GLOBAL EDITION

FINANCIAL ACCOUNTING

International Financial Reporting Standards

ELEVENTH EDITION

Walter T. Harrison Jr.
Charles T. Horngren
C. William (Bill) Thomas
Wendy M. Tietz
Themin Suwardy

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For my wife, Mary Ann.

C. William (Bill) Thomas

To my husband, Russ, who steadfastly supports me in every endeavor.

Wendy M. Tietz

ABOUT THE AUTHORS

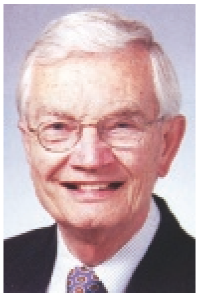
Walter T. Harrison, Jr., is professor emeritus of accounting at the Hankamer School of Business, Baylor University. He received his BBA from Baylor University, his MS from Oklahoma State University, and his PhD from Michigan State University.

Professor Harrison, recipient of numerous teaching awards from student groups as well as from university administrators, has also taught at Cleveland State Community College, Michigan State University, the University of Texas, and Stanford University.

A member of the American Accounting Association and the American Institute of Certified Public Accountants, Professor Harrison has served as chairman of the Financial Accounting Standards Committee of the American Accounting Association, on the Teaching/Curriculum Development Award Committee, on the Program Advisory Committee for Accounting Education and Teaching, and on the Notable Contributions to Accounting Literature Committee.

Professor Harrison has lectured in several foreign countries and published articles in numerous journals, including *Journal of Accounting Research*, *Journal of Accountancy*, *Journal of Accounting and Public Policy*, *Economic Consequences of Financial Accounting Standards*, *Accounting Horizons*, *Issues in Accounting Education*, and *Journal of Law and Commerce*.

Professor Harrison has received scholarships, fellowships, and research grants or awards from PricewaterhouseCoopers, Deloitte & Touche, the Ernst & Young Foundation, and the KPMG Foundation.



Charles T. Horngren was the Edmund W. Littlefield Professor of Accounting, emeritus, at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his PhD from the University of Chicago. He also received honorary doctorates from Marquette University and DePaul University.

A certified public accountant, Horngren served on the Accounting Principles Board, the Financial Accounting Standards Board Advisory Council, and the Council of the American Institute of Certified Public Accountants and served as a trustee of the Financial Accounting Foundation, which oversees the Financial Accounting Standards Board and the Government Accounting Standards Board.

Horngren is a member of the Accounting Hall of Fame. As a member of the American Accounting Association, Horngren was its president and its director of research. He received its first annual Outstanding Accounting Educator Award. The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He was the first person to have received both awards. The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren. Horngren was named Accountant of the Year, in Education, by the national professional accounting fraternity, Beta Alpha Psi. Professor Horngren was also a member of the Institute of Management Accountants, from whom he received its Distinguished Service Award. He was a member of the institute's Board of Regents, which administers the certified management accountant examinations.

Horngren is an author of these other accounting books published by Pearson: *Cost Accounting: A Managerial Emphasis*, Fifteenth Edition, 2015 (with Srikant M. Datar and Madhav V. Rajan); *Introduction to Financial Accounting*, Eleventh Edition, 2014 (with Gary L. Sundem, John A. Elliott, and Donna Philbrick); *Introduction to Management Accounting*, Sixteenth Edition, 2014 (with Gary L. Sundem, Jeff Schatzberg, and Dave Burgstahler);

Horngren's Financial & Managerial Accounting, Fifth Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura); and *Horngren's Accounting*, Eleventh Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura). Horngren was the consulting editor for Pearson's Charles T. Horngren Series in Accounting.

C. William (Bill) Thomas is the J. E. Bush Professor of Accounting and a Master Teacher at Baylor University. A Baylor University alumnus, he received both his BBA and MBA there and went on to earn his PhD from The University of Texas at Austin.

With primary interests in the areas of financial accounting and auditing, Bill Thomas has served as the J. E. Bush Professor of Accounting since 1995. He has been a member of the faculty of the Accounting and Business Law Department of the Hankamer School of Business since 1971, and served as chair of the department for 12 years. He was recognized as an Outstanding Faculty Member of Baylor University as well as a Distinguished Professor for the Hankamer School of Business. Dr. Thomas has received several awards for outstanding teaching, including the Outstanding Professor in the Executive MBA Programs as well as the designation as Master Teacher.

Thomas is the author of textbooks in auditing and financial accounting, as well as many articles in auditing, financial accounting and reporting, taxation, ethics, and accounting education. His scholarly work focuses on the subject of fraud prevention and detection, and ethical issues among accountants in public practice. He presently serves as the accounting and auditing editor of *Today's CPA*, the journal of the Texas Society of Certified Public Accountants, with a circulation of approximately 28,000.

Thomas is a certified public accountant in Texas. Prior to becoming a professor, Thomas was a practicing accountant with the firms of KPMG, LLP, and BDO Seidman, LLP. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas Society of Certified Public Accountants.

Wendy M. Tietz is a professor in the Department of Accounting in the College of Business Administration at Kent State University, where she has taught since 2000. She teaches introductory financial and managerial accounting in a variety of formats, including large sections, small sections, and web-based sections. She has received numerous college and university teaching awards while at Kent State University. Most recently she was named the Beta Gamma Sigma Professor of the Year for the College of Business Administration.

Dr. Tietz is a certified public accountant, a certified management accountant, and a chartered global management accountant. She is a member of the American Accounting Association (AAA), the Institute of Management Accountants (IMA), and the American Institute of Certified Public Accountants (AICPA). She has published articles in such journals as *Issues in Accounting Education, Accounting Education: An International Journal,* and *Journal of Accounting & Public Policy*. She received the 2014 Bea Sanders/AICPA Innovation in Teaching Award for her accounting educator blog entitled "Accounting in the Headlines." She regularly presents at AAA regional and national meetings. Dr. Tietz is also the coauthor of a managerial accounting textbook, *Managerial Accounting*, with Dr. Karen Braun.

Dr. Tietz received her PhD from Kent State University. She received both her MBA and BSA from the University of Akron. She worked in industry for several years, both as a controller for a financial institution and as the operations manager and controller for a recycled plastics manufacturer.

Themin Suwardy is the Associate Dean (Curriculum and Teaching) and MPA Programme Director at the School of Accountancy, Singapore Management University. Prior to joining academia, Suwardy was an auditor with KPMG Peat Marwick. He graduated with a Bachelor of Business (Accountancy) (Honours), a Bachelor of Computing (Information System), and a PhD from Monash University, Australia.

At SMU, he received numerous school/university awards, most recently the 2010 SMU Distinguished Teacher award and the 2009, 2010, and 2012 Best MBA Teacher award. He was also a recipient of the Hewlett-Packard Mobile Technology for Teaching Grant award (2004) and the inaugural CEEMAN's Champion Award for Management Teaching (2010) and was accorded Singapore's Public Administration Medal (Bronze) in 2011 for his contribution to education.

Suwardy has been an active member of the accounting profession through his involvement in various professional bodies, including CPA Australia, Institute of Certified Public Accountants of Singapore (ICPAS), Institute of Internal Auditors Singapore (IIAS), and International Association for Accounting Education and Research (IAAER). He served as a governor of IIAS (2009–2011) and vice president of IAAER (2009–2013). He is currently the elected president of CPA Australia—Singapore division.

Suwardy's main research areas include financial reporting and analysis, corporate governance, and accounting education with the emphasis on technologically enabled pedagogy. He is an associate editor of *Accounting Education: An International Journal*. His most recent research grant was to inform the International Accounting Education Standards Board (IAESB) on matters related to *IES 7—Continuing Professional Development*.

Suwardy has consulted and taught for many clients, including KPMG, DFS Galleria, Singapore Airlines, Singapore Institute of Directors, and the National Institute of Education.

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BRIEF CONTENTS

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CONTENTS

With

Financial Accounting

Student Text, Study Resources, and Pearson MyLab Accounting, students will have more

"I get it!"

moments!

PREFACE

Financial Accounting: *International Financial Reporting Standards* (IFRS) continues to give readers a solid foundation in the fundamentals of accounting and the basics of financial statements under IFRS, and then builds upon that foundation to offer more advanced and challenging concepts and problems. This approach helps students to better understand the meaning and relevance of financial information and develop the skills needed to analyze financial information in both their courses and careers.

Written in a manner suitable for accounting and non-accounting majors, *Financial Accounting: IFRS* is the ideal text for a first course in financial accounting with a focus on IFRS. With its long-standing reputation in the marketplace for being easy to read and understand, this text drives home fundamental concepts in a reader-friendly way without adding unnecessary complexity. While maintaining the hallmark features of accuracy, readability, and ease of understanding, this Global Edition includes updated explanations, coverage, new real-world examples, and most importantly, updates to the *Conceptual Framework*.

CHANGES FOR THE ELEVENTH EDITION

1. The first three chapters of the book cover the accounting cycle and how financial statements are constructed. In previous editions of the book, we used separate companies in each of Chapters 1, 2, and 3 to illustrate various phases of the accounting cycle. For this edition, in Chapter 1, we give an overview of the company's financial statements and explain what each contains. The Chapter Spotlight focuses on a new company, Alibaba, which provides an excellent illustration of how companies and accounting frameworks interact in a globalized setting. The updated coverage of the *Conceptual Framework* includes the latest changes made to the IFRS framework, setting the tone for relevant study in the subject. In Chapter 2, we cover business transactions—how they impact the accounting equation and how they are journalized, posted, and summarized. Chapters 3 and 4 come with updated Chapter Spotlights, featuring the latest financial statements and accounting practices of companies. New and updated box features reflect the latest discussions in the IFRS and harmonization contexts. Improved organization of material makes the sequence and flow of the topics easier to follow and retain. New adapted excerpts from real-world companies' notes to the financial statements illustrate how additional information is factored into the main statements.
2. A scaffolding approach has been implemented in the book and its resources. Chapter content and the end-of-chapter material builds from the basic short exercise featuring one basic concept to more advanced problems featuring multiple learning objectives. This allows the student to practice at the basic level and then build upon that success to advance to more challenging problems.
3. Short exercises, exercises, and problems are more clearly labeled by learning objective (LO). Most short exercises have been shortened and simplified in this edition to cover only one LO each. They can be used better to briefly cover single concepts as illustrations or class exercises. Exercises might cover two or three LOs, and problems cover multiple LOs.
4. Chapter 5 has been revised to include a new Chapter Spotlight on The LEGO Group to illustrate the use of internal controls and corporate governance; updated examples of accounting scandals and their repercussions to emphasize the significance of the need for internal controls under IFRS; and new A Closer Look boxes provide snapshots into upcoming changes in IFRS under the topics covered in this chapter and their relevance with International Accounting Standards (IAS) and harmonization. The updated sequence of the topics provides a better flow of the material.
5. Chapter 6 has been updated with a new Chapter Spotlight on Fast Retailing to provide a relevant illustration of a company accounting for merchandise operations across multiple brands. Updated excerpts adapted from various companies' financial statements offer a focused look into inventory management in modern business organizations. New Stop & Think boxes are tailored to act as important checkpoints for concepts on which later topics build. Updated illustrations provide a comparative look into real-world companies' accounts in terms of inventory management.
6. A new Chapter Spotlight focusing on Airbus Group in Chapter 7 illustrates how major companies with operations in multiple countries account for property, plant, and equipment along with intangibles. Adapted excerpts are used as snapshots into the group's classification of assets and methods of accounting.

7. Chapter 9 comes with a new Chapter Spotlight on Jardine Matheson Holdings Ltd. to represent how companies operating in multiple sectors account for liabilities. Updated explanations of the company's financial statements and adapted excerpts shed light on the specifics of the various categories of liabilities. New adapted excerpts from BP's notes to the accounts refer to the Gulf of Mexico oil spill to apply concepts to relatable, real-world incidents. Updated coverage on leases brings the chapter on a par with the latest developments in accounting for liabilities under IFRS.
8. The updated Chapter Spotlight for Chapter 10 and the new Chapter Spotlight on Singtel for Chapter 11 illustrate the management and accounting for shareholders' equity and cash flows. Revised coverage of the cash realization ratio and the direct method to account for cash flows allow a holistic understanding of the concept. New Stop & Think boxes and adapted excerpts from real-world companies' cash flow statements improve the understanding of concepts discussed in these chapters.
9. New Chapter Spotlight on Nestlé for Chapter 12 provides a significantly updated and comprehensive look into financial statement analysis for a company operating in multiple geographies and brands. A detailed look into the company's financial statements covers the various aspects involved in analysis. New Stop & Think boxes offer an opportunity for the students to try their hand at interpreting financial statements and assessing their interpretation.
10. In certain sections, the "Try It in Excel" feature has been added to illustrate the use of Excel and a business problem-solving tool. Students should be exposed to such Excel applications early and frequently in their business education. Throughout the book, most exhibits and journal entries are formatted as Excel worksheets. In addition, at certain points in the text, we include examples that show students step-by-step how to build Excel templates to facilitate the solutions of specific accounting problems.
11. Ethics is a vital part of accounting. Several sections of the text are dedicated to discussing ethical problems that can arise in dealing with that particular subject matter and how they should be properly handled.
12. In all chapters, there is an emphasis on how accounting information covered in that chapter is analyzed and used to help individuals make various kinds of business decisions. User-relevant information and key ratios that are covered in various chapters include the following:

    Chapter 3: Debt-paying ability: net working capital, current ratio, debt ratio

    Chapter 5: Liquidity: acid-test (quick) ratio, accounts receivable turnover, days' sales in receivables

    Chapter 6: Profitability: gross profit percentage, inventory turnover, inventory resident period

    Chapter 9: Time value: time value of money and how it impacts investing and lending decisions

    Chapter 9: Liquidity: accounts payable turnover, days' payable outstanding, cash collection cycle (days' sales in receivables + days inventory outstanding − days' payable outstanding)

    Chapter 10: Profitability: rate of return on ordinary equity, often simply called return on equity (ROE) (net income – preference dividends / total shareholders' equity – preference equity)

    Chapter 11: Cash flow: use of cash flow information by creditors and investors; free cash flow

    Chapter 13: Financial statement analysis: comprehensive financial statement analysis, incorporating all of the ratios covered in the previous chapters, applying them to the book's appendix focus company, Nestlé

13. Emphasis on *Conceptual Framework:* The *Conceptual Framework* is the best way to understand accounting in an IFRS setting. The Eleventh Edition includes updates in the *Conceptual Framework* and combines it with new and updated real-world applications. This approach ensures that students learn basic concepts in accounting in a way that is relevant, stimulating, and fun.
14. Integrated coverage of International Financial Reporting Standards (IFRS): This text offers detailed coverage of the accounting framework and how financial statements provide information for decision making. References to various standards from the IFRS framework offer students insights into the way accounting principles are expressed. A list of resources related to IFRS is available in Appendix D.

VISUAL WALK-THROUGH

Try It in Excel

Describes line-by-line how to retrieve and prepare accounting information (such as adjusted trial balance worksheets, ratio computations, depreciation schedules, bond discount and premium amortization schedules, and financial statement analysis) in Excel.

Try It in Excel®

If you are familiar with Excel, a quick look at Exhibit 2-2 should convince you of how easy it is to prepare the Income Statement, statement of retained earnings, and Balance Sheet in Excel. If you have not already prepared them earlier, prepare three simple templates for each of these financial statements for RedLotus Travel, Inc. You may use these templates again, and add to them, in Chapter 3 as you learn the adjusting entry process.

Selected problems in MyLab Accounting have already prepared these templates for you. The mid-chapter summary problem will illustrate this with another small company.

	A	B	C
1	**Compagnie Financière Richemont Consolidated Statement of Cash Flows**	**Financial Year Ended March 31**	
2	**(Adapted, in millions of €)**	**Dec. 31, 2016**	**Dec. 31, 2015**
3	Net cash from operating activities	€ 1,964	€ 1,704
4	Net cash used in investing activities	(1,287)	(343)
5	Net cash used in financing activities	(1,201)	(642)
6	Net cash flows	(524)	719
7	Effect of exchange rates	(80)	219
8	Beginning cash and cash equivalents	3,152	2,214
9	Ending cash and cash equivalents	€ 2,548	€ 3,152
10			

Excel Integrated Throughout Text!

Excel-based financial statements are used so that students will familiarize themselves with the accounting information format actually used in the business world.

Box Features Throughout Text!

Stop & Think boxes are found at various points in a chapter; this tool includes a question-and-answer snapshot asking students to apply what they just learned. A Closer Look boxes provide a snapshot into upcoming changes in IFRS (and IAS) under the topics covered in the chapters.

A Closer Look

In the next section, we will discuss some accounts that entities keep track of within their accounting systems. Different entities may use slightly different names to represent these accounts, due to historical and cultural factors and preference. For example, while many entities now use the term "Property, Plant and Equipment" (or PPE), U. S. companies tend to label them "Plant Assets," and others prefer the label them "Fixed Assets." Americans uses the term "stock" for both inventory and shares. For example, a statement like "I have sold all my Apple stocks" may mean Apple products or Apple shares. Similarly, many non-American entities will use the term "shareholders" as opposed to "stockholders." In our discussions, we will give you some synonyms or alternative account names so you can have a wider understanding of what different entities use in practice.

Mid-Chapter Summary Problem

Nora, the owner of a small business, came to you for help in reviewing the business's financial statements. She passed you a (rather disorganized) file containing many separate pieces of papers collated by her assistant. The first thing you noticed when you open the file was this document:

	A	B	C
1	**20X6 Balance Sheet[1]**		
2	All other assets less accumulated depreciation	58,000	
3	Cash	3,000	
4	Equity	2,500	
5	Loans[2]	80,000	
6	Payables[3]	1,170	
7	Prepayments	2,470	
8	Receivables[3]	15,920	

Chapter Summary Problems

Found in the middle and then at the end of each chapter along with solutions, this feature provides students with additional guided learning. By appearing twice in each chapter, it breaks down information and enables students to absorb and master the material in manageable pieces.

Decision Guidelines

Illustrates how financial statements are used and how accounting information aids companies in decision making.

DECISION GUIDELINES

IN EVALUATING A COMPANY, WHAT DO DECISION MAKERS LOOK FOR?

These Decision Guidelines illustrate how people use financial statements. Decision Guidelines appear throughout the text to show how accounting information aids decision making.

Suppose you are considering an investment in Alibaba. How do you proceed? Where do you get the information you need? What do you look for?

Decision	Guidelines
1. Can the company sell its products?	**1.** Sales revenue on the Income Statement. Are sales growing or falling?
2. What are the main income measures to watch for trends?	**2.** a. Gross profit (Sales – Cost of goods sold) b. Operating income (Gross profit – Operating expenses) c. Net income (bottom line of the Income Statement) All three income measures should be increasing over time.
3. What percentage of sales revenue ends up as profit?	**3.** Divide net income by sales revenue. Examine the trend of the net income percentage from year to year.
4. Can the company collect its receivables?	**4.** From the Balance Sheet, compare the percentage increase in accounts receivable to the percentage increase in sales. If receivables are growing much faster than sales, collections may be too slow, and the risk of defaults increases.
5. Can the company pay its a. Current liabilities? b. Current and long-term liabilities?	**5.** From the Balance Sheet, compare a. Current assets to current liabilities. Current assets should be somewhat greater than current liabilities. b. Total assets to total liabilities. Total assets must be somewhat greater than total liabilities.

Ethical Issue

This end-of-chapter feature presents students with ethical situations and requires them to work through the decision framework for making ethical judgments. Finally, they are asked to come to a decision and support it.

Ethical Issue

For each of the following situations, answer the following questions:

1. What is the ethical issue in this situation?
2. What are the alternatives?
3. Who are the stakeholders? What are the possible consequences to each? Analyze from the following standpoints: (a) economic, (b) legal, and (c) ethical.
4. Place yourself in the role of the decision maker. What would you do? How would you justify your decision?

Issue 1. Sunrise Bank recently appointed the accounting firm of Smith, Godfroy, and Hannaford as the bank's auditor. Sunrise quickly became one of Smith, Godfroy, and Hannaford's largest clients. Subject to banking regulations, Sunrise must provide for any expected losses on notes receivable that Sunrise may not collect in full.

During the course of the audit, Smith, Godfroy, and Hannaford determined that three large notes receivable of Sunrise seem questionable. Smith, Godfroy, and Hannaford discussed these loans with Susan Carter, controller of Sunrise. Carter assured the auditors that these notes were good and that the makers of the notes will be able to pay their notes after the economy improves.

Challenge Exercises

E2-37. ***(Learning Objective 5: Computing financial statement amounts)*** The manager of Pierce Furniture needs to compute the following amounts: LO 5

- **a.** Total cash paid during October.
- **b.** Cash collections from customers during October. Analyze Accounts Receivable.
- **c.** Cash paid on a note payable during October. Analyze Notes Payable.

Here's the additional data you need to analyze the accounts:

Account	Balance Sep 30	Balance Oct 31	Additional Information for the Month of October
1. Cash..............................	$ 12,000	$ 6,000	Cash receipts, $ 85,000
2. Accounts Receivable.......	27,500	26,000	Sales on account, $ 50,000
3. Notes Payable	16,100	23,000	New borrowing, $ 15,000

Challenge Exercises

Additional exercises have been developed to provide students with the opportunity for applied critical thinking.

DIGITAL WALK-THROUGH

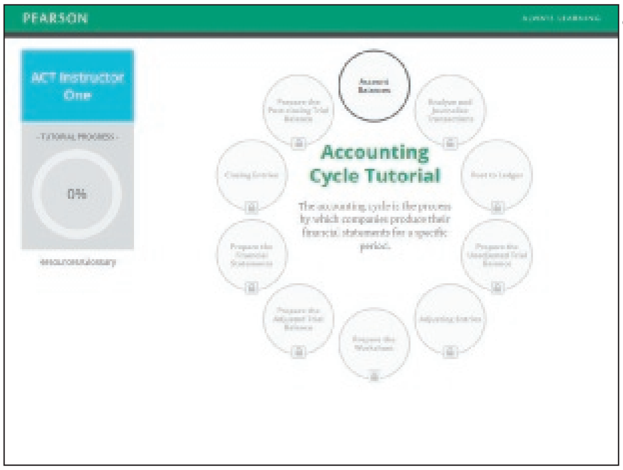
NEW!

Pearson eText

The Pearson eText, available through MyLab Accounting, gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Rich media options let students watch lecture and example videos as they read or do their homework. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners in your class.

The Pearson eText companion app allows existing subscribers to access their titles on an iPad or Android tablet for either online or offline viewing. The app is available on Google's Play Store and Apple's App Store.

- Now available on smartphones and tablets
- Seamlessly integrated videos and other rich media
- Accessible (screen-reader ready)
- Configurable reading settings, including resizable type and night-reading mode
- Instructor and student note taking, highlighting, bookmarking, and search



Accounting Cycle Tutorial (ACT)

NEW!

MyLab Accounting's new interactive tutorial helps students master the accounting cycle for early and continued success in the Introduction to Accounting course. The tutorial, accessed by computer, Smartphone, or tablet, provides students with brief explanations of each concept of the accounting cycle through engaging videos and animations. Students are immediately assessed on their understanding, and their performance is recorded in the MyLab Accounting grade book. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyLab Accounting to help them be successful with the accounting cycle.

Learning Catalytics

NEW!

Learning Catalytics, available through MyLab Accounting, is a "bring your own device" assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of automatically graded or open-ended questions that test content knowledge and build critical thinking skills.

STUDENT AND INSTRUCTOR RESOURCES

For Students

MyLab Accounting online Homework and Assessment Manager includes:

- Pearson eText
- Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- Videos
- Demo Docs
- Flash Cards
- Dynamic Study Modules
- QuickBooks Data Files
- Excel in Practice Data Files
- Working Papers

Student resource website: http://www.pearsonglobaleditions.com/harrison
This website contains the following:

- The QuickBooks Data Files and the Excel in Practice Data Files, related to select end-of-chapter problems
- Working Papers, for completing end-of-chapter questions in preformatted templates
- Student PowerPoint® Presentations

For Instructors

Instructor Resource Center: http://www.pearsonglobaleditions.com/harrison
For the instructor's convenience, the instructor resources can be downloaded from the textbook's catalog page and MyLab Accounting. Available resources include the following:

- *Instructor's Resource Manual*: Includes chapter outlines, suggested in-class activities, topics with which students struggle, as well as the following:
  - Assignment grid that outlines all end-of-chapter exercises, problems, and cases; the topic being covered in that particular exercise, problem, or cases; estimated completion time; level of difficulty; and availability in General Ledger, QuickBooks, or Excel templates.
- *Instructor's Solutions Manual*: Contains solutions to all end-of-chapter questions, including short exercises, exercises, problems, and cases.
- *Test Bank*: Includes more than 2,000 questions. Both objective-based questions and computational problems are available.
- *PowerPoint Presentations*: These presentations help facilitate classroom discussion.
  - Instructor PowerPoint Presentations with lecture notes
  - Student PowerPoint Presentations
- *Working Paper Templates and Solutions* in Excel and PDF Format
- *Image Library*
- *Data and Solution Files*: These include QuickBooks Data Files and Excel in Practice Data Files, related to select end-of-chapter problems. Corresponding solution files are also provided.

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ACCOUNTING CAREERS: MUCH MORE THAN COUNTING THINGS

What kind of career can you have in accounting? Almost any kind you want. A career in accounting lets you use your analytical skills in a variety of ways, and it brings both monetary and personal rewards.

Today's accountants obtain years of formal education at the college level which, for most, culminates in taking a very rigorous professional exam that qualifies them to hold the designation of Certified Public Accountant (CPA) or chartered accountant (CA). There are other professional designations that accountants may obtain as well, each with its own professional exam and set of professional standards. Examples are Certified Management Accountant (CMA), certified internal auditor (CIA), and Certified Fraud Examiner (CFE).

WHERE ACCOUNTANTS WORK

Where can you work as an accountant? There are four kinds of employers.

Public Practice

You can work for public accounting firm, which could be a large international firm or a variety of medium to small-sized firms. Within a CPA firm, you can specialize in areas such as audit, tax, or consulting. In this capacity, you'll be serving as an external accountant to many clients. At present, the six largest international firms are Deloitte, Ernst & Young (E&Y), KPMG, PricewaterhouseCoopers (PwC), Grant Thornton, and RSM McGladrey. However, there are many other firms with an international or national scope of practice. Most CPAs start their career at a large CPA firm. From there, they move on to obtain positions of leadership in the corporate finance world or just about anywhere with a demand for people who like solving complex problems.

Managerial Accounting

Instead of working for various clients, you can work in one corporation or nonprofit enterprise. Your role may be to analyze financial information and communicate that information to managers, who would use it to strategize and make decisions. You may be asked to help allocate corporate resources or make recommendations to improve financial performance. For example, you might do a cost-benefit analysis to help decide whether to acquire a company or build a factory. Or you might describe the financial implications of choosing one strategy over another. You might work in areas such as internal auditing, financial management, financial reporting, treasury management, and tax planning. The highest position in management accounting is the chief financial officer (CFO) position, with some CFOs rising to become chief executive officers (CEOs).

Government and Not-for-Profit Entities

As an accountant, you might work for the government—central, state, or local. Similar to corporate or private accounting roles, a government accountant's role includes responsibilities in the areas of auditing, financial reporting, and management accounting. You will be expected to evaluate how government agencies are managed. You may advise decision makers on how to allocate resources to improve efficiency. Many countries have agencies that hire CPAs to investigate the financial aspects of white-collar crime. You might find yourself working for tax authorities, national accounting or audit agencies, security commissions or stock exchanges, the ministry of finance or the treasury, or even the parliament.

As an accountant, you might also decide to work in the nonprofit sector. Colleges, universities, primary and secondary schools, hospitals, and charitable organizations all have accounting functions. Accountants for these types of entities prepare financial statements as well as budgets and projections. Most have special training in accounting standards that are specially designed for the nonprofit sector.

Education

You can work at a college or university, advancing the thought and theory of accounting and teaching future generations of new accountants. On the research side, you might study how companies use accounting information. You might develop new ways of categorizing financial data, or study accounting practices in different countries. You can then publish your ideas in journals and books and present them to colleagues at meetings around the world. On the education side, you can help others learn about accounting and give them the tools they need to be their best.

CPA: THREE LETTERS THAT SPEAK VOLUMES

When employers see the CPA designation, they know what to expect about your education, knowledge, abilities, and personal attributes. They value your analytical skills and extensive training. Your CPA credential gives you a distinct advantage in the job market and credibility in the workplace. It's a plus when dealing with other professionals such as bankers, attorneys, auditors, and government regulators. In addition, your colleagues in the private industry would tend to defer to you when dealing with complex business matters, particularly those involving financial management.

THE HOTTEST GROWTH AREAS IN ACCOUNTING

Recent legislations, such as the Sarbanes-Oxley Act of 2002 (SOX), around the world have increased the demand for accountants of all kinds. In addition to a strong overall demand, the following areas* of accounting are especially popular:

Sustainability Reporting

Sustainability reporting involves reporting on an organization's performance with respect to health, safety, and environmental issues (HSE). As businesses take a greater interest in environmental issues, CPAs are getting involved in reporting on matters like employee health, on-the-job accident rates, emissions of certain pollutants, spills, volumes of waste generated, and initiatives to minimize such incidents. Utilities, manufacturers, and chemical companies are particularly affected by environmental issues. As a result, they approach CPAs to set up a preventive system to ensure compliance and avoid future disputes or to provide assistance once legal complications arise.

*Refer to the Pearson Series in Accounting to identify the textbooks that will help you prepare for various branches of accounting.

Corporate social responsibility (CSR) reporting is similar to HSE reporting, but with a broader emphasis on social matters, such as ethical labor practices, training, education, diversity of workforce, and corporate philanthropic initiatives. Most of the world's largest corporations have extensive CSR initiatives.

Assurance Services

Assurance services are provided by a CPA to improve the quality of information, or its context, for decision makers. Such information can be financial or non-financial, and can be about past events or ongoing processes and systems. This broad concept includes audit and attestation services and is distinct from consulting because it focuses primarily on improving information rather than on providing advice or installing systems. You can use your analytical and information-processing expertise to provide assurance services in areas ranging from e-commerce to elder care, comprehensive risk assessment, business valuation, entity performance measurement, and information systems quality assessment.

Information Technology Services

Companies can't compete effectively if their information technology systems don't have the power or flexibility to perform essential functions. Companies need accountants with strong computer skills who can design and implement advanced systems to fit a company's specific needs and to find ways to protect and insulate data. CPAs skilled in software research and development (including multimedia technology) are also highly valued.

International Accounting

Globalization means that cross-border transactions have become commonplace. Countries in Eastern Europe and Latin America, which previously had closed economies, have open trade relations and are doing business with new trading partners. The passage of the North American Free Trade Agreement (NAFTA) and the General Agreement on Tariffs and Trade (GATT) facilitates trade, and the economic growth in areas such as the Pacific Rim further brings greater volumes of trade and financial flows. Organizations need accountants who understand international trade rules, accords, and laws; cross-border merger and acquisition issues; and foreign business customs, languages, cultures, and procedures.

Forensic Accounting

Forensic accounting is in growing demand after scandals such as the collapse of Enron and WorldCom, which are featured in this text. Forensic accountants look at a company's financial records for evidence of criminal activity. This could be anything from securities fraud to overvaluation of inventory; from money laundering to improper capitalization of expenses.

Whether you seek a career in a business, government, or nonprofit sector, accounting has a career for you. Every organization, from the smallest mom-and-pop music retailer to the biggest government agency in the world, needs accountants to help manage its resources.

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International Financial Reporting Standards

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1 *Conceptual Framework* and Financial Statements

SPOTLIGHT | Alibaba Group www.alibabagroup.com

In 1998, Jack Ma, a former English teacher from Hangzhou, China, started Alibaba with 18 other people. Alibaba was established to champion small businesses, in the belief that the Internet would level the playing field by enabling small enterprises to leverage innovation and technology to grow and compete more effectively in the domestic and global economies. Fast-forward 20 years. Alibaba is now a global Internet e-commerce giant with businesses ranging from marketplaces such as alibaba.com and taobao.com to financial services (AliPay), cloud computing, and even motion pictures (Alibaba Pictures). Alibaba's Initial Public Offering (IPO) on the New York Stock Exchange in 2014 is currently the largest IPO to date, having raised over US$20 billion.

In the financial year ended March 31, 2016, Alibaba earned a total revenue in excess of 100 billion Renminbi (¥), which is equivalent to about US$15.7 billion. After deducting the cost of sales and other expenses, Alibaba's 2016 net income was about ¥71 billion. From its operating activities, Alibaba generated cash flows of about ¥57 billion. Its assets grew from ¥255 billion the year before to ¥364 billion in 2016. ●

Renminbi Chinese currency, abbreviated RMB or CNY for Chinese Yuan, ¥

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Alibaba Group Holdings Limited Consolidated Income Statement	Year Ended March 31		
(Adapted, in millions of ¥ and US$)	**Mar. 31, 2015**	**Mar. 31, 2016**	**Mar. 31, 2016**
Revenue	¥ 76,204	¥ 101,143	$ 15,686
Cost of revenue	(23,834)	(34,355)	(5,328)
Product development expenses	(10,658)	(13,788)	(2,138)
Sales and marketing expenses	(8,513)	(11,307)	(1,753)
General and administrative expenses	(7,800)	(9,205)	(1,428)
Amortization of intangible assets	(2,089)	(2,931)	(455)
Impairment of goodwill	(175)	(455)	(71)
Income from operations	23,135	29,102	4,513
Other income	2,486	2,058	319
Interest and investment income	9,455	52,254	8,104
Interest expense	(2,750)	(1,946)	(301)
Share of results of equity investees	(1,590)	(1,730)	(269)
Income tax expenses	(6,416)	(8,449)	(1,310)
Net income	¥ 24,320	¥ 71,289	$ 11,056

The terms *revenue, net income,* etc. may be foreign to you now, but after you read this chapter, you will gain a greater understanding of financial statements. Welcome to the world of accounting!

Each chapter of this text begins with adapted extracts of an actual financial statement. In this chapter, our reference is the Consolidated Income Statements of Alibaba, for the two years ended March 31, 2015, and March 31, 2016. We will continue to explore various examples of financial statements (and their notes to the accounts) throughout this text, so you can relate the theories and concepts to actual financial accounting practices and disclosures.

The core of financial accounting revolves around the following financial statements:

- Statement of Comprehensive Income (which includes the above Income Statement)
- Statement of Financial Position (more commonly called Balance Sheet)
- Statement of Cash Flows
- Statement of Changes in Equity

Financial statements are the business documents that companies use to report the results of their activities to various user groups, which can include managers, investors, creditors, and regulatory agencies. In turn, these parties use the reported information to make a variety of decisions, such as whether to invest in or loan money to the company, amongst many others. To learn accounting, you must learn to focus on decisions. In this chapter we explain the *Conceptual Framework* of financial reporting, which underpins how a financial phenomenon is recognized, measured, and disclosed to the users of financial statements. We will also look at the bodies responsible for issuing accounting standards. We will discuss the judgment process that is necessary to make good accounting decisions. In addition to this, we will also discuss the contents of the four basic financial statements that report the results of those decisions. In later chapters, we will explain in more detail how to construct financial statements as well as how user groups typically use the information contained in these statements to make business decisions.

LEARNING OBJECTIVES

1. **Understand** the role of accounting in communicating financial information
2. **Understand** the underlying accounting concepts in the IFRS *Conceptual Framework*
3. **Obtain** insights into business operations through financial statements
4. **Identify** financial statements and their inter-relationships
5. **Understand** the role of ethics in accounting

UNDERSTAND THE ROLE OF ACCOUNTING IN COMMUNICATING FINANCIAL INFORMATION

Business Decisions

1 **Understand the role** of accounting in communicating financial information

Alibaba's shareholders and potential investors make many financial decisions. They decide when to buy, hold, or sell their investment. They assess the stewardship and accountability of the company's management. They assess the profitability, efficiency, liquidity, and cash flows of the company. Alibaba's management also uses financial information to help the company decide on its sources of funding and capital; they make costing and pricing decisions and analyze the performance of various business groups within the company. Accounting helps companies, their shareholders, and management make these decisions.

Take a look again at Alibaba's Consolidated Income Statement. Let us start with its "bottom line" on line 16. Alibaba calls it "net income" but other businesses may use terms such as "net profit" or "Income for the year." Net income is the excess of revenues over expenses. We can see that Alibaba earned a net income of ¥71 billion for the financial year ended March 31, 2016. That's good news because it means that Alibaba had ¥71 billion more in revenues than its expenses for the year, despite the challenging economic conditions and subdued economic growth since the global financial crisis of 2008. What is amazing is that Alibaba's growth in revenue is at 33%, but its net income has almost doubled!

Suppose you have some money to invest. What information would you need before deciding to invest in Alibaba? How would you know if the information appropriately reflects Alibaba's actual financial performance and financial position? Let's see how accounting gives you all this information.

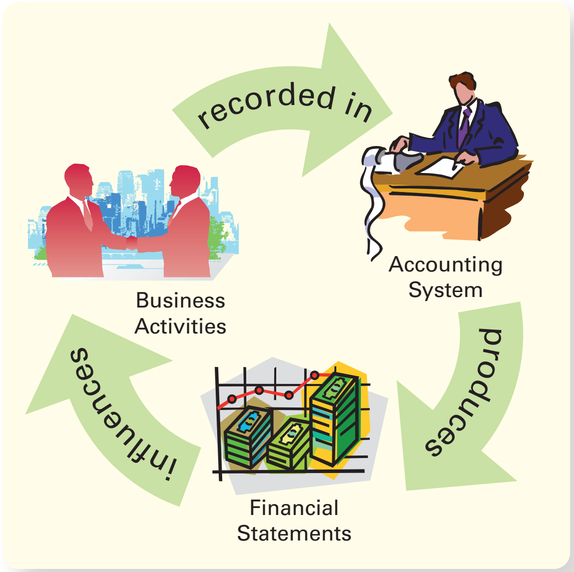
Accounting Is the Language of Business

Italian merchants in Genoa, Florence, and Venice were at the epicenter of trade between Europe and the Middle East in the 13th and the 14th centuries. As trading ventures grew, individual merchants were not able to provide the capital necessary to conduct business ventures on their own. Thus, the concept of "shareholders" and "capital" was born, and along with it the need to report on the venture's financial status to investors. Father Luca Pacioli, a contemporary of Leonardo da Vinci, documented the so-called "Venetian Method" of bookkeeping in his book titled *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (*Everything About Arithmetic, Geometry and Proportion*), published on November 10, 1494. As commerce grew in Europe, it quickly spread, and today we know it as the **double-entry system** of bookkeeping, which forms the basis of financial reporting to shareholders. In fact, November 10 is celebrated as International Accounting Day!

Accounting today is clearly more complex and sophisticated than what was prescribed by Pacioli, but at its heart, **accounting** is an information system. It records and measures business activities, processes data into information, and communicates this information to decision makers who make decisions that will have an impact on business activities. Indeed, accounting is "the language of business."

Exhibit 1-1 shows how business activities are recorded in the accounting system, which, in turn, produces financial reports that help decision making in business activities.

Exhibit 1-1 The Flow of Accounting Information



So, who needs to be familiar with this language? Those who run a business? Shareholders? Well anyone who makes any business decision needs to be familiar with accounting. Accounting is the language of communication in all businesses. The better our understanding of this language, the better we can understand our finances, our businesses, or our investments!

Two Perspectives of Accounting: Financial Accounting and Management Accounting

Both *external* and *internal users* of financial information exist. Therefore, we can classify accounting into two branches. **Financial accounting** provides information to decision makers outside the **reporting entity**. These are investors, creditors, government agencies, and the public. This text focuses on financial accounting.

Management accounting provides information for Alibaba's managers. Examples of management accounting information include budgets, forecasts, and projections that are used in making strategic decisions for the entity. Managers of Alibaba have the ability to determine the form and content of financial information in order to meet their own needs. Internal information must still be reliable and relevant for their decision needs.

You may be doing this course as an accounting student or a non-accounting student. Regardless of your eventual career ambitions, knowledge of accounting will help you understand how organizations operate. Many accounting graduates work in professional accounting services, typically with public accounting firms. These firms offer various services to business and government sectors, such as audit and assurance, taxation advice, consultancy, and advisory. Those who venture into the corporate world may work in various accounting functions, from treasury and finance, to internal audit and risk management. Even if you are not an accounting student, in almost all lines of work and across industries, you will have to make decisions in your day-to-day activities, most of which will require you to understand, prepare, or work with some form of financial reporting and budgeting. On an personal level, you may also find that accounting helps you manage your own finances and investments better.

Organizing a Business

Accounting is used in every type of business. A business generally takes one of the following forms:

- Proprietorship
- Partnership
- Corporation

Exhibit 1-2 compares ways to organize a business.

Exhibit 1-2 The Various Forms of Business Organization

	Proprietorship	Partnership	Corporation
1. *Owner(s)*	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
2. *Personal liability of owner(s) for business debts*	Proprietor is personally liable	General partners are personally liable; limited partners are not	Shareholders are *not* personally liable

Proprietorship. A **proprietorship** has a single owner, called the proprietor. Mark Zuckerburg's Facebook started out in a dormitory room at Harvard University; it was originally designed to serve as an intra-university software to help students recognize faces on campus. Steve Jobs and Steve Wozniak started Apple in the garage of Jobs' childhood home. Jack Ma started Alibaba in his apartment in Hangzhou. Almost every single big company you see today started just like Facebook, Apple, and Alibaba. Proprietorships tend to be small retail stores or individual providers of professional services—physicians, attorneys, software programmers, or accountants. Legally, the business *is* the proprietor, and the proprietor is personally liable for all the business's debts. But for accounting purposes, a proprietorship is a distinct entity, separate from its proprietor. Thus, the business records should not include the proprietor's personal finances.

Partnership. A **partnership** has two or more parties as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. Income and loss of the partnership "flows through" to the partners and they recognize it based on their agreed-upon percentage interest in the business. In general, a partnership is not a taxpaying entity. Instead, each partner takes a proportionate share of the entity's taxable income and pays tax according to that partner's individual or corporate rate. Many retail establishments, professional service firms (law, accounting, etc.), real estate, and oil and gas exploration companies operate as partnerships. Many partnerships are small or medium-sized, but some are very large, with thousands of partners. Partnerships are governed by agreement, usually spelled out in writing in the form of a contract between the partners. General partnerships have mutual agency and unlimited liability, meaning that each partner may conduct business in the name of the entity and can make agreements that legally bind all partners without limit for the partnership's debts. Therefore, partnerships are quite risky because an irresponsible partner can create large debts for the other general partners without their knowledge or authorization. This feature of general partnerships has spawned the creation of limited-liability partnerships (LLPs).

A *limited-liability partnership* is one in which a wayward partner cannot create a large liability for the other partners. In LLPs, each partner is liable for partnership debts only up to the extent of his or her investment in the partnership, plus his or her proportionate share of the liabilities. Each LLP, however, must have one general partner with unlimited liability for all partnership debts. Many of the accounting firms, such as the "Big 4" accounting firms (Deloitte, E&Y, KPMG, and PricewaterhouseCooopers) are now organized as LLPs.

Corporation. A **corporation** is a business owned by the **shareholders**, who own shares representing ownership in the corporation. One of the major advantages of doing business in the corporate form is the ability to raise capital from issuance of shares to the public. In 1999, Jack Ma founded Alibaba with a mere US$60,000—this was an initial investment from friends and close ones. Mark Zuckerberg and other Facebook founders incorporated their company in late 2004 and received initial investments from a group of people, including Peter Thiel, the co-founder of PayPal. All types of entities (individuals, partnerships, corporations, or other types) may be shareholders in a corporation. Even though proprietorships and partnerships are more numerous, corporations transact much more business and are larger in terms of assets, income, and number of employees. Most well-known companies, such as the Samsung Group, Starbucks, Google, Toyota, and LEGO, are corporations. Their full names usually indicate that they are structured as a company. The most common labels include *Corporation*, *Incorporated*, or simply *Company*. This depends very much on the local and legal practices in the country of incorporation. For example, in Australia you often see *Pty Ltd* (*Proprietary Limited*), in the United Kingdom you will see *PLC* (*Public Limited Company*), in Germany *AG* (*Aktiengesellschaft*), in Italy *SpA* (*Società per Azioni*), in Malaysia *Sdn Bhd* (*Sendirian Berhad*), in Singapore *Pte Ltd* (*Private Limited*), in Belgium *SA* (*Société Anonyme*), in Brazil *Ltda* (*Sociedade Limitada*), etc.

A corporation is formed under the relevant legislations extant in the country of incorporation. Unlike proprietorships and partnerships, a corporation is legally distinct from its owners. The corporation is like an artificial person and possesses many of the same rights that a person has. The shareholders have no personal obligation for the corporation's debts and have limited liability. Ultimate control of a corporation rests with the shareholders, who generally get one vote for each share they own. In general, shareholders elect the board of directors, which sets policy and appoints management officers, such as the chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO), and other key functions as necessary.

Role of Accounting Standards

In science, we assign numerals to represent the properties of material systems according to the scientific laws that govern those properties. For example, we can measure the size of an object, the temperature of a room, the speed of a car, and so on. Similarly, in accounting, we assign monetary amounts to represent elements of financial statements in accordance to some accounting standards. Accounting standards are necessary because without them, users of financial statements would have to learn the basis of accounting for each company, making comparisons to other companies' financial statements difficult.

Unfortunately, unlike scientific laws, accounting rules tend to vary in different jurisdictions. Until recently, one of the major challenges in conducting global business has been the fact that different countries have adopted different accounting standards for business transactions. Developed countries like the United States, the United Kingdom, Japan, Germany, Australia, etc., follow their own professional frameworks for measurement and disclosure of financial information, usually called **generally accepted accounting principles (GAAP)**. As investors seek to compare financial results across entities from different countries, they have had to restate and convert accounting data from one country to the next in order to make them comparable. This takes time and can be expensive, especially in a globalized world with multinationals operating across many countries.

A Closer Look

Alibaba's financial statements were prepared under U.S. GAAP (more on the role of accounting standards later in this chapter). For our discussions in this introductory chapter, there is no discernible difference in the presentation of items on the financial statements.

The potential solution to this problem lies with the **International Accounting Standards Board (IASB)** and its **International Financial Reporting Standards (IFRS)**. The IASB was formed in 2001 to replace the International Accounting Standards Committee (IASC) with the objective of developing a single set of high-quality, understandable, and enforceable accounting standards to help participants in the world's capital markets and other users make economic decisions. While IASB now sets IFRS, the previously issued International Accounting Standards (IAS) by the IASC continue to remain effective. This is why, in our study of accounting, we will see some standards labeled IAS or IFRS. Collectively, they can simply be referred to as IFRS. These standards may also be relabeled differently in different countries. For example, in Singapore, they are called Financial Reporting Standards (FRS), in Australia, they are labeled AASB after its national Australian Accounting Standards Board, in South Africa, they are called Generally Recognized Accounting Principles (GRAP), and so forth. Throughout this book, we will make references to accounting standards by their original IAS and IFRS numbers and titles. You can access IFRS from the IASB website at www.ifrs.org after completing a free registration process. If you are interested in comparisons between your local accounting standards and IFRS, you can refer to Appendix D which contains a listing of IFRS and some other useful resources.

These standards are now being used by most countries around the world. According to the IFRS Foundation, 84% of 150 jurisdictions (countries and territories) around the world either require or permit the use of IFRS for financial reporting, especially for listed companies. Other major economies, including the United States, Japan, India, and China, are working towards IFRS convergence. As this exercise gains momentum, you can expect to hear more about the adoption and use of IFRS, as well as global harmonization of accounting standards. When you do, the most important things to remember will be that these changes will be beneficial for financial statement users in the long run, and that most of what you learn in this accounting course will strongly apply.

A Closer Look

For a while, there was talk about the possibility of a full convergence between U.S. GAAP and IFRS. The signing of a Memorandum of Understanding (MoU) in September 2002 between the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) opened the way for various joint projects and joint pronouncements. Since 2007, non-U.S. companies listed in the United States are able to report using IFRS without reconciliation to GAAP. In 2008, an updated MoU further placed a set of common priorities and milestones for both IASB and FASB. Despite progress (and successes) in many joint projects between the FASB and the IASB, including the new joint standard on Revenue (see Chapter 3), the appetite for full convergence has diminished. The two boards have agreed to disagree on a number of key standards such as leasing, financial instruments, etc.

Outside of the United States, however, convergence is continuing with increasing jurisdiction, either mandating or allowing the use of IFRS for listed companies. In fact, the vision of global accounting standards has been publicly supported by many governments and international organizations, including the G20 (group of twenty major economies in the world), the World Bank, the International Monetary Fund (IMF), the International Committee of Securities Commissions (IOSCO), and the International Federation of Accountants (IFAC).

	Number of Jurisdictions				
Region	**Jurisdictions in the region**	**Jurisdictions that require IFRS Standards for all or most domestic publicly accountable entities**	**Jurisdictions that require IFRS Standards as % of total jurisdictions in the region**	**Jurisdictions that permit or require IFRS Standards for at least some (but not all or most) domestic publicly accountable entities**	**Jurisdictions that neither require nor permit IFRS Standards for any domestic publicly accountable entities**
Europe	44	43	98%	1	0
Africa	23	19	83%	1	3
Middle East	13	13	100%	0	0
Asia-Oceania	33	24	73%	3	6
Americas	37	27	73%	8	2
Totals	150	126	84%	13	11
As % of 150	100%	84%		9%	7%

For more information about individual jurisdiction profile, visit http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx.

The advantages of adopting one common set of standards are clear. Companies in jurisdictions that have mandated or allowed the use of IFRS, such as Australia, Hong Kong, the United Arab Emirates, Europe, Japan, and the United States, will have financial statements that are more comparable with each other. It will be far easier for investors and other financial statement users to evaluate the information of various companies across the globe, and companies will only have to prepare one set of financial statements, instead of multiple versions. Thus, in the long run, the global use of IFRS should reduce the costs of doing business globally.

UNDERSTAND THE UNDERLYING ACCOUNTING CONCEPTS IN THE IFRS *CONCEPTUAL FRAMEWORK*

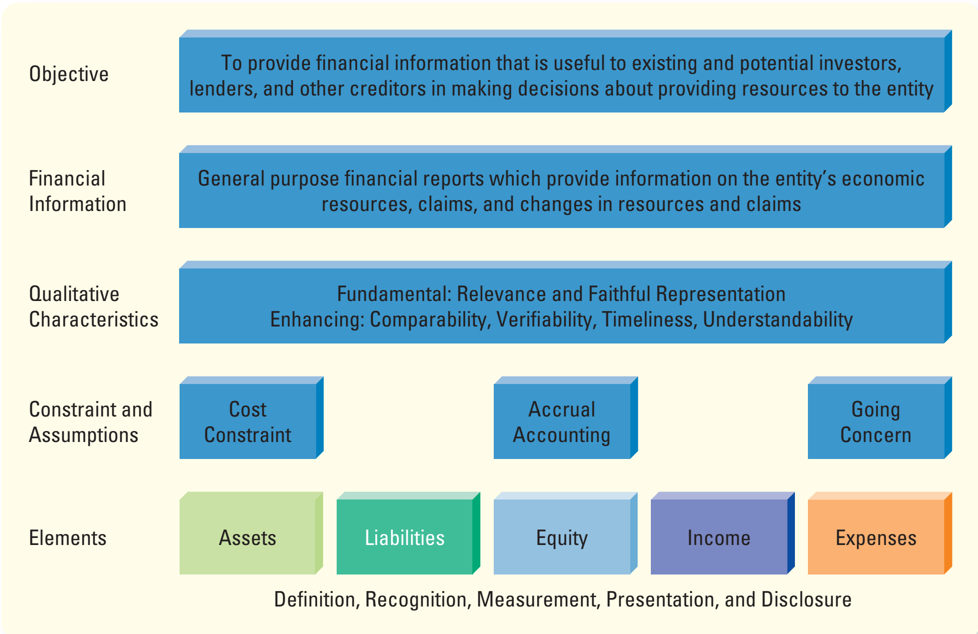
The *Conceptual Framework*

2 **Understand** the underlying accounting concepts in the IFRS *Conceptual Framework*

The ***Conceptual Framework*** lays the foundation for resolving the big issues in accounting. You can think of it as the "Why, Who, What, How" of financial reporting. The *Conceptual Framework for Financial Reporting* (we will refer to it as the *Conceptual Framework*) prescribes the nature, function, and boundaries within which financial accounting and reporting operate. The existing *Conceptual Framework* (last updated in 2010) is a joint publication by the IASB and the FASB, used as a foundation for reviewing existing and developing new accounting standards. The revised *Conceptual Framework* is expected to be released toward the end of 2017. You can access the *Conceptual Framework* on the IASB website. Your instructor may alternatively direct you to a copy of the *Conceptual Framework* as applicable in your jurisdiction.

The *Conceptual Framework's* focus is on **general purpose financial statements**, which are prepared and presented annually and are directed toward the common information needs of a wide range of financial statement users. Many of these users rely on the financial statements as their major source of financial information. Special purpose financial reports, such as computations for taxation purposes or other regulatory reporting requirements, are outside the scope of the *Conceptual Framework*. Exhibit 1-3 gives an overview of the *Conceptual Framework*.

Exhibit 1-3 | *Conceptual Framework* of Financial Reporting



Why Is Financial Reporting Important?

The *Conceptual Framework* states that the objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors. This includes information about the entity's resources and claims to those resources, and the effects of transactions and other events and conditions that change those resources and claims. Users evaluate financial statements to make decisions like whether or not to make additional investments into the entity, provide credit and financing, or assess the management's efficiency and effectiveness in its use of the entity's resources.

While financial statements can be used to help users assess the financial health of an entity, as well as its strengths and weaknesses, they are not designed to show the "value" of an entity; that depends on many other factors besides financial statements, such as general economic conditions and expectations, political events and climate, and industry and company outlook.

Who Are the Users of Financial Reports?

Different users make different types of economic decisions based on their relationship with the entity. In your personal and professional life, you are very likely to assume any of these user roles. Here are some examples of users who may be interested in Alibaba's financial statements (and other parts of a company's annual report, which we will discuss in Chapter 4):

- Investors in Alibaba would want to know if they are getting adequate returns for the risks they are taking when they invest in the company. They may decide to increase, hold, or decrease their ownership of Alibaba by buying or selling their shares on the stock exchange.
- Employees of Alibaba may be interested in its financial information for many reasons. Job security, salary increments, and compensation bonuses are usually worse off when a company has declining profits or is experiencing losses.
- Creditors, such as bankers or other financial institutions, may need to decide if they will grant Alibaba additional loans for expansion plans. They would want to know if Alibaba has the ability to service interest payments and whether it will be able to repay the loan principal.
- Suppliers and trade creditors often grant credit terms to their customers. They would want to know that Alibaba will be able to pay their invoices as and when they become due.
- It is unlikely that retail customers would demand financial information before buying merchandise from Alibaba. However, if you know that Alibaba is experiencing financial difficulties or suffering losses, you may be worried that it will not be able to offer warranty support or repair services for its products.
- The government and its agencies are interested in various aspects of a business, for example, tax collection and allocation of grants or subsidies. Listed companies would also need to comply with the stock exchange's disclosure requirements or "listing rules."
- With increasing expectations of corporate social responsibility, members of the public may be interested in Alibaba executive remuneration, health and safety issues, or even the environmental impact of its business operations.

It is important to note that the *Conceptual Framework* specifically states that general purpose financial reports do not satisfy all the potential information needs of financial statement users. The *Conceptual Framework* focuses on primary users of financial statements, which includes existing and potential investors, lenders, and creditors. The IASB uses the *Conceptual Framework* in setting accounting standards that provide an information set to meet the needs of the maximum number of primary users. Other non-primary users, such as government regulators, may find financial statements useful, but the financial statements are not primarily directed towards them.

What Makes Financial Information Useful?

The *Conceptual Framework* uses the term **qualitative characteristics** to describe the attributes that will most likely make the information provided in financial statements useful to users. The *Conceptual Framework* suggests that if financial information is to be useful, it must first be relevant and it must faithfully represent what it purports to represent—these are the "fundamental qualitative characteristics." Information that is relevant and faithfully represented may be further enhanced if it is comparable, verifiable, timely, and understandable—these are the "enhancing