 Statement of Cash Flows

- Reorganized chapter, to present the indirect method through preparation of the statement of cash flows first, followed by the discussion of the direct method as well as the advantages and disadvantages of both methods.
- New Evolving Issue, "Direct versus Indirect Controversy," on the arguments in favor of each method.

See the next two pages for a complete list of content revisions by chapter.

Supplementary Materials

The Solutions Manual, Test Bank, PowerPoint, Instructor's Manual, and all other materials were updated to reflect changes in the Second Edition. Instructor resources and additional student resources, such as online self-tests, are available at **www.wiley.com/college/kieso**. Supplementary materials are also available in *WileyPLUS* where additional resources can help instructors create assignments and track student progress. Additional Course Management Resources are available.

Content Changes by Chapter

Chapter 1 Financial Accounting and Accounting Standards

- Revised opening story, to include more recent commentaries on IFRS.
- New WDNM box, on recent progress toward global adoption of IFRS.
- Updated and expanded discussion of the IASB's standard-setting structure.
- Revised International Convergence section, to include recent developments.
- Moved Appendix 1A, The U.S. Standard-Setting Environment, to book's companion website.

Chapter 2 Conceptual Framework for Financial Reporting

- Updated Conceptual Framework discussion to reflect recent IASB discussion paper, e.g., materiality no longer considered a separate constraint.
- Updated discussion on fair value, including the establishment of the fair value hierarchy, and the revenue recognition principle.
- New WDNM boxes, on the importance of faithful representation, as exemplified by the scandal at **Olympus Corp.**, and the concept of prudence.
- Updated discussion plus added an illustration on the five steps of revenue recognition.
- Updated Constraints section as now only cost constraint is included in the Conceptual Framework.

Chapter 3 The Accounting Information System

- New opening story on impact of global economic crime.
- Enhanced Adjusting Entries section, to provide additional explanation and visuals to students.
- New WDNM box, on companies' need to update their accounting information systems yet unwillingness to interrupt their operations to do so.

Chapter 4 Income Statement and Related Information

- Updated opening story, to discuss recent IASB project on financial statement presentation.
- New sections on the one statement and two statement formats for reporting components of other comprehensive income.
- Rewrote Allocation to Non-Controlling Interest section, to increase student understanding.
- New WDNM boxes, on a recent study that reinforces concerns about earnings management and the use of pro forma earnings measures.
- New Evolving Issue on income reporting.

Chapter 5 Statement of Financial Position and Statement of Cash Flows

- New WDNM box, on presentation order of assets on the statement of financial position.
- New Evolving Issue, on statement of financial position reporting.
- Moved **M&S**'s financial statements from Appendix 5B to Appendix A at end of textbook.

Chapter 6 Accounting and the Time Value of Money

- New opening story, about developing fair value estimates and applying fair value guidance to specific examples.

Chapter 7 Cash and Receivables

- Revised opening story, about banks' bad debt allowances.
- New WDNM box, on consequences of requiring companies to value their securities at fair value.
- New Evolving Issue, on the three-bucket approach of classifying loans and impairment stages.

Chapter 8 Valuation of Inventories: A Cost-Basis Approach

- New opening story, about the difficulties in determining the point at which inventory is considered to be sold.
- Moved Appendix 8B (Special Issues Related to LIFO) and related assignment material to book's companion website.
- Deleted material on sales on installment in Special Sales Agreements section.

Chapter 9 Inventories: Additional Valuation Issues

- New opening story, about why investors need comparable information about inventory when evaluating retailers' financial statements.

Chapter 10 Acquisition and Disposition of Property, Plant, and Equipment

- New opening story, about importance of capital expenditures and how they can affect a company's income.

Chapter 11 Depreciation, Impairments, and Depletion

- New WDNM box, on why some companies do not use revaluation accounting.

Chapter 12 Intangible Assets

- New opening story, on increasing amount of sustainable information provided by companies.
- New Underlying Concepts note about surrounding controversy for R&D accounting.
- New WDNM boxes: (1) how companies protect their intangible assets, (2) the patent battles between e-tailers and cell phone companies, and (3) global R&D incentives.
- New Evolving Issue, on the recognition of R&D and internally generated intangibles.

Chapter 13 Current Liabilities, Provisions, and Contingencies

- Revised Unearned Revenues section, to correspond to recent revenue recognition standard.
- New section on value-added tax (VAT).
- New sections on assurance-type and service-type warranties.
- New Evolving Issue, on how to account for greenhouse gases.

Chapter 14 Non-Current Liabilities

- New opening story, about the impact of long-term debt on governments and companies.
- New WDNM box, on why companies issue 100-year bonds.
- Updated Fair Value Option section, on how to treat changes in liability value due to credit risk changes.
- New footnote on IASB consolidation guidance for whether an off-balance-sheet entity should be on-balance-sheet.

Chapter 15 Equity

- Updated opening story, on the global IPO market.
- New WDNM boxes, on whether buybacks signal good or bad news about companies, and an analysis of recent company dividend payouts.
- Significantly enhanced Share Dividends and Share Splits sections to reflect recent information and pronouncements.

Chapter 16 Dilutive Securities and Earnings per Share

- Updated WDNM box on convertible bonds, to include more recent offerings from Asian companies.
- New illustration on company equity grants.

Chapter 17 Investments

- Revised WDNM box on fair value, to discuss controversial valuation of Greek government bond holdings.
- New illustration to clarify how to determine the adjustment to the carrying value of an investment.
- New Evolving Issue, on fair value controversy.
- New Appendix 17B on required fair value disclosures; deleted discussion of reclassification adjustments (old Appendix 17A).

Chapter 18 Revenue Recognition

- Completely rewritten chapter to reflect recently issued revenue recognition standard, including an overview and discussion of the five-step process.
- New opening story, featuring **Rolls-Royce**, **Qwest Communications**, **Sinovel Wind Group**, and **iGo**, to demonstrate challenges of recognizing revenue properly.
- New Evolving Issue, on the implementation of the recently issued revenue recognition standard.

Chapter 19 Accounting for Income Taxes

- Updated opening story, to include the most recent tax system recommendations by the G20.
- Updated footnotes on determining true cost of taxes and deferred tax assets (**Sony**'s experience in post-quake Japan).
- Expanded discussion of the components of income tax expense on the income statement.
- New WDNM box, on how a reduction in tax rates can be a double-edged sword for companies that have large deferred tax asset balances.

Chapter 20 Accounting for Pensions and Postretirement Benefits

- Chapter has been significantly revised to reflect recent IASB standards. Details are given below.
- Updated opening story, to include recent information about swings in pension plans' status.
- Updated WDNM box, to highlight increased popularity of defined contribution plans with employers as well as differences between countries in which plans are offered.
- New section on Net Defined Benefit Obligation (Asset).
- Rewrote Components of Pension Expense as new section, Reporting Changes in the Defined Benefit Obligation (Asset) to reflect recent IFRS.
- Expanded and updated section on Past Service Cost to reflect recent IASB rulings, including discussion of curtailments.
- New section on Remeasurements, replacing outdated discussion of corridor amortization.

Chapter 21 Accounting for Leases

- Updated opening story on aircraft leasing data and added information about IASB's work on new lease standard.
- New Evolving Issue, on proposal to address off-balance-sheet reporting of leases.

Chapter 22 Accounting Changes and Error Analysis

- New WDNM box, on how accounting changes create comparability challenges.
- Revised WDNM box, on need to protect company statements from negative effects of fraud.
- Reformatted examples of counterbalancing and non-counterbalancing errors as illustrations, for improved student understanding.

Chapter 23 Statement of Cash Flows

- Reorganized chapter, to present indirect method through preparation of the statement of cash flows first, followed by discussion of the direct method and advantages and disadvantages of both methods.
- New WDNM box, on COROA (cash operating return on assets), a new measure of profitability.
- Reformatted "Direct versus Indirect Controversy" as new Evolving Issue box, to highlight the arguments in favor of each method.
- New Underlying Concepts, on how statement of cash flows information and disclosures relate to the objective of financial reporting and the full disclosure principle.

Chapter 24 Presentation and Disclosure in Financial Reporting

- New opening story, about IASB survey of criticisms of current financial statement disclosures and how the Board plans to respond.
- New WDNM boxes: (1) requirements for disclosing collateral arrangements in repurchase agreements, (2) how note disclosure requirements can positively affect securities markets, and (3) differences in British forecasted information.
- New Evolving Issue, on anticipated increase in note disclosure requirements as IFRS and U.S. GAAP converge.
- New graphs on types and trends of economic crime and fraud.

Appendices A-C (New!)

Financial statements for **Marks & Spencer**, **adidas**, and **Puma**.

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We Need Better, Not More

Acknowledgments

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Practicing Accountants and Business Executives

From the fields of corporate and public accounting, we owe thanks to the following practitioners for their technical advice and for consenting to interviews.

Mike Crooch, *FASB (retired);* Tracy Golden, *Deloitte LLP;* John Gribble, *PricewaterhouseCoopers (retired);* Darien Griffin, *S.C. Johnson & Son;* Michael Lehman, *Sun Microsystems, Inc.;* Tom Linsmeier, *FASB;* Michele Lippert, *Evoke.com;* Sue McGrath, *Vision Capital Management;* David Miniken, *Sweeney Conrad;* Robert Sack, *University of Virginia;* Clare Schulte, *Deloitte LLP;* Willie Sutton, *Mutual Community Savings Bank, Durham, NC;* Lynn Turner, *former SEC Chief Accountant;* Rachel Woods, *PricewaterhouseCoopers;* Arthur Wyatt, *Arthur Andersen & Co., and the University of Illinois—Urbana.*

Finally, we appreciate the exemplary support and professional commitment given us by the development, marketing, production, and editorial staffs of John Wiley & Sons, including the following: Joel Hollenbeck, Chris DeJohn, Karolina Zarychta, Ed Brislin, Sandra Dumas, Brian Kamins, Tai Harriss, Allie Morris, Greg Chaput, Harry Nolan, Maureen Eide, and Kristine Carney. Thanks, too, to Jackie Henry and the staff at Aptara®, Inc. for their work on the textbook, Cyndy Taylor, and to Rebecca Sage and the staff at Integra Publishing Services for their work on the solutions manual.

Suggestions and comments from users of this book will be appreciated. Please feel free to e-mail any one of us at *AccountingAuthors@yahoo.com*.

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CHAPTER 1

Financial Reporting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1 Describe the growing importance of global financial markets and its relation to financial reporting.

2 Identify the major financial statements and other means of financial reporting.

3 Explain how accounting assists in the efficient use of scarce resources.

4 Explain the need for high-quality standards.

5 Identify the objective of financial reporting.

6 Identify the major policy-setting bodies and their role in the standard-setting process.

7 Explain the meaning of IFRS.

8 Describe the challenges facing financial reporting.

Revolution in International Financial Reporting

The age of free trade and the interdependence of national economies is now with us. Many of the largest companies in the world often do more of their business in foreign lands than in their home country. Companies now access not only their home capital markets for financing but others as well. As this globalization takes place, companies are recognizing the need to have one set of financial reporting standards. For globalization to be efficient, what is reported for a transaction in Beijing should be reported the same way in Paris, New York, or London.

A revolution is therefore occurring in financial reporting. In the past, many countries used their own set of standards or followed standards set by larger countries, such as those in Europe or in the United States. However, that situation is changing rapidly. A single set of rules, called International Financial Reporting Standards (IFRS), is now being used by over 115 countries. Here is what some are saying about IFRS.

- "The global financial crisis that began in 2007 and continues today provides a very clear illustration of the globally connected nature of financial markets and the pressing need for a single set of high quality global accounting standards. That is why the G20 . . . has supported the work of the IASB and called for a rapid move towards global accounting." [Michael Prada, chairman of the IFRS Foundation.]
- "Large multi-national companies stand to realize great benefits from a move to a single set of standards. Companies will have more streamlined IT, easier training, and there will be better communication with outside parties. In fact, the move to IFRS is not so much about the accounting but about the economics of a shrinking world." [Sir David Tweedie, former chairman of the IASB.]
- "The added costs from having to use this complex hodgepodge (different country reporting standards) of financial information can run in the tens of millions of dollars annually. In the international arena, they can act as a barrier to forming and allocating capital efficiently. Thus, there are growing demands for the development of a single set of high quality international accounting standards." [Robert Herz, former chairman of the FASB.]

INTERNATIONAL FOCUS

> Read the **Global Accounting Insights** on pages 17–18 for a discussion of international financial reporting.

- "The current and growing breadth of IFRS adoption across the world suggests that IFRS has become the most practical approach to achieving the objective of having a single set of high-quality, generally accepted standards for financial reporting. Those who share this belief are influenced by the fact that the IASB's structure and due-process procedures are open, accessible, responsive, and marked by extensive consultation." [KPMG Defining Issues.]
- "Developments such as the shocks of the Asian financial crisis, the Enron and WorldCom scandals, and Europe's creation of a unified financial market helped build consensus for global accounting standards. Every relevant international organization has expressed its support for our work to develop a global language for financial reporting." [Hans Hoogervorst, chairman of the IASB, June 2013.]

What these statements suggest is that the international standard-setting process is rapidly changing. And with these changes, it is hoped that a more effective system of reporting will develop, which will benefit all.

PREVIEW OF CHAPTER 1

As the opening story indicates, countries are moving quickly to adopt International Financial Reporting Standards (IFRS). It is estimated that as many as 310 of the 500 largest global companies are using IFRS. However, the accounting profession faces many challenges in establishing these standards, such as developing a sound conceptual framework, use of fair value measurements, proper consolidation of financial results, off-balance-sheet financing, and proper accounting for leases and pensions. This chapter discusses the international financial reporting environment and the many factors affecting it, as follows.

Financial Reporting and Accounting Standards

Global Markets	Objective of Financial Reporting	Standard-Setting Organizations	Financial Reporting Challenges
• Financial statements and financial reporting • Accounting and capital allocation • High-quality standards	• General-purpose financial statements • Equity investors and creditors • Entity perspective • Decision-usefulness	• IOSCO • IASB • Hierarchy of IFRS	• Political environment • Expectations gap • Significant financial reporting issues • Ethics • International convergence

GLOBAL MARKETS

LEARNING OBJECTIVE 1
Describe the growing importance of global financial markets and its relation to financial reporting.

World markets are becoming increasingly intertwined. International consumers drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, watch U.S. movies, and use Arabian oil. The tremendous variety and volume of both exported and imported goods indicates the extensive involvement in international trade—for many companies, the world is their market.

To provide some indication of the extent of globalization of economic activity, Illustration 1-1 provides a listing of the top 20 global companies in terms of sales.

Rank	Company	Country	Revenues ($ millions)	Rank	Company	Country	Revenues ($ millions)
1	**Royal Dutch Shell**	Netherlands	484,489	11	**Total**	France	231,580
2	**ExxonMobil**	U.S.	452,926	12	**Volkswagen**	Germany	221,551
3	**Wal-Mart Stores**	U.S.	446,950	13	**Japan Post Holdings**	Japan	211,019
4	**BP**	U.K.	386,463	14	**Glencore International**	Switzerland	186,152
5	**Sinopec Group**	China	375,214	15	**Gazprom**	Russia	157,831
6	**China National Petroleum**	China	352,338	16	**E.ON**	Germany	157,057
7	**State Grid**	China	259,142	17	**ENI**	Italy	153,676
8	**Chevron**	U.S.	245,621	18	**ING Group**	Netherlands	150,571
9	**ConocoPhillips**	U.S.	237,272	19	**General Motors**	U.S.	150,276
10	**Toyota Motor**	Japan	235,364	20	**Samsung Electronics**	South Korea	148,944

Source: http://money.cnn.com/magazines/fortune/global500/2012/full_list/index.html.

ILLUSTRATION 1-1
Top 20 Global Companies in Terms of Sales

In addition, due to technological advances and less onerous regulatory requirements, investors are able to engage in financial transactions across national borders and to make investment, capital allocation, and financing decisions involving many foreign companies. Also, many investors, in attempts to diversify their portfolio risk, have invested more heavily in international markets. As a result, an increasing number of investors are holding securities of foreign companies. For example, over a recent seven-year period, estimated investments in foreign equity securities by U.S. investors increased over 20-fold, from $200 billion to $4,200 billion.

An indication of the significance of these international investment opportunities can be found when examining the number of foreign registrations on various securities exchanges. As shown in Illustration 1-2, a significant number of foreign companies are found on national exchanges.

ILLUSTRATION 1-2
International Exchange Statistics

Exchange (Location)	Total Share Trading ($ billions)	Total Listings	Domestic Listings	Foreign Listings	Foreign %
NYSE Euronext (U.S.)	18,027,080	2,308	1,788	520	22.5
NASDAQ OMX	12,723,520	2,680	2,383	297	11.1
Tokyo SE Group	3,986,204	2,291	2,280	11	0.5
London SE Group	2,825,662	2,886	2,288	598	20.7
NYSE Euronext (Europe)	2,125,422	1,112	969	143	12.9
Korea Exchange	2,022,640	1,816	1,799	17	0.9
Deutsche Börse (Germany)	1,750,853	746	670	76	10.2
Hong Kong Exchanges	1,444,712	1,496	1,472	24	1.6
Australian Securities Exchange	1,194,163	2,079	1,983	96	4.6
Taiwan SE Corporation	887,520	824	772	52	6.3
Singapore Exchange	284,289	773	462	311	40.2

Source: Focus: The Monthly Newsletter of Regulated Exchanges (September 2011).

As indicated, capital markets are increasingly integrated and companies have greater flexibility in deciding where to raise capital. In the absence of market integration, there can be company-specific factors that make it cheaper to raise capital and list/trade securities in one location versus another. With the integration of capital markets, the automatic linkage between the location of the company and location of the capital market is loosening. As a result, companies have expanded choices of where to raise capital, either equity or debt. The move toward adoption of global accounting standards has and will continue to facilitate this trend.

Financial Statements and Financial Reporting

2 LEARNING OBJECTIVE
Identify the major financial statements and other means of financial reporting.

Accounting is the universal language of business. One noted economist and politician indicated that the single-most important innovation shaping capital markets was the development of sound accounting principles. The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties. Users of these financial reports include investors, creditors, managers, unions, and government agencies. In contrast, **managerial accounting** is the process of identifying, measuring, analyzing, and communicating financial information needed by management to plan, control, and evaluate a company's operations.

Financial statements are the principal means through which a company communicates its financial information to those outside it. These statements provide a company's history quantified in money terms. The **financial statements** most frequently provided are (1) the statement of financial position, (2) the income statement (or statement of comprehensive income), (3) the statement of cash flows, and (4) the statement of changes in equity. Note disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of **financial reporting** other than formal financial statements. Examples include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and social or environmental impact statements. Companies may need to provide such information because of authoritative pronouncements, regulatory rule, or custom. Or, they may supply it because management wishes to disclose it voluntarily.

In this textbook, we focus on the development of two types of financial information: (1) the basic financial statements and (2) related disclosures.

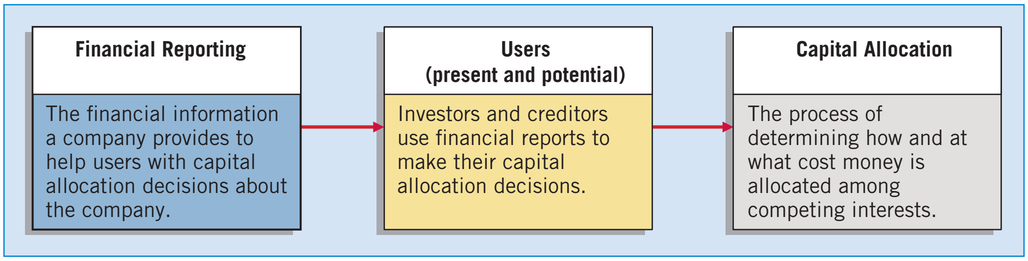
Accounting and Capital Allocation

3 LEARNING OBJECTIVE
Explain how accounting assists in the efficient use of scarce resources.

Resources are limited. As a result, people try to conserve them and ensure that they are used effectively. Efficient use of resources often determines whether a business thrives. This fact places a substantial burden on the accounting profession.

Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant financial information that faithfully represents financial results allows investors and creditors to compare the income and assets employed by such companies as **Nokia** (FIN), **McDonald's** (USA), **Air China Ltd.** (CHN), and **Toyota Motor** (JPN). Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. Illustration 1-3 (on page 6) shows how this process of capital allocation works.

ILLUSTRATION 1-3
Capital Allocation Process



An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

High-Quality Standards

LEARNING OBJECTIVE 4
Explain the need for high-quality standards.

To facilitate efficient capital allocation, investors need relevant information and a faithful representation of that information to enable them to make comparisons across borders. For example, assume that you were interested in investing in the telecommunications industry. Four of the largest telecommunications companies in the world are **Nippon Telegraph and Telephone** (JPN), **Deutsche Telekom** (DEU), **Telefonica** (ESP and PRT), and **AT&T** (USA). How do you decide which, if any, of these telecommunications companies you should invest in? How do you compare, for example, a Japanese company like Nippon Telegraph and Telephone with a German company like Deutsche Telekom?

A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Investors are able to make better investment decisions if they receive financial information from Nippon Telegraph and Telephone that is comparable with Deutsche Telekom. Globalization demands a single set of high-quality international accounting standards. But how is this to be achieved? Here are some elements:

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 regulatory review and enforcement.
6. Education and training of market participants.
7. Common delivery systems (e.g., eXtensible Business Reporting Language—XBRL).
8. Common approach to corporate governance and legal frameworks around the world.[1]

Fortunately, as indicated in the opening story, significant changes in the financial reporting environment are taking place, which hopefully will lead to a single, widely accepted set of high-quality accounting standards. The major standard-setters of the world, coupled with regulatory authorities, now recognize that capital formation and investor understanding is enhanced if a single set of high-quality accounting standards is developed.

[1]Robert H. Herz, "Towards a Global Reporting System: Where Are We and Where Are We Going?" *AICPA National Conference on SEC and PCAOB Reporting Developments* (December 10, 2007).

OBJECTIVE OF FINANCIAL REPORTING

5 LEARNING OBJECTIVE
Identify the objective of financial reporting.

What is the **objective (or purpose) of financial reporting**? The objective of general-purpose financial reporting is to **provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity**. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. [1] Information that is decision-useful to capital providers (investors) may also be useful to other users of financial reporting who are not investors. Let's examine each of the elements of this objective.

IFRS See the Authoritative Literature section (page 19).

General-Purpose Financial Statements

General-purpose financial statements provide financial reporting information to a wide variety of users. For example, when **Nestlé** (CHE) issues its financial statements, these statements help shareholders, creditors, suppliers, employees, and regulators to better understand its financial position and related performance. Nestlé's users need this type of information to make effective decisions. To be cost-effective in providing this information, general-purpose financial statements are most appropriate. In other words, general-purpose financial statements provide at the **least cost the most useful information possible**.

Equity Investors and Creditors

The objective of financial reporting identifies investors and creditors as the primary user group for general-purpose financial statements. Identifying investors and creditors as the primary user group provides an important focus of general-purpose financial reporting. For example, when Nestlé issues its financial statements, its primary focus is on investors and creditors because they have the most critical and immediate need for information in financial reports. Investors and creditors need this financial information to assess Nestlé's ability to generate net cash inflows and to understand management's ability to protect and enhance the assets of the company, which will be used to generate future net cash inflows. As a result, the primary user groups are not management, regulators, or some other non-investor group.

What do the numbers mean? *DON'T FORGET STEWARDSHIP*

In addition to providing decision-useful information about future cash flows, management also is accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use. For example, the management of Nestlé has the responsibility for protecting its economic resources from unfavorable effects of economic factors, such as price changes, and technological and social changes. Because Nestlé's performance in discharging its responsibilities (referred to as its **stewardship** responsibilities) usually affects its ability to generate net cash inflows, financial reporting may also provide decision-useful information to assess management performance in this role. [2]

Entity Perspective

As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Companies are viewed as separate and distinct from their owners (present shareholders) using this perspective. The assets of Nestlé are viewed as assets of the company and not of a specific creditor or shareholder. Rather, these investors have claims on Nestlé's assets in the form of liability or equity claims. The entity perspective is consistent with the present business environment where most companies engaged in financial reporting have substance distinct from their investors (both shareholders and creditors). Thus, a perspective that financial reporting should be focused only on the needs of shareholders—often referred to as the **proprietary perspective**—is not considered appropriate.

Decision-Usefulness

Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the **decision-usefulness** approach). As indicated earlier, when making these decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood. Financial statements and related explanations should be a primary source for determining this information.

The emphasis on "assessing cash flow prospects" does not mean that the cash basis is preferred over the accrual basis of accounting. Information based on accrual accounting generally better indicates a company's present and continuing ability to generate favorable cash flows than does information limited to the financial effects of cash receipts and payments.

Recall from your first accounting course the objective of **accrual-basis accounting**: It ensures that a company records events that change its financial statements in the periods in which the events occur, rather than only in the periods in which it receives or pays cash. Using the accrual basis to determine net income means that a company recognizes revenues when it provides the goods or performs the services rather than when it receives cash. Similarly, it recognizes expenses when it incurs them rather than when it pays them. Under accrual accounting, a company generally recognizes revenues when it makes sales. The company can then relate the revenues to the economic environment of the period in which they occurred. Over the long run, trends in revenues and expenses are generally more meaningful than trends in cash receipts and disbursements.[2]

STANDARD-SETTING ORGANIZATIONS

LEARNING OBJECTIVE 6

Identify the major policy-setting bodies and their role in the standard-setting process.

For many years, many nations have relied on their own standard-setting organizations. For example, Canada has the Accounting Standards Board, Japan has the Accounting Standards Board of Japan, Germany has the German Accounting Standards Committee, and the United States has the Financial Accounting Standards Board (FASB). The standards issued by these organizations are sometimes principles-based, rules-based, tax-oriented, or business-based. In other words, they often differ in concept and objective.

The main international standard-setting organization is based in London, United Kingdom, and is called the **International Accounting Standards Board (IASB)**. The IASB issues **International Financial Reporting Standards (IFRS)**, which are used on most foreign exchanges. As indicated earlier, IFRS is presently used or permitted in over 115 countries and is rapidly gaining acceptance in other countries as well.

[2]As used here, cash flow means "cash generated and used in operations." The term *cash flows* also frequently means cash obtained by borrowing and used to repay borrowing, cash used for investments in resources and obtained from the disposal of investments, and cash contributed by or distributed to owners.

IFRS has the best potential to provide a common platform on which companies can report and investors can compare financial information. As a result, our discussion focuses on IFRS and the organization involved in developing these standards—the International Accounting Standards Board (IASB). (A detailed discussion of the U.S. system is provided at the book's companion website, *www.wiley.com/college/kieso*.) The two organizations that have a role in international standard-setting are the **International Organization of Securities Commissions** (IOSCO) and the IASB.

International Organization of Securities Commissions (IOSCO)

The **International Organization of Securities Commissions (IOSCO)** is an association of organizations that regulate the world's securities and futures markets. Members are generally the main financial regulator for a given country. IOSCO does not set accounting standards. Instead, this organization is dedicated to ensuring that the global markets can operate in an efficient and effective basis. The member agencies (such as from France, Germany, New Zealand, and the United States) have resolved to:

- Cooperate together to promote high standards of regulation in order to maintain just, efficient, and sound markets.
- Exchange information on their respective experiences in order to promote the development of domestic markets.
- Unite their efforts to establish standards and an effective surveillance of international securities transactions.
- Provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

IOSCO supports the development and use of IFRS as the single set of high-quality international standards in cross-border offerings and listings. It recommends that its members allow multinational issuers to use IFRS in cross-border offerings and listings, as supplemented by reconciliation, disclosure, and interpretation where necessary to address outstanding substantive issues at a national or regional level. (For more information, go to *http://www.iosco.org/*.)

What do the numbers mean? HOW IS IT GOING?

How much progress has been made toward the goal of one single set of global accounting standards? To answer this question, the IASB conducted a major survey on IFRS adoption. The survey indicates that there is almost universal support (95 percent) for IFRS as the single set of global accounting standards. This includes those jurisdictions that have yet to make a decision on adopting IFRS, such as the United States.

More than 80 percent of the jurisdictions report IFRS adoption for all (or in five cases, almost all) public companies. Most of the remaining 11 non-adopters have made significant progress toward IFRS adoption. In addition, those jurisdictions that have adopted IFRS have made very few modifications to the standards. More than 40 percent of the IFRS adopters do so automatically, without an endorsement process. Moreover, where modifications have occurred, they are regarded as temporary arrangements to assist in the migration from national accounting standards to IFRS. It is expected that most of these transitional adjustments will ultimately disappear.

Admittedly, a few large and important economies have not yet (fully) adopted IFRS. But even in such countries, more progress is being made than many people are aware of. Japan already permits the use of full IFRS and has recently widened the scope of companies that are allowed to adopt it. In the United States, non-U.S. companies are allowed to use IFRS for listings on their exchanges. Today, more than 450 foreign private issuers are reporting using IFRS in U.S. regulatory filings, which represents trillions of dollars in market capitalization. In short, much progress has been made by countries in using IFRS.

Source: Adapted from Hans Hoogervorst, "Breaking the Boilerplate," IFRS Foundation Conference (June 13, 2013).