

Financial Accounting

IFRS 5th Edition

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Chapter 1

Accounting in Action

Chapter Outline

Learning Objectives

- LO 1** Identify the activities and users associated with accounting.
- LO 2** Explain the building blocks of accounting: ethics, principles, and assumptions.
- LO 3** State the accounting equation, and define its components.
- LO 4** Analyze the effects of business transactions on the accounting equations.
- LO 5** Describe the five financial statements and how they are prepared.

How you can be a successful student

- Self-learning is very important
 - Utilize tutorial & HW questions
- Prepare your own notes
 - It helps you digest knowledge
- Don't procrastinate until very end to submit assignments
 - Things pile up very quickly
- Approach TAs and USTFs!
 - They were selected because they did well in the course.

Learning Objective 1

Identify the activities and users associated with accounting.

What do you think of accounting?

Common perceptions

- **Accounting is boring**
 - Can be true in beginning. Has lot of concepts & assumptions that you must grasp.
 - But it can be interesting if you learn to connect the dots – i.e., link concepts to real-world examples
- **Accounting is useless**
 - You will use accounting to understand how businesses speak to investors

What is Accounting?

- Accounting is the process of *identifying, measuring, recording, and communicating* economic events in order to provide information for decision-making purposes.
- It is the **language of businesses!**
- There are two primary types of accounting systems:
 - financial accounting (provides information to decision-makers external to the firm)
 - Managerial accounting (provides information to decision-makers internal to the firm)

When do we use accounting?

- Companies will publish **information** according to guidelines
 - Guidelines are called **GAAP** (Generally Accepted Accounting Principles)
 - Other countries use **IFRS** (International Financial Reporting Standards)
- You will use accounting to understand these information to make useful decisions
 - Decisions as an investor
 - Decisions as an entrepreneur

Is accounting easy?

- Not necessarily.
- It may be difficult in the beginning.
- You have to know concepts & framework.
- Think of it as learning when to add & subtract.
- It will become easy as you learn!

What are three accounting activities?

- Accounting is the process of *identifying, measuring, recording, and communicating* economic events in order to provide information for decision-making purposes.
- It is the **language of businesses!**
 - They use the same language to communicate their performance

Accounting Activities Illustrated

Three Activities

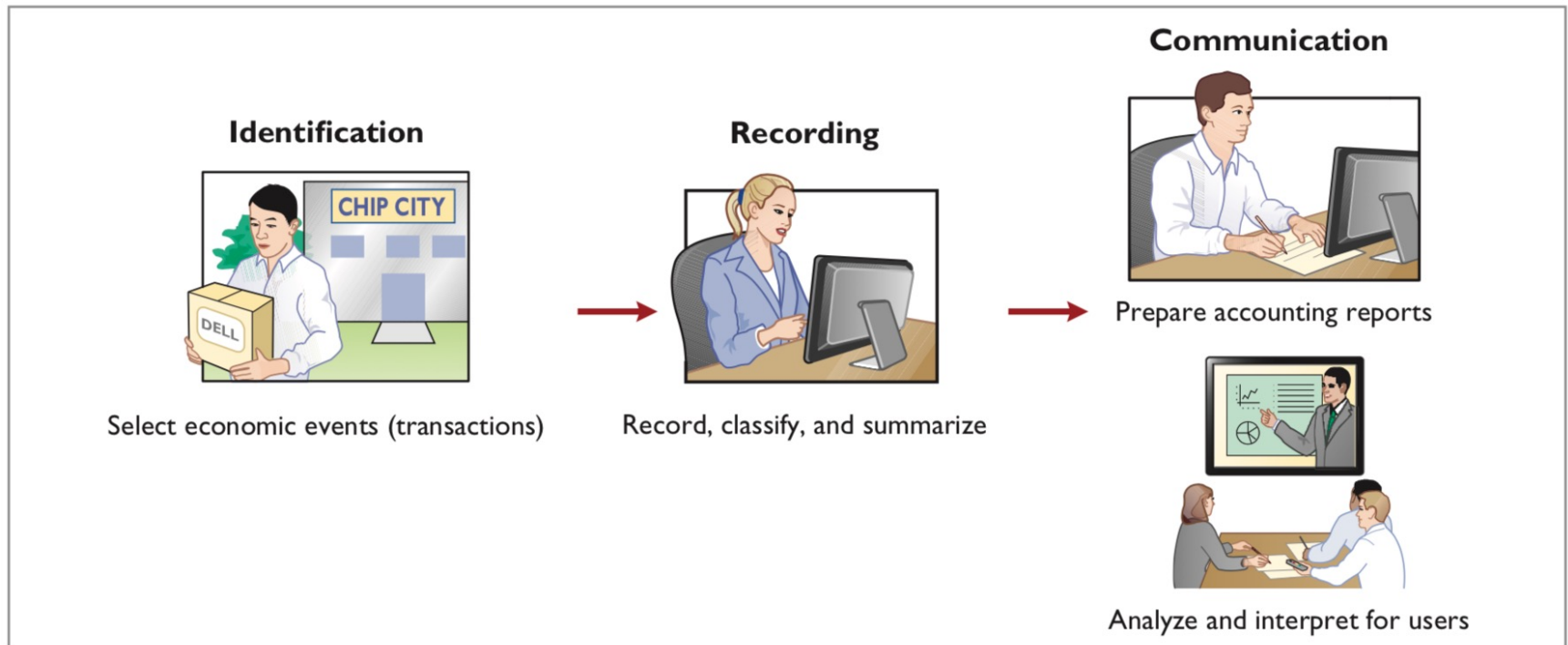


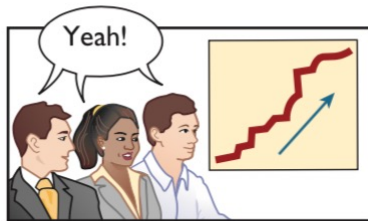
Illustration 1.1: The activities of the accounting process.

Who uses accounting information?

- **Internal:** Managers who plan, organize, and run the business.
 - Rely on **managerial accounting** for decision-making.
 - Examples: Marketing, production, finance managers.
- **External:** Users outside of the organization.
 - Rely on **financial accounting** for decision-making.
 - Examples: Investors and creditors.

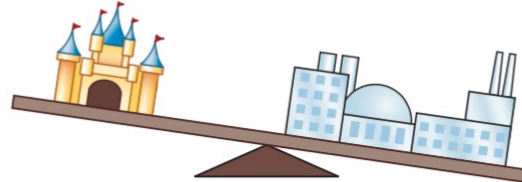
External Users

Questions Asked by External Users



Investors

Is **Lenovo** 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?

Illustration 1.3: Questions that external users ask.

Evidence That Accounting Information is Important to Investors

Stock price reaction to earnings announcements

JAN 25th, 2023: Electric vehicle maker Tesla reported earnings after the bell, beating on both earnings and revenue. Shares rose more than 5% after hours after CEO Elon Musk said the company might be able to produce 2 million cars this year. Here are the results.

Earnings (adjusted): \$1.19 vs \$1.13 per share expected, per Refinitiv
Revenue: \$24.32 billion vs \$24.16 billion expected, per Refinitiv.

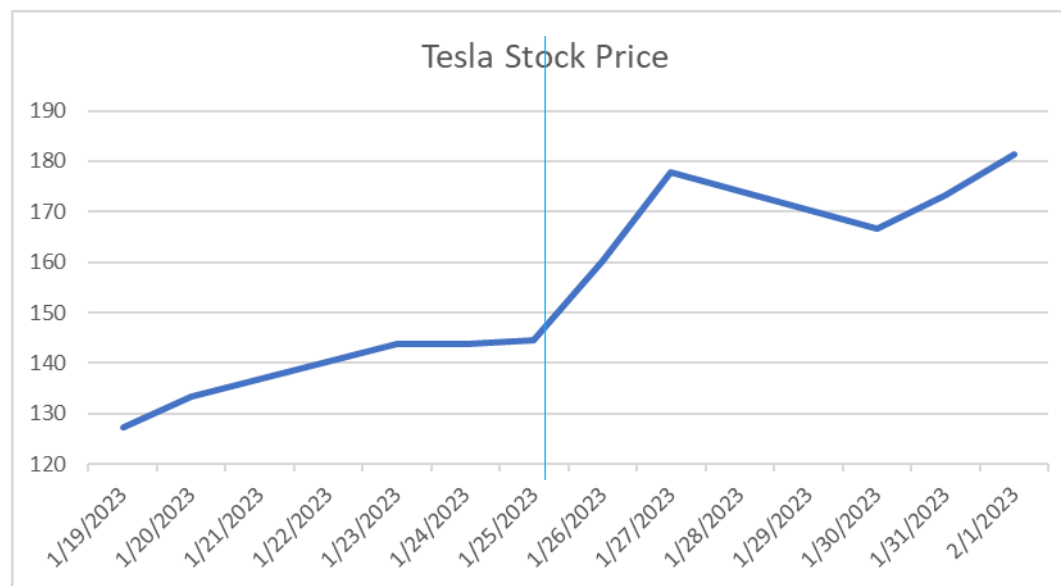
In the year-ago quarter, Tesla reported revenue of \$17.72 billion

<https://www.cnbc.com/2023/01/25/tesla-tsla-earnings-q4-2022.html>

Evidence That Accounting Information is Important to Investors

Stock price reaction to earnings announcements

Date	Price
1/19/2023	127.17
1/20/2023	133.42
1/23/2023	143.75
1/24/2023	143.89
1/25/2023	144.43
1/26/2023	160.27
1/27/2023	177.9
1/30/2023	166.66
1/31/2023	173.22
2/1/2023	181.41





**Global
NEWS**



Evidence That Accounting Information is Important to Investors

Cumulative returns around earnings restatements

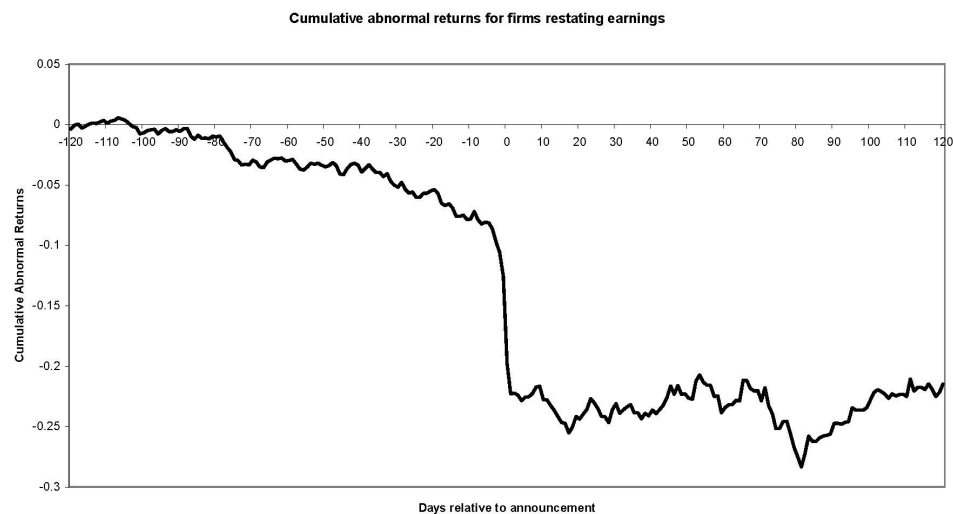


Figure 1: This figure shows cumulative abnormal returns for firms subject to earnings restatements for the period 1971-2000. The return period starts 120 days prior to the earnings restatement date and continues until 120 days after the restatement date. The stock returns are adjusted for the value weighted with dividend index.

How Do Creditors (e.g., banks) Use Accounting Information?

- Debt contract
 - I am CEO of Apple. Want to make improvements to the iPhone.
 - I take out a \$100M loan from Chase
- In the debt contract, **I am making a promise**
 - I will keep paying interest on time
 - I will keep my leverage ratio below a certain amount
- If these are violated, Chase may **increase the interest rate** / make me **pre-pay the loan** before maturity

Specific Example

Many aspects of debt contracts are based on accounting information:

- Interest rate charged
- Nature of debt covenants imposed
- Example (Vertex Pharmaceuticals):
 - On October 13, 2016, we entered into a Credit Agreement...with Bank of America...Under the Credit Agreement, **the applicable margin on base rate loans ranges from 0.75% to 1.50%...based on our consolidated leverage ratio** (the ratio of our total consolidated funded indebtedness to our consolidated EBITDA for the most recently completed four fiscal quarter period). The Credit Agreement **contains customary representations and warranties and affirmative and negative covenants, including financial covenants to maintain (x) subject to certain limited exceptions, a consolidated leverage ratio of 3.00 to 1.00 and (y) consolidated EBITDA of at least \$200 million**, in each case to be measured on a quarterly basis.

Additional External Users

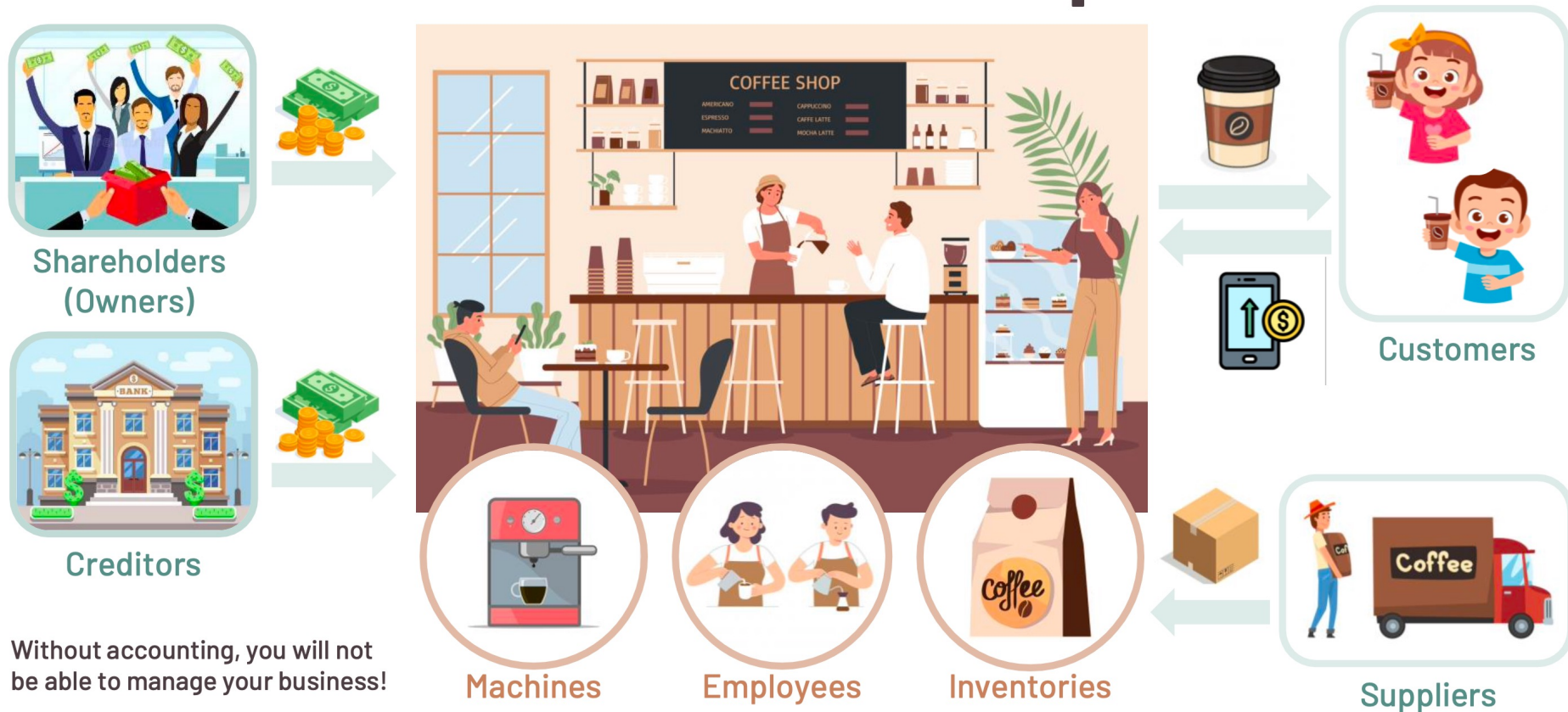
- **Taxing authorities:** Does the company comply with the tax laws?
- **Regulatory agencies:** Is the company operating within prescribed rules?
- **Labor unions:** Does the company have the ability to pay increased wages and benefits to union members?

<https://onlinelibrary.wiley.com/doi/full/10.1111/j.1911-3846.2012.01160.x>

Let's put everything together

- I want to open a coffee shop
 - What do you need?
- Internal transactions related to
 - Machine
 - Employees
 - Inventories and supplies (coffee beans, cups, straws etc.)
- External transactions related to
 - Shareholders (owners)
 - Creditors (e.g., banks)
 - Suppliers
 - Customers

An overview of business operations



Knowledge is power



Accounting provides the detailed information about each aspect of your business and gives you the big picture

Marketing shows how to attract and retain customers

Supply chain management shows how to control inventories to meet demands

Finance shows how to raise money from shareholders and creditors

Management shows how to monitor and incentivize your employees

Economics shows how coffee bean prices are affected by demand and supply

Accounting is strange, but only at beginning!

- Reasons
 - Abstract concepts
 - Accounting equation is not intuitive
 - Double-entry bookkeeping is complex
- Solutions
 - Link real-world examples to accounting concepts
 - Practice on your own!
 - Utilize TA / USTF office hours

About this course

- **WileyPlus**
 - Tutorial questions
 - **Unlimited attempts** for each set
 - TA / USTF will record tutorial for each chapter
 - Watch and follow along
 - Homework assignments
 - Have **three attempts** for each set – we will **keep highest score**
 - Do them independently
- **Review Sessions** (before mid-term and final)
 - Onsite sessions will be assigned on SIS
 - We will make announcements later
- **Office hours**
 - Bring questions to TA / USTF
 - We will make announcement later

Grades

- Tutorial: 10% (On WileyPlus)
- HW: 20% (On WileyPlus)
- Mid-term: 30% (Closed-book, closed notes)
 - 3/18/2024
- Final: 40% (Closed-book, closed notes)
 - 5/13/2024