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FINANCIAL ACCOUNTING

3e

IFRS EDITION

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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">• 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• Comprehensive income statement

Financial Accounting
IFRS 3rd Edition
Weygandt • Kimmel • Kieso

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.

What is Accounting?

Accounting consists of three basic activities—it

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

the economic events of an organization to interested users.

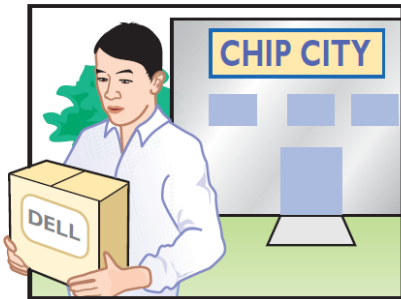
*Learning
Objective 1
Explain what
accounting is.*

Three Activities

Illustration 1-1

The activities of the accounting process

Identification



Select economic events (transactions)

Recording



Record, classify, and summarize

Communication



Prepare accounting reports



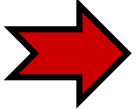
Analyze and interpret for users

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

Assumptions

Review Question

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

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

Who Uses Accounting Data?

INTERNAL USERS



Marketing

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



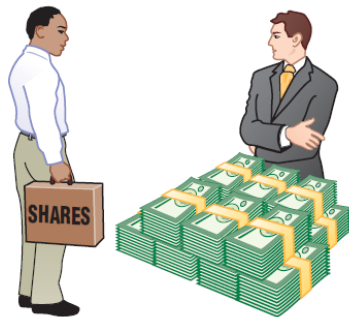
Snack chips



Beverages

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

Who Uses Accounting Data?

EXTERNAL USERS



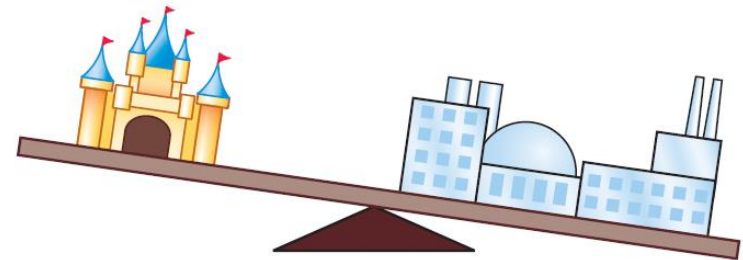
Investors

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



Creditors

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



DO IT!

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

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.

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

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.

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 1-4
Steps in analyzing ethics cases
and situations

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.”

(continued)

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).

Accounting Standards

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



International Financial
Reporting Standards

*Learning
Objective 4*
*Explain accounting
standards and the
measurement
principles.*



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

Generally Accepted Accounting Principles (GAAP)

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.

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).

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



**Forms of Business
Ownership**

Forms of Business Ownership

Proprietorship

- ◆ Owned by one person
- ◆ Owner is often manager/operator
- ◆ 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

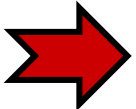
Corporation

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

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.

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.

(continued)

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?



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.
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.

True

True

False



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

The Basic Accounting Equation

Learning Objective 6

State the accounting equation, and define its components.

Basic Accounting Equation

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

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

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.

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.

Basic Accounting Equation

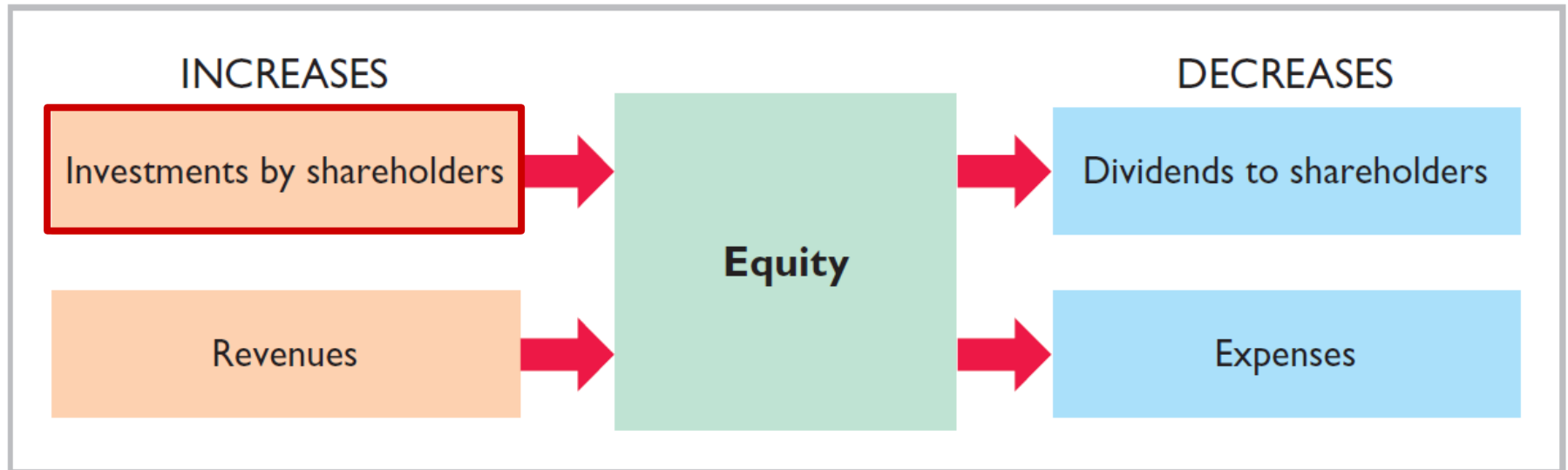
$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Equity}}$$

Equity

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

Equity

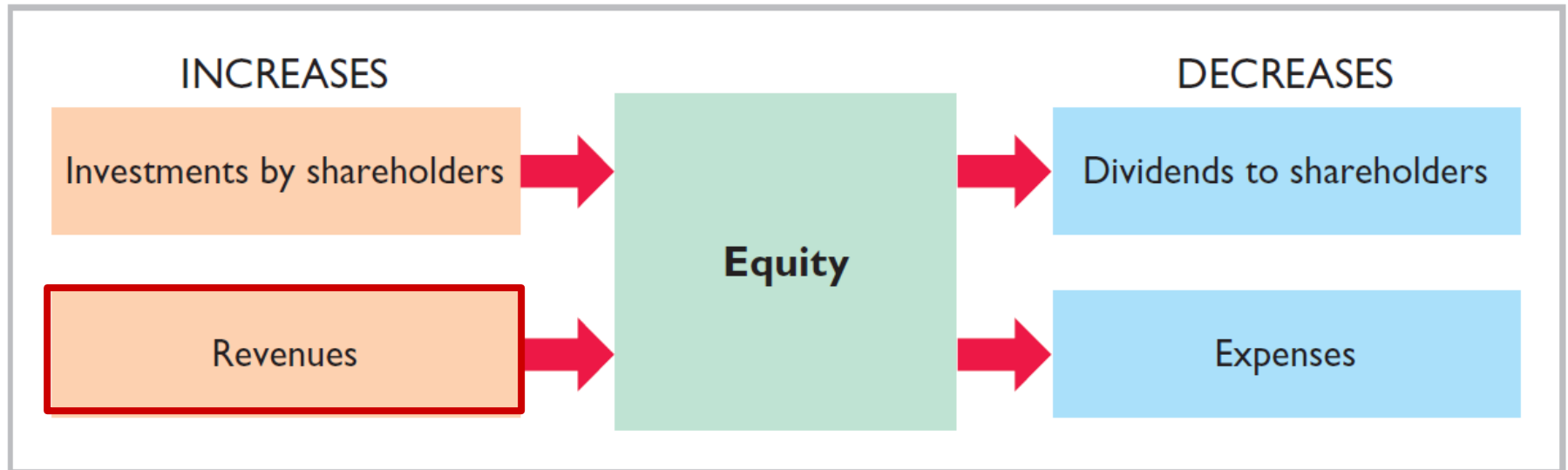
Illustration 1-7
Increases and
decreases in equity



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

Stockholders' Equity

Illustration 1-7
Increases and
decreases in equity

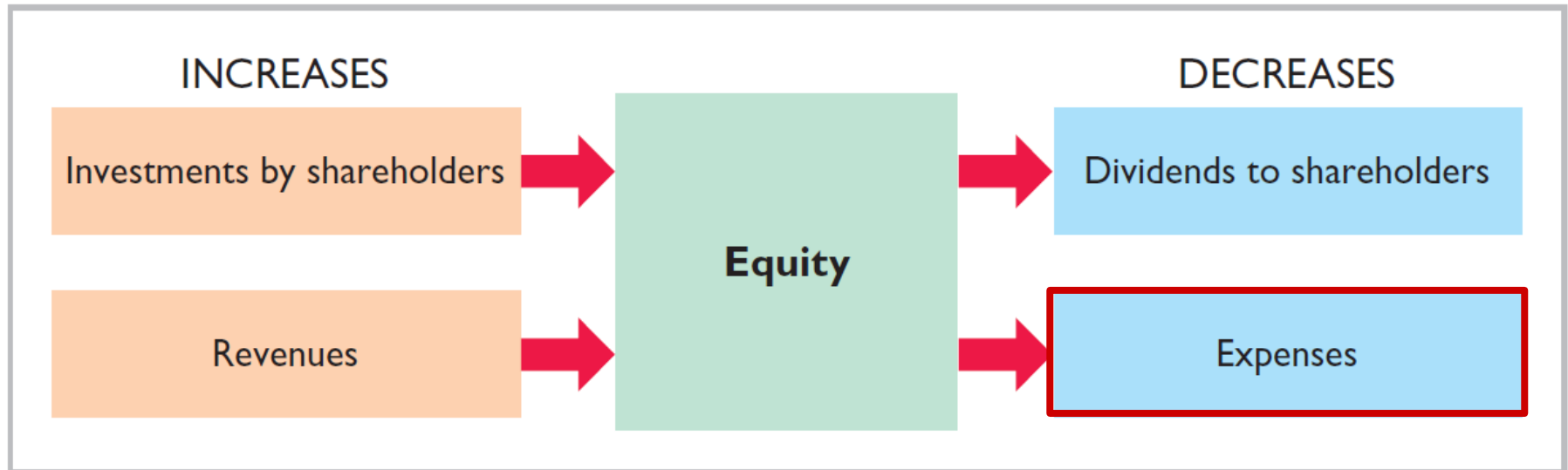


Revenues result from business activities entered into for the purpose of earning income.

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

Stockholders' Equity

Illustration 1-7
Increases and
decreases in equity

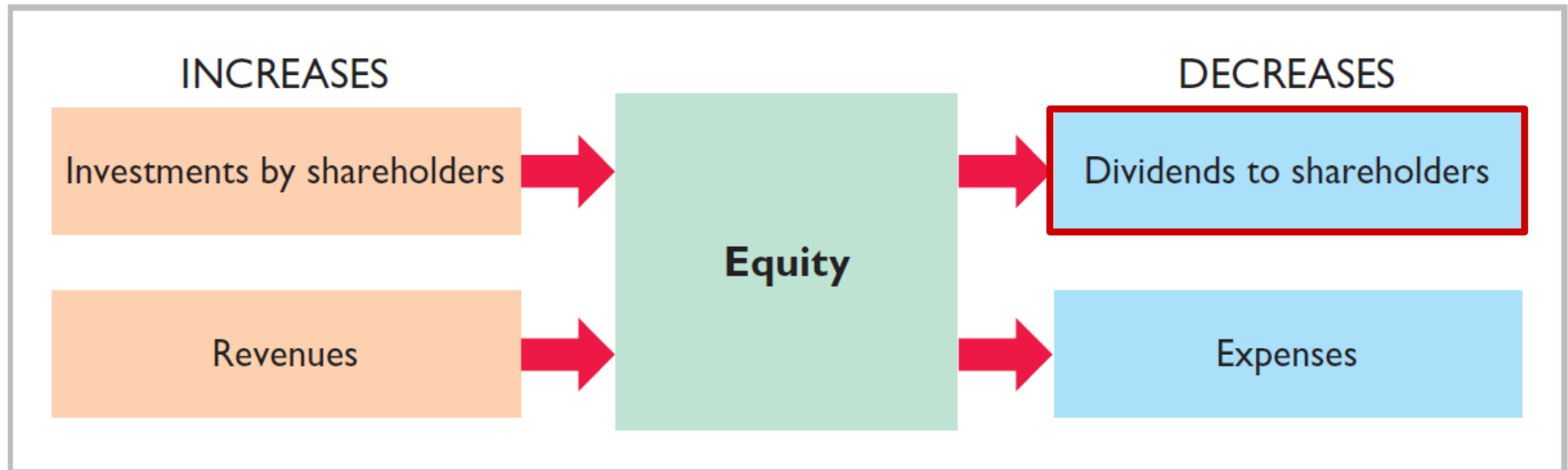


Expenses are the cost of assets consumed or services used in the process of earning revenue.

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

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**.



DO IT!

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

	<u>Classification</u>	<u>Effect on Equity</u>
1. Rent Expense		
2. Service Revenue		
3. Dividends		
4. Salaries and Wages Expense		

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.*

Transaction Analysis

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

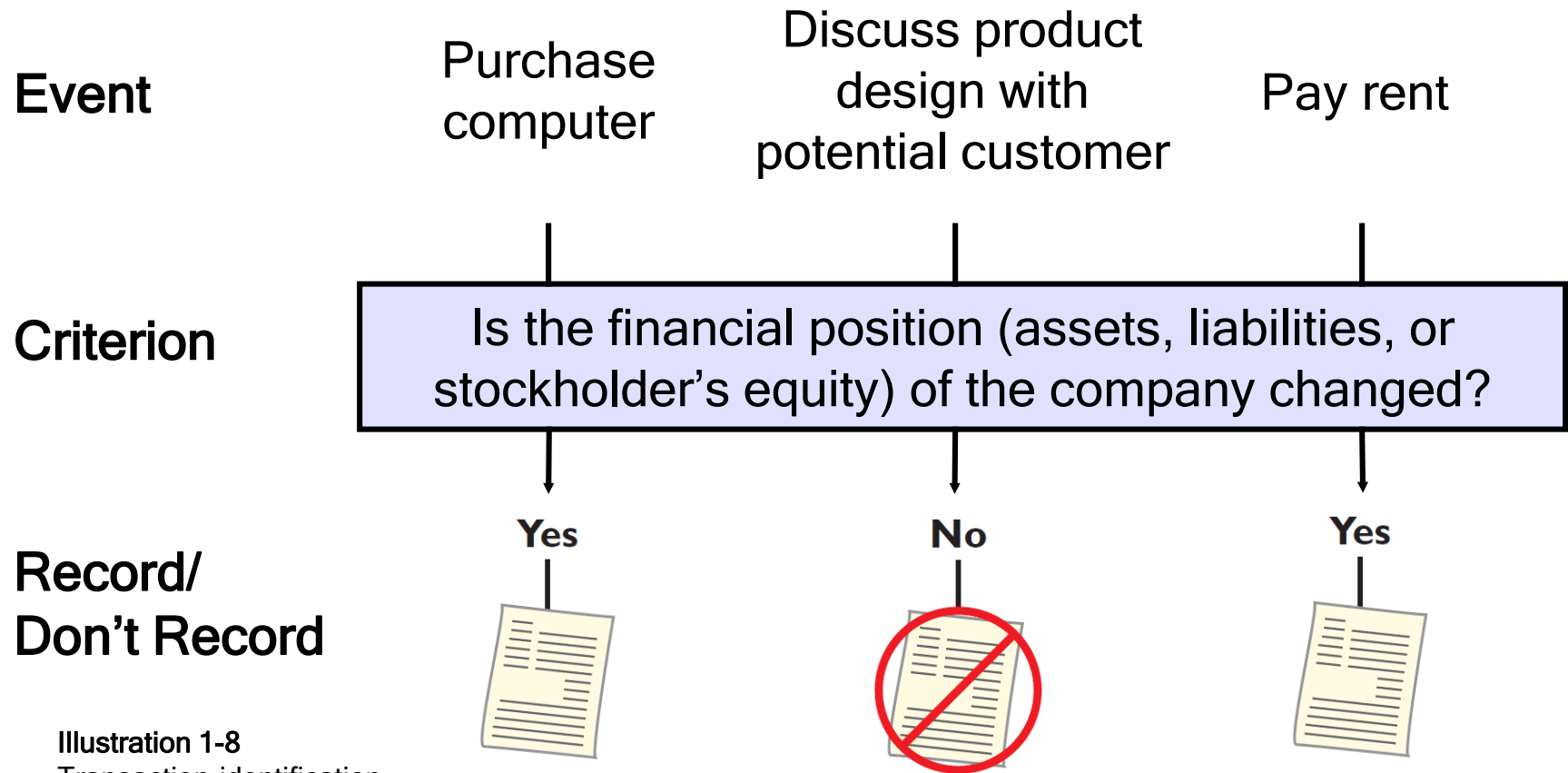


Illustration 1-8
Transaction-identification
process

Transaction Analysis

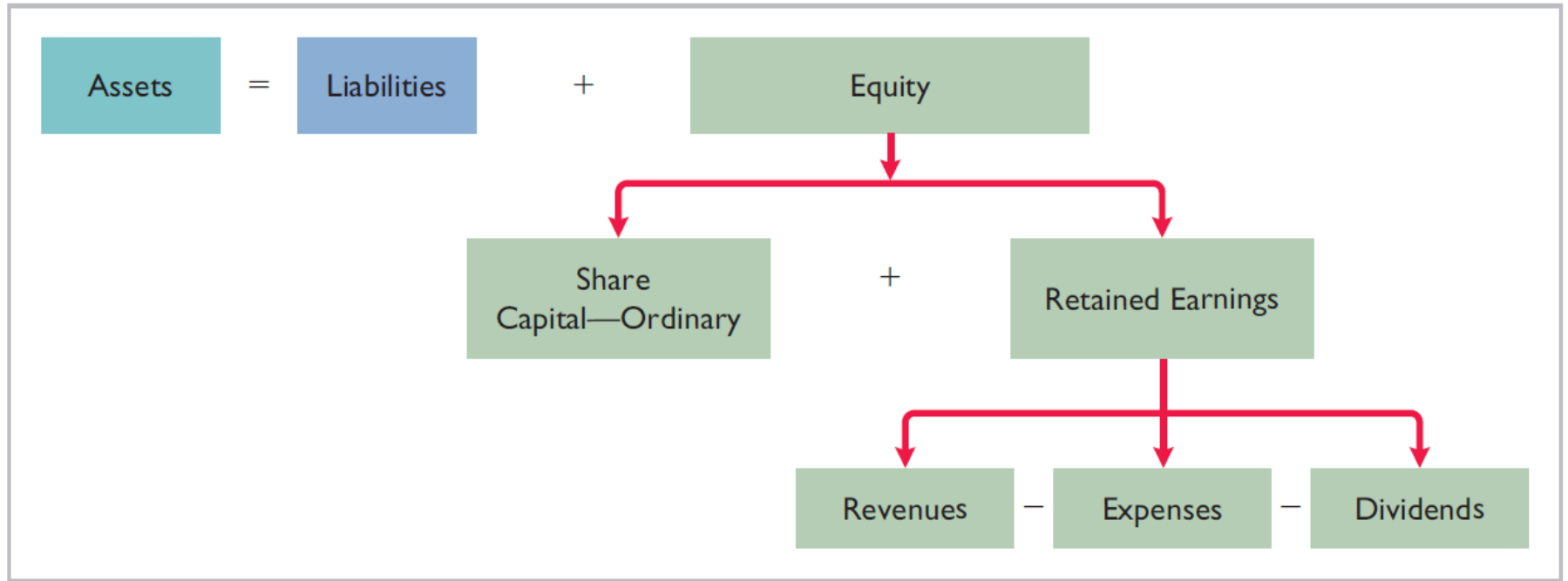


Illustration 1-9
Expanded accounting equation

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

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

TRANSACTION 2. PURCHASE OF EQUIPMENT FOR CASH Softbyte SA 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			
2.	-7,000			+7,000					

TRANSACTION 3. PURCHASE OF SUPPLIES ON CREDIT Softbyte SA purchases for €1,600 headsets and other accessories expected to last several months. The supplier allows Softbyte to pay this bill in October.

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.			+1,600		+1,600				

TRANSACTION 4. SERVICES PERFORMED FOR CASH Softbyte SA receives €1,200 cash from customers for app development services it has performed.

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.			+1,600		+1,600				
4.	+1,200						+1,200		

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

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.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	

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

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.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		

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

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.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600	
								-900	
								-200	

TRANSACTION 8. PAYMENT OF ACCOUNTS PAYABLE Softbyte SA pays its €250 *Programming News* bill in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable.

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.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600	
								-900	
								-200	
8.	-250				-250				

TRANSACTION 9. RECEIPT OF CASH ON ACCOUNT Softbyte SA
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.	- Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600	
								-900	
								-200	
8.	-250				-250				
9.	+600	-600							

TRANSACTION 10. DIVIDENDS

The corporation pays a dividend of €1,300 in cash to Ray and Barbara Neal, the shareholders of Softbyte SA.

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.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600	
								-900	
								-200	
8.	-250				-250				
9.	+600	-600							
10.	-1,300								-1,300
1-45	€18,050				€18,050				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.



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.



DO IT!

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

Trans- action	Assets		=	Liabilities +		Equity			
	Cash	+ Equipment		Accounts Payable	+ Share Capital	Retained Earnings			
						Rev.	- Exp.	- Div.	
1.	+25,000				+25,000				



DO IT!

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

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



DO IT!

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

Trans- action	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			



DO IT!

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

Trans- action	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	



DO IT!

5. The company paid a dividend of €1,000 in cash to shareholders.

Trans- action	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	
5.	-1,000								-1,000
	€31,150	+ €7,000	=	€7,000	+ €25,000	+ €8,000	- €850	- €1,000	
	€38,150			€38,150					

The Basic Accounting Equation

Companies prepare **five** financial statements :

*Learning
Objective 8
Understand the
five financial
statements
and how they
are prepared.*

Income
Statement

Retained
Earnings
Statement

Statement
of Financial
Position

Statement
of Cash
Flows

Comprehensive
Income
Statement

SOFTBYTE SA
Income Statement
For the Month Ended September 30, 2017

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 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	<u>1,300</u>
Retained earnings, September 30	<u>€1,450</u>

1

SOFTBYTE SA
Retained Earnings Statement
For the Month Ended September 30, 2017

1

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>

SOFTBYTE SA
Statement of Financial Position
September 30, 2017

2

<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	<u>1,450</u>
Liabilities	
Accounts payable	<u>1,600</u>
Total equity and liabilities	<u>€18,050</u>

SOFTBYTE SA		
Statement of Financial Position		
September 30, 2017		
<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 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		<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>

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

Illustration 1-11
Financial statements and their interrelationships

Income Statement

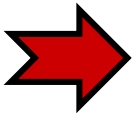
- ◆ Reports the profitability of the company's operations over a specific period of time.
- ◆ Lists revenues first, followed by expenses.
- ◆ Shows net income (or net loss).
- ◆ Does not include investment and dividend transactions between the shareholders and the business.

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.



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.

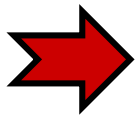
Statement of Financial Position

- ◆ 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).

Financial Statements

Review Question

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

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

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.

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.

Comprehensive Income Statement

- ◆ Other comprehensive income items are not part of net income.
- ◆ Reported either by
 - ▶ Combining with income statement, or
 - ▶ Separate statement.

Illustration 1-13
Comprehensive
income statement

SOFTBYTE SA	
Comprehensive Income Statement	
For the Month Ended September 30, 2017	
Net income	€2,750
Other comprehensive income	<u>600</u>
Comprehensive income	<u><u>€3,350</u></u>

Net income	€2,750
Other comprehensive income	<u>600</u>
Comprehensive income	<u><u>€3,350</u></u>

People, Planet, and Profit Insight

Beyond Financial Statements

Should we expand our financial statements beyond the income statement, retained earnings statement, statement of financial position, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing shareholders' interests. A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But, many interest in and useful efforts are underway. Throughout this textbook, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to shareholders.



DO IT!

Presented below is selected information related to Flanagan Group plc at December 31, 2017. Flanagan reports financial information monthly.

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.
- (b) Determine the net income that Flanagan reported for December 2017.
- (c) Determine the equity of Flanagan at December 31, 2017.

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
Total assets	£27,000

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	<u>22,000</u>
----------------	---------------

Net income	<u>£14,000</u>
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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	<u>2,000</u>	<u>18,500</u>
Equity		<u><u>£ 8,500</u></u>

APPENDIX 1A

Accounting Career Opportunities

Public Accounting

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

Learning Objective 9

Explain the career opportunities in accounting.

Governmental Accounting

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

Private Accounting

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

Forensic Accounting

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

A Look at U.S. GAAP

Learning Objective 10

*Describe the
impact of IFRS on
U.S. financial
reporting.*

Key Points

Most agree that there is a need for one set of international accounting standards. Here is why:

Multinational corporations. Today's companies view the entire world as their market. For example, large companies often generate more than 50% of their sales outside their own boundaries.

Mergers and acquisitions. The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations in the future.

Information technology. As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.



A Look at U.S. GAAP

Key Points

Financial markets. Financial markets are of international significance today. Whether it is currency, equity securities (shares), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

Similarities

- GAAP is based on a conceptual framework that is similar to that used to develop IFRS.
- The three common forms of business organization that are presented in the chapter, proprietorships, partnerships, and corporations, are also found in the United States. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurism, the relative use of each form will vary across countries.

A Look at U.S. GAAP

Similarities

- Transaction analysis is basically the same under IFRS and GAAP but, as you will see in later chapters, the different standards may impact how transactions are recorded.
- Financial frauds have occurred at companies such as **Satyam Computer Services** (IND), **Parmalat** (ITA), and **Royal Ahold** (NLD). They have also occurred at large U.S. companies such as **Enron**, **WorldCom**, and **AIG**.



A Look at U.S. GAAP

Differences

- The Sarbanes-Oxley Act (SOX) mandates certain internal controls for large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.
- U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.
- IFRS tends to be less detailed in its accounting and disclosure requirements than GAAP. This difference in approach has resulted in a debate about the merits of “principles-based” (IFRS) versus “rules-based” (GAAP) standards.



A Look at U.S. GAAP

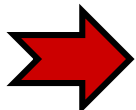
Looking to the Future

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. Consider, for example, that as a result of a joint project on the conceptual framework, the definitions of the most fundamental elements (assets, liabilities, equity, revenues, and expenses) may actually change. However, whether the IASB adopts internal control provisions similar to those in SOX remains to be seen.

A Look at U.S. GAAP

IFRS Self-Test Questions

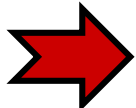
Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?

- a) Mergers and acquisition activity.
- b) Financial markets.
- c) Multinational corporations.
-  d) GAAP is widely considered to be a superior reporting system.

A Look at U.S. GAAP

IFRS Self-Test Questions

The Sarbanes-Oxley Act determines:

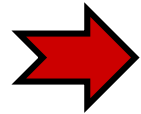
- a) international tax regulations.
- b) internal control standards as enforced by the IASB.
-  c) internal control standards of U.S. publicly traded companies.
- d) U.S. tax regulations.



A Look at U.S. GAAP

IFRS Self-Test Questions

IFRS is considered to be more:



- a) principles-based and less rules-based than **GAAP**.
- b) rules-based and less principles-based than **GAAP**.
- c) detailed than **GAAP**.
- d) None of the above.

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