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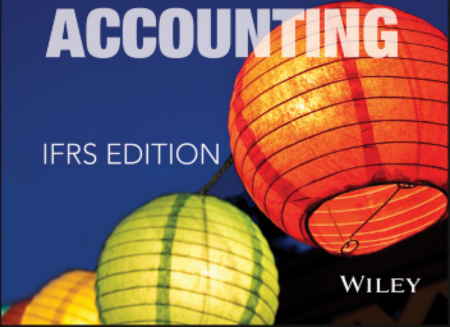
FINANCIAL ACCOUNTING

3e

IFRS EDITION



WILEY

ACCOUNT CLASSIFICATION AND PRESENTATION

Account Title	Classification	Financial Statement	Normal Balance
		A	
Accounts Payable	Current Liability	Statement of Financial Position	Credit
Accounts Receivable	Current Asset	Statement of Financial Position	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Statement of Financial Position	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Statement of Financial Position	Credit
Administrative Expenses	Operating Expense	Income Statement	Debit
Advertising Expense	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Statement of Financial Position	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
		B	
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Non-Current Liability	Statement of Financial Position	Credit
Buildings	Plant Asset	Statement of Financial Position	Debit
		C	
Cash	Current Asset	Statement of Financial Position	Debit
Copyrights	Intangible Asset	Statement of Financial Position	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
		D	
Debt Investments	Current Asset/Long-Term Investment	Statement of Financial Position	Debit
Depreciation Expense	Operating Expense	Income Statement	Debit
Dividend Revenue	Other Income and Expense	Income Statement	Credit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Statement of Financial Position	Credit
		E	
Equipment	Plant Asset	Statement of Financial Position	Debit
		F	
Freight-Out	Operating Expense	Income Statement	Debit
		G	
Gain on Disposal of Plant Assets	Other Income and Expense	Income Statement	Credit
Goodwill	Intangible Asset	Statement of Financial Position	Debit
		I	
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Statement of Financial Position	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Income and Expense	Income Statement	Debit
Interest Payable	Current Liability	Statement of Financial Position	Credit
Interest Receivable	Current Asset	Statement of Financial Position	Debit
Interest Revenue	Other Income and Expense	Income Statement	Credit
Inventory	Current Asset	Statement of Financial Position (2)	Debit

Account Title	Classification	Financial Statement	Normal Balance
		L	
Land	Plant Asset	Statement of Financial Position	Debit
Loss on Disposal of Plant Assets	Other Income and Expense	Income Statement	Debit
		M	
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Non-Current Liability	Statement of Financial Position	Credit
		N	
Notes Payable	Current Liability/ Non-Current Liability	Statement of Financial Position	Credit
		P	
Patents	Intangible Asset	Statement of Financial Position	Debit
Prepaid Insurance	Current Asset	Statement of Financial Position	Debit
		R	
Rent Expense	Operating Expense	Income Statement	Debit
Research and Development Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Equity	Statement of Financial Position and Retained Earnings Statement	Credit
		S	
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Statement of Financial Position	Credit
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Share Capital—Ordinary	Equity	Statement of Financial Position	Credit
Share Capital—Preference	Equity	Statement of Financial Position	Credit
Share Investments	Current Asset/Long-Term Investment	Statement of Financial Position	Debit
Share Premium—Ordinary	Equity	Statement of Financial Position	Credit
Share Premium—Preference	Equity	Statement of Financial Position	Credit
Supplies	Current Asset	Statement of Financial Position	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
		T	
Treasury Shares	Equity—Contra	Statement of Financial Position	Debit
		U	
Unearned Service Revenue	Current Liability	Statement of Financial Position	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

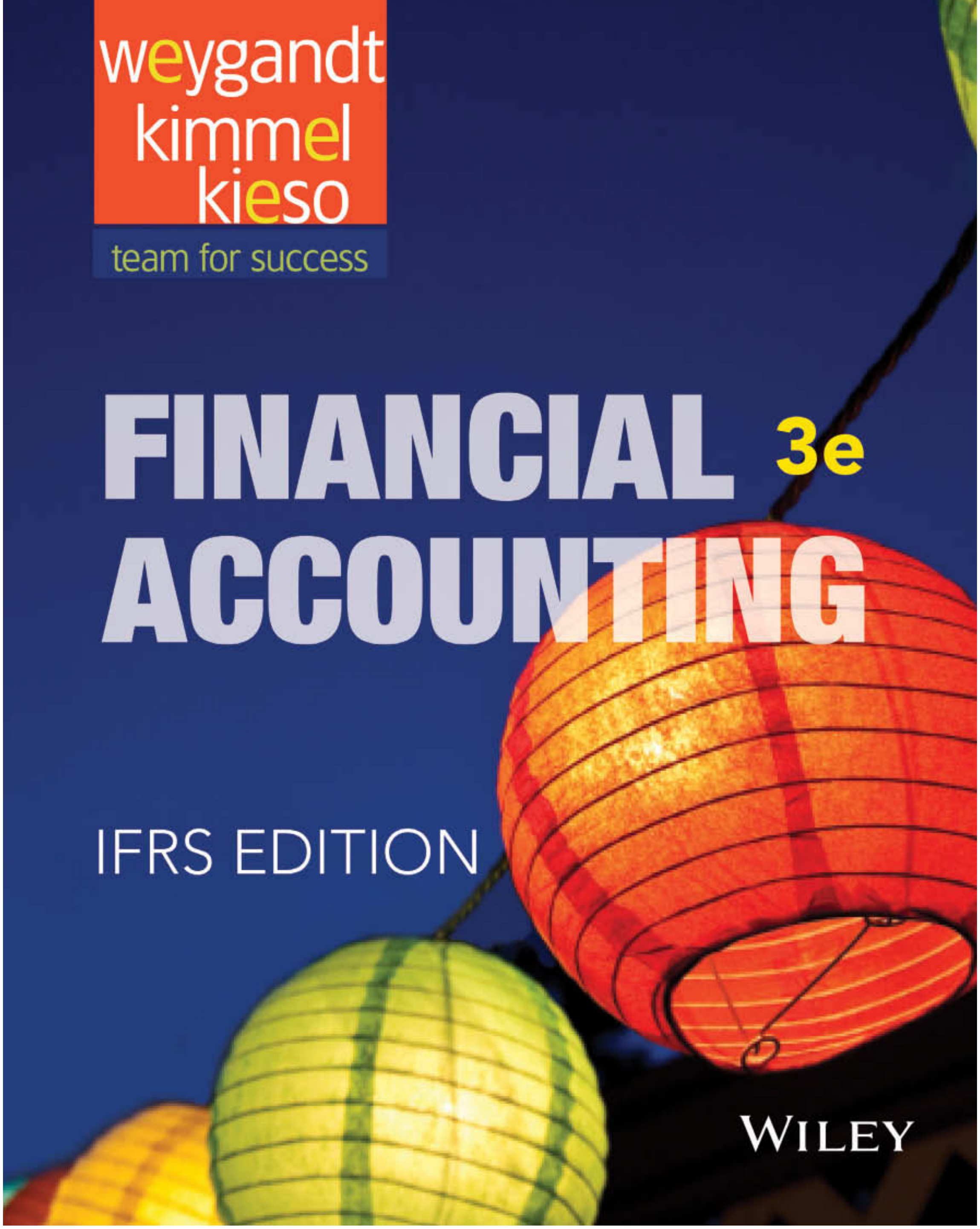
(1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.

(2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.

The following is a sample chart of accounts. It does not represent a comprehensive chart of all the accounts used in this textbook but rather those accounts that are commonly used. This sample chart of accounts is for a company that generates both service revenue as well as sales revenue. It uses the perpetual approach to inventory. If a periodic system was used, the following temporary accounts would be needed to record inventory purchases: Purchases, Freight-In, Purchase Returns and Allowances, and Purchase Discounts.

CHART OF ACCOUNTS

Assets	Liabilities	Equity	Revenues	Expenses
Cash	Notes Payable	Share Capital—Preference	Service Revenue	Administrative Expenses
Accounts Receivable	Accounts Payable	Share Capital—Ordinary	Sales Revenue	Amortization Expense
Allowance for Doubtful Accounts	Unearned Service Revenue	Share Premium—Preference	Sales Discounts	Bad Debt Expense
Interest Receivable	Salaries and Wages Payable	Share Premium—Ordinary	Sales Returns and Allowances	Cost of Goods Sold
Inventory	Interest Payable	Retained Earnings	Interest Revenue	Depreciation Expense
Supplies	Dividends Payable	Treasury Shares	Gain on Disposal of Plant Assets	Freight-Out
Prepaid Insurance	Income Taxes Payable	Dividends		Income Tax Expense
Land	Bonds Payable	Income Summary		Insurance Expense
Equipment	Mortgage Payable			Interest Expense
Accumulated Depreciation—Equipment				Loss on Disposal of Plant Assets
Buildings				Maintenance and Repairs Expense
Accumulated Depreciation—Buildings				Rent Expense
Copyrights				Salaries and Wages Expense
Goodwill				Selling Expenses
Patents				Supplies Expense
				Utilities Expense



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Brief Contents

APPENDICES

*Available at the book's companion website, **www.wiley.com/college/weygandt.**

From the Authors

Dear Student,

Why This Course? *Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like TSMC or Apple or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.*

> "Whether you are looking at a large multinational company like TSMC or Apple or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening."

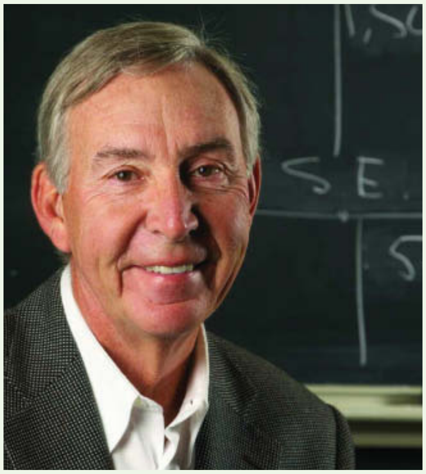
Why This Book? *Thousands of students have used this textbook. Your instructor has chosen it for you because of its trusted reputation. The authors have worked hard to keep the book fresh, timely, and accurate.*

How to Succeed? *We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this textbook provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the textbook itself, WileyPLUS and the book's companion website also offers various support resources.*

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

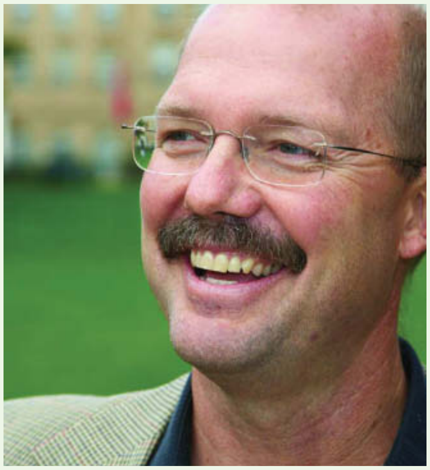
Jerry J. Weygandt
Paul D. Kimmel
Donald E. Kieso

Author Commitment



Jerry Weygandt

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 fi nancial 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 Certifi ed Public Accountants, and the Wisconsin Society of Certifi ed 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 Certifi ed 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.



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PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He is an Associate Professor at the University of Wisconsin—Milwaukee, and has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award, the Reggie Taite Excellence in Teaching Award and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review, Accounting Horizons, Advances in Management Accounting, Managerial Finance, Issues in Accounting Education, Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education. He has published papers and given numerous talks on incorporating critical thinking into accounting education, and helped prepare a catalog of critical thinking resources for the Federated Schools of Accountancy.

Don Kieso

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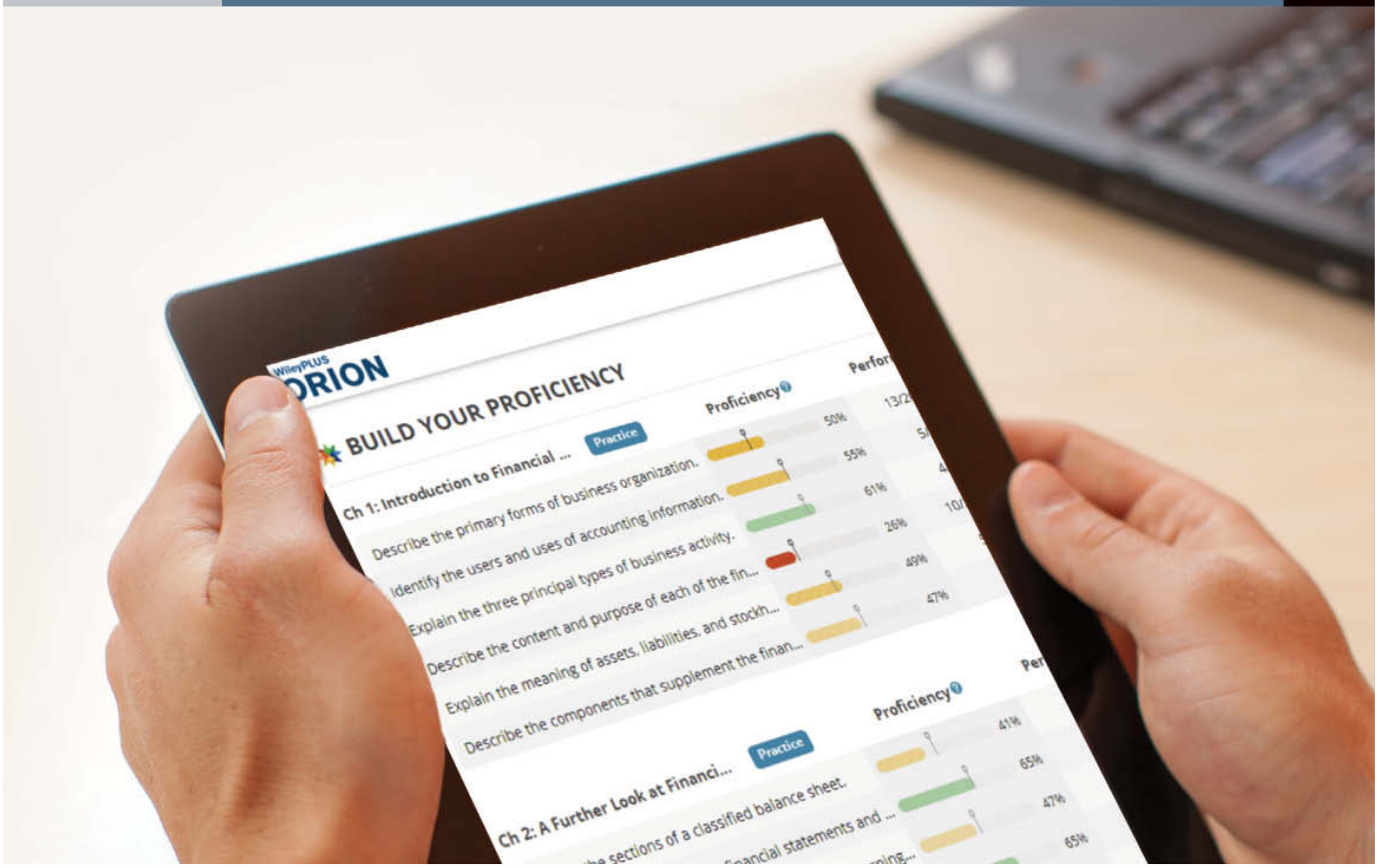
Practice Made Simple

The Team for Success is focused on helping students get the most out of their accounting course by **making practice simple**. Both in the printed text and the online environment of *WileyPLUS*, new opportunities for self-guided practice allow students to check their knowledge of accounting concepts, skills, and problem-solving techniques as they receive individual feedback at the question, learning objective, and course level.

Personalized Practice

Based on cognitive science, **WileyPLUS** with **ORION** is a personalized, adaptive learning experience that gives students the practice they need to build proficiency on topics while using their study time most effectively. The adaptive engine is powered by hundreds of unique questions per chapter, giving students endless opportunities for practice throughout the course.



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Review and Practice

A new section in the text and in **WileyPLUS** offers students more opportunities for self-guided practice.

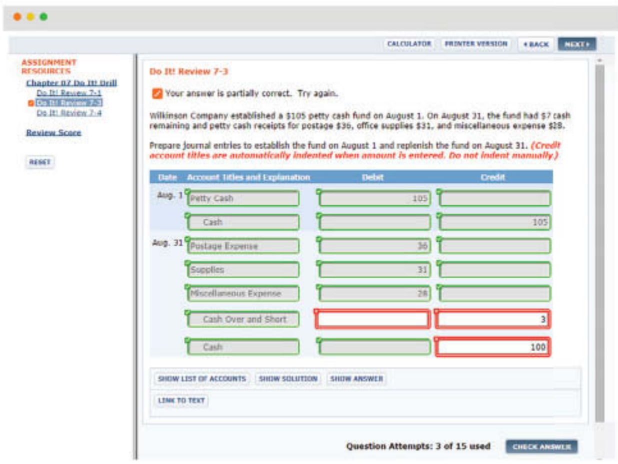
SOLUTIONS TO PRACTICE EXERCISES

1. (a)	Dec. 31	Bad Debt Expense Accounts Receivable—M. Jack	1,500	1,500
(b) (1)	Dec. 31	Bad Debt Expense [($850,000 − $30,000) × 1.5%] Allowance for Doubtful Accounts	12,300	12,300
(2)	Dec. 31	Bad Debt Expense Allowance for Doubtful Accounts [($150,000 × 10%) − $2,400]	12,600	12,600
(c) (1)	Dec. 31	Bad Debt Expense [($850,000 − $30,000) × 0.75%] Allowance for Doubtful Accounts	6,150	6,150
(2)	Dec. 31	Bad Debt Expense Allowance for Doubtful Accounts [($150,000 × 6%) + $200]	9,200	9,200

In the text, the new Review and Practice section includes:

- Learning Objectives Review
- Glossary Review
- Practice Multiple-Choice Questions and Solutions
- Practice Exercises and Solutions
- Practice Problem and Solution

In **WileyPLUS**, the new practice assignments include several Do It! Reviews, Brief Exercises, Exercises, and Problems, giving students the opportunity to check their work or see the answer and solution after their final attempt.



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What's New?

WileyPLUS with ORION

Several thousand new questions are available for practice and review. WileyPLUS with Orion is an adaptive study and practice tool that helps students build proficiency in course topics.

Updated Content and Design

We scrutinized all chapter material to find new ways to engage students and help them learn accounting concepts. Homework problems were updated in all chapters.

The learning objective structure helps students practice their understanding of concepts with DO IT! exercises before they move on to different topics in other learning objectives. Coupled with a new interior design and revised infographics, the outcomes-oriented approach motivates students and helps them make the best use of their time.

Student Practice and Solutions

New practice opportunities with solutions are integrated throughout the textbook and WileyPLUS course. Each textbook chapter now provides students with a **Review and Practice** section that includes learning objective summaries, glossary review, multiple-choice questions with feedback for each answer choice, and both practice exercises and problems with detailed solutions.

In **WileyPLUS**, two brief exercises, two DO IT! exercises, two exercises, and a new problem are available for practice with each chapter. These new practice questions are algorithmic, providing students with multiple opportunities for advanced practice.

Real World Context

We expanded our practice of using numerous examples of real companies throughout the textbook. New financial reporting problems in each chapter require students to analyze the financial statements of TSMC, Nestlé, Petra Foods, and Apple. In WileyPLUS, real-world Insight boxes now have questions that can be assigned as homework.

A Look at U.S. GAAP

This end-of-chapter section offers Key Points, Similarities, and Differences to help students compare IFRS with U.S. GAAP. Assessment material is also provided to test students' understanding.

Excel

New Excel skill videos help students understand Excel features they can apply in their accounting studies.

More information about the Third Edition is available on the book's website at **www.wiley.com/college/weygandt**.

Table of Contents

Acknowledgments

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CHAPTER 1

Accounting in Action

The Feature Story helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.

FEATURE STORY Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" In response, consider the quote from Harold Geneen, the former chairman of a major international company: "To be good at your business, you have to know the numbers—cold."

Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting is the means for communicating the numbers. If you don't know how to read financial statements, you cannot really know your business.

Many companies spend significant resources teaching their employees basic accounting so that they can read financial statements and understand how their actions affect the company's financial results. Employers need managers in all areas of the company to be "financially literate."

Taking this course will go a long way to making you financially literate. In this book, you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results.

Appendices A, B, and C of this textbook provide real financial statements of three companies from different countries that report using International Financial Reporting Standards (IFRS): Taiwan Semiconductor Manufacturing Company (TSMC) Ltd. (TWN), Nestlé SA (CHE), and Petra Foods Ltd. (SGP). Throughout this textbook, we increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements. In addition, we encourage you to visit each company's website where you can view its complete annual report. In examining the financial reports of these three companies, you will see that the accounting practices of companies in specific countries that follow IFRS sometimes differ with regard to particular details. However, more importantly, you will find that the basic accounting principles are the same. As a result, by learning these basic principles as presented in this textbook, you will be well equipped to begin understanding the financial results of companies around the world. ■

✔ The Navigator

- ☐ Scan Learning Objectives
- ☐ Read Feature Story
- ☐ Review and Practice pp. 28–34
  - Reviews of Learning Objectives and Glossary
  - Answer Practice Multiple-Choice Questions, Exercises, and Problem
- ☐ Complete Assignments
- ☐ Watch WileyPLUS Chapter Reviews
- ☐ Read A Look at U.S. GAAP

LEARNING OBJECTIVES

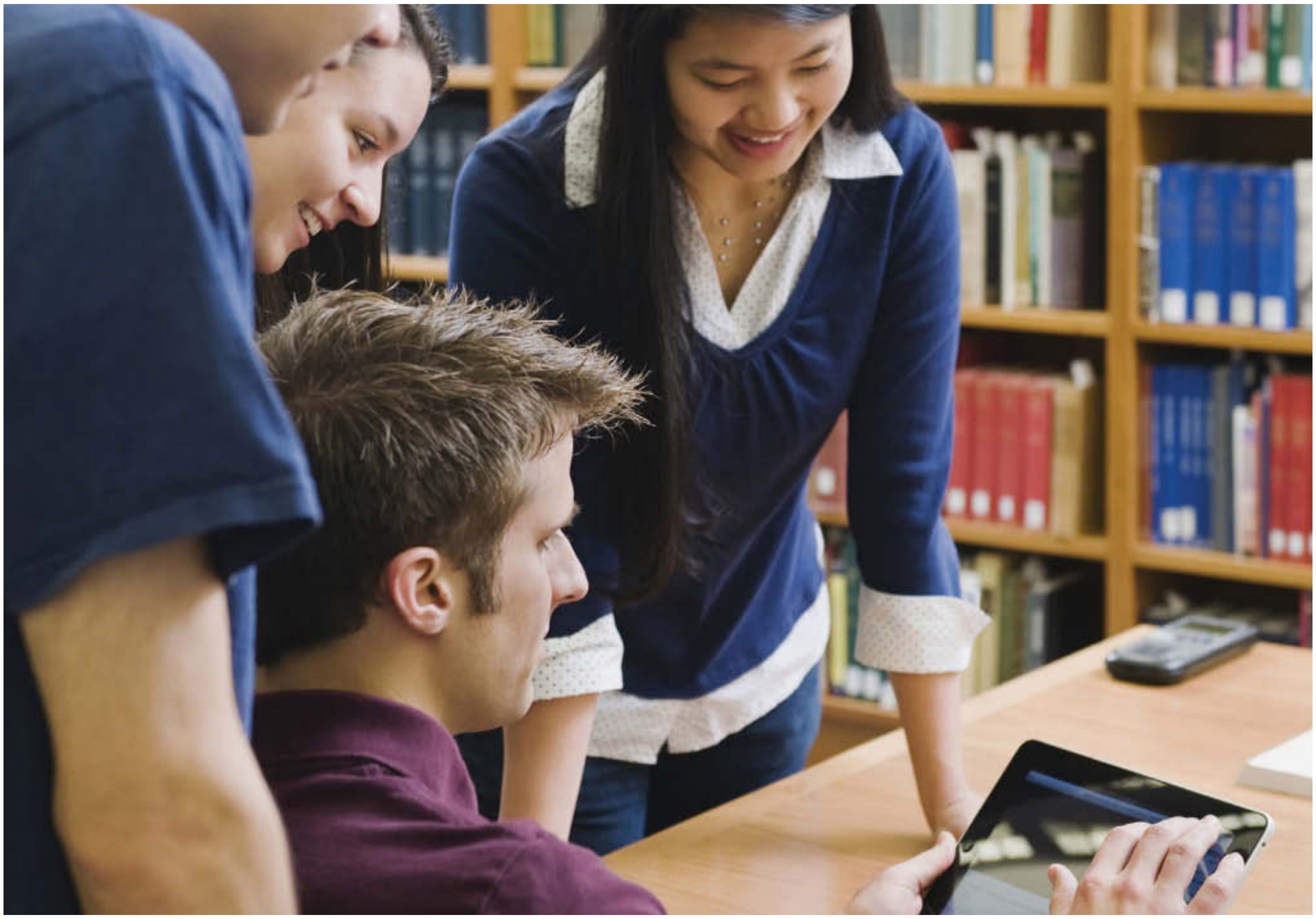
After studying this chapter, you should be able to:

1. Explain what accounting is.
2. Identify the users and uses of accounting.
3. Understand why ethics is a fundamental business concept.
4. Explain accounting standards and the measurement principles.
5. Explain the monetary unit assumption and the economic entity assumption.
6. State the accounting equation, and define its components.
7. Analyze the effects of business transactions on the accounting equation.
8. Understand the five financial statements and how they are prepared.

✔ The Navigator

The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and set priorities as you study.

Learning Objectives give you a framework for learning the specific concepts covered in the chapter.



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PREVIEW OF CHAPTER 1

The Preview describes and outlines the major topics and subtopics you will see in the chapter.

The Feature Story highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The content and organization of Chapter 1 are as follows.

ACCOUNTING IN ACTION

What Is Accounting?	The Building Blocks of Accounting	The Basic Accounting Equation	Using the Accounting Equation	Financial Statements
• Three activities • Who uses accounting data?	• Ethics in financial reporting • Accounting standards • Measurement principles • Assumptions	• Assets • Liabilities • Equity	• Transaction analysis • Summary of transactions	• Income statement • Retained earnings statement • Statement of financial position • Statement of cash flows • Comprehensive income statement

✔ The Navigator

What Is Accounting?

Learning Objective 1
Explain what accounting is.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? Accounting.[1] Why do people choose accounting? They want to acquire the skills needed to understand what is happening financially inside a company. Accounting is the financial information system that provides these insights. In short, to understand an organization of any type, you have to know the numbers.

***Essential terms** are printed in blue when they first appear, and are defined in the end-of-chapter **Glossary Review**.*

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

Three Activities

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 food and snacks by Unilever (GBR and NLD), the providing of telephone services by Chunghwa Telecom (TWN), and the manufacture of motor vehicles by Tata Motors (IND).

Once a company like Unilever 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, Unilever also classifies and summarizes economic events.

Finally, Unilever **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, Unilever accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. 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.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses**, **meaning**, **and limitations of reported data**. Appendix A of this textbook shows the financial statements of Taiwan Semiconductor Manufacturing Company (TSMC) Ltd. (TWN). Appendix B illustrates the financial statements of Nestlé SA (CHE), and Appendix C includes the financial statements of Petra Foods Ltd. (SGP). We refer to these statements at various places throughout the textbook. (In addition, in the *A Look at U.S. GAAP* section at the end of each chapter, the U.S. company Apple Inc. is analyzed.) At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1-1 summarizes the activities of the accounting process.

You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting

[1]The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

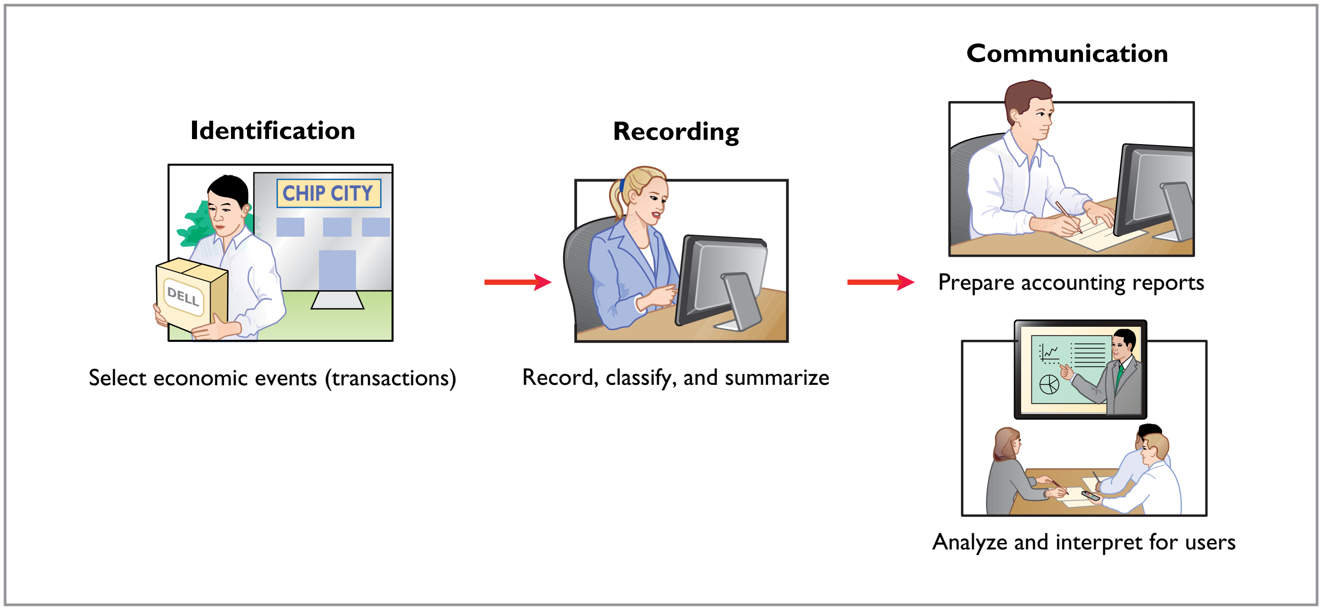


Illustration 1-1
The activities of the accounting process

involves **the entire process of identifying, recording, and communicating economic events.**[2]

Who Uses Accounting Data?

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.

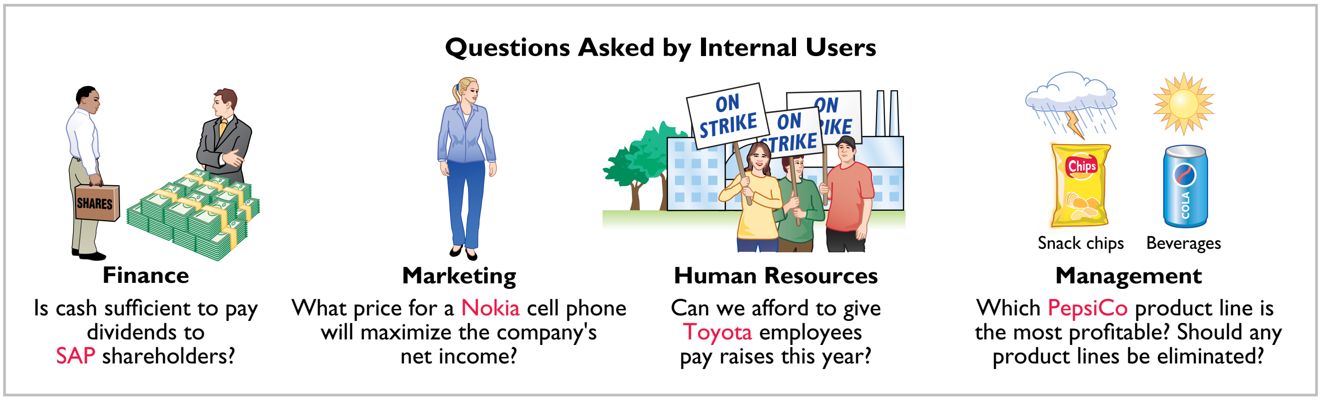
Learning Objective 2

Identify the users and uses of accounting.

INTERNAL USERS

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.

Illustration 1-2
Questions that internal users ask



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. Examples are financial comparisons of

[2]The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite,* Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

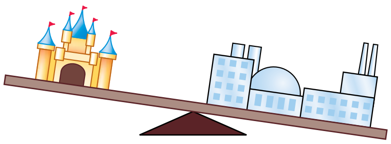
EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **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. Illustration 1-3 shows some questions that investors and creditors may ask.

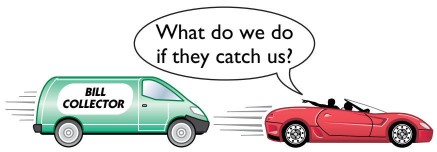
Illustration 1-3
Questions that external users ask

Questions Asked by External Users

Investors
Is Royal Dutch Shell earning satisfactory income?



Investors
How does Disney compare in size and profitability with Time Warner?



Creditors
Will Singapore Airlines be able to pay its debts as they come due?

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the State Administration of Taxation in the People's Republic of China (CHN), want to know whether the company complies with tax laws. **Regulatory agencies**, such as the Autorité des Marchés Financiers (FRA) or the Federal Trade Commission (USA), want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like Tesla Motors, Inc. (USA) will continue to honor product warranties and support its product lines. **Labor unions**, such as the German Confederation of Trade Unions (DEU), want to know whether the companies have the ability to pay increased wages and benefits to union members.

> DO IT!

Basic Concepts

*The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the Action Plan necessary to complete the exercise, and they show a Solution.*

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

Action Plan
✔ Review the basic concepts discussed.
✔ Develop an understanding of the key terms used.

Solution

1. True. 2. False. Bookkeeping involves only the recording step. 3. False. Accountants analyze and interpret information in reports as part of the communication step. 4. False. The two most common types of external users are investors and creditors. 5. True.

Related exercise material: **E1-1, E1-2, and DO IT! 1-1.**

✔ The Navigator

The Building Blocks of Accounting

Learning Objective 3
Understand why ethics is a fundamental business concept.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be at work—ethical behavior.

Ethics in Financial Reporting

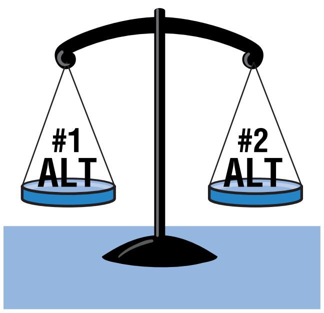
People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the securities market if they think share prices are rigged. In recent years, the financial press has been full of articles about financial scandals at Enron (USA), Parmalat (ITA), Satyam Computer Services (IND), AIG (USA), and others. As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent share prices tumbling." Imagine trying to carry on a business or invest money 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. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this textbook:

1. A number of the *Feature Stories* and other parts of the textbook discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of each chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in Illustration 1-4.

Illustration 1-4
Steps in analyzing ethics cases and situations



1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the *stakeholders*—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Ethics Insight — I Felt the Pressure—Would You?

Dewey & LeBoeuf LLP (USA)

© Alliance/Shutterstock

"I felt the pressure." That's what some of the employees of the now-defunct law firm of Dewey & LeBoeuf LLP (USA) indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- "I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate."
- "I intentionally gave the auditors incorrect information in the course of the audit."

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Source: Ashby Jones, "Guilty Pleas of Dewey Staff Detail the Alleged Fraud," *Wall Street Journal* (March 28, 2014).

Q Why did these employees lie, and what do you believe should be their penalty for these lies? (See page 49.)

***Insight** boxes provide examples of business situations from various perspectives—ethics, investor, global, and corporate social responsibility. Guideline answers to the critical thinking questions are available near the end of the chapter.*

Accounting Standards

Learning Objective 4

Explain accounting standards and the measurement principles.

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 **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**. More than 130 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**. IFRSs are determined by the IASB. The IASB is headquartered in London, with its 15 board members drawn from around the world. Most companies in the United States follow standards issued by the FASB, referred to as **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 made efforts to reduce the differences between IFRS and U.S. GAAP. This process is referred to as **convergence**. Because convergence is such an important issue, we provide at the end of each chapter a section called *A Look at U.S. GAAP*, to provide a comparison with IFRS.

Measurement Principles

• HELPFUL HINT
Relevance and *faithful representation* are two primary qualities that make accounting information useful for decision-making.

***Helpful Hints** further clarify concepts being discussed.*

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 (RUS) 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.

Global Insight **The Korean Discount**

SeongJoon Cho/Bloomberg/Getty Images, Inc.

If you think that accounting standards don't matter, consider recent events in South Korea. International investors expressed concerns that the financial reports of some South Korean companies were inaccurate. Accounting practices sometimes resulted in differences between stated revenues and actual revenues. Because investors did not have complete faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was referred to as the "Korean discount."

In response, Korean regulators decided to require companies to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

Q What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (See page 49.)

Assumptions

Learning Objective 5

Explain the monetary unit assumption and the economic entity assumption.

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 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.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money. Throughout this textbook, we use a variety of currencies in our examples and end-of-chapter materials, such as those shown in Illustration 1-5.

Illustration 1-5
Currencies used in this textbook

Brazil, real	R$	South Africa, rand	R
China, yuan renminbi	¥	South Korea, won	₩
Europe, euro	€	Switzerland, Swiss franc	CHF
Hong Kong, dollar	HK$	Taiwan, new dollar	NT$
India, rupee	Rs	Turkey, lira	₺
Indonesia, rupia	Rp	United Kingdom, pound	£
Japan, yen	¥	United States, dollar	$
Russia, ruble	₽		

***Ethics Notes** help sensitize you to some of the ethical issues in accounting.*

ECONOMIC ENTITY ASSUMPTION

An economic entity can be any organization or unit in society. It may be a company (Telefónica (ESP)), a governmental unit (the city-state of Singapore), a municipality (Toronto, Canada), a school district (St. Louis District 48), or a church (Baptist). 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, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the boutique. Similarly, Metro (DEU) and Coca-Cola (USA) are segregated into separate economic entities for accounting purposes.

Ethics Note

The importance of the economic entity assumption is illustrated by scandals involving Adelphia (USA). In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over $2 billion of loans to the founding family.

PROPRIETORSHIP A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **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.

PARTNERSHIP A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and chartered public accountants).

CORPORATION A business organized as a separate legal entity under corporation law and having ownership divided into transferable shares is a **corporation**. The holders of the shares (shareholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Shareholders **may transfer**

all or part of their ownership shares to other investors at any time (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

Although the combined number of proprietorships and partnerships in the world significantly exceeds the number of corporations, the revenue produced by corporations is much greater. Most of the largest companies in the world—for example, ING (NLD), Royal Dutch Shell (GBR and NLD), Apple Inc. (USA), Fortis (BEL), and Toyota (JPN)—are corporations.

Accounting Across the Organization **Spinning the Career Wheel**

© Josef Volavka/iStockphoto

One question that students frequently ask is, "How will the study of accounting help me?" A working knowledge of accounting is desirable for virtually *every field* of endeavor. Some examples of how accounting is used in other careers include:

General management: Imagine running Volkswagen (DEU), Saudi Telecom (SAU), a Subway (USA) franchise, or a Fuji (JPN) bike shop. All general managers need to understand where the company's cash comes from and where it goes in order to make wise business decisions.

Marketing: Marketing specialists at a company like Hyundai Motor (KOR) develop strategies to help the sales force be successful. But making a sale is meaningless unless it is profitable. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for Société Générale (FRA) or a financial analyst for ICBC (CHN)? These fields rely heavily on accounting. In all of them, you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for Sotheby's International Realty (GBR)? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

Q How might accounting help you? (See page 49.)

> DO IT!

Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Convergence refers to efforts to reduce differences between IFRS and U.S. GAAP.
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).
3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

Action Plan

✔ Review the discussion of ethics and financial reporting standards.

✔ Develop an understanding of the key terms used.

Solution

1. True. 2. True. 3. False. The historical cost principle dictates that companies record assets at their cost. Under the historical cost principle, the company must also use cost in later periods. 4. False. Faithful representation means that financial information matches what really happened; the information is factual. 5. True.

Related exercise material: **E1-3, E1-4, and DO IT! 1-2.**

✔ The Navigator

The Basic Accounting Equation

Learning Objective 6

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, adidas (DEU) has total assets of approximately €11.6 billion. Liabilities and equity are the rights or claims against these resources. Thus, adidas has €11.6 billion of claims against its €11.6 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **equity**. adidas has liabilities of €6.1 billion and equity of €5.5 billion.

We can express the relationship of assets, liabilities, and equity as an equation, as shown in Illustration 1-6.

Illustration 1-6
The basic accounting equation

Assets = Liabilities + Equity

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and equity.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as adidas. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Taipai Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Taipai Pizza are tables, chairs, cash register, oven, tableware, and, of course, cash.

Liabilities

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Taipai Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.