CHAPTER 1

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Accounting in Action

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*The **Chapter Preview** describes the purpose of the chapter and highlights major topics.*

Chapter Preview

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

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.*

Feature Story

Knowing the Numbers

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

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

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

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

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

Appendices A, B, and C of this text provide real financial statements of three companies from different countries that report using International Financial Reporting Standards (IFRS): **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN), **Nestlé SA** (CHE), and **Delfi Limited** (SGP). Throughout this text, we increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements. In addition, we encourage you to visit each company's website where you can view its complete annual report.

Even though these three companies are based in three different countries, they all follow IFRS. This means they all follow the same basic accounting principles. As a result, their financial statements are very similar. Therefore, by learning these basic principles as presented in this text, you will be well equipped to begin understanding the financial results of companies around the world.

*The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.*

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Identify the activities and users associated with accounting.	• Who uses accounting data • Data analytics	**DO IT! 1** Basic Concepts
LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.	• Ethics in financial reporting • Accounting standards • Measurement principles • Assumptions	**DO IT! 2** Building Blocks of Accounting
LO 3 State the accounting equation, and define its components.	• Assets • Liabilities • Equity	**DO IT! 3** Equity Effects
LO 4 Analyze the effects of business transactions on the accounting equation.	• Accounting transactions • Transaction analysis • Summary of transactions	**DO IT! 4** Tabular Analysis
LO 5 Describe 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	**DO IT! 5** Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a targeted summary and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

1.1 Accounting Activities and Users

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

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

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users.

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

1. As a starting point to the accounting process, a company identifies the **economic events relevant to its business**. Examples of economic events are the sale of food and snacks by **Unilever** (GBR), the providing of telephone services by **Chunghwa Telecom** (TWN), and the manufacture of motor vehicles by **Tata Motors** (IND).
2. Once a company like Unilever identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in monetary units. In recording, Unilever also classifies and summarizes economic events.
3. Finally, Unilever **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**.

To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, Unilever accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information.

- Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships.
- Interpretation involves **explaining the uses, meaning, and limitations of reported data**.

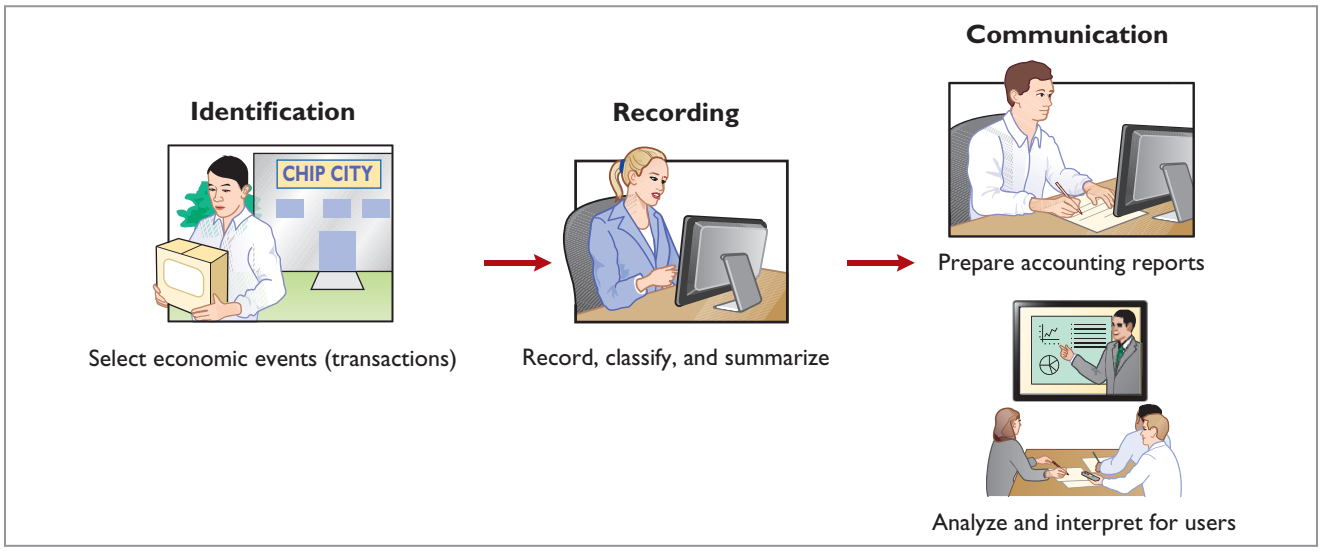
Appendix A of this text shows the financial statements of **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN). Appendix B illustrates the financial statements of **Nestlé SA** (CHE), and Appendix C includes the financial statements of **Delfi Limited** (SGP). We refer to these statements at various places throughout the text. (In addition, in the *A Look at U.S. GAAP* section at the end of each chapter, the U.S. company **Apple Inc.** is analyzed.)

At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

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

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 **The activities of the accounting process**



You should understand that the accounting process **includes** the bookkeeping function.

- **Bookkeeping** usually involves **only** the recording of economic events.
- It is therefore just one part of the accounting process.

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

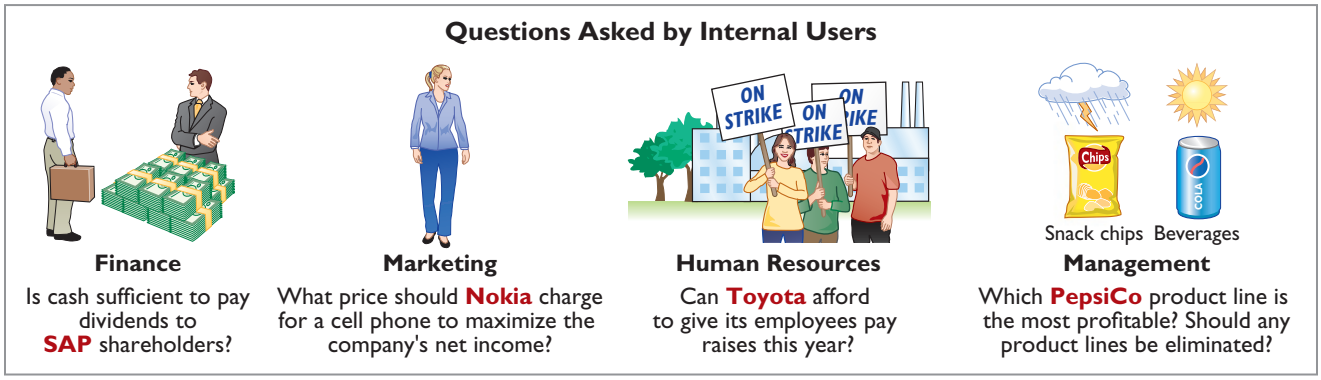
Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in **Illustration 1.2**.

ILLUSTRATION 1.2 **Questions that internal users ask**



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

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

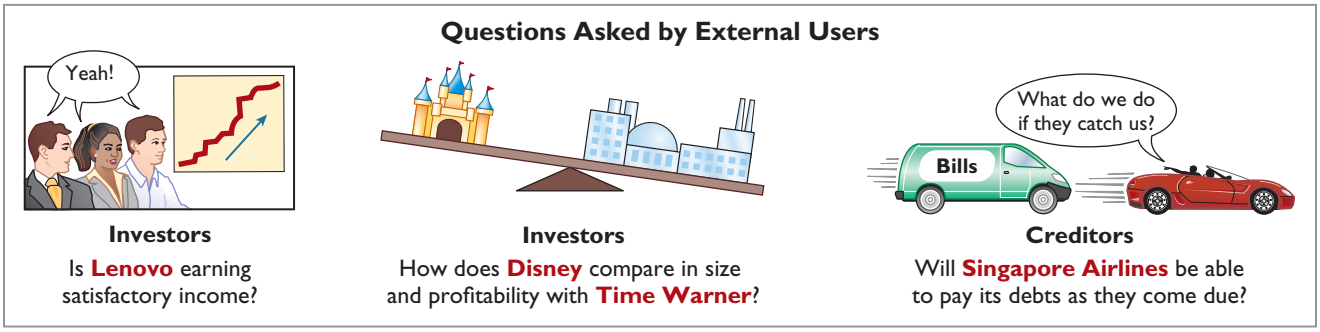
External Users

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

- **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company.
- **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.

Illustration 1.3 shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 **Questions that external users ask**



Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably.

- **Taxing authorities**, such as the **State Administration of Taxation in the People's Republic of China** (CHN), want to know whether the company complies with tax laws.
- **Regulatory agencies**, such as the **Financial Services Authority of Indonesia** (IDN), want to know whether the company is operating within prescribed rules.
- **Customers** are interested in whether a company like **Tesla Motors, Inc.** (USA) will continue to honor product warranties and support its product lines.
- **Labor unions**, such as the **Indian National Trade Union Congress** (IND), want to know whether companies have the ability to pay increased wages and benefits to union members.

Data Analytics

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

Illustration 1.4 shows the four most common types of data analytics that help answer questions ranging from what happened and why did it happen, to what is likely to happen and what should we do about it? Analytics range from simple analysis that can be performed using spreadsheets with tools like pivot tables and graphs, to complex statistical software and even artificial intelligence. More complex analysis provides greater value to the business.

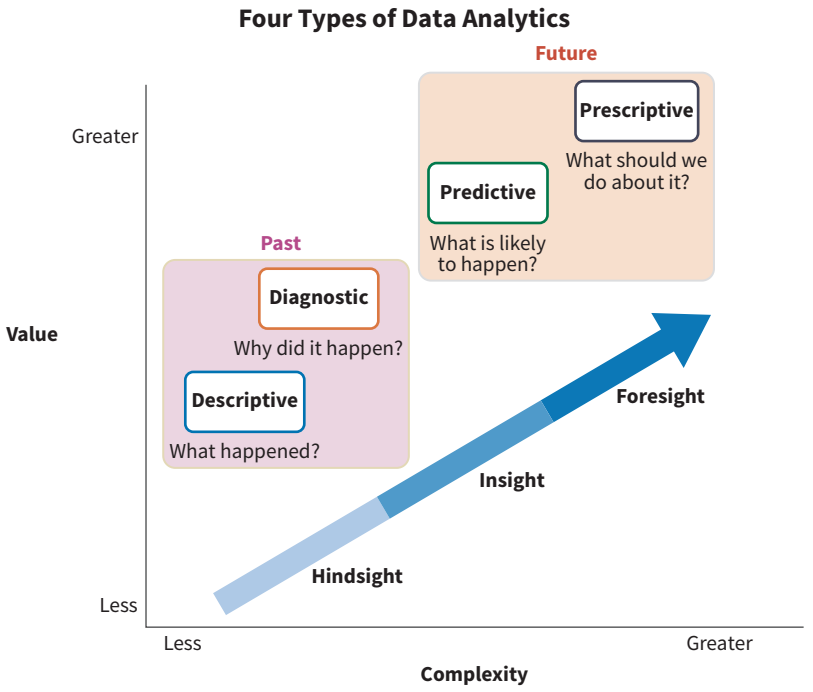
Helpful Hints further clarify concepts being discussed.

HELPFUL HINT

Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.

ILLUSTRATION 1.4

Four types of data analytics



Insight boxes provide examples of business situations from various perspectives—ethics; investor, global; environmental, social, and governance; and data analytics.

Data Analytics Insight Netflix

UnSplash

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And **Netflix** (USA), the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making? (Answer is available near the end of the chapter.)

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

ACTION PLAN

- **Review the basic concepts discussed.**
- **Develop an understanding of the key terms used.**

DO IT! 1 | Basic Concepts

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

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

Solution

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

Related exercise material: **DO IT! 1.1, E1.1, and E1.2.**

1.2 The Building Blocks of Accounting

LEARNING OBJECTIVE 2

Explain the building blocks of accounting: ethics, principles, and assumptions.

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

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't invest in the securities market if they think share prices are rigged. In recent years, the financial press has been full of articles about financial scandals at **Mahindra Satyam** (IND), **Toshiba** (JPN), **Pou Sheng International** (HKG), **Siwei** (CHN), and other companies.

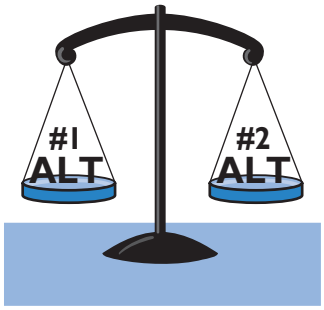
As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent share prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this text:

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

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in **Illustration 1.5**.

ILLUSTRATION 1.5 **Steps in analyzing ethics cases and situations**



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

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

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

Ethics Insight Toshiba

nmann77/Adobe Stock

Loyalty to Your Employer Is Great, Until It Is Not

A common attribute of Japanese employees is a culture of strong loyalty to their employer. This loyalty arises out of a common practice of lifetime employment combined with a general cultural value of respect. While strong loyalty is a positive in many respects, it can create challenges in some circumstances.

For example, **Toshiba** (JPN), like many Japanese businesses, was severely affected by a series of events in the early 2000s. First, the company, along with the rest of the world, experienced the financial crisis and subsequent global recession in 2008 and 2009. Next, in 2011, an earthquake and subsequent tsunami in northern Japan triggered a significant recession in Japan. The company experienced a 14% decline in revenue from 2007 to 2013, and a 90% decline in profits over the same period.

In response to these events, company leadership began to pressure divisional and mid-level managers to achieve unreasonable financial goals. These managers, unable to meet the unreasonably high performance expectations and influenced by a strong culture of loyalty and respect, were left with little choice but to create profits where there were none. They committed a number of financial frauds, including unreasonable estimates and improper recording of transactions with suppliers.

In 2015, when these matters came to light, it was determined that reported revenues during this period had been overstated by ¥129 million and profits for the period has been overstated by ¥477 million.

Source: Based on Dennis Caplan, Saurav Dutta, and David Marchinko, "Unmasking the Fraud at Toshiba," *Issues in Accounting Education*, Vol. 34, No. 3 (August 2019).

What would you do if your company asked you to misreport an item? (Answer is available near the end of the chapter.)

Accounting Standards

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies. Presently, there are two primary accounting standard-setting bodies—the **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**.

- More than 150 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**.
- IFRSs are determined by the IASB. The IASB is headquartered in London, with its board members drawn from around the world.
- Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP)**.

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. We provide at the end of each chapter a section called *A Look at U.S. GAAP*, to provide a comparison with IFRS.

Global Insight

Toru-Hanai/Pool/
Getty Images

The Korean Discount

If you think that accounting standards don't matter, consider these 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 share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would 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: Based on 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? (Answer is available at the end of the chapter.)

Measurement Principles

IFRS uses one of two measurement bases, the historical cost basis or the current value basis. Selection of which basis to use is generally determined by considering the qualitative characteristics of useful information, including relevance and faithful representation (see **Helpful Hint**). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

HELPFUL HINT

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

Historical Cost

The **historical cost basis** records and reports assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if Great Wall Manufacturing purchases land for ¥300,000 (amounts in thousands), the company initially reports it in its accounting records at ¥300,000. But what does Great Wall do if, by the end of the next year, the current value of the land has increased to ¥400,000? Under the historical cost basis, it continues to report the land at ¥300,000.

Current Value

The **current value basis** records and reports assets and other accounts at current value. Depending on the nature of the item being reported, current value is determined based on the item's fair value (the price received to sell an asset or settle a liability), value in use (the present value of the future cash flows associated with the item), or current cost (the current replacement cost of the item).

Current value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at current value because market value information is usually readily available for these types of assets.

- In determining which measurement basis to use, companies weigh the factual nature of historical cost figures versus the relevance of current value.
- In general, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to current value, most companies choose to use cost.

Only in situations where assets are actively traded, such as investment securities, do companies apply the current value extensively.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to using the historical cost basis.

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

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

ETHICS NOTE

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

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

Economic Entity Assumption

An economic entity can be any organization or unit in society. It may be a company (such as **Maruti Suzuki** (IND)), a governmental unit (the Indonesian province of Papua), a municipality (Beijing), or a temple (the Temple of the Six Banyan Trees). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Barb Su, owner of Barb's Bike Shop, must keep her personal living costs separate from the expenses of the business. Similarly, **Maxway Cycles Co.** (TWN) and **Asia Bicycle Trading Company** (TWN) are segregated into separate economic entities for accounting purposes (see **Ethics Note**).

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

- Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship.
- The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.

There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved.

- Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner.
- Each partner generally has unlimited personal liability for the debts of the partnership.
- Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.

Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and accountants).

Corporation A business organized as a separate legal entity under jurisdiction corporation law and having ownership divided into transferable shares is a **corporation**.

- The holders of the shares (shareholders) enjoy limited liability; that is, they are not personally liable for the debts of the corporate entity.
- Shareholders may transfer all or part of their ownership shares to other investors at any time (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation.
- Because ownership can be transferred without dissolving the corporation, the corporation enjoys an unlimited life.

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

Accounting Across the Organization

blublaf/E+/Getty Images

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 the following.

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

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

Finance: Do you want to be a banker for **Shanghai Commercial and Savings Bank** (TWN) 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 **Hong Kong Property Services** (HKG)? 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?

How might accounting help you? (Answer is available near the end of the chapter.)

DO IT! 2 | Building Blocks of Accounting

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

1. Ethics are the standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).
3. An asset recorded using the historical cost basis results in recording assets at their cost. In later periods, however, the current value of the asset must be used if current value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

ACTION PLAN

- **Review the discussion of ethics and financial reporting standards.**
- **Develop an understanding of the key terms used.**

Solution

1. True. **2.** True. **3.** False. Assets recorded using the historical cost basis are not adjusted in later periods to current value. They remain at their original cost. **4.** False. Faithful representation means that financial information matches what really happened; the information is factual. **5.** True.

Related exercise material: **DO IT! 1.2, E1.3, and E1.4.**

1.3 The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes.

- **Assets** are the resources a business owns. For example, **adidas** (DEU) has total assets of approximately €15,176 billion. Liabilities and equity are the rights or claims against these resources. Thus, adidas has €15,176 billion of claims against its €15,176 billion of assets.
- Claims of those to whom the company owes money (creditors) are called **liabilities**.
- Claims of owners are called **equity**. adidas has liabilities of €8,721 billion and equity of €6,455 billion.

We can express the relationship of assets, liabilities, and equity as an equation, as shown in **Illustration 1.6**.

ILLUSTRATION 1.6
The basic accounting equation

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

This relationship is the **basic accounting equation**.

- Assets must equal the sum of liabilities and equity.
- Liabilities appear before equity in the basic accounting equation because they are paid first if a business is liquidated.

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

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

Assets

As noted previously, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales.

- The common characteristic possessed by all assets is **the capacity to provide future services or benefits**.
- In a business, that service potential or future economic benefit eventually results in cash inflows (receipts).

For example, consider Taipei Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Taipei Pizza are tables, chairs, sound system, cash register, oven, tableware, and, of course, cash.

Liabilities

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

- Taipei Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Taipei Pizza also has a **note payable** to First Bank for the money borrowed to purchase the delivery truck.
- Taipei Pizza may also have **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Taipei Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

Equity

The ownership claim on a company's total assets is **equity**. It is equal to total assets minus total liabilities. Here is why.

- The assets of a business are claimed by either creditors or shareholders. To find out what belongs to shareholders, we subtract creditors' claims (the liabilities) from the assets.
- The remainder is the shareholders' claim on the assets—equity. It is often referred to as **residual equity**—that is, the equity "left over" after creditors' claims are satisfied.

Equity generally consists of (1) share capital—ordinary and (2) retained earnings.

Share Capital—Ordinary

A company may obtain funds by selling ordinary shares to investors. **Share capital—ordinary** is the term used to describe the amounts paid in by shareholders for the ordinary shares they purchase.

Retained Earnings

Retained earnings is determined by three items: revenues, expenses, and dividends.

Revenues **Revenues** **are the gross increases in equity resulting from business activities entered into for the purpose of earning income** (see **Helpful Hint**).[3] Generally, revenues result from selling merchandise, performing services, renting property, and lending money.

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Taipai Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are sales, fees, services, commissions, interest, dividends, royalties, and rent.

HELPFUL HINT

The effect of revenues is positive—an increase in equity coupled with an increase in assets or a decrease in liabilities.

Expenses **Expenses** are the cost of assets consumed or services used in the process of earning revenue. **They are decreases in equity that result from operating the business** (see **Helpful Hint**). Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used.

For example, Taipai Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.), cost of beverages, wages expense,

HELPFUL HINT

The effect of expenses is negative—a decrease in equity coupled with a decrease in assets or an increase in liabilities.

[3]IFRS uses both the term income and the term revenue to refer to the increase in equity resulting from business activities entered into for the purpose of earning income. To avoid confusion, we will use the term revenue consistently in this text.

utilities expense (electric, gas, and water expense), telephone expense, delivery expense (gasoline, repairs, licenses, etc.), supplies expense (napkins, detergents, aprons, etc.), rent expense, interest expense, and property tax expense.

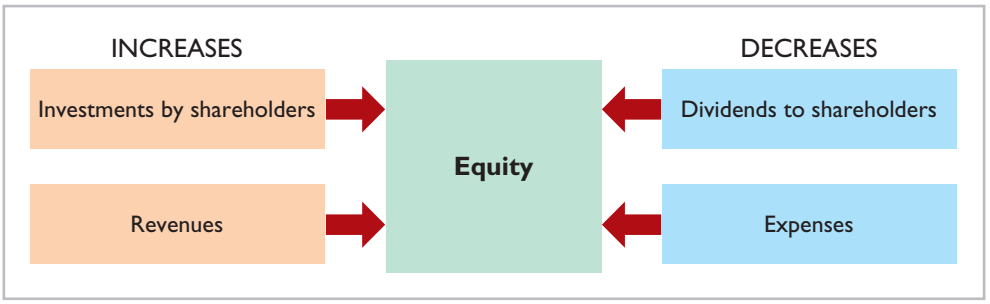
Dividends Net income represents an increase in net assets which is then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a **dividend**.

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

A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the shareholders).

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast, reductions (decreases) in equity result from expenses and dividends. These relationships are shown in **Illustration 1.7**.

ILLUSTRATION 1.7 **Increases and decreases in equity**



ACTION PLAN

- **Understand the sources of revenue.**
- **Understand what causes expenses.**
- **Review the rules for changes in equity: Investments and revenues increase equity. Expenses and dividends decrease equity.**
- **Recognize that dividends are distributions of cash or other assets to shareholders.**

DO IT! 3 | Equity Effects

Classify the following items as issuance of shares (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

a. Rent Expense.
b. Service Revenue.
c. Dividends.
d. Salaries and Wages Expense.

Solution

a. Rent Expense is an expense (E); it decreases equity. **b.** Service Revenue is a revenue (R); it increases equity. **c.** Dividends is a distribution to shareholders (D); it decreases equity. **d.** Salaries and Wages Expense is an expense (E); it decreases equity.

Related exercise material: **BE1.1, BE1.2, BE1.3, BE1.4, BE1.5, BE1.6, DO IT! 1.3, and E1.5.**

1.4 Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.

*This **accounting cycle graphic** illustrates the steps companies follow each period to record transactions and eventually prepare financial statements.*

The system of collecting and processing transaction data and communicating financial information to decision-makers is known as the **accounting information system**. Factors that shape an accounting information system include the nature of the company's business, the types of transactions, the size of the company, the volume of data, and the information demands of management and others.

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. Many companies upgraded their accounting information systems to prevent cybersecurity attacks. In addition, companies are utilizing new technologies.

- Cloud-based storage permits employees to access records from different locations.
- Data automation and analytics tools help companies interpret large volumes of data to support enhanced decision-making and automating routine processes.

In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** (USA) stated, "We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area."

Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic, the accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters 2–4.

In this text, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

Accounting Transactions

Transactions (**business transactions**) are a business's economic events recorded by accountants. Transactions may be external or internal.

- **External transactions** involve economic events between the company and some outside enterprise. For example, Taipai Pizza's purchase of cooking equipment from a supplier, payment of monthly rent to the landlord, and sale of pizzas to customers are external transactions.
- **Internal transactions** are economic events that occur entirely within one company. The use of cooking and cleaning supplies are internal transactions for Taipai Pizza.

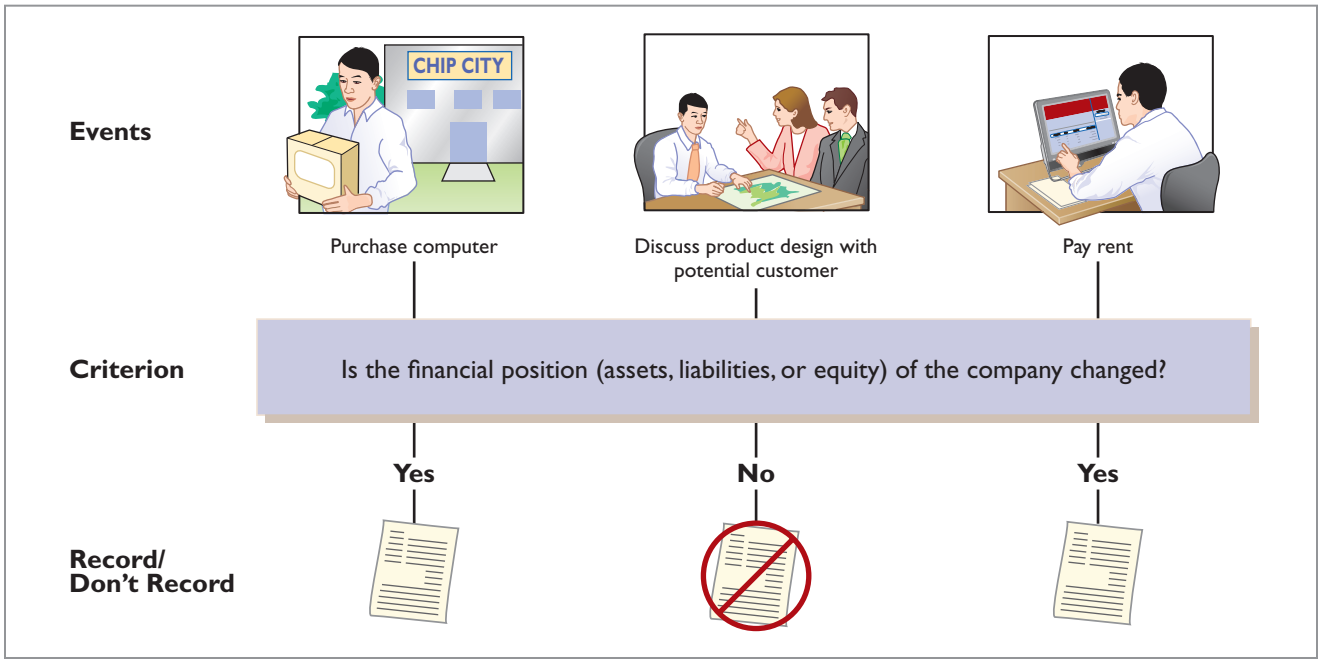
Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions. Employees will earn wages, and suppliers will deliver ordered merchandise.

A company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. **Illustration 1.8** demonstrates the transaction identification process.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding:

- Decrease in another asset, *or*
- Increase in a specific liability, *or*
- Increase in equity.

ILLUSTRATION 1.8 **Transaction identification process**



Two or more items could be affected. For example, as one asset is increased €10,000, another asset could decrease €6,000 and a liability could increase €4,000. Any change in a liability or ownership claim is subject to similar analysis.

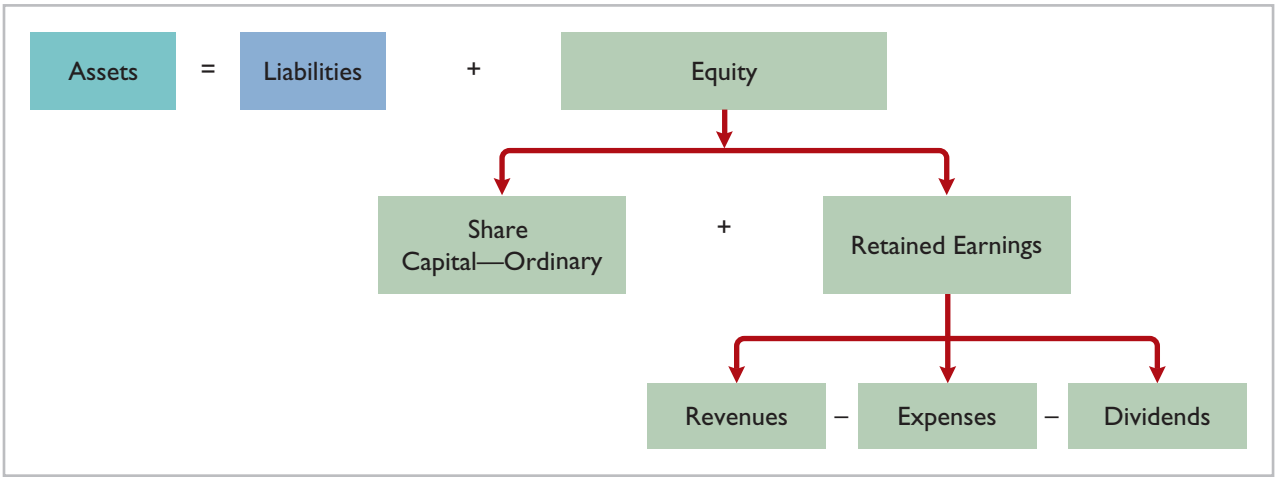
Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte SA. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on equity. Recall that equity is comprised of two parts: share capital—ordinary and retained earnings.

- Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash.
- Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends.

Illustration 1.9 shows the **expanded accounting equation**.

ILLUSTRATION 1.9 **Expanded accounting equation**



If you are tempted to skip ahead after you've read a few of the following transaction analyses, don't do it. Each has something unique to teach, something you'll need later (see **Helpful Hint**). (We assure you that we've kept them to the minimum needed!)

HELPFUL HINT

You will want to study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.

Transaction (1). Investment by Shareholders Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2025, 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.[4]

Basic Analysis	The asset Cash increases €15,000, and equity identified as Share Capital—Ordinary increases €15,000.

Equation Analysis

	Assets	=	Liabilities	+	Equity	
	Cash	=			Share Capital	
(1)	**+€15,000**	**=**			**+€15,000**	**Issued Shares**

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, issued shares) is indicated. Why does this matter?

- Because investments by shareholders do not represent revenues, and they are excluded in determining net income.
- Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations.

Additional investments (i.e., investments made by shareholders after the corporation has been initially formed) have the same effect on equity as the initial investment.

Transaction (2). Purchase of Equipment for Cash Softbyte SA purchases computer equipment for €7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

Basic Analysis	The asset Cash decreases €7,000, and the asset Equipment increases €7,000.

Equation Analysis

	Assets			=	Liabilities	+	Equity
	Cash	+	Equipment	=			Share Capital
	€15,000						€15,000
(2)	**−7,000**		**+€7,000**				
	€ 8,000	+	€7,000	=			€15,000
	€15,000						

Observe that total assets are still €15,000. Share Capital—Ordinary also remains at €15,000, the amount of the original investment.

Transaction (3). Purchase of Supplies on Credit Softbyte SA purchases headsets (and other computer accessories expected to last several months) for €1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October.

- This transaction is a purchase on account (a credit purchase).
- Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions.

[4]For the illustrative equations that follow, we use the general account title "Share Capital" instead of "Share Capital—Ordinary" for space considerations.

Basic Analysis

The asset Supplies increases €1,600, and the liability Accounts Payable increases €1,600.

Equation Analysis

	Assets					=	Liabilities	+	Equity
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital
	€8,000				€7,000				€15,000
(3)			+€1,600				+€1,600		
	€8,000	+	€1,600	+	€7,000	=	€1,600	+	€15,000
			€16,600				€16,600		

Total assets are now €16,600. This total is matched by a €1,600 creditor's claim and a €15,000 ownership claim.

Transaction (4). Services Performed for Cash Softbyte SA receives €1,200 cash from customers for app development services it has performed. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases equity**.

Basic Analysis

The asset Cash increases €1,200, and equity increases €1,200 due to Service Revenue.

Equation Analysis

	Assets					=	Liabilities	+	Equity					
										Retained Earnings				
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Rev.	−	Exp.	− Div.
	€8,000		€1,600		€7,000		€1,600		€15,000					
(4)	+1,200										+€1,200			
	€9,200	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+	€1,200			
			€17,800						€17,800					

Service Revenue

The two sides of the equation balance at €17,800. Service Revenue is included in determining Softbyte's net income.

- Note that we do not have room to give details for each individual revenue and expense account in this illustration. Thus, revenues (and expenses when we get to them) are summarized under one column heading for Revenues and one for Expenses.
- However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements later in the chapter.

Transaction (5). Purchase of Advertising on Credit Softbyte SA receives a bill for €250 from *Programming News* for advertising on its website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in equity.

Basic Analysis

The liability Accounts Payable increases €250, and equity decreases €250 due to Advertising Expense.

Equation Analysis

	Assets					=	Liabilities	+	Equity					
										Retained Earnings				
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Rev.	−	Exp.	− Div.
	€9,200		€1,600		€7,000		€1,600		€15,000		€1,200			
(5)							+250						−€250	
	€9,200	+	€1,600	+	€7,000	=	€1,850	+	€15,000	+	€1,200	−	€250	
			€17,800						€17,800					

Advertising Expense

The two sides of the equation still balance at €17,800. Retained Earnings decreases when Softbyte incurs the expense.

- Expenses do not have to be paid in cash at the time they are incurred.
- When Softbyte pays at a later date, the liability Accounts Payable will decrease and the asset Cash will decrease [see Transaction (8)].

The cost of advertising is an expense (rather than an asset) because Softbyte has used the benefits. Advertising Expense is included in determining net income.

Transaction (6). Services Performed for Cash and Credit Softbyte SA performs €3,500 of app development services for customers. The company receives cash of €1,500 from customers, and it bills the balance of €2,000 on account. This transaction results in an equal increase in assets and equity.

Basic Analysis	Three specific items are affected: The asset Cash increases €1,500, the asset Accounts Receivable increases €2,000, and equity increases €3,500 due to Service Revenue.

Equation Analysis

	Assets				= Liabilities +	Equity					
		Accounts			Accounts	Share	Retained Earnings				
	Cash +	Receivable +	Supplies +	Equipment	= Payable +	Capital +	Rev.	−	Exp.	− Div.	
	€ 9,200		€1,600	€7,000	€1,850	€15,000	€1,200		€250		
(6)	**+1,500**	**+€2,000**					**+3,500**				**Service Revenue**
	€10,700 +	€2,000 +	€1,600 +	€7,000	= €1,850 +	€15,000 +	€4,700	−	€250		
	€21,300				€21,300						

Softbyte recognizes €3,500 in revenue when it performs the services. In exchange for these services, it received €1,500 in Cash and Accounts Receivable of €2,000. This Accounts Receivable represents customers' promise to pay €2,000 to Softbyte in the future. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

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. These payments result in an equal decrease in assets and equity.

Basic Analysis	The asset Cash decreases €1,700, and equity decreases €1,700 due to the following specific expenses: Rent Expense, Salaries and Wages Expense, and Utilities Expense.

Equation Analysis

	Assets				= Liabilities +	Equity					
		Accounts			Accounts	Share	Retained Earnings				
	Cash +	Receivable +	Supplies +	Equipment	= Payable +	Capital +	Rev.	−	Exp.	− Div.	
	€10,700	€2,000	€1,600	€7,000	€1,850	€15,000	€4,700		€ 250		
(7)	**−1,700**								**−600**		**Rent Exp.**
									−900		**Sal./Wages Exp.**
									−200		**Utilities Exp.**
	€ 9,000 +	€2,000 +	€1,600 +	€7,000	= €1,850 +	€15,000 +	€4,700	−	€1,950		
	€19,600				€19,600						

The two sides of the equation now balance at €19,600. Three lines are required in the analysis to indicate the different types of expenses that have been incurred.

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 and a decrease in equity.

Basic Analysis

This cash payment "on account" decreases the asset Cash by €250 and also decreases the liability Accounts Payable by €250.

Equation Analysis

	Assets							=	Liabilities	+	Equity						
			Accounts						Accounts		Share		Retained Earnings				
	Cash	+	Receivable	+	Supplies	+	Equipment	=	Payable	+	Capital	+	Rev.	−	Exp.	−	Div.
	€9,000		€2,000		€1,600		€7,000		€1,850		€15,000		€4,700		€1,950		
(8)	**−250**								**−250**								
	€8,750	+	€2,000	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+	€4,700	−	€1,950		
	€19,350								€19,350								

Observe that the payment of a liability related to an expense that has previously been recorded does not affect equity. Softbyte recorded the expense [in Transaction (5)] and should not record it again.

Transaction (9). Receipt of Cash on Account Softbyte SA receives €600 in cash from customers who had been billed for services [in Transaction (6)]. Transaction (9) does not change total assets, but it changes the composition of those assets.

Basic Analysis

The asset Cash increases €600, and the asset Accounts Receivable decreases €600.

Equation Analysis

	Assets							=	Liabilities	+	Equity						
			Accounts						Accounts		Share		Retained Earnings				
	Cash	+	Receivable	+	Supplies	+	Equipment	=	Payable	+	Capital	+	Rev.	−	Exp.	−	Div.
	€8,750		€2,000		€1,600		€7,000		€1,600		€15,000		€4,700		€1,950		
(9)	**+600**		**−600**														
	€9,350	+	€1,400	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+	€4,700	−	€1,950		
	€19,350								€19,350								

Note that the collection of an account receivable for services previously billed and recorded does not affect equity. Softbyte already recorded this revenue [in Transaction (6)] and should not record it again.

Transaction (10). Dividends The company pays a dividend of €1,300 in cash to Ray and Barbara Neal, the shareholders of Softbyte SA. This transaction results in an equal decrease in assets and equity.

Basic Analysis

The asset Cash decreases €1,300, and equity decreases €1,300 due to dividends.

Equation Analysis

	Assets							=	Liabilities	+	Equity							
			Accounts						Accounts		Share		Retained Earnings					
	Cash	+	Receivable	+	Supplies	+	Equipment	=	Payable	+	Capital	+	Rev.	−	Exp.	−	Div.	
	€9,350		€1,400		€1,600		€7,000		€1,600		€15,000		€4,700		€1,950			
(10)	**−1,300**																**−€1,300**	**Dividends**
	€8,050	+	€1,400	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+	€4,700	−	€1,950	−	€1,300	
	€18,050								€18,050									

Note that the dividend reduces retained earnings, which is part of equity. **Dividends are not expenses**. Like shareholders' investments, dividends are excluded in determining net income.

Summary of Transactions

Illustration 1.10 summarizes the September transactions of Softbyte SA to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction. Finally, Illustration 1.10 demonstrates a number of significant facts:

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.

ILLUSTRATION 1.10 **Tabular summary of Softbyte SA transactions**

	Assets							= Liabilities +	Equity					
											Retained Earnings			
Trans-action	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	= Accounts Payable	+ Share Capital	+	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)	–1,300												–€1,300	**Dividends**
	€ 8,050	+	€1,400	+	€1,600	+	€7,000	= €1,600	+ €15,000	+	€4,700	– €1,950	– €1,300	
	€18,050								**€18,050**					

There! You made it through transaction analysis. If you feel a bit shaky on any of the transactions, it might be a good idea at this point to get up, take a short break, and come back again for a brief (10- to 15-minute) review of the transactions, to make sure you understand them before you go on to the next section.

DO IT! 4 | Tabular Analysis

Transactions made by Virmari & Co., a public accounting firm in France, 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.

ACTION PLAN

- **Analyze the effects of each transaction on the accounting equation.**
- **Use appropriate category names (not descriptions).**
- **Keep the accounting equation in balance.**

Solution

	Assets			=	Liabilities	+	Equity							
									Retained Earnings					
Trans-action	Cash	+	Equipment	=	Accounts Payable	+	Share Capital	+	Rev.	–	Exp.	–	Div.	
(1)	+€25,000						+€25,000							
(2)			+€7,000		+€7,000									
(3)	+8,000								+€8,000					**Service Revenue**
(4)	–850										–€850			**Rent Expense**
(5)	–1,000												–€1,000	**Dividends**
	€31,150	+	€7,000	=	€7,000	+	€25,000	+	€8,000	–	€850	–	€1,000	
	€38,150				€38,150									

Related exercise material: **BE1.7, BE1.8, BE1.9, DO IT! 1.4, E1.6, E1.7, and E1.8.**

1.5 Financial Statements

LEARNING OBJECTIVE 5

Describe the five financial statements and how they are prepared.

HELPFUL HINT

The income statement, retained earnings statement, statement of cash flows, and comprehensive income statement are all for a *period* of time, whereas the statement of financial position is for a *point* in time.

Companies prepare five financial statements from the summarized accounting data (see **Helpful Hint**):

1. An **income statement** presents the revenues and expenses and resulting net income or net loss for a specific period of time.
2. A **retained earnings statement** summarizes the changes in retained earnings for a specific period of time.[5]
3. A **statement of financial position** (sometimes referred to as a *balance sheet*) reports the assets, liabilities, and equity of a company at a specific date.
4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
5. A **comprehensive income statement** presents other comprehensive income items that are not included in the determination of net income. Note that IFRS contains two concepts of income: net income and comprehensive income. In later chapters, we will provide more insight into the differences between these two income concepts.

These statements provide relevant financial data for internal and external users. **Illustration 1.11** shows the first four financial statements from the above list of Softbyte SA (see **Helpful Hints**). (Illustration 1.11 assumes Softbyte has no other comprehensive income items.) A comprehensive income statement is presented in Illustration 1.13 for Softbyte.

Note that the statements shown in Illustration 1.11 are interrelated:

1. Net income of €2,750 on the **income statement** is added to the beginning balance of retained earnings in the **retained earnings statement**.
2. Retained earnings of €1,450 at the end of the reporting period shown in the **retained earnings statement** is reported on the **statement of financial position**.
3. Cash of €8,050 on the **statement of financial position** is reported on the **statement of cash flows**.

Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate these notes and schedules in later chapters of this text.

Be sure to carefully examine the format and content of each statement in Illustration 1.11. We describe the essential features of each in the following sections.

[5]Most companies prepare a statement of changes in equity, which includes the information for the retained earnings statement along with the sources of the changes in the other equity accounts.

ILLUSTRATION 1.11

Financial statements and their interrelationships

Softbyte SA
Income Statement
For the Month Ended September 30, 2025

Revenues		
Service revenue		€4,700
Expenses		
Salaries and wages expense	€900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		**€2,750**

Softbyte SA
Retained Earnings Statement
For the Month Ended September 30, 2025

Retained earnings, September 1	€ 0
Add: Net income	**2,750**
	2,750
Less: Dividends	1,300
Retained earnings, September 30	**€1,450**

Softbyte SA
Statement of Financial Position
September 30, 2025

Assets		
Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		**8,050**
Total assets		€18,050
Equity and Liabilities		
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, 2025

Cash flows from operating activities		
Cash receipts from revenues		€ 3,300
Cash payments for expenses		(1,950)
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)	13,700
Net increase in cash		8,050
Cash at the beginning of the period		0
Cash at the end of the period		**€ 8,050**

1

2

3

HELPFUL HINT

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

HELPFUL HINT

The arrows in this illustration show the interrelationships of the four financial statements.

1. **Net income is computed first and is needed to determine the ending balance in retained earnings.**
2. **The ending balance in retained earnings is needed in preparing the statement of financial position.**
3. **The cash shown on the statement of financial position is needed in preparing the statement of cash flows.**

HELPFUL HINT

Note that final sums are double-underlined, and negative amounts (in the statement of cash flows) are presented in parentheses.

Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time. For example, Softbyte SA's income statement is dated "For the Month Ended September 30, 2025." It is prepared from the data appearing in the revenue and expense columns of Illustration 1.10. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

- The income statement lists revenues first, followed by expenses.
- Then, the statement shows net income (or net loss).
- When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

Although practice varies, we have chosen to list expenses in order of magnitude in our illustrations. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the shareholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte SA was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in equity.

Retained Earnings Statement

Softbyte SA's 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 ("For the Month Ended September 30, 2025"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1.10) and from the income statement (Illustration 1.11).

- The first line of the statement shows the beginning retained earnings amount, followed by net income and dividends.
- The retained earnings ending balance is the final amount on the statement.
- The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

Statement of Financial Position

Softbyte SA's statement of financial position reports the assets, liabilities, and equity at a specific date (September 30, 2025). The company prepares the statement of financial position from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1.10).

- Observe that the statement of financial position lists assets at the top, followed by equity and then liabilities.
- Total assets must equal total equity and liabilities.

Softbyte SA reports only one liability, Accounts Payable, on its statement of financial position. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in **Illustration 1.12**.

ILLUSTRATION 1.12
Presentation of liabilities

Liabilities	
Notes payable	€10,000
Accounts payable	63,000
Salaries and wages payable	18,000
Total liabilities	**€91,000**

The statement of financial position is like a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

Accounting Across the Organization Vodafone

Chris Ison/AP Photos

A Wise End

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 Company** (USA), the Saturday closest to September 30; and **Diageo** (GBR), June 30. Why do companies choose the particular year-ends that they do?

Many companies 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.

What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends? (Answer is available near the end of the chapter.)

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing activities, (3) its financing activities, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period (see **Helpful Hint**).

HELPFUL HINT

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

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

As shown in Softbyte SA's statement of cash flows in Illustration 1.11, cash increased €8,050 during the period. Net cash provided by operating activities increased cash €1,350. Cash flow from investing activities decreased cash €7,000. And cash flow from financing activities increased cash €13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 13 will examine in detail how the statement is prepared.

Comprehensive Income Statement

In some cases, Softbyte SA must prepare a comprehensive income statement in addition to its income statement. Softbyte prepares this second statement if it has other comprehensive income items.

- Other comprehensive income items are not part of net income but are considered important enough to be reported separately.
- Softbyte adds other comprehensive income to net income to arrive at comprehensive income.

Illustration 1.13 shows a comprehensive income statement, assuming that Softbyte SA has other comprehensive income of €600.

ILLUSTRATION 1.13
Comprehensive income statement

Softbyte SA
Comprehensive Income Statement
For the Month Ended September 30, 2025

Net income	€2,750
Other comprehensive income	600
Comprehensive income	€3,350

In this two statement format, the comprehensive income statement is reported directly after the traditional income statement. Examples of this two statement format can be seen in the financial statements of **Nestlé** and **Delfi Limited** in Appendices B and C, respectively.

IFRS does allow an alternative statement format in which the information contained in the income statement and the comprehensive income statement are combined in a single statement, referred to as a **statement of comprehensive income**. An example of this approach can be seen in the financial statements of **TSMC** in Appendix A. *In this text, we use the two statement approach*. We provide a more detailed discussion about the components of other comprehensive income in later chapters.

Environmental, Social, and Governance Insight

Marek Uliasz/
Getty Images

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 interesting and useful efforts are underway.

Throughout this text, 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.

Why might a company's shareholders be interested in its environmental and social performance? (Answer is available near the end of the chapter.)

ACTION PLAN

- **Remember the basic accounting equation: assets must equal liabilities plus equity.**
- **Review previous financial statements to determine how total assets, net income, and equity are computed.**

DO IT! 5 | Financial Statement Items

Presented below is selected information related to Li Fashions at December 31, 2025. Li reports financial information monthly.

Equipment	HK$10,000	Utilities Expense	HK$ 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 Li at December 31, 2025.

b. Determine the net income that Li reported for December 2025.

c. Determine the equity of Li at December 31, 2025.

Solution

a. The total assets are HK$27,000, comprised of Equipment HK$10,000, Accounts Receivable HK$9,000, and Cash HK$8,000.

b. Net income is HK$14,000, computed as follows.

Revenues		
Service revenue		HK$36,000
Expenses		
Rent expense	HK$11,000	
Salaries and wages expense	7,000	
Utilities expense	4,000	
Total expenses		22,000
Net income		HK$14,000

c. The ending equity of Li Fashions is HK$8,500. By rewriting the accounting equation, we can compute equity as assets minus liabilities, as follows.

Total assets [as computed in (a)]		HK$27,000
Less: Liabilities		
Notes payable	HK$16,500	
Accounts payable	2,000	18,500
Equity		HK$ 8,500

Note that it is not possible to determine the company's equity in any other way because the beginning total for equity is not provided.

Related exercise material: **BE1.10, BE1.11, DO IT! 1.5, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16, E1.17, and E1.18.**

Appendix 1A Career Opportunities in Accounting

LEARNING OBJECTIVE *6

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

- There are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."
- It is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the turmoil over toxic (misstated) assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
- Recent internal control requirements dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, an independent accountant such as a Chartered Accountant (CA) or a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position in accordance with international financial reporting standards. Analysts, investors, and creditors rely heavily on these "audit opinions," which CAs and CPAs have the exclusive authority to issue.

Taxation is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies.

A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to performing support services for major marketing projects and merger and acquisition activities.

Many accountants are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Sinopec** (CHN), **Google** (USA), or **Samsung** (KOR). In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation. You might also be a member of your company's internal audit team. In response to increased internal control requirements, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on greater importance.

Alternatively, many accountants work for not-for-profit organizations such as the **International Red Cross** (CHE) or the **Bill and Melinda Gates Foundation** (USA), or for museums, libraries, or performing arts organizations.

Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, tax authorities, law enforcement agencies, and company regulators all employ accountants. There is also a very high demand for accounting educators at public colleges and universities and in local governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of theft and fraud occurring at companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

The Review and Practice section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Review and Practice

Learning Objectives Review

1 Identify the activities and users associated with accounting.

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labor unions.

2 Explain the building blocks of accounting: ethics, principles, and assumptions.

Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behavior.

Accounting is based on standards such as International Financial Reporting Standards (IFRS). IFRS generally uses one of two measurement principles. The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

3 State the accounting equation, and define its components.

The basic accounting equation is:

Assets = Liabilities + Equity

Assets are resources a business owns. Liabilities are creditorship claims on total assets. Equity is the ownership claim on total assets.

The expanded accounting equation is:

Assets = Liabilities + Share Capital—Ordinary
+ Revenues − Expenses − Dividends

Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash. Revenues are the gross increase in equity resulting from business activities for the purpose of earning income. Expenses are the costs of assets consumed or services used in the process of earning revenue. Dividends are payments the company makes to its shareholders.

4 Analyze the effects of business transactions on the accounting equation.

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in equity.

5 Describe the five financial statements and how they are prepared.

An income statement presents the revenues and expenses, and resulting net income or net loss, for a specific period of time. A retained earnings statement summarizes the changes in retained earnings for a specific period of time. A statement of financial position reports the assets, liabilities, and equity at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time. A comprehensive income statement adds or subtracts any items of other comprehensive income to net income to arrive at comprehensive income.

*6 Explain the career opportunities in accounting.

Accounting offers many different jobs in fields such as public and private accounting, governmental, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

Glossary Review

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-3).

Accounting information system The system of collecting and processing transaction data and communicating financial information to decision-makers. (p. 1-15).

Assets Resources a business owns. (p. 1-12).

***Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 1-27).

Basic accounting equation Assets = Liabilities + Equity. (p. 1-12).

Bookkeeping A part of the accounting process that involves only the recording of economic events. (p. 1-4).

Comprehensive income statement A financial statement that presents items that are not included in the determination of net income, referred to as other comprehensive income. (p. 1-22).

Corporation A business organized as a separate legal entity under jurisdiction corporation law, having ownership divided into transferable shares. (p. 1-11).

Current value basis A measurement basis that results in reporting assets and liabilities at current value. (p. 1-9).

Data analytics The evaluation of data, often employing both software and statistics, to draw inferences. (p. 1-5).

Dividend A distribution of cash or other assets by a corporation to its shareholders. (p. 1-14).

Economic entity assumption An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 1-10).

Equity The ownership claim on a company's total assets. (p. 1-13).

Ethics The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 1-7).

Expanded accounting equation Assets = Liabilities + Share Capital—Ordinary + Revenues − Expenses − Dividends. (p. 1-16).

Expenses The cost of assets consumed or services used in the process of earning revenue. (p. 1-13).

Faithful representation Numbers and descriptions match what really existed or happened—they are factual. (p. 1-9).

Financial accounting The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 1-5).

Financial Accounting Standards Board (FASB) A private organization that establishes generally accepted accounting principles (GAAP) in the United States. (p. 1-8).

***Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-28).

Generally accepted accounting principles (GAAP) Common U.S. standards that indicate how to report economic events. (p. 1-8).

Historical cost basis A measurement basis that results in companies recording assets and other accounts at their cost. (p. 1-9).

Income statement A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. (p. 1-22).

International Accounting Standards Board (IASB) An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 1-8).

International Financial Reporting Standards (IFRS) International accounting standards set by the International Accounting Standards Board (IASB). (p. 1-8).

Liabilities Creditor claims on total assets. (p. 1-13).

*Management consulting An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-27).

Managerial accounting The field of accounting that provides internal reports to help users make decisions about their companies. (p. 1-5).

Monetary unit assumption An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 1-10).

Net income The amount by which revenues exceed expenses. (p. 1-24).

Net loss The amount by which expenses exceed revenues. (p. 1-24).

Partnership A business owned by two or more persons associated as partners. (p. 1-10).

*Private (or managerial) accounting An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation. (p. 1-28).

Proprietorship A business owned by one person. (p. 1-10).

*Public accounting An area of accounting in which the accountant offers expert service to the general public. (p. 1-27).

Relevance Financial information that is capable of making a difference in a decision. (p. 1-9).

Retained earnings statement A financial statement that summarizes the changes in retained earnings for a specific period of time. (p. 1-22).

Revenues The gross increase in equity resulting from business activities entered into for the purpose of earning income. (p. 1-13).

Share capital—ordinary Amounts paid in by shareholders for the ordinary shares they purchase. (p. 1-13).

Statement of cash flows A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 1-22).

Statement of financial position (balance sheet) A financial statement that reports the assets, liabilities, and equity of a company at a specific date. (p. 1-22).

*Taxation An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-27).

Transactions The economic events of a business that are recorded by accountants. (p. 1-15).

Practice Multiple-Choice Questions

1. **(LO 1)** Which of the following is **not** a step in the accounting process?

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

2. **(LO 1)** Which of the following statements about users of accounting information is **incorrect**?

   a. Management is an internal user.
   b. Taxing authorities are external users.
   c. Present creditors are external users.
   d. Regulatory authorities are internal users.

3. **(LO 2)** The historical cost basis results in:

   a. initially recording assets at cost and adjusting when the current value changes.
   b. keeping activities of an entity separate and distinct from its owner.
   c. recording and reporting assets at their cost.
   d. including only transaction data capable of being expressed in terms of money in the accounting records.

4. **(LO 2)** Which of the following statements about basic assumptions is **correct**?

   a. Basic assumptions are the same as accounting principles.
   b. The economic entity assumption states that there should be a particular unit of accountability.
   c. The monetary unit assumption enables accounting to measure employee morale.
   d. Partnerships are not economic entities.

5. **(LO 2)** The three types of business entities are:

   a. proprietorships, small businesses, and partnerships.
   b. proprietorships, partnerships, and corporations.
   c. proprietorships, partnerships, and large businesses.
   d. financial, manufacturing, and service companies.

6. **(LO 3)** 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.

7. **(LO 3)** As of December 31, 2025, Stoneland AG has assets of €3,500 and equity of €2,000. What are the liabilities for Stoneland AG as of December 31, 2025?

   a. €1,500. **b.** €1,000. **c.** €2,500. **d.** €2,000.

8. **(LO 4)** Performing services on account will have the following effects on the components of the basic accounting equation:

   a. increase assets and decrease equity.
   b. increase assets and increase equity.
   c. increase assets and increase liabilities.
   d. increase liabilities and increase equity.

9. **(LO 4)** Which of the following events is **not** recorded in the accounting records?

   a. Equipment is purchased on account.
   b. An employee is terminated.
   c. A cash investment is made into the business.
   d. The company pays a cash dividend.

10. **(LO 4)** During 2025, Xia Lin Company's assets decreased ¥500,000 and its liabilities decreased ¥900,000. Its equity therefore:

   a. increased ¥400,000. **c.** decreased ¥400,000.
   b. decreased ¥1,400,000. **d.** increased ¥1,400,000.

11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.

a. decreases equity and decreases liabilities.

b. increases assets and decreases liabilities.

c. decreases assets and increases equity.

d. decreases assets and decreases liabilities.

12. (LO 5) Which of the following statements is **false**?

a. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

b. A statement of financial position reports the assets, liabilities, and equity at a specific date.

c. An income statement presents the revenues, expenses, assets, and liabilities for a specific period of time.

d. A retained earnings statement summarizes the changes in retained earnings for a specific period of time.

13. (LO 5) On the last day of the period, Jim Otto Company buys a $900 machine on credit. This transaction will affect the:

a. income statement only.

b. statement of financial position only.

c. income statement and retained earnings statement only.

d. income statement, retained earnings statement, and statement of financial position.

14. (LO 5) 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.

***15. (LO 6)** Services performed by a public accountant include:

a. auditing, taxation, and management consulting.

b. auditing, budgeting, and management consulting.

c. auditing, budgeting, and cost accounting.

d. internal auditing, budgeting, and management consulting.

Solutions

1. b. Economic entity is not one of the steps in the accounting process. The other choices are true because (a) identification is the first step in the accounting process, (c) recording is the second step in the accounting process, and (d) communication is the third and final step in the accounting process.

2. d. Regulatory authorities are external, not internal, users of accounting information. The other choices are true statements.

3. c. The historical cost basis results in assets being recorded at their cost. The other choices are incorrect because (a) historical cost basis assets are not adjusted for changes in current value, (b) describes the economic entity assumption, and (d) describes the monetary unit assumption.

4. b. The economic entity assumption states that there should be a particular unit of accountability. The other choices are incorrect because (a) basic assumptions are not the same as accounting principles, (c) the monetary unit assumption allows accounting to measure economic events, and (d) partnerships are economic entities.

5. b. Proprietorships, partnerships, and corporations are the three types of business entities. Choices (a) and (c) are incorrect because small and large businesses only denote the sizes of businesses. Choice (d) is incorrect because financial, manufacturing, and service companies are types of businesses, not business entities.

6. d. Net income results when revenues exceed expenses. The other choices are incorrect because (a) assets and liabilities are not used in the computation of net income; (b) revenues, not assets, are included in the computation of net income; and (c) when expenses exceed revenues, a net loss results.

7. a. Using a variation of the basic accounting equation, Assets − Equity = Liabilities, €3,500 − €2,000 = €1,500. The other choices are therefore incorrect.

8. b. When services are performed on account, assets are increased and equity is increased. The other choices are incorrect because when services are performed on account (a) equity is increased, not decreased; (c) liabilities are not affected; and (d) equity is increased and liabilities are not affected.

9. b. If an employee is terminated, this represents an activity of a company, not a business transaction. Assets, liabilities, and equity are not affected. Thus, there is no effect on the accounting equation. The other choices are incorrect because they are all recorded: (a) when equipment is purchased on account, both assets and liabilities increase; (c) when a cash investment is made into a business, both assets and equity increase; and (d) when a dividend is paid, both assets and equity decrease.

10. a. Using the basic accounting equation, Assets = Liabilities + Equity, −¥500,000 = −¥900,000 + Equity, so equity increased ¥400,000, not (b) decreased ¥1,400,000, (c) decreased ¥400,000, or (d) increased ¥1,400,000.

11. d. Payment of an account payable results in an equal decrease of assets (cash) and liabilities (accounts payable). The other choices are incorrect because payment of an account payable (a) does not affect equity, (b) does not increase assets, and (c) does not affect equity.

12. c. An income statement presents the revenues and expenses for a specific period of time but not assets and liabilities. The other choices are true statements.

13. b. This transaction will cause assets to increase by $900 and liabilities to increase by $900. The other choices are incorrect because this transaction (a) will have no effect on the income statement, (c) will have no effect on the income statement or the retained earnings statement, and (d) will affect the statement of financial position but not the income statement or the retained earnings statement.

14. c. The statement of financial position is the statement that reports assets, liabilities, and equity. The other choices are incorrect because (a) the income statement reports revenues and expenses, (b) the retained earnings statement reports details about equity, and (d) the statement of cash flows reports inflows and outflows of cash.

***15. a.** Auditing, taxation, and management consulting are all services performed by public accountants. The other choices are incorrect because public accountants do not perform budgeting or cost accounting.

Practice Brief Exercises

Use basic accounting equation.

1. (LO 3) At the beginning of the year, Ortiz Eyewear had total assets of £900,000 and total liabilities of £440,000. Answer the following questions.

a. If total assets decreased £100,000 during the year and total liabilities increased £80,000 during the year, what is the amount of equity at the end of the year?

b. During the year, total liabilities decreased £100,000 and equity increased £200,000. What is the amount of total assets at the end of the year?

c. If total assets increased £50,000 during the year and equity increased £60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

1. a. (£900,000 − £440,000) − £100,000 − £80,000 = £280,000 equity

b. £900,000 − £100,000 + £200,000 = £1,000,000 total assets

c. £440,000 − £60,000 + £50,000 = £430,000 total liabilities

Determine effect of transactions on basic accounting equation

2. (LO 4) Presented below are three business transactions. List the letters (a), (b), and (c) with columns for assets, liabilities and equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and equity.

a. Purchased equipment on account.

b. Declared and paid cash dividends.

c. Paid expenses in cash.

Solution

	Assets	Liabilities	Equity
2. a.	+	+	NE
b.	−	NE	−
c.	−	NE	−

Determine effect of transactions on basic accounting equation.

3. (LO 4) Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and equity for the following three transactions.

a. Performed accounting services for clients for cash.

b. Borrowed cash from a bank on a note payable.

c. Paid cash for rent for the month.

Solution

	Assets	Liabilities	Equity
3. a.	+	NE	+
b.	+	+	NE
c.	−	NE	−

Determine where items appear on financial statements.

4. (LO 5) Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

a. Dividends.

b. Cash.

c. Salaries and wages expense.

d. Service revenue.

e. Accounts payable.

Solution

4. **a.** Dividends — RES
   b. Cash — SFP
   c. Salaries and wages expense — IS
   d. Service revenue — IS
   e. Accounts payable — SFP

5. **(LO 5)** Presented below in alphabetical order are statement of financial position items for Feagler Gardening at December 31, 2025. Prepare a statement of financial position following the format of Illustration 1.11.

Prepare a statement of financial position.

Accounts receivable	€12,500
Cash	38,000
Notes payable	40,000
Share capital—ordinary	10,500

Solution

5.

Feagler Gardening
Statement of Financial Position
December 31, 2025

Assets	
Accounts receivable	€12,500
Cash	38,000
Total assets	€50,500
Equity and Liabilities	
Equity	
Share capital—ordinary	€10,500
Liabilities	
Notes payable	40,000
Total equity and liabilities	€50,500

Practice Exercises

1. **(LO 3, 4)** Selected transactions for Fabulous Flora are listed below.

Analyze the effect of transactions.

1. Issued ordinary shares for cash to start business.
2. Purchased equipment on account.
3. Paid salaries.
4. Billed customers for services performed.
5. Received cash from customers billed in (4).
6. Paid dividends.
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and equity. For example, the first answer is: (1) Increase in assets and increase in equity.

Solution

1. 1. Increase in assets and increase in equity.
   2. Increase in assets and increase in liabilities.
   3. Decrease in assets and decrease in equity.
   4. Increase in assets and increase in equity.
   5. Increase in assets and decrease in assets.
   6. Decrease in assets and decrease in equity.
   7. Increase in liabilities and decrease in equity.
   8. Increase in assets and decrease in assets.
   9. Increase in assets and increase in equity.

Analyze the effect of transactions on assets, liabilities, and equity.

2. **(LO 3, 4)** Alma's Payroll Services entered into the following transactions during May 2025.

1. Purchased computers for $15,000 from Bytes of Data on account.
2. Paid $3,000 cash for May rent on storage space.
3. Received $12,000 cash from customers for contracts billed in April.
4. Performed payroll services for Magic Construction Company for $2,500 cash.
5. Paid Northern Ohio Power Co. $7,000 cash for energy usage in May.
6. Shareholders invested an additional $25,000 in the business.
7. Paid Bytes of Data for the computers purchased in (1) above.
8. Incurred advertising expense for May of $900 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. an increase in assets and a decrease in assets.
b. an increase in assets and an increase in equity.
c. an increase in assets and an increase in liabilities.
d. a decrease in assets and a decrease in equity.
e. a decrease in assets and a decrease in liabilities.
f. an increase in liabilities and a decrease in equity.
g. an increase in equity and a decrease in liabilities.

Solution

2.

1. c	3. a	5. d	7. e
2. d	4. b	6. b	8. f

Practice Problem

Prepare a tabular summary and financial statements.

(LO 4, 5) Su Feng opens her own law office, Legal Services Ltd., on July 1, 2025. During the first month of operations, the following transactions occurred (NT$ in thousands).

1. Shareholders invested NT$10,000 in cash in exchange for ordinary shares of Legal Services Ltd.
2. Paid NT$800 for July rent on office space.
3. Purchased office equipment on account NT$3,000.
4. Performed legal services for clients for cash NT$1,500.
5. Borrowed NT$700 cash from a bank on a note payable.
6. Performed legal services for client on account NT$2,000.
7. Paid monthly expenses: salaries NT$500 utilities NT$300, and advertising NT$100.

Instructions

a. Prepare a tabular summary of the transactions. (Prepare using NT$ in thousands.)
b. Prepare the income statement, retained earnings statement, and statement of financial position at July 31, 2025, for Legal Services Ltd. (Prepare using NT$ in thousands.)

Solution

a.

	Assets				=	Liabilities			+	Equity							
Trans-action	Cash	+	Accounts Receivable	+	Equipment	=	Notes Payable	+	Accounts Payable	+	Share Capital	+	Retained Earnings Rev.	−	Retained Earnings Exp.	−	Retained Earnings Div.	
1.	+NT$10,000*										+NT$10,000							**Issued Shares**
2.	−800														−NT$800			**Rent Expense**
3.					+NT$3,000				+NT$3,000									
4.	+1,500												+NT$1,500					**Service Revenue**
5.	+700						+NT$700											
6.			+NT$2,000										+2,000					**Service Revenue**
7.	−900														−500			**Sal./Wages Exp.**
															−300			**Utilities Expense**
															−100			**Advertising Expense**
	NT$10,500	+	NT$2,000	+	NT$3,000	=	NT$700	+	NT$3,000	+	NT$10,000	+	NT$3,500	−	NT$1,700			
	NT$15,500										NT$15,500							

*Amounts shown in thousands of NT$.

b.

Legal Services Ltd.
Income Statement
For the Month Ended July 31, 2025
(NT$ in thousands)

Revenues		
Service revenue		NT$3,500
Expenses		
Rent expense	NT$800	
Salaries and wages expense	500	
Utilities expense	300	
Advertising expense	100	
Total expenses		1,700
Net income		NT$1,800

Legal Services Ltd.
Retained Earnings Statement
For the Month Ended July 31, 2025
(NT$ in thousands)

Retained earnings, July 1	NT$ –0–
Add: Net income	1,800
Retained earnings, July 31	NT$1,800

Legal Services Ltd.
Statement of Financial Position
July 31, 2025
(NT$ in thousands)

Assets		
Equipment		NT$ 3,000
Accounts receivable		2,000
Cash		10,500
Total assets		NT$15,500
Equity and Liabilities		
Equity		
Share capital—ordinary	NT$10,000	
Retained earnings	1,800	NT$11,800
Liabilities		
Notes payable	700	
Accounts payable	3,000	3,700
Total equity and liabilities		NT$15,500

Questions

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.

2. Identify and describe the steps in the accounting process.

3. **a.** Who are internal users of accounting data?

b. How does accounting provide relevant data to these users?

4. What uses of financial accounting information are made by (a) investors and (b) creditors?

5. What are the four most common types of data analytics, and what basic question does each address?

6. "Bookkeeping and accounting are the same." Do you agree? Explain.

7. Remmers Travel Agency purchased land for £85,000 cash on December 10, 2025. At December 31, 2025, the land's value has increased to £93,000. What amount should be reported for land on Remmers' statement of financial position at December 31, 2025? Explain.

8. What is the monetary unit assumption?

9. What is the economic entity assumption?

10. What are the three basic forms of profit-oriented business organizations?

11. Teresa Alvarez is the owner of a successful printing shop. Recently, her business has been increasing, and Teresa has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Teresa would enjoy if she were to incorporate her business.

12. What is the basic accounting equation?

13. **a.** Define the terms assets, liabilities, and equity.

b. What items affect equity?

14. Which of the following items are liabilities of Designer Jewelry Stores?

a. Cash.
b. Accounts payable.
c. Dividends.
d. Accounts receivable.
e. Supplies.
f. Equipment.
g. Salaries and wages payable.
h. Service revenue.
i. Rent expense.

15. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.

16. Are the following events recorded in the accounting records? Explain your answer in each case.

a. The president of the company dies.

b. Supplies are purchased on account.

c. An employee is fired.

17. Indicate how the following business transactions affect the basic accounting equation.

a. Paid cash for janitorial services.

b. Purchased equipment for cash.

c. Received cash in exchange for ordinary shares.

d. Paid accounts payable in full.

18. Listed below are some items found in the financial statements of Min-Seo Promotions. Indicate in which financial statement(s) the following items would appear.

a. Service revenue.
b. Equipment.
c. Advertising expense.
d. Accounts receivable.
e. Retained earnings.
f. Salaries and wages payable.

19. In February 2025, Xia Sun invested an additional £10,000 in Midtown plc. Midtown's accountant, Jon Shin, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

20. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's statement of financial position." Do you agree? Explain.

21. Jardine plc had an equity balance of £158,000 at the beginning of the period. At the end of the accounting period, the equity balance was £198,000.

a. Assuming no additional investment or distributions during the period, what is the net income for the period?

b. Assuming an additional investment of £13,000 but no distributions during the period, what is the net income for the period?

22. Summarized operations for Carston Gardens for the month of July are as follows.

Revenues recognized: for cash £30,000; on account £70,000.

Expenses incurred: for cash £26,000; on account £40,000.

Indicate for Carston Gardens (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.

23. The basic accounting equation is Assets = Liabilities + Equity. Replacing the words in that equation with numeric amounts, what is **TSMC**'s accounting equation at December 31, 2020? The financial statements of TSMC are presented in Appendix A.

Brief Exercises

Use basic accounting equation.

BE1.1 (LO 3) Presented below is the basic accounting equation (in thousands). Determine the missing amounts.

	Assets	=	Liabilities	+	Equity
a.	¥88,000		¥50,000		?
b.	?		¥45,000		¥70,000
c.	¥94,000		?		¥60,000

BE1.2 (LO 3) Given the accounting equation, answer each of the following questions. *Use basic accounting equation.*

a. The liabilities of Shumway Ltd. are £120,000 and the equity is £232,000. What is the amount of Shumway Ltd.'s total assets?

b. The total assets of Shumway Ltd. are £190,000 and its equity is £80,000. What is the amount of its total liabilities?

BE1.3 (LO 3) At the beginning of the year, Gilles Plumbers had total assets of €800,000 and total liabilities of €300,000. Answer the following questions. (Note that each situation is independent.) *Use basic accounting equation.*

a. If total assets increased €150,000 during the year and total liabilities decreased €60,000, what is the amount of equity at the end of the year?

b. During the year, total liabilities increased €100,000 and equity decreased €70,000. What is the amount of total assets at the end of the year?

c. If total assets decreased €80,000 and equity increased €120,000 during the year, what is the amount of total liabilities at the end of the year?

BE1.4 (LO 3) Use the expanded accounting equation to answer each of the following questions. *Solve expanded accounting equation.*

a. The liabilities of Kumar Company are ₹90,000. Share capital—ordinary is ₹150,000; dividends are ₹40,000; revenues, ₹450,000; and expenses, ₹340,000. What is the amount of Kumar's total assets?

b. The total assets of Kalim Company are ₹57,000. Share capital—ordinary is ₹35,000; dividends are ₹7,000; revenues, ₹52,000; and expenses, ₹35,000. What is the amount of the company's total liabilities?

c. The total assets of Siram Co. are ₹660,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Siram Co.'s equity?

BE1.5 (LO 3) Indicate whether each of the following items is an asset (A), liability (L), or part of equity (E). *Identify assets, liabilities, and equity.*

_____ **a.** Accounts receivable.
_____ **b.** Salaries and wages payable.
_____ **c.** Equipment.
_____ **d.** Supplies.
_____ **e.** Share capital—ordinary.
_____ **f.** Notes payable.

BE1.6 (LO 3) Classify each of the following items as dividends (D), revenue (R), or expense (E). *Classify items affecting equity.*

_____ **a.** Advertising expense.
_____ **b.** Service revenue.
_____ **c.** Insurance expense.
_____ **d.** Salaries and wages expense.
_____ **e.** Dividends.
_____ **f.** Rent revenue.
_____ **g.** Utilities expense.

BE1.7 (LO 4) Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and equity. For each column, indicate whether the transactions increased (+), decreased (–), or had no effect (NE) on assets, liabilities, and equity. *Determine effect of transactions on basic accounting equation.*

a. Purchased supplies on account.

b. Received cash for performing a service.

c. Paid expenses in cash.

BE1.8 (LO 4) Follow the same format as in BE1.7. Determine the effect on assets, liabilities, and equity of the following three transactions. *Determine effect of transactions on basic accounting equation.*

a. Shareholders invested cash in the business.

b. Payment of dividends.

c. Received cash from a customer who had previously been billed for services performed.

BE1.9 (LO 4) Presented below are three transactions. Mark each transaction as affecting shareholders' investment (I), dividends (D), revenue (R), expense (E), or not affecting equity (NE). *Determine effect of transactions on equity.*

_____ **a.** Received cash for services performed.
_____ **b.** Paid cash to purchase equipment.
_____ **c.** Paid employee salaries.

BE1.10 (LO 5) In alphabetical order below are statement of financial position items for Grande Ltd. at December 31, 2025. Prepare a statement of financial position, following the format of Illustration 1.11. *Prepare a statement of financial position.*

Accounts payable	£90,000
Accounts receivable	62,500
Cash	49,000
Share capital—ordinary	21,500

Determine where items appear on financial statements.

BE1.11 (LO 5) Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

_____ **a.** Notes payable.
_____ **b.** Advertising expense.
_____ **c.** Share capital—ordinary.
_____ **d.** Cash.
_____ **e.** Service revenue.

DO IT! Exercises

Review basic concepts.

DO IT! 1.1 (LO 1) Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and examination.
2. The accounting process includes the bookkeeping function.
3. Managerial accounting provides reports to help investors and creditors evaluate a company.
4. The two most common types of external users are investors and creditors.
5. Internal users include human resources managers.

Identify building blocks of accounting.

DO IT! 1.2 (LO 2) Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. IFRS are issued by the FASB.
2. The standards of conduct by which actions are judged as loyal or disloyal are ethics.
3. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
4. Using the historical cost basis means that companies record assets at their cost and continue to report them at their cost over the time the assets are held.
5. The monetary unit assumption requires that companies record only transactions that can be measured in money.

Evaluate effects of transactions on equity.

DO IT! 1.3 (LO 3) Classify the following items as investment by shareholders (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

1. Dividends.
2. Rent revenue.
3. Advertising expense.
4. Shareholders invest cash in business.

Prepare tabular analysis.

DO IT! 1.4 (LO 4) Transactions made by Callahan Ltd., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the accounting equation, similar to that shown in Illustration 1.10.

1. The company performed R20,000 of services for customers, on credit.
2. The company received R20,000 in cash from customers who had been billed for services [in transaction (1)].
3. The company received a bill for R3,200 of advertising but will not pay it until a later date.
4. The company paid a dividend of R5,000 in cash to shareholders.

Determine specific amounts on the financial statements.

DO IT! 1.5 (LO 5) Presented below is selected information related to Tsui Repairs at December 31, 2025. Tsui reports financial information monthly (amounts in thousands).

Accounts Payable	HK$ 3,000	Salaries and Wages Expense	HK$16,500
Cash	6,500	Notes Payable	25,000
Advertising Expense	6,000	Rent Expense	10,500
Service Revenue	53,500	Accounts Receivable	13,500
Equipment	29,000	Dividends	7,500

a. Determine the total assets of Tsui Repairs at December 31, 2025.
b. Determine the net income that Tsui Repairs reported for December 2025.
c. Determine the equity of Tsui Repairs at December 31, 2025.

Exercises

E1.1 (LO 1) Genesis Company performs the following accounting tasks during the year.

Classify the three activities of accounting.

_____Analyzing and interpreting information.
_____Classifying economic events.
_____Explaining uses, meaning, and limitations of data.
_____Keeping a systematic chronological diary of events.
_____Measuring events in currency (such as euros or yen).
_____Preparing accounting reports.
_____Reporting information in a standard format.
_____Selecting economic activities relevant to the company.
_____Summarizing economic events.

Accounting is "an information system that **identifies**, **records**, and **communicates** the economic events of an organization to interested users."

Instructions

Categorize the accounting tasks performed by Genesis as relating to either the identification (I), recording (R), or communication (C) aspects of accounting.

E1.2 (LO 1) **a.** The following are users of financial statements.

Identify users of accounting information.

_____Customers.
_____Tax authorities.
_____Labor unions.
_____Marketing manager.
_____Production supervisor.
_____Financial regulators.
_____Store manager.
_____Suppliers.
_____Vice president of finance.

Instructions

Identify the users as being either **external users** or **internal users**.

b. The following questions could be asked by an internal user or an external user.

_____Can we afford to give our employees a pay raise?
_____Did the company earn a satisfactory income?
_____Do we need to borrow in the near future?
_____How does the company's profitability compare to other companies?
_____What does it cost us to manufacture each unit produced?
_____Which product should we emphasize?
_____Will the company be able to pay its short-term debts?

Instructions

Identify each of the questions as being more likely asked by an **internal user** or an **external user**.

E1.3 (LO 2) Angela Manternach, president of Manternach Designs, has instructed Carla Ruden, the head of the accounting department for Manternach Designs, to report the company's land in the company's accounting reports at its current value of €170,000 instead of its cost of €100,000. Manternach says, "Showing the land at €170,000 will make our company look like a better investment when we try to attract new investors next month."

Discuss how using the historical cost basis makes ethical decision-making either easier or more difficult.

Instructions

Explain the ethical situation involving Carla Ruden, identifying the stakeholders and the alternatives.

E1.4 (LO 2) The following situations involve accounting principles and assumptions.

Use accounting concepts.

1. Julia A/S owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Julia reports the buildings at their current value in its accounting reports.

2. Dekalb Creations includes in its accounting records only transaction data that can be expressed in terms of money.
3. Omar Shariff, owner of Omar's Oasis, records his personal living costs as expenses of the business.

Instructions

For each of the three situations, determine if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

Classify accounts as assets, liabilities, and equity.

E1.5 (LO 3) Diehl Cleaners has the following statement of financial position items.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Share capital—ordinary

Instructions

Classify each item as an asset, liability, or equity.

Analyze the effect of transactions.

E1.6 (LO 4) Selected transactions for Spring Cruises are listed below.

1. Received cash investment from shareholders to start business in exchange for ordinary shares.
2. Paid monthly rent.
3. Purchased equipment on account.
4. Billed customers for services performed.
5. Paid dividends.
6. Received cash from customers billed in (4).
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and equity. For example, the first answer is: (1) Increase in assets and increase in equity.

Analyze the effect of transactions on assets, liabilities, and equity.

E1.7 (LO 4) Collins Computer Timeshare entered into the following transactions during May 2025.

1. Purchased computers for R$20,000 from Digital Equipment on account.
2. Paid R$4,000 cash for May rent on storage space.
3. Received R$17,000 cash from customers for contracts billed in April.
4. Performed computer services for Viking Construction for R$4,000 cash.
5. Paid Tri-State Power R$11,000 cash for energy usage in May.
6. Shareholders invested an additional R$29,000 in the business in exchange for ordinary shares.
7. Paid Digital Equipment for the computers purchased in (1) above.
8. Incurred advertising expense for May of R$1,200 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. An increase in assets and a decrease in assets.

b. An increase in assets and an increase in equity.

c. An increase in assets and an increase in liabilities.

d. A decrease in assets and a decrease in equity.

e. A decrease in assets and a decrease in liabilities.

f. An increase in liabilities and a decrease in equity.

g. An increase in equity and a decrease in liabilities.

E1.8 (LO 4, 5) **Writing** An analysis of the transactions made by Kang & Co., a public accounting firm, for the month of August is shown below. *Analyze transactions and compute net income.*

	Assets				= Liabilities +	Equity					
		Accounts			Accounts	Share	Retained Earnings				
	Cash +	Receivable +	Supplies +	Equipment =	Payable +	Capital +	Rev. −	Exp. −	Div.		
1.	+£15,000					+£15,000					**Issued Shares**
2.	−2,000			+£5,000	+£3,000						
3.	−750		+£750								
4.	+4,600	+£4,500					+£9,100				**Service Revenue**
5.	−1,500				−1,500						
6.	−2,000								−£2,000		**Dividends**
7.	−650							−£650			**Rent Expense**
8.	+450	−450									
9.	−3,900							−3,900			**Sal./Wages Expense**
10.					+500			−500			**Utilities Expense**

Instructions

a. Describe each transaction that occurred for the month.

b. Determine how much equity increased for the month.

c. Compute the amount of net income for the month.

E1.9 (LO 5) An analysis of transactions for Kang & Co. was presented in E1.8. *Prepare financial statements.*

Instructions

Prepare an income statement and a retained earnings statement for August and a statement of financial position at August 31, 2025. Assume that August is the company's first month of business.

E1.10 (LO 5) Kinney A.Ş. had the following assets and liabilities on the dates indicated. *Determine net income (or loss).*

December 31	Total Assets	Total Liabilities
2024	₺400,000	₺250,000
2025	₺460,000	₺300,000
2026	₺590,000	₺400,000

Kinney began business on January 1, 2024, with an investment of ₺100,000.

Instructions

From an analysis of the change in equity during the year, compute the net income (or loss) for:

a. 2024, assuming Kinney's paid ₺12,000 in dividends for the year.

b. 2025, assuming shareholders made an additional investment of ₺34,000 and Kinney paid no dividends in 2025.

c. 2026, assuming shareholders made an additional investment of ₺12,000 and Kinney paid dividends of ₺25,000 in 2026.

E1.11 (LO 5) Two items are omitted from each of the following summaries of statement of financial position and income statement data for two proprietorships for the year 2025, Greene's Goods and Solar Enterprises. *Analyze financial statements items.*

	Greene's Goods	Solar Enterprises
Beginning of year:		
Total assets	€110,000	€129,000
Total liabilities	85,000	(c)
Total equity	(a)	80,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total equity	40,000	130,000
Changes during year in equity:		
Additional investment	(b)	25,000
Dividends	37,000	(d)
Total revenues	220,000	100,000
Total expenses	175,000	60,000

Instructions

Determine the missing amounts.

Prepare income statement, comprehensive income statement, and retained earnings statement.

E1.12 (LO 5) The following information relates to Karen Weigel Co. for the year 2025.

Retained earnings, January 1, 2025	$42,000	Advertising expense	$ 1,800
Dividends paid during 2025	6,000	Rent expense	10,400
Service revenue	63,600	Utilities expense	3,100
Salaries and wages expense	30,200	Other comprehensive income	460

Instructions

After analyzing the data, prepare (a) an income statement and (b) a comprehensive income statement for the year 2025.

Correct an incorrectly prepared statement of financial position.

E1.13 (LO 5) Lynn Dreise is the bookkeeper for Sanculi SpA. Lynn has been trying to get the statement of financial position of Sanculi to balance correctly. Sanculi's statement of financial position is shown as follows.

Sanculi SpA
Statement of Financial Position
December 31, 2025

Assets		Liabilities	
Equipment	€48,000	Share capital—ordinary	€50,000
Supplies	8,000	Retained earnings	17,500
Cash	14,000	Accounts payable	16,000
Dividends	5,000	Accounts receivable	(8,500)
Total assets	€75,000	Total equity and liabilities	€75,000

Instructions

Prepare a correct statement of financial position.

Compute net income and prepare a statement of financial position.

E1.14 (LO 5) Bear Park Ltd., a camping ground in the Lake District, has compiled the following financial information as of December 31, 2025.

Revenues during 2025—camping fees	£140,000	Notes payable	£ 60,000
Revenues during 2025—general store	47,000	Expenses during 2025	150,000
Accounts payable	11,000	Supplies on hand	2,500
Cash on hand	20,000	Share capital—ordinary	20,000
Original cost of equipment	105,500	Retained earnings	?
Current value of equipment	140,000		

Instructions

a. Determine Bear Park's net income for 2025.

b. Prepare a statement of financial position for Bear Park Ltd. as of December 31, 2025.

Prepare an income statement and comprehensive income statement.

E1.15 (LO 5) Presented below is financial information related to the 2025 operations of Delgado Cruises SA.

Maintenance and repairs expense	R$ 97,000
Utilities expense	10,000
Salaries and wages expense	144,000
Advertising expense	3,500
Ticket revenue	342,000
Other comprehensive income	4,200

Instructions

Prepare the 2025 income statement and comprehensive income statement for Delgado Cruises SA.

E1.16 (LO 5) Presented below is information related to Ling an Co.

Prepare a retained earnings statement.

Retained earnings, January 1, 2025	£ 23,000
Share capital—ordinary	10,000
Legal service revenue—2025	340,000
Total expenses—2025	211,000
Assets, January 1, 2025	95,000
Liabilities, January 1, 2025	62,000
Assets, December 31, 2025	168,000
Liabilities, December 31, 2025	80,000
Dividends—2025	64,000

Instructions

Prepare the 2025 retained earnings statement for Ling an Co.

E1.17 (LO 5) This information is for Java Growers for the year ended December 31, 2025 (amounts in thousands).

Prepare a cash flow statement.

Cash received from revenues from customers	Rp600,000
Cash received for issuance of ordinary shares	280,000
Cash paid for new equipment	95,000
Cash dividends paid	20,000
Cash paid for expenses	430,000
Cash balance 1/1/25	28,000

Instructions

Prepare the 2025 statement of cash flows for Java Growers.

E1.18 (LO 5) The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, investments by shareholders, and dividends paid.

Identify cash flow activities.

Presented below are the following transactions.

1. Shareholders invested €20,000 cash in exchange for ordinary shares.
2. Issued note payable for €12,000 cash.
3. Purchased office equipment for €11,000 cash.
4. Received €15,000 cash for services performed.
5. Paid €1,000 cash for rent.
6. Paid €600 dividend.
7. Paid €5,700 cash for salaries.

Instructions

Classify each of these transactions as operating, investing, or financing activities.

Problems

P1.1 (LO 4) On April 1, Julie Chen established Miaoli's Travel Agency. The following transactions were completed during the month.

Analyze transactions and compute net income.

1. Shareholders invested NT$15,000 cash in the business in exchange for ordinary shares.
2. Paid NT$600 cash for April office rent.
3. Purchased equipment for NT$3,000 cash.
4. Incurred NT$700 of advertising costs for online ads, on account.
5. Paid NT$900 cash for office supplies.
6. Performed services worth NT$10,000: NT$3,000 cash is received from customers, and the balance of NT$7,000 is billed to customers on account.

7. Declared and paid NT$600 dividend.
8. Paid NT$500 of the online advertising amount due in transaction (4).
9. Paid employees' salaries NT$2,500.
10. Received NT$4,000 in cash from customers who have previously been billed in transaction (6).

Check figures *provide a key number to let you know you are on the right track.*

a. Total assets NT$20,800

b. Net income NT$6,200

Instructions

a. Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Share Capital—Ordinary, Revenues, Expenses, and Dividends.

b. From an analysis of the retained earnings columns, compute the net income or net loss for April.

Analyze transactions and prepare income statement, retained earnings statement, and statement of financial position.

P1.2 (LO 4, 5) Ai Fang Co. opened as a new computer services business on August 1, 2025. During August, the following transactions occurred.

1. Shareholders invested ¥20,000 cash in the business in exchange for ordinary shares.
2. Purchased equipment for ¥2,000, paying ¥1,000 in cash and the balance on account.
3. Paid ¥600 cash for August office rent.
4. Purchased ¥500 of supplies on account.
5. Recognized revenue of ¥7,500, of which ¥4,000 is collected in cash with the balance to be collected later.
6. Paid for the supplies purchased in transaction (4).
7. Declared and paid ¥700 dividend.
8. Incurred utility expenses for the month on account ¥270.
9. Paid salaries of ¥2,800 for August.
10. Received ¥2,000 from Standard Bank—money borrowed on a note payable.

a. Total assets ¥26,400

b. Net income ¥3,830
Ending retained earnings ¥3,130

Instructions

a. Prepare a tabular analysis of the August transactions. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Share Capital—Ordinary + Revenues – Expenses – Dividends.

b. Prepare an income statement and a retained earnings statement for August, and a statement of financial position at August 31, 2025, for Ai Fang Co.

Prepare income statement, retained earnings statement, and statement of financial position.

P1.3 (LO 5) On May 1, 2025, Park Flying School Ltd., a company that provides flying lessons, was started with an investment of ₩45,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2025, and the revenues and expenses for the month of May (all amounts in thousands).

Cash	₩ 4,500	Notes Payable	₩28,000
Accounts Receivable	7,420	Rent Expense	1,000
Equipment	64,000	Maintenance and Repairs Expense	400
Service Revenue	6,800	Gasoline Expense	2,500
Advertising Expense	500	Utilities Expense	400
Accounts Payable	1,400		

No additional investments were made in May, but the company paid dividends of ₩480,000 during the month.

a. Net income ₩2,000
Total assets ₩75,920

b. Net income ₩1,400

Instructions

a. Prepare an income statement and a retained earnings statement for the month of May and a statement of financial position at May 31. (Show numbers in thousands.)

b. Prepare an income statement and a retained earnings statement for May assuming the following data are not included above: (1) ₩900,000 worth of services were performed and billed but not collected at May 31, and (2) ₩1,500,000 of gasoline expense was incurred but not paid.

Analyze transactions and prepare financial statements.

P1.4 (LO 4, 5) Matt Stiner started a delivery service, Stiner Deliveries Ltd., on June 1, 2025. The following transactions occurred during the month of June.

June 1 Shareholders invested £10,000 cash in the business in exchange for ordinary shares.
2 Purchased a used van for deliveries for £14,000. Matt paid £2,000 cash and signed a note payable for the remaining balance.
3 Paid £500 for office rent for the month.

5 Performed services worth £4,800 on account.
9 Declared and paid £300 in cash dividends.
12 Purchased supplies for £150 on account.
15 Received a cash payment of £1,250 for services performed on June 5.
17 Purchased gasoline for £100 on account.
20 Received a cash payment of £1,500 for additional services performed.
23 Made a cash payment of £500 on the note payable.
26 Paid £250 for utilities.
29 Paid for the gasoline purchased on account on June 17.
30 Paid £1,000 for employee salaries.

Instructions

a. Show the effects of the above transactions on the accounting equation using the following format.

a. Total assets £25,800

	Assets								=	Liabilities			+	Equity						
			Accounts							Notes		Accounts		Share		Retained Earnings				
Date	Cash	+	Receivable	+	Supplies	+	Equipment		=	Payable	+	Payable	+	Capital	+	Rev.	–	Exp.	–	Div.

Include margin explanations for any changes in the Retained Earnings account in your analysis.

b. Prepare an income statement for the month of June.

b. Net income £4,450

c. Prepare a statement of financial position at June 30, 2025.

c. Cash £8,100

P1.5 (LO 4, 5) **Writing** Financial statement information about four different companies is as follows.

Determine financial statement amounts and prepare retained earnings statement.

	Crosby Company	Stills Company	Nash Company	Young Company
January 1, 2025				
Assets	HK$ 900,000	HK$1,100,000	(g)	HK$1,500,000
Liabilities	650,000	(d)	HK$ 750,000	(j)
Equity	(a)	500,000	450,000	1,000,000
December 31, 2025				
Assets	(b)	1,370,000	2,000,000	(k)
Liabilities	550,000	750,000	(h)	800,000
Equity	400,000	(e)	1,300,000	1,400,000
Equity changes in year				
Additional investment	(c)	150,000	100,000	150,000
Dividends	100,000	(f)	140,000	100,000
Total revenues	3,500,000	4,200,000	(i)	5,000,000
Total expenses	3,300,000	3,850,000	3,420,000	(l)

Instructions

a. Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets – Liabilities = Equity = HK$250,000.)

b. Prepare the retained earnings statement for Stills Company. Assume beginning retained earnings was HK$200,000.

c. Explain the sequence for preparing financial statements and the interrelationship of the retained earnings statement to the income statement and statement of financial position.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT1.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

Refer to TSMC's financial statements and answer the following questions. (Use amounts as reported in New Taiwan dollars.)

a. What were TSMC's total assets at December 31, 2020? At December 31, 2019?

b. How much cash (and cash equivalents) did TSMC have on December 31, 2020?

c. What amount of accounts payable did TSMC report on December 31, 2020? On December 31, 2019?

d. What was TSMC's revenue in 2019? In 2020?

e. What is the amount of the change in TSMC's net income from 2019 to 2020?

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT1.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

Refer to the financial statements and answer the following questions.

a. Based on the information contained in these financial statements, determine the following for each company.

   1. Total assets at December 31, 2020.
   2. Accounts (trade) receivable, net at December 31, 2020.
   3. Net sales for year ended December 31, 2020.
   4. Net income (profit) for year ended December 31, 2020.

b. What percentage do receivables represent of total assets for the two companies? What percentage does net income represent of sales (revenue) for the two companies?

Real-World Focus

CT1.3 This exercise will familiarize you with the skills needed (other than accounting skills) to be a successful accountant.

Instructions

Search the Internet for "start here go places" to access resources for future accountants and then answer the following questions.

a. What are the four skill sets that are useful for success in accounting?

b. Why are these skill sets useful for a successful accounting career?

Decision-Making Across the Organization

CT1.4 Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range Ltd. on March 1, 2025, investing £25,000 of their cash savings in the business in exchange for ordinary shares. A caddy shack was constructed for cash at a cost of £8,000, and £800 was spent on golf balls and golf clubs. The company leased five acres of land at a cost of £1,000 per month and paid the first month's rent. During the first month, advertising costs totaled £750, of which £100 was unpaid at March 31, and £500 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, the company paid a total of £1,000 in dividends. A £120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was £18,900.

Anya and Nick thought they had a pretty good first month of operations. But, their estimates of profitability ranged from a loss of £6,100 to net income of £2,480.

Instructions

With the class divided into groups, answer the following.

a. How could the Ramons have concluded that the company operated at a loss of £6,100? Was this a valid basis on which to determine net income?

b. How could the Ramons have concluded that the company operated at a net income of £2,480? (*Hint:* Prepare a statement of financial position at March 31.) Was this a valid basis on which to determine net income?

c. Without preparing an income statement, determine the actual net income for March.

d. What was the revenue recognized in March?

Communication Activity

CT1.5 Erin Danielle, the bookkeeper for Liverpool Ltd., has been trying to determine the correct statement of financial position for the company. The company's statement of financial position is shown below.

Liverpool Ltd.
Statement of Financial Position
For the Month Ended December 31, 2025

Assets		Liabilities	
Equipment	£25,500	Share capital—ordinary	£20,000
Cash	9,000	Accounts receivable	(5,000)
Supplies	3,000	Retained earnings	4,000
Accounts payable	(8,000)	Notes payable	10,500
	£29,500		£29,500

Instructions

Explain to Erin Danielle in an email why the original statement of financial position is incorrect, and what should be done to correct it.

All About You

CT1.6 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity to being both unethical and illegal attempts to mislead investors and creditors.

Instructions

Provide responses for each of the following questions.

a. Discuss whether you think each of the following actions to increase the chances of receiving financial aid is ethical.

1. Spend the student's assets and income first, before spending parents' assets and income.
2. Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
3. State that a truly financially dependent child is independent.
4. Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

b. What are some reasons why a **company** might want to overstate its earnings?

c. What are some reasons why a **company** might want to understate its earnings?

d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

Considering Environmental, Social, and Governance Reporting

CT1.7 Although **Clif Bar & Company** (USA) is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

Instructions

Go to the Who We Are page at the Clif Bar website and identify the five aspirations.

Answers to Insight and Accounting Across the Organization Questions

Using Data Science to Create Art Q: How can "big data" improve decision-making? **A:** Companies analyze the large amounts of data now available to improve cost estimation for future projects as well as identify bottlenecks and opportunities to increase the efficiency of production processes.

Loyalty to Your Employer Is Great, Until It Is Not Q: What would you do if your company asked you to misreport an item? **A:** You would be placed in a difficult situation. However, although you might be pressured by your supervisor to make the company's financial statements look better than warranted, you can be prosecuted for fraudulent activities.

The Korean Discount Q: What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? **A:** Transparency refers to the extent to which outsiders have knowledge regarding a company's financial performance and financial position. If a company lacks transparency, its financial reports do not adequately inform investors of critical information that is needed to make investment decisions. If company transparency is increased, investors would be more willing to supply the financial capital that businesses need in order to grow, which would spur the country's economic growth.

Spinning the Career Wheel Q: How might accounting help you? **A:** You will need to understand financial reports in any enterprise with which you are associated. Accounting reports provide financial information about the resources, claims on resources, and the performance of an organization, which is important for any role in the organization. Whether you become a manager, doctor, lawyer, social worker, teacher, engineer, architect, or entrepreneur, a working knowledge of accounting is relevant.

A Wise End Q: What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends? **A:** You most likely would choose a different year-end for a ski resort and ski rental business, which would be busiest during the coldest months of the year, versus a college bookstore, which would be busiest at the beginning and end of each semester. So for the ski resort and rental business, May 31 (or some other month not during the busy winter months) would make sense. For the college bookstore, June 30 or July 31 (or some other month not during the busy school months) would make sense.

Beyond Financial Statements Q: Why might a company's shareholders be interested in its environmental and social performance? **A:** Many companies now recognize that being a socially responsible organization is not only the right thing to do, but it also is good for business. Many investment professionals understand, for example, that environmental, social, and proper corporate governance of companies affects the performance of their investment portfolios. For example, **British Petroleum**'s (GBR) oil spill disaster is a classic example of the problems that can occur for a company and its shareholders. BP's share price was slashed, its dividend reduced, its executives replaced, and its reputation badly damaged. Socially responsible investment funds are now gaining momentum in the marketplace, such that companies now recognize this segment as an important investment group.

A Look at U.S. GAAP

LEARNING OBJECTIVE 7

Describe the impact of U.S. accounting standards on global financial reporting.

As indicated in the chapter, IFRSs, which are issued by the IASB, are used by most countries in the world. However, another major standard-setter resides in the United States: the Financial Accounting Standards Board (FASB). Prior to the creation of IFRS, the U.S. accounting standards, referred to as generally accepted accounting principles (GAAP), were used by companies in many countries.

Key Points

While the IASB and the FASB often work together on projects, it appears for the foreseeable future the two Boards will continue to exist independent of one another. It is therefore important for investors, accountants, and students to understand the key similarities and differences that exist between the standards.

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.

- 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**.

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.

GAAP Practice

GAAP Self-Test Questions

1. 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.
2. 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.
3. 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 answer choices is correct.
4. Which of the following statements is **false**?
   - **a.** GAAP is based on a conceptual framework that is similar to that used to develop IFRS.
   - **b.** FASB and the IASB are working on a joint project related to the conceptual framework.
   - **c.** Non-U.S. companies that trade shares in U.S. markets must reconcile their accounting with GAAP.
   - **d.** Proprietorships, partnerships, and corporations are also found in countries that use IFRS.
5. Which of the following is **true**?
   - **a.** Financial frauds have not occurred in U.S. companies because GAAP has detailed accounting and disclosure requirements.
   - **b.** Transaction analysis is basically the same under GAAP and IFRS.
   - **c.** IFRS companies have agreed to adopt the Sarbanes-Oxley Act related to internal control in 2025.
   - **d.** Foreign companies that trade shares in U.S. markets must reconcile their accounting with the FASB.

GAAP Exercises

GAAP1.1 Who are the two key international players in the development of international accounting standards? Explain their role.

GAAP1.2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

GAAP1.3 What is the benefit of a single set of high-quality accounting standards?

GAAP1.4 Discuss the potential advantages and disadvantages that countries outside the United States should consider before adopting regulations, such as those in the Sarbanes-Oxley Act, that increase corporate internal control requirements.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP1.5 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Refer to Apple's financial statements to answer the following questions.

a. What were Apple's total assets at September 26, 2020? At September 28, 2019?

b. How much cash did Apple have on September 26, 2020?

c. What amount of accounts payable did Apple report on September 26, 2020? On September 28, 2019?

d. What were Apple's total revenues in 2020? In 2019? In 2018?

e. What is the amount of the change in Apple's net income from 2019 to 2020?

Answers to GAAP Self-Test Questions

1. d **2.** c **3.** a **4.** c **5.** b