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## PREVIEW OF CHAPTER 1

ACCOUNTING IN ACTION				
What is Accounting?	The Building Blocks of Accounting	The Basic Accounting Equation	Using the Accounting Equation	Financial Statements
<ul style="list-style-type: none"> <li>• Three activities</li> <li>• Who uses accounting data?</li> </ul>	<ul style="list-style-type: none"> <li>• Ethics in financial reporting</li> <li>• Accounting standards</li> <li>• Measurement principles</li> <li>• Assumptions</li> </ul>	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Equity</li> </ul>	<ul style="list-style-type: none"> <li>• Transaction analysis</li> <li>• Summary of transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Income statement</li> <li>• Retained earnings statement</li> <li>• Statement of financial position</li> <li>• Statement of cash flows</li> <li>• Comprehensive income statement</li> </ul>

**Financial Accounting  
IFRS 3rd Edition  
Weygandt • Kimmel • Kieso**

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## CHAPTER 1 | Accounting in Action

### 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 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.

1-3

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## What is Accounting?

**Accounting** consists of three basic activities—it

- ◆ **identifies,**
- ◆ **records, and**
- ◆ **communicates**

the economic events of an organization to interested users.

**Learning Objective 1**  
Explain what accounting is.

1-4

LO 1

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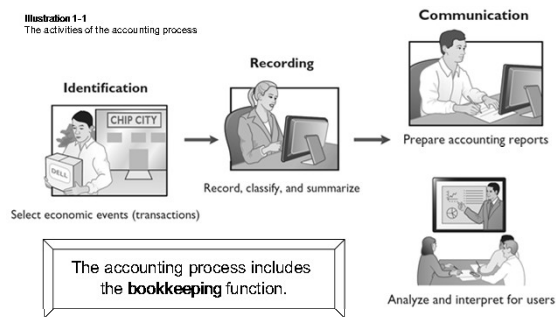
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## Three Activities

**Illustration 1-1**  
The activities of the accounting process



1-5

LO 1

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## Assumptions

### Review Question

Which of the following is **not** a step in the accounting process?

- a. Identification.
- b. Recording.
- ⇒ c. Economic entity.
- d. Communication

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LO 1

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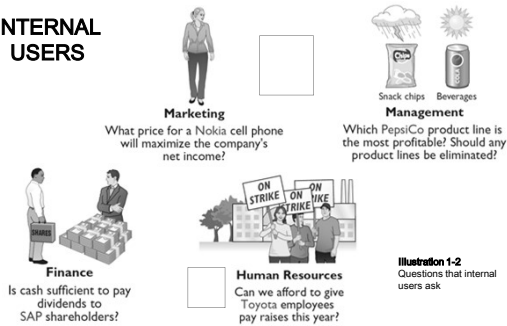
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## Who Uses Accounting Data?

### INTERNAL USERS



**Marketing**  
What price for a Nokia cell phone will maximize the company's net income?

**Management**  
Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

**Finance**  
Is cash sufficient to pay dividends to SAP shareholders?

**Human Resources**  
Can we afford to give Toyota employees pay raises this year?

**Illustration 1-2**  
Questions that internal users ask

1-7

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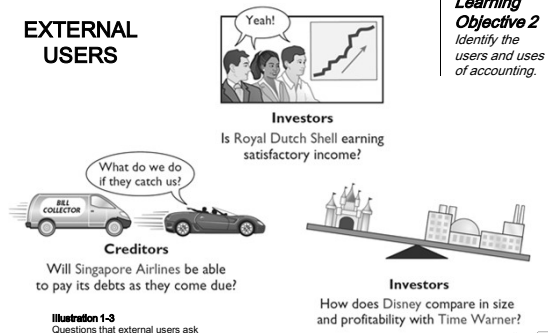
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## Who Uses Accounting Data?

### EXTERNAL USERS



**Investors**  
Is Royal Dutch Shell earning satisfactory income?

**Creditors**  
What do we do if they catch us?  
Will Singapore Airlines be able to pay its debts as they come due?

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

**Learning Objective 2**  
Identify the users and uses of accounting.

**Illustration 1-3**  
Questions that external users ask

1-8

LO 2

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### > DO IT!

Indicate whether the following statements are **true or false**.

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

**Solution:** 1. True 2. False 3. False 4. False 5. True

1-9

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## The Building Blocks of Accounting

### Ethics in Financial Reporting

Standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**.

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

- ◆ Recent financial scandals include: **Enron** (USA), **Parmalat** (ITA), **Satyam Computer Services** (IND), **AIG** (USA), and others.
- ◆ Effective financial reporting depends on sound ethical behavior.

1-10

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### Ethics in Financial Reporting

**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.



**Illustration 14**  
Steps in analyzing ethics cases and situations

1-11

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### Ethics Insight

**Dewey & LeBoeuf (USA)**

#### I Felt the Pressure—Would You?

"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."

1-12

(continued)

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## Ethics Insight

Dewey & LeBoeuf (USA)

### I Felt the Pressure—Would You?

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).

1-13

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## Accounting Standards

**International Accounting Standards Board (IASB)** <http://www.iasb.org/>



International Financial Reporting Standards



**Financial Accounting Standards Board (FASB)** <http://www.fasb.org/>

Generally Accepted Accounting Principles (GAAP)

### Learning Objective 4

Explain accounting standards and the measurement principles.

1-14

LO 4

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## Measurement Principles

**HISTORICAL COST PRINCIPLE** (or cost principle) dictates that companies record assets at their cost.

**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).

### Helpful Hint

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

1-15

LO 4

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### Global Insight The Korean Discount

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).

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### Assumptions

#### MONETARY UNIT ASSUMPTION

requires that companies include in the accounting records only transaction data that can be expressed in terms of money.

**Learning Objective 5**  
Explain the monetary unit assumption and the economic entity assumption.

**ECONOMIC ENTITY ASSUMPTION** requires that activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

- ◆ Proprietorship
- ◆ Partnership
- ◆ Corporation



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### Forms of Business Ownership

Proprietorship	Partnership	Corporation
<ul style="list-style-type: none"><li>◆ Owned by one person</li><li>◆ Owner is often manager/operator</li><li>◆ Owner receives any profits, suffers any losses, and is personally liable for all debts</li></ul>	<ul style="list-style-type: none"><li>◆ Owned by two or more persons</li><li>◆ Often retail and service-type businesses</li><li>◆ Generally unlimited personal liability</li><li>◆ Partnership agreement</li></ul>	<ul style="list-style-type: none"><li>◆ Ownership divided into shares</li><li>◆ Separate legal entity organized under corporation law</li><li>◆ Limited liability</li></ul>

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## Assumptions

### Review Question

The historical cost principle states that:

- a. assets should be initially recorded at cost and adjusted when the fair value changes.
- b. activities of an entity are to be kept separate and distinct from its owner.
- c. assets should be recorded at their cost.
- d. only transaction data capable of being expressed in terms of money be included in the accounting records.



1-19

LO 5

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## Accounting Across the Organization

### Spinning the Career Wheel

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.

1-20

(continued)

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## Accounting Across the Organization

### Spinning the Career Wheel

**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?

1-21

LO 5

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> DO IT!

Indicate whether each of the following statements presented below is true or false.

1. Convergence refers to efforts to reduce differences between IFRS and U.S. GAAP. **True**
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB). **True**
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. **False**

1-22 LO 5

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> DO IT!

Indicate whether each of the following statements presented below is true or false.

4. Relevance means that financial information matches what really happened; the information is factual. **False**
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption. **True**

1-23 LO 5

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### The Basic Accounting Equation

**Basic Accounting Equation**

- ◆ Provides the **underlying framework** for recording and summarizing economic events.
- ◆ Assets **must** equal the sum of liabilities and equity.

**Assets** = **Liabilities** + **Equity**

*Learning Objective 6*  
State the accounting equation, and define its components.

1-24 LO 6

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### Basic Accounting Equation

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Equity}}$$

#### Assets

- ◆ Resources a business owns.
- ◆ Provide future services or benefits.
- ◆ Cash, Inventory, Equipment, etc.

1-25

LO 6

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### Basic Accounting Equation

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Equity}}$$

#### Liabilities

- ◆ Claims against assets (debts and obligations).
- ◆ Creditors (party to whom money is owed).
- ◆ Accounts Payable, Notes Payable, Salaries and Wages Payable, etc.

1-26

LO 6

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### Basic Accounting Equation

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Equity}}$$

#### Equity

- ◆ Ownership claim on total assets.
- ◆ Referred to as residual equity.
- ◆ **Share Capital—Ordinary** and **Retained Earnings**.

1-27

LO 6

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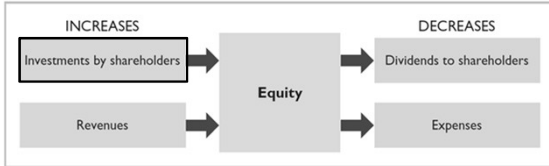
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## Equity

Illustration 1-7  
Increases and decreases in equity



**Investments by shareholders** represent the total amount paid in by shareholders for the ordinary shares they purchase.

1-28

LO 6

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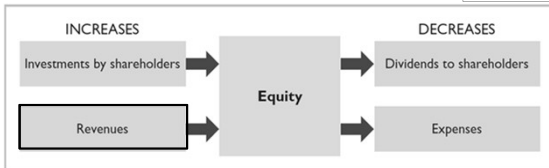
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## Stockholders' Equity

Illustration 1-7  
Increases and decreases in equity



**Revenues** result from business activities entered into for the purpose of earning income.

Common sources of revenue are: sales, fees, services, commissions, interest, dividends, royalties, and rent.

1-29

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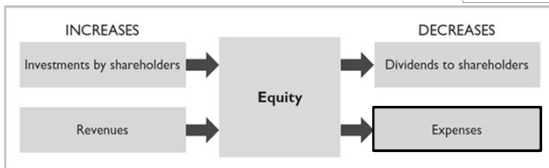
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## Stockholders' Equity

Illustration 1-7  
Increases and decreases in equity



**Expenses** are the cost of assets consumed or services used in the process of earning revenue.

Common expenses are: salaries expense, rent expense, utilities expense, property tax expense, etc.

1-30

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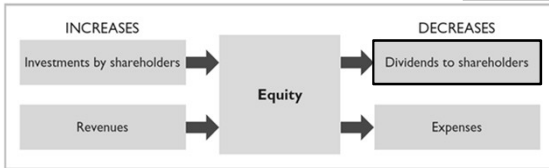
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## Stockholders' Equity

**Illustration 1-7**  
Increases and decreases in equity



**Dividends** are the distribution of cash or other assets to shareholders.

Dividends reduce retained earnings. However, dividends are **not expenses**.

1-31

LO 6

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### > DO IT!

Classify the following items as issuance of stock, dividends, revenues, or expenses. Then indicate whether each item increases or decreases stockholders' equity.

	Classification	Effect on Equity
1. Rent Expense	<input type="text"/>	<input type="text"/>
2. Service Revenue	<input type="text"/>	<input type="text"/>
3. Dividends	<input type="text"/>	<input type="text"/>
4. Salaries and Wages Expense	<input type="text"/>	<input type="text"/>

1-32

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## The Basic Accounting Equation

**Transactions** are a business's economic events recorded by accountants.

- ◆ May be **external** or **internal**.
- ◆ Not all activities represent transactions.
- ◆ Each transaction has a dual effect on the accounting equation.

**Learning Objective 7**  
*Analyze the effects of business transactions on the accounting equation.*

1-33

LO 7

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## Transaction Analysis

**Illustration:** Are the following events recorded in the accounting records?

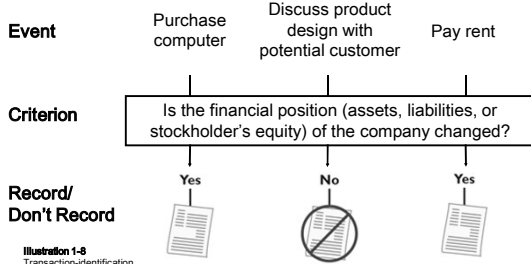


Illustration 1-8  
Transaction-identification process

1-34

LO 7

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## Transaction Analysis

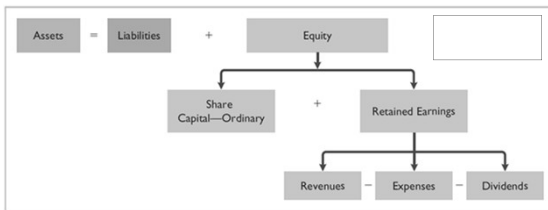


Illustration 1-9  
Expanded accounting equation

1-35

LO 7

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## Transaction Analysis

**TRANSACTION 1. INVESTMENT BY STOCKHOLDERS** Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2017, they invest **€15,000 cash** in the business in exchange for **€15,000 of ordinary shares**. The ordinary shares indicates the ownership interest that the Neals have in Softbyte SA. This transaction results in an equal increase in both assets and equity.

Illustration 1-10

Transaction	Assets				=	Liabilities		+	Equity			
	Cash	Accounts Receivable	Supplies	Equipment		Accounts Payable	Share Capital		Retained Earnings	Rev.	Exp.	Div.
1.	+15,000								+15,000			

1-36

LO 7

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**TRANSACTION 5. PURCHASE OF ADVERTISING ON CREDIT** Softbyte SA receives a bill for €250 from the *Programming News* for advertising on its website but postpones payment until a later date.

Illustration 1-10

Transaction	Assets				=	Liabilities +		Equity		
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Share Capital	Rev.	Exp.	Div.	
1.	+15,000					+15,000				
2.	-7,000			+7,000						
3.			+1,800		+1,800					
4.	+1,200						+1,200			
5.					+250				-250	

1-40

LO 7

**TRANSACTION 6. SERVICES PROVIDED FOR CASH AND CREDIT.**

Softbyte provides €3,500 of services. The company receives cash of €1,500 from customers, and it bills the balance of €2,000 on account.

Illustration 1-10

Transaction	Assets				=	Liabilities +		Equity		
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Share Capital	Rev.	Exp.	Div.	
1.	+15,000					+15,000				
2.	-7,000			+7,000						
3.			+1,800		+1,800					
4.	+1,200						+1,200			
5.					+250				-250	
6.	+1,500	+2,000					+3,500			

1-41

LO 7

**TRANSACTION 7. PAYMENT OF EXPENSES** Softbyte SA pays the following expenses in cash for September: office rent €600, salaries and wages of employees €900, and utilities €200.

Illustration 1-10

Transaction	Assets				=	Liabilities +		Equity		
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Share Capital	Rev.	Exp.	Div.	
1.	+15,000					+15,000				
2.	-7,000			+7,000						
3.			+1,800		+1,800					
4.	+1,200						+1,200			
5.					+250				-250	
6.	+1,500	+2,000					+3,500			
7.	-1,700							-600	-900	
									-200	

1-42

LO 7



## Summary of Transactions

1. Each transaction must be analyzed in terms of its effect on:
  - a. The three components of the basic accounting equation.
  - b. Specific types (kinds) of items within each component.
2. The two sides of the equation must always be equal.
3. The Share Capital—Ordinary and Retained Earnings columns indicate the causes of each change in the shareholders' claim on assets.

1-46

LO 7

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### > DO IT!

Transactions made by Virmari & Co. SA, a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-10.

1. The company issued ordinary shares for €25,000 cash.
2. The company purchased €7,000 of office equipment on credit.
3. The company received €8,000 cash in exchange for services performed.
4. The company paid €850 for this month's rent.
5. The company paid a dividend of €1,000 in cash to shareholders.

1-47

LO 7

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### > DO IT!

1. The company issued ordinary shares for €25,000 cash.

Transaction	Assets		=	Liabilities		+	Equity		
	Cash	+ Equipment	=	Accounts Payable	+ Share Capital	+	Rev.	Exp.	Div.
1.	+25,000				+25,000				

1-48

LO 7

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> DO IT!

2. The company purchased €7,000 of office equipment on credit.

Transaction	Assets		=	Liabilities		+	Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Share Capital	+	Retained Earnings	Rev.	Exp.	Div.
1.	+25,000									+25,000
2.		+7,000		+7,000						

1-49

LO 7

> DO IT!

3. The company received €8,000 cash in exchange for services performed.

Transaction	Assets		=	Liabilities		+	Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Share Capital	+	Retained Earnings	Rev.	Exp.	Div.
1.	+25,000									+25,000
2.		+7,000		+7,000						
3.	+8,000									+8,000

1-50

LO 7

> DO IT!

4. The company paid €850 for this month's rent.

Transaction	Assets		=	Liabilities		+	Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Share Capital	+	Retained Earnings	Rev.	Exp.	Div.
1.	+25,000									+25,000
2.		+7,000		+7,000						
3.	+8,000									+8,000
4.	-850								-850	

1-51

LO 7



SOFTBYTE SA	
Retained Earnings Statement For the Month Ended September 30, 2017	
Retained earnings, September 1	€ 0
Add: Net income	2,750
	<u>2,750</u>
Less: Dividends	1,300
Retained earnings, September 30	€1,450
SOFTBYTE SA	
Statement of Financial Position September 30, 2017	
<b>Assets</b>	
Equipment	€ 7,000
Supplies	1,600
Accounts receivable	1,400
Cash	8,050
Total assets	€18,050
<b>Equity and Liabilities</b>	
Equity	
Share capital—ordinary	€15,000
Retained earnings	1,450
	€16,450
Liabilities	
Accounts payable	1,600
Total equity and liabilities	€18,050

1-55

Illustration 1-11

LO 8

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SOFTBYTE SA	
Statement of Financial Position September 30, 2017	
<b>Assets</b>	
Equipment	€ 7,000
Supplies	1,600
Accounts receivable	1,400
Cash	8,050
Total assets	€18,050
<b>Equity and Liabilities</b>	
Equity	
Share capital—ordinary	€15,000
Retained earnings	1,450
	€16,450
Liabilities	
Accounts payable	1,600
Total equity and liabilities	€18,050
SOFTBYTE SA	
Statement of Cash Flows For the Month Ended September 30, 2017	
Cash flows from operating activities	
Cash receipts from revenues	€ 3,300
Cash payments for expenses	(1,550)
Net cash provided by operating activities	1,350
Cash flows from investing activities	
Purchase of equipment	(7,000)
Cash flows from financing activities	
Sale of ordinary shares	€15,000
Payment of cash dividends	(1,300)
Net increase in cash	13,700
Cash at the beginning of the period	0
Cash at the end of the period	€8,050

Illustration 1-11  
Financial statements  
and their  
interrelationships

1-56

LO 8

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## Income Statement

- ◆ Reports the profitability of the company's operations over a specific period of time.
- ◆ Lists revenues first, followed by expenses.
- ◆ Shows net income (or net loss).
- ◆ Does not include investment and dividend transactions between the shareholders and the business.

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## Financial Statements

### Review Question

Net income will result during a time period when:

- a. assets exceed liabilities.
- b. assets exceed revenues.
- c. expenses exceed revenues.
- ⇒ d. revenues exceed expenses.

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## Retained Earnings Statement

- ◆ Reports the changes in retained earnings for a specific period of time.
- ◆ The time period is the same as that covered by the income statement.
- ◆ Information provided indicates the reasons why retained earnings increased or decreased during the period.

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## Statement of Financial Position

- ◆ Reports the assets, liabilities, and equity at a specific date.
- ◆ Lists assets at the top, followed by liabilities and equity.
- ◆ Total assets must equal total liabilities and equity.
- ◆ Is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

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## Financial Statements

### Review Question

The financial statement that reports assets, liabilities, and equity is the:

- a. income statement.
- b. retained earnings statement.
- Σ c. statement of financial position.
- d. statement of cash flows.

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## Accounting Across the Organization

### A Wise End

### Vodafone (GBR)

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are **Vodafone Group** (GBR), March 31; **Walt Disney Productions** (USA), September 30; and **JJB Sports** (GBR), the Sunday that falls before, but closest to, January 31. Why do companies choose the particular year-ends that they do? Many opt to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.

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## Statement of Cash Flows

- ◆ Information on the cash receipts and payments for a specific period of time.
- ◆ Answers the following:
  - ▶ Where did cash come from?
  - ▶ What was cash used for?
  - ▶ What was the change in the cash balance?

### HELPFUL HINT

Investing activities pertain to investments made by the company, not investments made by the owners.

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Information related to Flanagan Group plc at December 31, 2017.

Equipment	£10,000	Utilities Expense	£ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

**(a) Determine the total assets of Flanagan at December 31, 2017.**

Equipment	£10,000	
Cash	8,000	
Accounts Receivable	9,000	
<b>Total assets</b>	<b>£27,000</b>	

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Information related to Flanagan Group plc at December 31, 2017.

Equipment	£10,000	Utilities Expense	£ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

**(b) Determine the net income reported for December 2017.**

Revenues		
Service revenue		£36,000
Expenses		
Rent expense	£11,000	
Salaries and wages expense	7,000	
Utilities expense	4,000	
Total expenses		22,000
<b>Net income</b>		<b>£14,000</b>

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Information related to Flanagan Group plc at December 31, 2017.

Equipment	£10,000	Utilities Expense	£ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

**(c) Determine the equity of Flanagan at December 31, 2017.**

Total assets [as computed in (a)]		£27,000
Less: Liabilities		
Notes payable	£16,500	
Accounts payable	2,000	18,500
<b>Equity</b>		<b>£ 8,500</b>

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