

The background of the cover is a deep red with intricate, swirling teal patterns that resemble smoke or stylized clouds. On the right side, three large, red, spherical lanterns are stacked vertically, each with a visible internal frame and a small opening at the top. The lanterns are slightly out of focus, creating a sense of depth.

weygandt
kimmel
kieso

team for success

Financial
ACCOUNTING
IFRS EDITION ^{2e}N

Prepared by
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University of California, Santa Barbara

Chapter 1

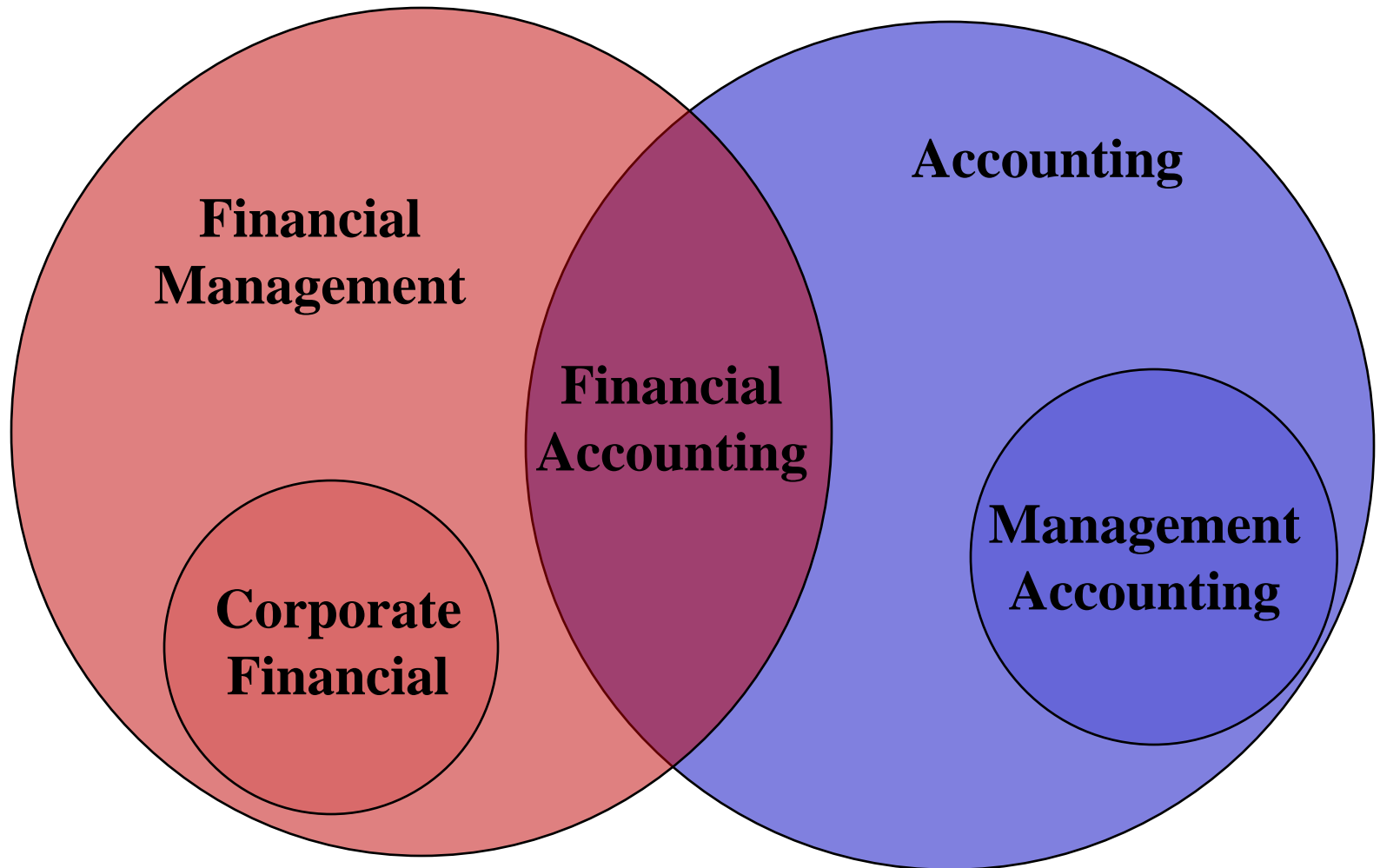
Accounting in Action

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 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 four financial statements and how they are prepared.**

Where is Financial Accounting?



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">• Three activities• Who uses accounting data?	<ul style="list-style-type: none">• Ethics in financial reporting• Accounting standards• Measurement principles• Assumptions	<ul style="list-style-type: none">• Assets• Liabilities• Equity	<ul style="list-style-type: none">• Transaction analysis• Summary of transactions	<ul style="list-style-type: none">• Income statement• Retained earnings statement• Statement of financial position• Statement of cash flows

Financial Accounting
IFRS Second Edition
Weygandt • Kimmel • Kieso

What is Accounting?

Accounting consists of three basic activities - it

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

the economic events of an organization to interested users.

What is Accounting?

Three Activities

Illustration 1-1

The activities of the accounting process

Identification



Identify economic events (transactions)

Recording



Record, classify, and summarize

Communication



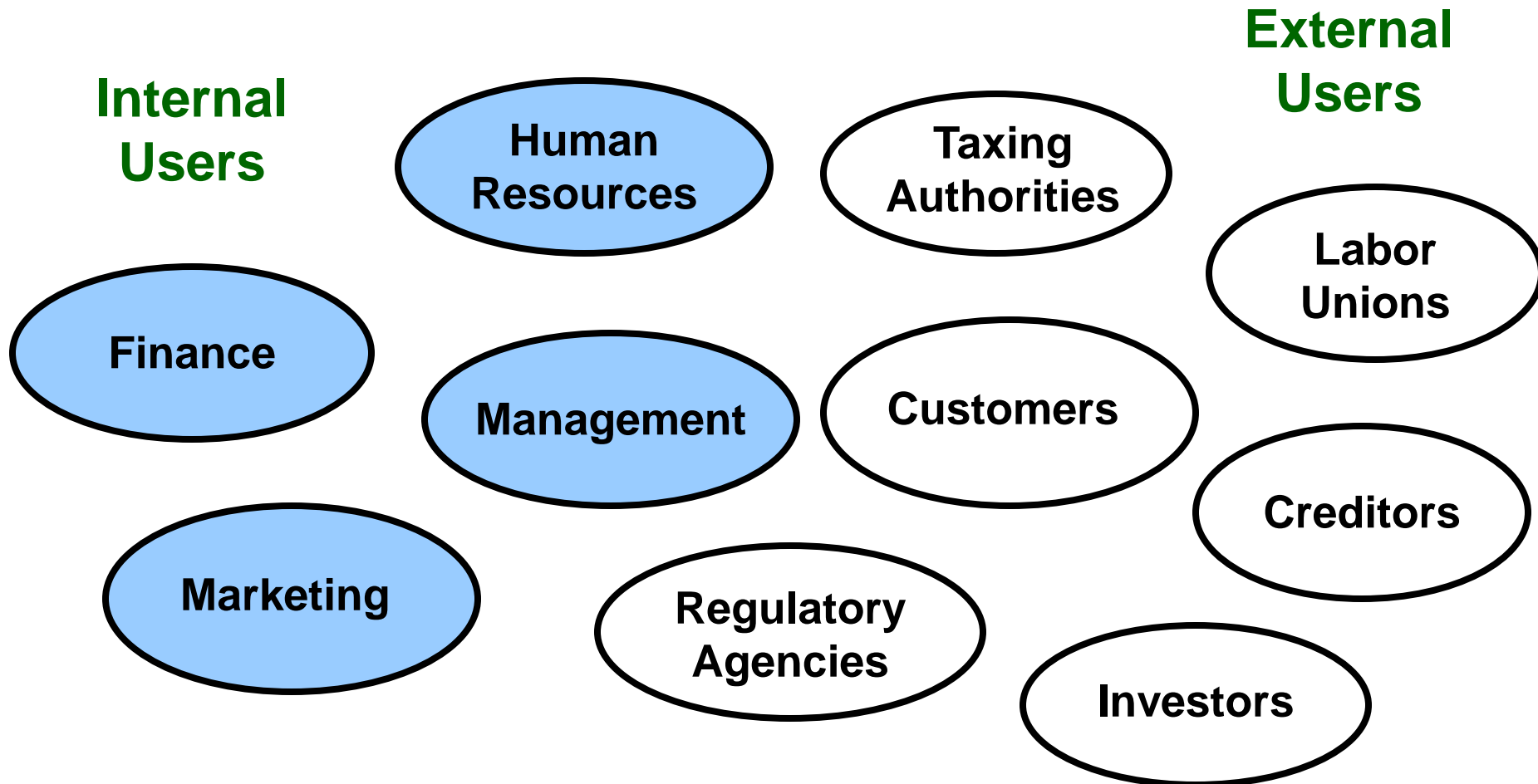
Prepare accounting reports



Analyze and interpret for users

The accounting process includes the **bookkeeping** function.







Who Uses Accounting Data



Who Uses Accounting Data

Common Questions Asked

User

- | | | |
|---|--|------------------------|
| 1. Can we afford to give our employees a pay raise? |  | Human Resources |
| 2. Did the company earn a satisfactory income? |  | Investors |
| 3. Should any product lines be eliminated? |  | Management |
| 4. Is cash sufficient to pay dividends to shareholders? |  | Finance |
| 5. What price for our product will maximize net income? |  | Marketing |
| 6. Will the company be able to pay its debts? |  | Creditors |

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**.

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

Ethics in Financial Reporting

Question

Ethics are the standards of conduct by which one's actions are judged as:

- a. right or wrong.
- b. honest or dishonest.
- c. fair or not fair.
- ☒ d. all of these options.

The Building Blocks of Accounting

Accounting Standards



International Accounting Standards Board (IASB)

<http://www.iasb.org/>

International Financial Reporting Standards (IFRS)



Financial Accounting Standards Board (FASB)

<http://www.fasb.org/>

Generally Accepted Accounting Principles (GAAP)

The Building Blocks of Accounting

Measurement Principles

Cost Principle – or historical 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).

INTERNATIONAL INSIGHT



The Korean Discount

If you think that accounting standards don't matter, consider recent events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have 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 stock price was often referred to as the "Korean discount."

In response, Korean regulators decided that, beginning in 2011, companies will have 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).



What is meant by the phrase "make the country's businesses more transparent"?
Why would increasing transparency spur economic growth?

The Building Blocks of Accounting

Assumptions

Monetary Unit – include in the accounting records only transaction data that can be expressed in money terms.

Economic Entity – 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.



**Forms of Business
Ownership**

Forms of Business Ownership

Proprietorship

- ◆ Generally owned by one person
- ◆ Often small service-type businesses
- ◆ Owner receives any profits, suffers any losses, and is personally liable for all debts

Partnership

- ◆ Owned by two or more persons
- ◆ Often retail and service-type businesses
- ◆ Generally unlimited personal liability
- ◆ Partnership agreement

Corporation

- ◆ Ownership divided into shares
- ◆ Separate legal entity organized under corporation law
- ◆ Limited liability



DO IT!

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

1. The three steps in the accounting process are identification, recording, and communication.
2. The two most common types of external users are investors and company officers.
3. Shareholders in a corporation enjoy limited legal liability as compared to partners in a partnership.

True

False

True



DO IT!

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

4. The primary accounting standard-setting body outside the United States is the International Accounting Standards Board (IASB).
5. The 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.

True

False

The Building Blocks of Accounting

Question

Combining the activities of Kellogg and General Mills would violate the

- a. cost principle.
- ☒ b. economic entity assumption.
- c. monetary unit assumption.
- d. ethics principle.

Forms of Business Ownership

Question

A business organized as a separate legal entity under law having ownership divided into ordinary shares is a

- a. proprietorship.
- b. partnership.
- ☒ c. corporation.
- d. sole proprietorship.

The Basic Accounting Equation

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

Provides the **underlying framework** for recording and summarizing economic events.

Applies to all economic entities regardless of size.

The Basic Accounting Equation

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

Provides the **underlying framework** for recording and summarizing economic events.

Assets

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

The Basic Accounting Equation

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

Provides the **underlying framework** for recording and summarizing economic events.

Liabilities

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

The Basic Accounting Equation

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

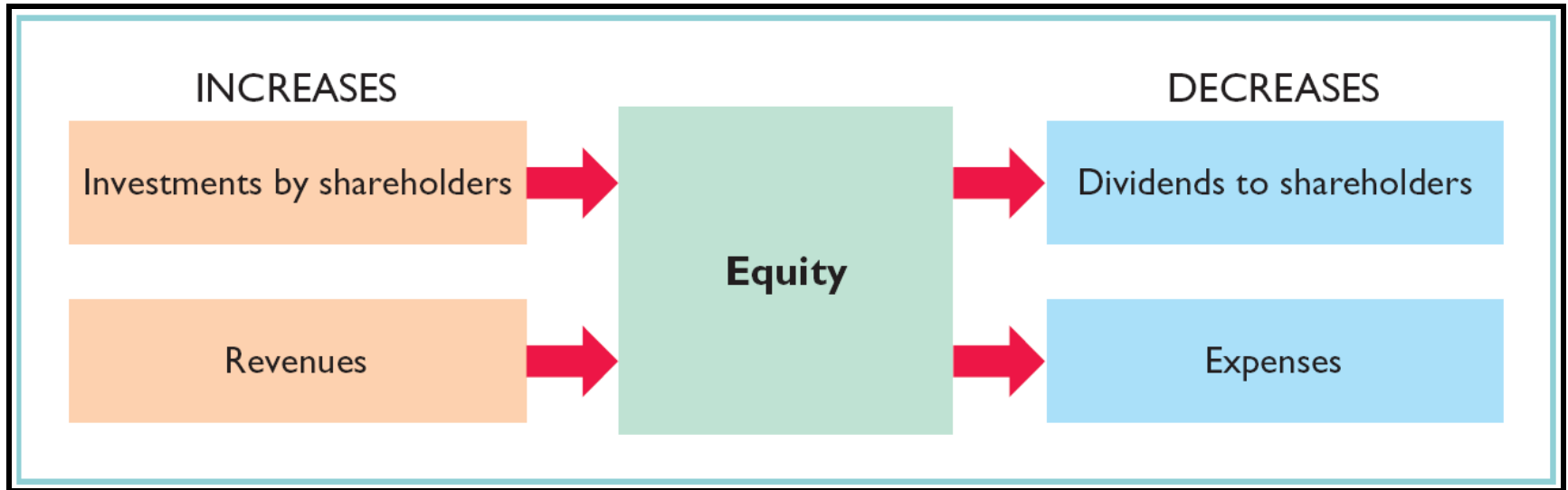
Provides the **underlying framework** for recording and summarizing economic events.

Equity

- ◆ Ownership claim on total assets.
- ◆ Referred to as residual equity.
- ◆ Share capital-ordinary and retained earnings.

The Basic Accounting Equation

Illustration 1-7

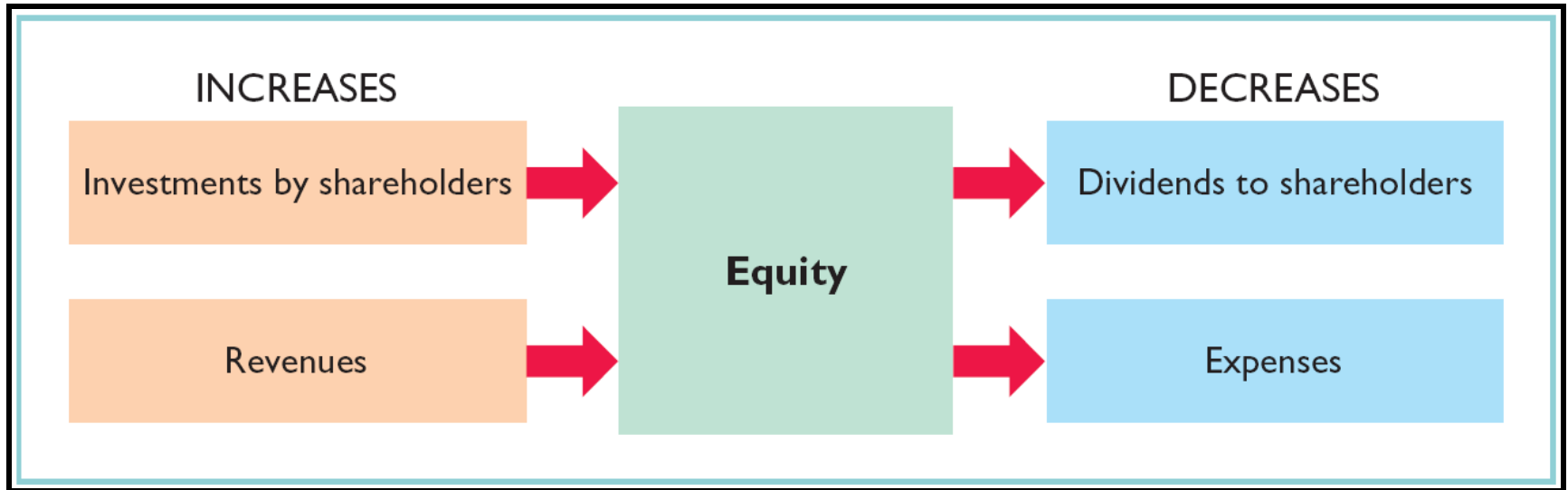


Revenues result from business activities entered into for the purpose of earning income.

Generally results from selling merchandise, performing services, renting property, and lending money.

The Basic Accounting Equation

Illustration 1-7

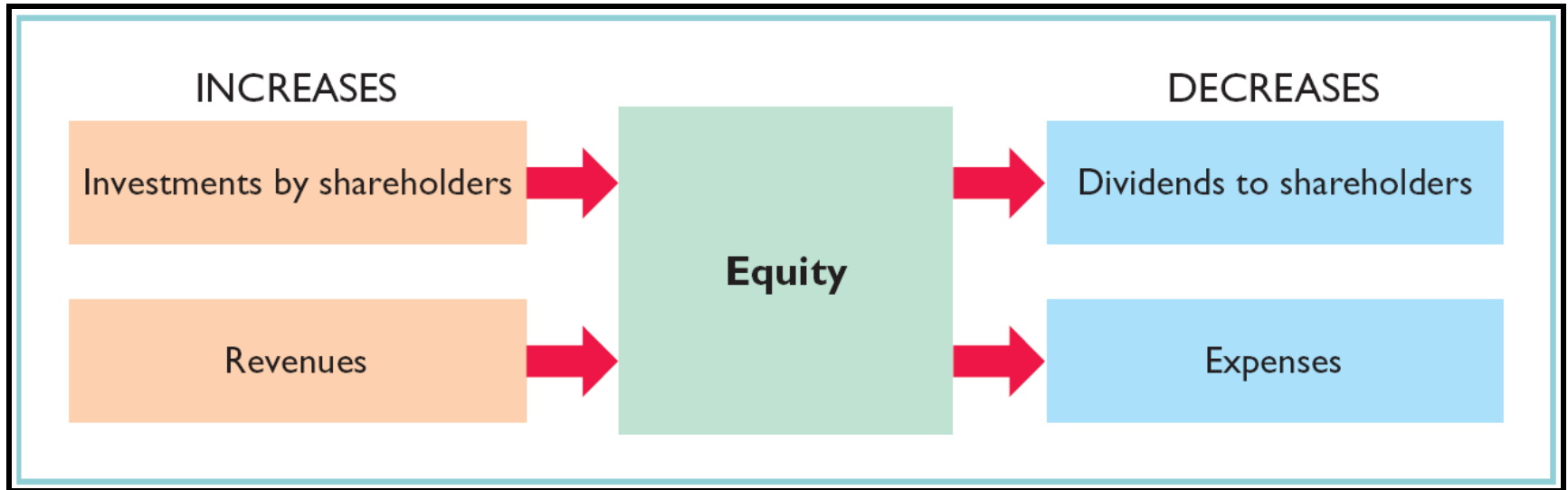


Expenses are the cost of assets consumed or services used in the process of earning revenue.

Common expenses are salaries expense, rent expense, interest expense, property tax expense, etc.

The Basic Accounting Equation

Illustration 1-7



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

- ◆ Reduce retained earnings
- ◆ Not an expense



DO IT!

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

	<u>Classification</u>	<u>Effect on Equity</u>
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 expense	<input type="text"/>	<input type="text"/>

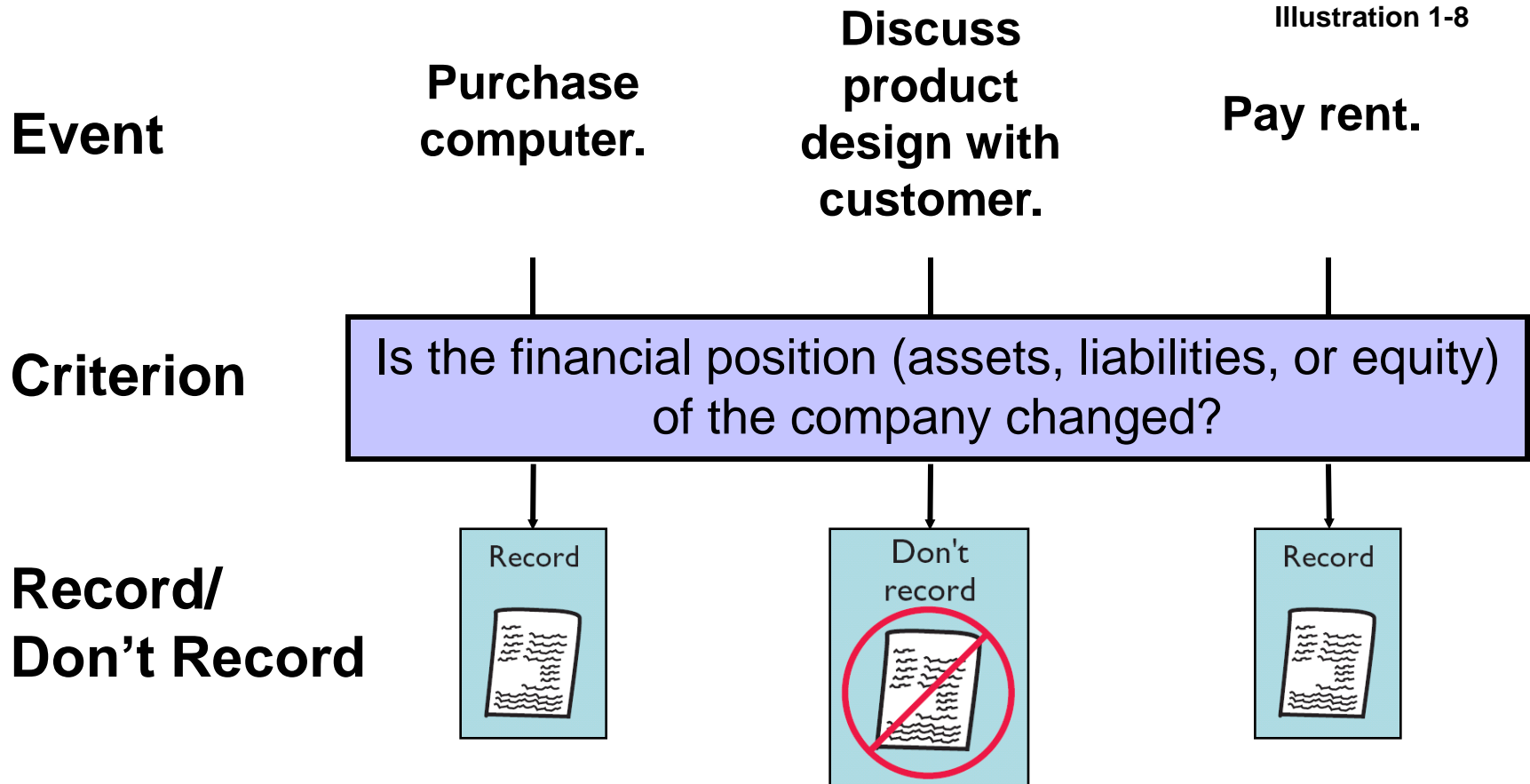
Using the Accounting Equation

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.

Using the Accounting Equation

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

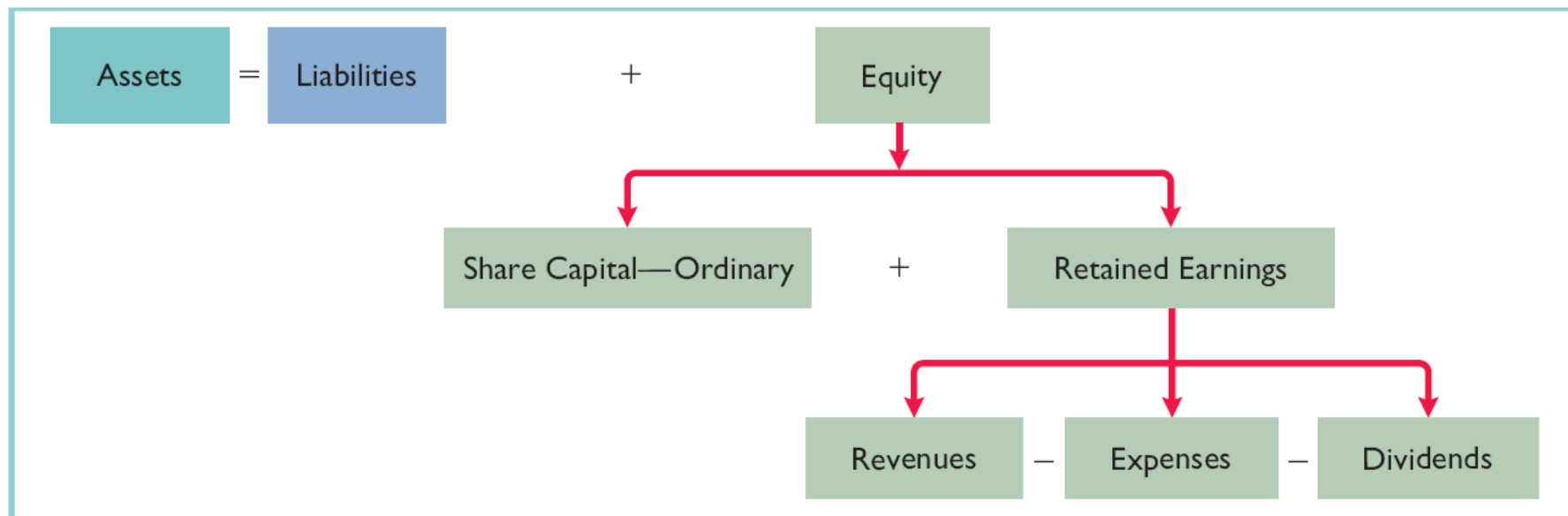


Using the Accounting Equation

Transaction Analysis

Illustration 1-9

Expanded accounting equation



Transaction Analysis

Transaction (1). Investment by Shareholders. Ray and Barbara Neal decides to open a computer programming service which he names Softbyte. On September 1, 2014, they invest €15,000 cash in exchange for €15,000 of ordinary shares.

Illustration 1-10

Trans- action	Assets				=	Liabilities	+	Equity			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Share Capital	+ Retained Earnings	Rev.	- Exp.	- Div.
(1)					=						
(2)					=						
(3)					=						
(4)					=						
(5)					=						
(6)					=						
(7)					=						
					=						
					=						
(8)					=						
(9)					=						
(10)					=						
					=						

Transaction Analysis

Transaction (2). Purchase of Equipment for Cash. Softbyte purchases computer equipment for €7,000 cash.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings	Rev.	- Exp. - Div.
(1)	+€15,000					+ €15,000			Issued Shares
(2)									
(3)									
(4)									
(5)									
(6)									
(7)									
(8)									
(9)									
(10)									

Transaction Analysis

Transaction (3). Purchase of Supplies on Credit. Softbyte purchases for €1,600 from Acme Supply Company computer paper and other supplies expected to last several months. The purchase is on account.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings	Rev.	- Exp. - Div.
(1)	+€15,000					+ €15,000			
(2)	-7,000			+€7,000					
(3)									
(4)									
(5)									
(6)									
(7)									
(8)									
(9)									
(10)									

Issued Shares

Transaction Analysis

Transaction (4). Services Provided for Cash. Softbyte receives €1,200 cash from customers for programming services it has provided.

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					Issued Shares
(2)	-7,000			+€7,000								
(3)			+€1,600			+€1,600						
(4)												
(5)												
(6)												
(7)												
(8)												
(9)												
(10)												

Transaction Analysis

Transaction (5). Purchase of Advertising on Credit. Softbyte receives a bill for €250 from the Daily News for advertising but postpones payment until a later date.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity				
	Cash	+ <u>Accounts Receivable</u>	+ <u>Supplies</u>	+ <u>Equipment</u>	= <u>Accounts Payable</u>	+ <u>Share Capital</u>	+ <u>Retained Earnings</u>	<u>Rev.</u>	- <u>Exp.</u>	- <u>Div.</u>
(1)	+€15,000					+ €15,000				Issued Shares
(2)	-7,000			+€7,000						
(3)			+€1,600		+€1,600					
(4)	+1,200						+€1,200			Service Revenue
(5)										
(6)										
(7)										
(8)										
(9)										
(10)										

Issued Shares

Service Revenue

Transaction Analysis

Transaction (6). Services Provided for Cash and Credit. Softbyte provides €3,500 of programming services for customers. The company receives cash of €1,500 from customers, and it bills the balance of €2,000 on account.

Illustration 1-10

Trans- action	Assets				=	Liabilities	+	Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Share Capital	+ Retained Earnings	Rev.	- Exp.	- Div.	
(1)	+€15,000						+ €15,000					Issued Shares
(2)	-7,000			+€7,000								
(3)			+€1,600			+€1,600						
(4)	+1,200							+€1,200				Service Revenue
(5)						+250				-€250		Adver. Expense
(6)												
(7)												
(8)												
(9)												
(10)												

Transaction Analysis

Transaction (7). Payment of Expenses. Softbyte pays the following expenses in cash for September: store rent €600, salaries and wages of employees €900, and utilities €200.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity						
	Cash	+	Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+	Retained Earnings			
									Rev.		– Exp.	– Div.
(1)	+€15,000						+ €15,000					Issued Shares
(2)	–7,000				+€7,000							
(3)				+€1,600		+€1,600						
(4)	+1,200							+€1,200				Service Revenue
(5)						+250			–€250			Adver. Expense
(6)	+1,500		+€2,000					+3,500				Service Revenue
(7)												
(8)												
(9)												
(10)												

Transaction Analysis

Transaction (8). Payment of Accounts Payable. Softbyte pays its €250 Daily News bill in cash.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings			
							Rev.	– Exp.	– Div.	
(1)	+€15,000					+ €15,000				Issued Shares
(2)	–7,000			+€7,000						
(3)			+€1,600		+€1,600					
(4)	+1,200						+€1,200			Service Revenue
(5)					+250			–€250		Adver. Expense
(6)	+1,500	+€2,000					+3,500			Service Revenue
(7)	–1,700							–600		Rent Expense
								–900		Sal./Wages Exp.
								–200		Utilities Expense
(8)										
(9)										
(10)										

Transaction Analysis

Transaction (9). Receipt of Cash on Account. Softbyte receives €600 in cash from customers who had been billed for services [in Transaction (6)].

Illustration 1-10

Trans- action	Assets				=	Liabilities	+	Equity							
	Cash	+	Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings				
											Rev.		–	Exp.	–
(1)	+€15,000							+	€15,000						Issued Shares
(2)	–7,000				+€7,000										
(3)				+€1,600			+€1,600								
(4)	+1,200									+€1,200					Service Revenue
(5)							+250					–€250			Adver. Expense
(6)	+1,500		+€2,000							+3,500					Service Revenue
(7)	–1,700											–600			Rent Expense
												–900			Sal./Wages Exp.
												–200			Utilities Expense
(8)	–250						–250								
(9)															
(10)															

Transaction Analysis

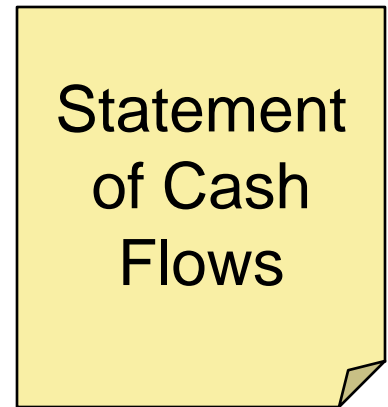
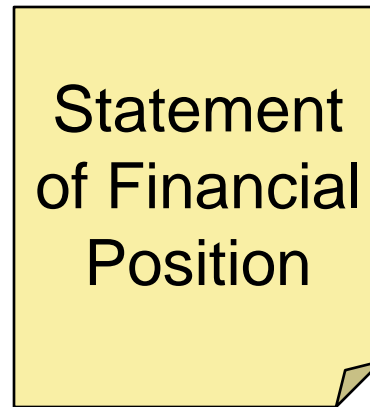
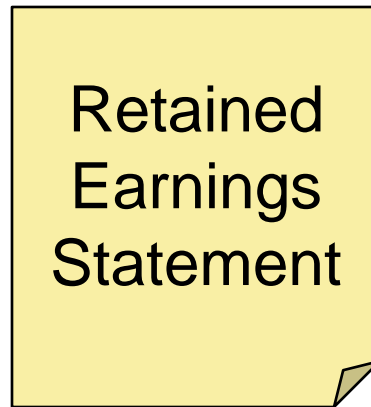
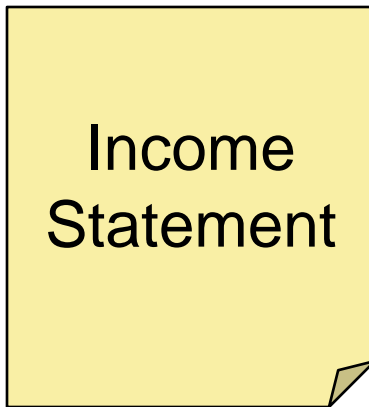
Transaction (10). Dividends. The corporation pays a dividend of €1,300 in cash.

Illustration 1-10

Trans- action	Assets				= Liabilities +	Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings			
							Rev.	– Exp.	– Div.	
(1)	+€15,000					+ €15,000				Issued Shares
(2)	–7,000			+€7,000						
(3)			+€1,600		+€1,600					
(4)	+1,200						+€1,200			Service Revenue
(5)					+250			–€250		Adver. Expense
(6)	+1,500	+€2,000					+3,500			Service Revenue
(7)	–1,700							–600		Rent Expense
								–900		Sal./Wages Exp.
								–200		Utilities Expense
(8)	–250				–250					
(9)	+600	–600								
(10)										

Financial Statements

Companies prepare **four** financial statements :



Financial Statements

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.

Financial Statements

Net income is needed to determine the ending balance in retained earnings.

Softbyte Inc. Income Statement For the Month Ended September 30, 2014		
Revenues		
Service revenue		€ 4,700
Expenses		
Salaries and wages expense	€900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u>€2,750</u>
Softbyte Inc. Retained Earnings Statement For the Month Ended September 30, 2014		
Retained earnings, September 1	€	0
Add: Net income		<u>2,750</u>
		<u>2,750</u>
Less: Dividends		<u>1,300</u>
Retained earnings, September 30		<u>€1,450</u>

Illustration 1-11
Financial statements and
their interrelationships

1

Financial Statements

The ending balance in retained earnings is needed in preparing the balance sheet

Softbyte Inc. Retained Earnings Statement For the Month Ended September 30, 2014

Retained earnings, September 1	€ 0
Add: Net income	2,750
	<u>2,750</u>
Less: Dividends	<u>1,300</u>
Retained earnings, September 30	<u>€1,450</u>

Illustration 1-11

Softbyte Inc. Statement of Financial Position September 30, 2014

Assets

Equipment	€ 7,000
Supplies	1,600
Accounts receivable	1,400
Cash	8,050
	<u>8,050</u>
Total assets	<u>€18,050</u>

Equity and Liabilities

Equity	
Share capital—ordinary	€15,000
Retained earnings	<u>1,450</u>
Liabilities	
Accounts payable	<u>1,600</u>
Total equity and liabilities	<u>€18,050</u>

Financial Statements

The balance sheet and income statement are needed to prepare statement of cash flows.

Softbyte Inc. Statement of Financial Position September 30, 2014		
<u>Assets</u>		
Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		8,050
Total assets		<u>€18,050</u>
<u>Equity and Liabilities</u>		
Equity		
Share capital—ordinary	€15,000	
Retained earnings	1,450	€16,450
Liabilities		
Accounts payable		1,600
Total equity and liabilities		<u>€18,050</u>
Softbyte Inc. Statement of Cash Flows For the Month Ended September 30, 2014		
Cash flows from operating activities		
Cash receipts from revenues		€ 3,300
Cash payments for expenses		<u>(1,950)</u>
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	<u>(1,300)</u>	<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u>€8,050</u>

Illustration 1-11

Financial Statements

Question

Which of the following financial statements is prepared as of a specific date?

- ☒ a. Statement of financial position.
- b. Income statement.
- c. Retained earnings statement.
- d. Statement of cash flows.

APPENDIX 1A ACCOUNTING CAREER OPPORTUNITIES

Public Accounting

Careers in auditing, taxation, and management consulting serving the general public.

Private Accounting

Careers in industry working in cost accounting, budgeting, accounting information systems, and taxation.

Government

Careers with the tax authorities, law enforcement agencies, and corporate regulators.

Forensic Accounting

Uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

APPENDIX 1A ACCOUNTING CAREER OPPORTUNITIES

“Show Me the Money”

Salary estimates for jobs in public and corporate accounting

Illustration 1A-1

<u>Employer</u>	<u>Jr. Level (0–3 yrs.)</u>	<u>Sr. Level (4–6 yrs.)</u>
Public accounting (large firm)	\$48,750–\$69,250	\$66,750–\$86,000
Public accounting (small firm)	\$41,000–\$56,000	\$54,000–\$69,750
Corporate accounting (large company)	\$38,000–\$57,250	\$55,750–\$73,500
Corporate accounting (small company)	\$33,500–\$49,000	\$46,500–\$58,750

Upper-level management salaries in corporate accounting

Illustration 1A-2

<u>Position</u>	<u>Large Company</u>	<u>Small to Medium Company</u>
Chief financial officer	\$183,250–\$384,000	\$94,250–\$175,750
Corporate controller	\$122,000–\$180,000	\$80,500–\$134,750
Tax manager	\$ 92,250–\$130,250	\$74,250–\$100,250

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