GLOBAL EDITION

Financial Accounting

INTERNATIONAL FINANCIAL REPORTING STANDARDS

NINTH EDITION

Walter T. Harrison Jr.
Charles T. Horngren
C. William Thomas
Themin Suwardy

ALWAYS LEARNING

PEARSON

FINANCIAL ACCOUNTING

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International Financial Reporting Standards

Ninth Edition

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For our wives,

Nancy, Joan, Mary Ann, and Febrita

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*.

He is co-author of *Financial & Managerial Accounting*, second edition, 2009 and *Accounting*, eighth edition, 2009 (with Charles T. Horngren and M. Suzanne Oliver), published by Pearson Prentice Hall. 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.

Horngren served the American Accounting Association as its president and as director of research. He received the association's first annual Outstanding Accounting Educator Award. He also received its Lifetime Contribution to Management Accounting Award.

The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He is the first person to have received both awards.

The American Institute of Certified Public Accountants presented him with its first Outstanding Educator Award.

He was also named Accountant of the Year, Education, by the national professional accounting fraternity, Beta Alpha Psi.

Professor Horngren was a member of the Institute of Management Accountants, where 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 authored several other accounting books published by Pearson: *Cost Accounting: A Managerial Emphasis*; *Introduction to Financial Accounting*; *Accounting*; and *Introduction to Management Accounting*.

He was also the Consulting Editor for the Charles T. Horngren Series in Accounting.

Charles William (Bill) Thomas is the KPMG/Thomas L. Holton Chair, 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 and the KPMG/Thomas L. Holton Chair since 2006. 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 from 1983 until 1995. He was recognized as an Outstanding Faculty Member of Baylor University in 1984 and Distinguished Professor for the Hankamer School of Business in 2002. Dr. Thomas has received several awards for outstanding teaching, including the Outstanding Professor in the Executive MBA Programs in 2001, 2002, and 2006. In 2004, he received the designation as Master Teacher, an honor that has only been bestowed on 21 persons since the University's inception in 1845.

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, as well as ethical issues among accountants in public practice. His most recent publication of national prominence is "The Rise and Fall of the Enron Empire" which appeared in the April 2002 *Journal of Accountancy*, and which was selected by Encyclopedia Britannica for inclusion in its *Annals of American History*. He presently serves as both technical and 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.

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) and 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 2009, 2010 and 2012 Best MBA Teacher award. He was also a recipient of the Hewlett-Packard Mobile Technology for Teaching Grant award (2004), 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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"I get it!"

moments!

Hallmark Features

Financial Accounting: IFRS continues the hallmark features you have come to expect of a leading introductory financial accounting textbook. Written in a manner suitable for both students of accounting and non-accounting majors, *Financial Accounting: IFRS* is the ideal text for a first course in financial accounting with a focus on IFRS.

Emphasis on Conceptual Framework

The conceptual framework is the best way to understand accounting in an IFRS setting. Accounting produces financial statements that are useful to existing and potential investors, lenders, and other creditors. Students are introduced to the big questions of accounting: why, who, what, when, how, and so forth. The conceptual framework has been updated to include the latest pronouncements, an objective of financial reporting, and qualitative characteristics. Elements of financial statements are defined early in the text. Students see how these elements interact with each other and are reported in the financial statements.

Integrated Coverage of International Financial Reporting Standards (IFRS)

This text has been substantially rewritten as an IFRS textbook, rather than just add-on material to a US-GAAP textbook. Students and instructors will continue to benefit from the pedagogical approaches of an established accounting text.

A CLOSER LOOK

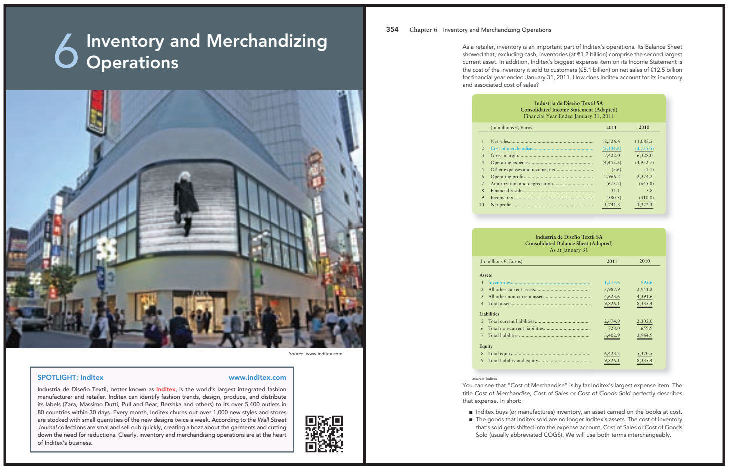
The current *Conceptual Framework* is still a "work in progress" and is very much subject to further developments. Whilst a number of chapters are now completed, there are still certain sections that are either uncompleted or temporarily carried over from its older edition. This revision project is undertaken jointly by the IASB and FASB. Refer to www.ifrs.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm for additional information on the various stages of the project.

The text now starts with a more detailed coverage of the accounting framework and how financial statements provide information for decision making. Selected references are made to IFRSs to get students accustomed to the way principles and rules are expressed in accounting standards. More technical details and relevant accounting updates are provided in 'A Closer Look' boxes for students and instructors. A list of resources related to IFRSs is available in Appendix D.

Learn from over 50 real-world companies' financial statements and excerpts

Each chapter starts with excerpts of financial statements of real companies around the world, all prepared under IFRS. Students are exposed to theories and concepts of accounting they learn are reflected in financial statements, which are used for decision making.

Where relevant, more in-depth excerpts of notes to the accounts are also provided to further illustrate actual financial reporting practices.



6 Inventory and Merchandizing Operations

Source: www.inditex.com

SPOTLIGHT: Inditex www.inditex.com

Industria de Diseño Textil, better known as Inditex, is the world's largest integrated fashion manufacturer and retailer. Inditex can identify fashion trends, design, produce, and distribute its labels (Zara, Massimo Dutti, Pull and Bear, Bershka and others) to its over 5,400 outlets in 80 countries within 30 days. Every month, Inditex churns out over 1,000 new styles and stores are stocked with small quantities of the new designs twice a week. According to the *Wall Street Journal* collections are smal and sell oub quickly, creating a bozz about the garments and cutting down the need for reductions. Clearly, inventory and merchandising operations are at the heart of Inditex's business.

354 Chapter 6 Inventory and Merchandizing Operations

As a retailer, inventory is an important part of Inditex's operations. Its Balance Sheet showed that, excluding cash, inventories (at €1.2 billion) comprise the second largest current asset. In addition, Inditex's biggest expense item on its Income Statement is the cost of the inventory it sold to customers (€5.1 billion) on net sales of €12.5 billion for financial year ended January 31, 2011. How does Inditex account for its inventory and associated cost of sales?

Industria de Diseño Textil SA
Consolidated Income Statement (Adapted)
Financial Year Ended January 31, 2011

	(In millions €, Euros)	2011	2010
1	Net sales	12,526.6	11,083.5
2	Cost of merchandise	(5,104.6)	(4,755.5)
3	Gross margin	7,422.0	6,328.0
4	Operating expenses	(4,452.2)	(3,952.7)
5	Other expenses and income, net	(3.6)	(1.1)
6	Operating profit	2,966.2	2,374.2
7	Amortization and depreciation	(675.7)	(645.8)
8	Financial results	31.1	3.8
9	Income tax	(580.3)	(410.0)
10	Net profit	1,741.3	1,322.1

Industria de Diseño Textil SA
Consolidated Balance Sheet (Adapted)
As at January 31

	(In millions €, Euros)	2011	2010
	Assets		
1	Inventories	1,214.6	992.6
2	All other current assets	3,987.9	2,951.2
3	All other non-current assets	4,623.6	4,391.6
4	Total assets	9,826.1	8,335.4
	Liabilities		
5	Total current liabilities	2,674.9	2,305.0
6	Total non-current liabilities	728.0	659.9
7	Total liabilities	3,402.9	2,964.9
	Equity		
8	Total equity	6,423.2	5,370.5
9	Total liability and equity	9,826.1	8,335.4

Source: Inditex

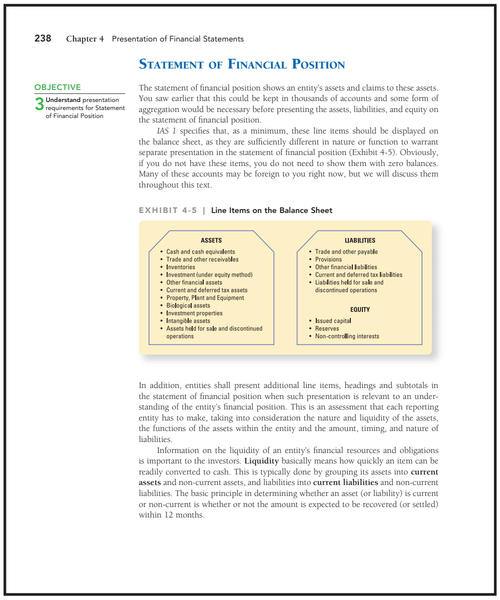
You can see that "Cost of Merchandise" is by far Inditex's largest expense item. The title *Cost of Merchandise, Cost of Sales* or *Cost of Goods Sold* perfectly describes that expense. In short:

- Inditex buys (or manufactures) inventory, an asset carried on the books at cost.
- The goods that Inditex sold are no longer Inditex's assets. The cost of inventory that's sold gets shifted into the expense account, Cost of Sales or Cost of Goods Sold (usually abbreviated COGS). We will use both terms interchangeably.

Accounting Cycle: from start to finish

Financial Accounting: IFRS helps students "nail" the accounting cycle up front in order to increase success and retention later on. The concepts and mechanics students learn in the critical accounting cycle chapters are used consistently and repetitively—and with clear-cut details and explanations—throughout the remainder of the text.

Chapter 1 introduces the accounting cycle with a brief financial statement overview, using the financial statements of Samsung. This first exposure to accounting explores financial statements in depth, familiarizes students with using real business data, and points out basic relationships between the different types of statements.



238 Chapter 4 Presentation of Financial Statements

STATEMENT OF FINANCIAL POSITION

OBJECTIVE

3 **Understand** presentation requirements for Statement of Financial Position

The statement of financial position shows an entity's assets and claims to these assets. You saw earlier that this could be kept in thousands of accounts and some form of aggregation would be necessary before presenting the assets, liabilities, and equity on the statement of financial position.

IAS 1 specifies that, as a minimum, these line items should be displayed on the balance sheet, as they are sufficiently different in nature or function to warrant separate presentation in the statement of financial position (Exhibit 4-5). Obviously, if you do not have these items, you do not need to show them with zero balances. Many of these accounts may be foreign to you right now, but we will discuss them throughout this text.

EXHIBIT 4-5 | **Line Items on the Balance Sheet**

ASSETS

- Cash and cash equivalents
- Trade and other receivables
- Inventories
- Investment (under equity method)
- Other financial assets
- Current and deferred tax assets
- Property, Plant and Equipment
- Biological assets
- Investment properties
- Intangible assets
- Assets held for sale and discontinued operations

LIABILITIES

- Trade and other payable
- Provisions
- Other financial liabilities
- Current and deferred tax liabilities
- Liabilities held for sale and discontinued operations

EQUITY

- Issued capital
- Reserves
- Non-controlling interests

In addition, entities shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. This is an assessment that each reporting entity has to make, taking into consideration the nature and liquidity of the assets, the functions of the assets within the entity and the amount, timing, and nature of liabilities.

Information on the liquidity of an entity's financial resources and obligations is important to the investors. **Liquidity** basically means how quickly an item can be readily converted to cash. This is typically done by grouping its assets into **current assets** and non-current assets, and liabilities into **current liabilities** and non-current liabilities. The basic principle in determining whether an asset (or liability) is current or non-current is whether or not the amount is expected to be recovered (or settled) within 12 months.

Chapter 2 continues the discussion of the accounting cycle by explaining how to analyze and record basic transactions, and builds in repetition to ensure that students understand the fundamentals when they prepare the trial balance.

Chapter 3 concludes the discussion of the accounting cycle with adjusting and closing entries, and preparation of the related trial balances to close the loop for students.

Chapter 4 is a brand new chapter on the presentation of financial statements. Students are guided through how businesses communicate their financial results to their stakeholders through an annual report.

Consistent Application and Reinforcement Strategy that Maximizes Understanding

Throughout the text, the core concepts and mechanics are brought together using consistent language, format, and formulas. Students also receive thorough explanations and details that show the meaning behind each concept and how to do the computation following it, providing an in-depth understanding of the fundamentals.

Whether it's the first transaction or the last, students perform the analysis in the same way, thus reinforcing their understanding, reducing the level of confusion and frustration, and helping them capture those "I get it!" moments.

Hallmark Features (continued)

Summary Problems and Solutions appear in both the middle and end-of-chapter sections, providing students with additional guided learning. By presenting these problems and solutions twice in one chapter, this text breaks up the information, enabling students to absorb and master the material in more manageable pieces.

END-OF-CHAPTER SUMMARY PROBLEM

The Cessna Aircraft Company has an outstanding issue of 8% convertible bonds that mature in 20X8. Suppose the bonds are issued on October 1, 20X0, and pay interest each April 1 and October 1.

Requirements

1. Complete the following effective-interest amortization table through October 1, 20X2.
   Bond Data
   Maturity (face) value—$100,000
   Stated interest rate—8%
   Interest paid—4% semi-annually, $4,000 ($100,000 × 0.08 × 6/12)

MID-CHAPTER SUMMARY PROBLEM

Assume that Estée Lauder faced the following liability situations at June 30, 20X1, the end of the company's fiscal year. Show how Estée Lauder would report these liabilities on its balance sheet at June 30, 20X1.

a. Salary expense for the last payroll period of the year was $900,000. Of this amount, employees' withheld income tax totaled $88,000 and employer's payroll taxes were $61,000. These payroll amounts will be paid in early July.
b. In fiscal year 20X1, management estimates new warranty obligation of $8 million arising from sales in 20X1. One year ago, at June 30, 20X0, provision for warranty stood at $3 million. Warranty payments were $9 million during the year ended June 30, 20X1.
c. The company pays royalties on its purchased trademarks. Royalties for the trademarks are equal to a percentage of Estée Lauder's sales. Assume that sales in 20X1 were $400 million and were subject to a royalty rate of 3%. At June 30, 20X1, Estée Lauder owes two-thirds of the year's royalty, to be paid in July.
d. Long-term debt totals $100 million and is payable in annual installments of $10 million each. The interest rate on the debt is 7%, and the interest is paid each December 31.

Answer

Liabilities at June 30, 20X1:	
a. Current liabilities:	
Salary payable ($900,000 − $88,000 − $61,000).................	$ 751,000
Employee income tax payable	88,000
Employer payroll tax payable..	61,000

Stop & Think sections relate concepts to everyday life so that students can see the immediate relevance.

STOP & THINK . . .

Suppose Mustafa Confectionery had beginning allowance of SAR (Saudi Arabia Riyal) 600,000. During the year, it wrote off SAR 200,000 of receivables. At the end of the year, an assessment of its receivables shows that credit quality has improved, and accordingly, the required ending balance for allowance for uncollectible account is SAR 300,000. What is the bad debt expense for the year?

Answer:

The current balance of the allowance account after receivable write-offs is SAR 400,000. Since the required ending allowance is SAR 300,000, i.e. lower than the current allowance, Mustafa will record a "negative" expense of SAR 100,000. This negative expense will result in an increase in profit for the year.

Demo Docs in the accounting cycle chapters offer fully worked-through problems that weave computation and concepts together in a step-by-step format, helping students understand the "how" and "why." Additional Demo Docs are available in the study guide and in MyAccountingLab.

Demo Doc

The Accounting Equation and Financial Statement Preparation

To make sure you understand this material, work through the following demonstration "Demo Doc" with detailed comments to help you see the concept within the framework of a worked-through problem.

Learning Objectives 3, 4, 5

David Richardson is the only shareholder of DR Painting, Inc., a painting business near a historical housing district. At March 31, 20X6, DR Painting had the following information:

Cash	$27,300
Accounts receivable	1,400
Supplies	1,800
Truck	20,000
Accounts payable	1,000
Share capital	40,000
Retained earnings (March 1)	5,000
Retained earnings (March 31)	?
Dividends	1,500
Service revenue	7,000
Salary expense	1,000

Requirements

1. Prepare the income statement (the first part of statement of comprehensive income) and statement of changes in equity for the month of March 20X6 and the balance sheet of the business at March 31, 20X6. Use Exhibits 1-8, 1-9, and 1-10 in the text as a guide.
2. Write the accounting equation of the business.

Decision Guidelines in the end-of-chapter material summarize the chapter's key terms, concepts, and formulas in the context of business decisions. Not only does this help students read more actively in the question and answer format, but it also reinforces how the accounting information they are learning is used to make decisions in business.

DECISION GUIDELINES

PPE AND RELATED EXPENSES

Dairy Farm International Holdings, like all other companies, must make some decisions about how to account for its property, plant and equipment (PPE) and intangibles. Let's review some of these decisions.

Decision	Guidelines
Capitalize or expense a cost?	General rule: Capitalize all costs that provide future benefit for the business such as a new package-handling system. Expense all costs that provide no future benefit, such as ordinary repairs to a delivery vehicle.
Capitalize or expense:	
■ Cost associated with a new asset?	Capitalize all costs that bring the asset to its intended use, including asset purchase price, transportation charges, and taxes paid to acquire the asset.
■ Cost associated with an existing asset?	Capitalize only those costs that add to the asset's usefulness or to its useful life. Expense all other costs as maintenance or repairs.
Which depreciation method to use:	
■ For financial reporting?	Use the method that best matches depreciation expense against the revenues produced by the asset. Most companies use the straight-line method.
■ For income tax?	Use the method that produces the fastest tax deductions. Depending on the applicable fax regulations, a company may be able to apply different depreciation methods for financial reporting and for income-tax purposes.
■ How to account for natural resources?	Capitalize the asset's acquisition cost and all later costs that add to the natural resource's future benefit. Then record depletion expense, as computed by the units-of-production method.

Other Features

Ethics in Accounting

Sound ethical judgment is important for every major financial decision—which is why this text provides consistent ethical reinforcement in every chapter. A decision making model is introduced in Chapter 1 and applied to each of the end-of-chapter cases.

Furthermore, in an age of financial scandals, understanding fraud is a key component of financial accounting. Chapter 5 now includes the concept of fraud, and introduces students to the "fraud triangle" (pressure, opportunity, and rationalization) and a discussion of internal controls as the primary way companies prevent fraud.

For example, "Cooking the Books" sections highlight real fraud cases in relevant sections throughout the text, giving students real-life business context. Examples include the following:

COOKING THE BOOKS with Liabilities

Crazy Eddie, Inc.

Accidentally understating liabilities is one thing, but doing it intentionally is quite another. When unethical management decides to cook the books in the area of liabilities, its strategy is to deliberately understate recorded liabilities. This can be done by intentionally under-recording the amount of existing liabilities, or by omitting certain liabilities altogether.

Crazy Eddie, Inc. (first discussed in Chapter 6) used multiple tactics to overstate its financial position from 1984 through 1987. In addition to overstating inventory (thus understating cost of goods sold and overstating income), the manage-

Extended Coverage of Cash Flows and Ratios

The current economy has created a shift in how we view money—specifically, cash. Cash flow is the lifeblood of any business, and its coverage has been increased and highlighted across the chapters so that students can easily see the connections and understand the significance of cash flow information. Similarly, financial ratios are discussed where appropriate in each chapter rather than leaving them to the end of the textbook.

Reporting Financing Activities on the Statement of Cash Flows

CASH FLOW

The GSK consolidated balance sheet (p. 574) shows that the company finances 78.5% of its operations with debt. Let's examine GSK's financing activities as reported on its statement of cash flows. Exhibit 9-14 is an excerpt from GSK's consolidated statement of cash flows.

EXHIBIT 9-14 | GSK's Consolidated Statement of Cash Flows

GlaxoSmithKline (GSK) plc
Consolidated Cash Flow Statements (Adapted)
For the year ended December 31

	(In millions €)	2011	2010
1	**Cash flow from operating activities**		
2	Net profits after tax	5,458	1,853
3	Increase/(decrease) in trade payables	442	154
4	Increase/(decrease) in other payables	2	(179)

New to the Ninth Edition

Students and instructors will benefit from a variety of new content and features in the Ninth Global Edition of *Financial Accounting: International Financial Reporting Standards*. To reflect the most recent developments in the economy and in the accounting industry, the following content additions or changes have been made.

Each chapter features **new Company Spotlights** from different countries and industries, which help to broaden students' general knowledge of businesses. Company spotlights featured include Samsung, De Beers, Richemont, BASF, Nestlé, Inditex, Dairy Farm, Vivendi, GlaxoSmithKline, L'Occitane, Royal Philips Electronics and Vodafone. In addition, many chapters feature additional excerpts from other companies such as AirAsia, Singapore Airlines, UK's Royal Mail, Amazon.com, Lenovo, Bossini, Adidas, and many more.

Key terms have also been changed to reflect the more common practices and words used in the international accounting standards. Where relevant, students are shown **examples of financial reporting practices by 170 IFRS companies** around the world, based on a study by the American Institute of Certified Public Accountants (AICPA) in 2011.

Financial ratio analysis is introduced from Chapter 5 onwards, with benchmarks to prior years, peer companies and/or industry averages. A new **running case study at the end of each chapter featuring Vodafone** provides students with the opportunity to apply what they have learned in each chapter with a real-life company's financial statements.

A new convention to identify the financial year (e.g. 20X6) has been implemented. Questions, Exercises, and Problems have been updated. All Group B questions are now in € (Euros).

In this edition, we have introduced **QR (Quick Response) codes** to help you navigate to specific websites or web pages. Scan the codes using your mobile devices and your browser will open the appropriate link, with no need to type out long URLs. You may need to download a QR reader app for your mobile device. These are usually available free of charge from your device's app store or market.

The first chapter has been updated to **include the recently pronounced Conceptual Framework for Financial Reporting** by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board. Changes related to the objective of financial reporting and qualitative characteristics have been reflected. The *Conceptual Framework* sets the foundation for students' understanding of the principle-based approach of International Financial Reporting Standards.

Chapter 1 helps students see **financial statements as outputs of an accounting system**, on which a variety of users rely on to make their decisions. Appendix D is updated with a table highlighting the IFRS coverage topic by topic and other additional resources for further review of relevant accounting standards.

With the recent changes and events in the economy, educating students on the importance of ethics and ethical decision making is critical. The discussion of **ethics in accounting** has been updated and moved to Chapter 1, placing greater emphasis on the importance of ethics at the very beginning of the text. The Global Edition also introduces an **expanded decision making model** in Chapter 1 and integrates the model throughout the entire text with economic, legal, and ethical dimensions. The **Ethical Cases** in the end-of-chapter material have been rewritten to unify and better integrate coverage on this important topic so that the material is reinforced consistently in every chapter.

Chapter 4 is a **new chapter on the presentation of financial statements**. It introduces students to how companies use annual reports to communicate with their stakeholders. Students see a variety of annual reports, and are introduced to the general presentation requirements of financial statements. We also discuss the presentation requirements for each financial statement (except for Statement of Cash Flows, which is covered in Chapter 11).

Chapter 5 is a new streamlined chapter combining the topics of **internal control, cash, and receivables**. In an age of public scandals, **understanding fraud** is a key component of financial accounting. It includes the concept of fraud, and introduces students to the "fraud triangle" (pressure, opportunity, and rationalization) that leads to the discussion of internal controls as the primary way that companies prevent fraud—which has also been updated.

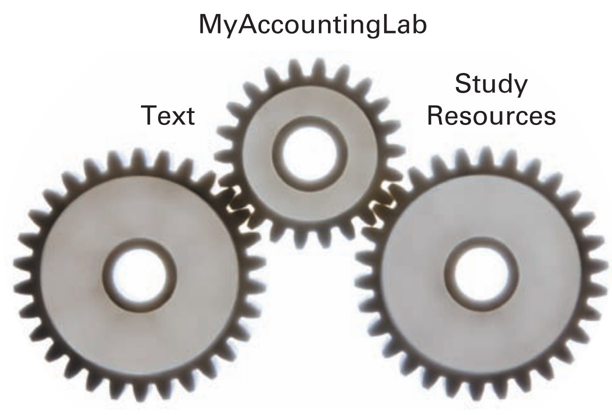
Chapter 6 has new **additional materials on merchandizing operations**. It also has expanded discussions on IFRS use of cost formulas and net realizable value.

Other changes include:

- **Chapter 7** has been updated to better reflect the alternative measurement option for PPE under IFRS.
- **Chapter 8** now combines the discussions on short-term and long-term investments in one place.
- **Chapter 9** has been updated with more complete discussion about short-term and long-term liabilities.
- **Chapter 10** has been updated with more extracts of financial statements to help students understand equity-related transactions.
- **Chapter 11** now includes additional discussions on cash flow ratios and clarifies the use of "net profit before tax" under indirect method for cash flows from operating activities.
- **Chapter 12** now offers a better taxonomy of financial ratios, including an introduction to case flow-related ratios.

Students Will "Get It" Anytime, Anywhere

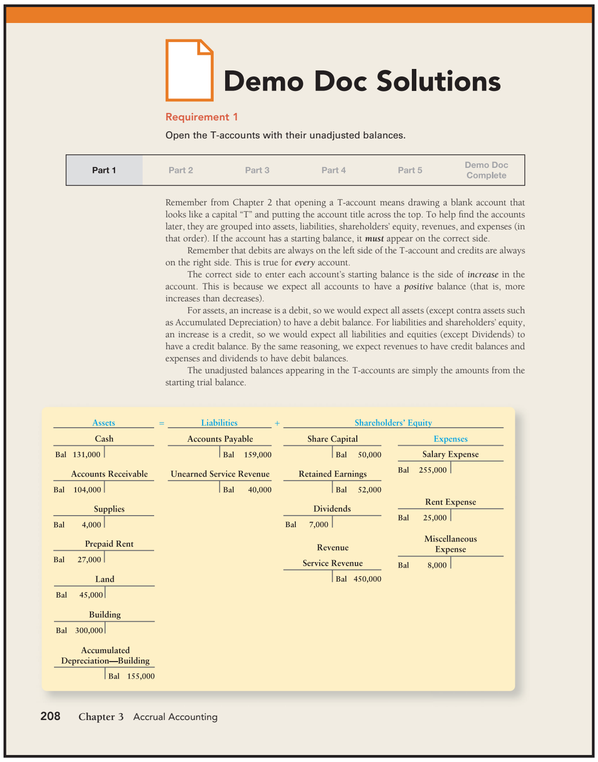
Students understand (or "get it") right after you do a problem in class. Once they leave the classroom, however, students often struggle to complete the homework on their own. This frustration can cause students to quit on the material altogether and fall behind in the course, resulting in an entire class falling behind as the instructor attempts to keep everyone on the same page.



With the *Financial Accounting*, Ninth Global Edition, **Student Learning System**, all the features of the student text, study resources, and online homework system are designed to work together to provide students with the consistency, repetition, and high level of detail that will keep both instructors and students on track, providing more "I get it!" moments inside and outside the classroom.

Replicating the Classroom Experience with Demo Doc Examples

The Demo Doc examples consist of entire problems, worked through step-by-step, from start to finish, narrated with the kind of omments that instructors would say in class. The Demo Docs are available in the accounting cycle chapters of the text and in the study guide. Demo Docs will aid students when they are trying to solve exercises and problems on their own, duplicating the classroom experience outside of class.



Demo Doc Solutions

Requirement 1

Open the T-accounts with their unadjusted balances.

Part 1 | Part 2 | Part 3 | Part 4 | Part 5 | Demo Doc Complete

Remember from Chapter 2 that opening a T-account means drawing a blank account that looks like a capital "T" and putting the account title across the top. To help find the accounts later, they are grouped into assets, liabilities, shareholders' equity, revenues, and expenses (in that order). If the account has a starting balance, it ***must*** appear on the correct side.

Remember that debits are always on the left side of the T-account and credits are always on the right side. This is true for *every* account.

The correct side to enter each account's starting balance is the side of *increase* in the account. This is because we expect all accounts to have a *positive* balance (that is, more increases than decreases).

For assets, an increase is a debit, so we would expect all assets (except contra assets such as Accumulated Depreciation) to have a debit balance. For liabilities and shareholders' equity, an increase is a credit, so we would expect all liabilities and equities (except Dividends) to have a credit balance. By the same reasoning, we expect revenues to have credit balances and expenses and dividends to have debit balances.

The unadjusted balances appearing in the T-accounts are simply the amounts from the starting trial balance.

Assets = Liabilities + Shareholders' Equity

Assets:
Cash — Bal 131,000 (debit)
Accounts Receivable — Bal 104,000 (debit)
Supplies — Bal 4,000 (debit)
Prepaid Rent — Bal 27,000 (debit)
Land — Bal 45,000 (debit)
Building — Bal 300,000 (debit)
Accumulated Depreciation—Building — Bal 155,000 (credit)

Liabilities:
Accounts Payable — Bal 159,000 (credit)
Unearned Service Revenue — Bal 40,000 (credit)

Shareholders' Equity:
Share Capital — Bal 50,000 (credit)
Retained Earnings — Bal 52,000 (credit)
Dividends — Bal 7,000 (debit)

Revenue
Service Revenue — Bal 450,000 (credit)

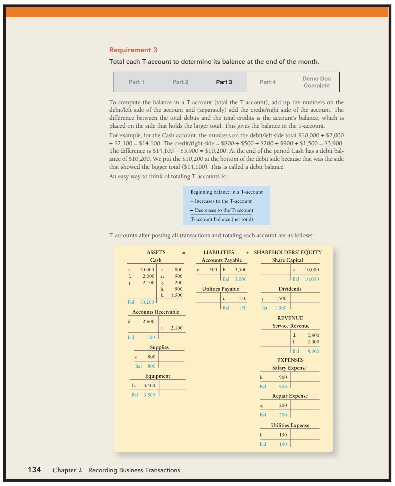
Expenses
Salary Expense — Bal 255,000 (debit)
Rent Expense — Bal 25,000 (debit)
Miscellaneous Expense — Bal 8,000 (debit)

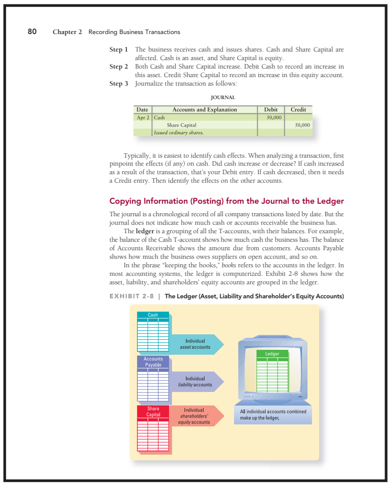
208 Chapter 3 Accrual Accounting

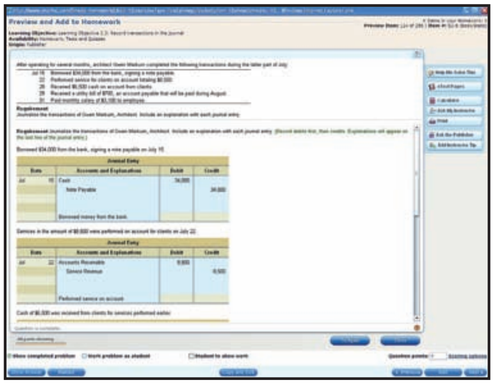
with the Student Learning System!

Consistency, Repetition, and a High Level of Detail Throughout the Learning Process

The concepts, materials, and practice problems are presented with clarity and consistency across all mediums—textbook, study resources, and online homework system. No matter which platform students use they will continually experience the same look, feel, and language, minimizing confusion and ensuring clarity.

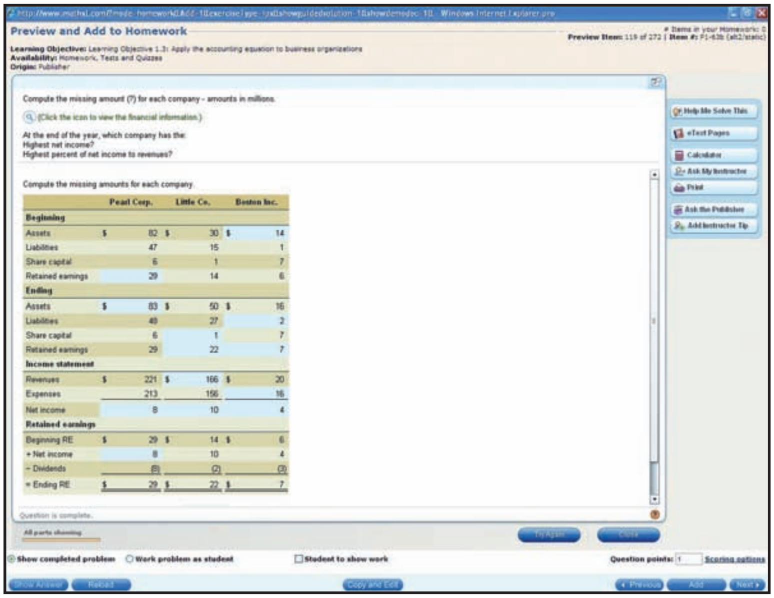






Experiencing the Power of Practice with MyAccountingLab: www.myaccountinglab.com

MyAccountingLab is an online homework system that gives students more "I get it!" moments through the power of practice. With **MyAccountingLab**, students can:



- Work on problems assigned by the instructor that are either exact matches or algorithmic versions of the end-of-chapter material.
- Use the Study Plan for self-assessment and customized study outlines.
- Use the Help Me Solve This for a step-by-step tutorial.
- Open textbook pages to find the material they need to get help on specific problems.
- See how IFRS will impact decisions in accounting.

MyAccountingLab

Student Resources

Study Guide with Demo Docs

This chapter-by-chapter learning aid helps students get the maximum benefit from their study time. For each chapter there is an explanation of each Learning Objective; additional Demo Docs; Quick Practice, True/False, and Multiple Choice questions; Quick Exercises; and a Do It Yourself question, all with solutions.

MyAccountingLab

www.myaccountinglab.com

MyAccountingLab is Web-based tutorial and assessment software for accounting that gives students more "I get it!" moments. MyAccountingLab provides students with a personalized interactive learning environment where they can complete their course assignments with immediate tutorial assistance, learn at their own pace, and measure their progress.

In addition to completing assignments and reviewing tutorial help, students have access to the following resources in MyAccountingLab:

- The Flash-based eText
- Study Guide
- Student PowerPoints
- Flashcards
- IFRS Readings

Instructor Resources

The primary goal of the Instructor Resources is to help instructors deliver their course with ease, using any delivery method—traditional, self-paced, or online.

MyAccountingLab

www.myaccountinglab.com

MyAccountingLab is web-based tutorial and assessment software for accounting that not only gives students more "I get it!" moments, but also provides instructors the flexibility to make technology an integral part of their course. And, because practice makes perfect, **MyAccountingLab** offers exactly the same end-of-chapter material found in the text with algorithmic options that instructors can assign for homework. **MyAccountingLab** also replicates the text's exercises and problems with journal entries and financial statements so that students are familiar and comfortable working with the material.

Instructor's Manual

The Instructor's Manual offers course-specific content including a guide to available resources, a road map for using **MyAccountingLab**, as well as content-specific material including chapter overviews, teaching outlines, student summary handouts, lecture outline tips, assignment grids, ten-minute quizzes, and more!

Instructor Resource Center: www.pearsonglobaleditions.com/harrison

For your convenience, our instructor supplements are available for download from the textbook's catalog page or your **MyAccountingLab** account. Available resources include the following:

- Solutions Manual containing the fully worked-through and accuracy-checked solutions for every question, exercise, and problem in the text
- Test Item File with TestGen Software providing multiple choice, true/false, and problem-solving questions correlated by Learning Objective and difficulty level
- Instructor's Manual

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Annual reports, including the financial statements and notes to the financial statements, should be read in their entirety. Excerpts provided in this textbook are intended for teaching and learning purposes. Copyright of these excerpts remain with the original copyright holders. Readers are encouraged to obtain the full annual reports for a complete picture of the respective companies' financial position and financial performance. Summarized data, tables, and charts are produced based on information available publicly.

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.

Accounting is widely believed to have been documented by Fra Luca Bartolomeo de Pacioli, an Italian mathematician and Franciscan friar in the 16th century. Pacioli was a close friend of Leonardo da Vinci, and collaborated with him on many projects.

Accounting as the profession we know today has its roots in the Industrial Revolution during the 18th and 19th centuries, mostly in England. However, accounting did not attain the stature of other professions such as law, medicine, or engineering until early in the 20th century. Professions are distinguished from trades by the following characteristics: (1) a unifying body of technical literature; (2) standards of competence; (3) codes of professional conduct; and (4) dedication to service to the public.

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 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 a public accounting firm, which could be a large international firm or a variety of medium to small-sized firms. Within the 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 different clients. At present, the largest six international firms are Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers, Grant Thornton, and RSM McGladrey. However, there are many other firms with international and 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, industry, or just about anywhere there is a demand for persons who like solving complex problems.

Managerial Accounting

Instead of working for a wide variety of clients, you can work within one corporation or non-profit enterprise. Your role may be to analyze financial information and communicate that information to managers, who use it to plot strategy and make decisions. You may be called upon to help allocate corporate resources or 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—federal, state, or local. Like your counterparts in public accounting and business, your role as a government accountant includes responsibilities in the areas of auditing, financial reporting, and management accounting. You'll evaluate how government agencies are being managed. You may advise decision makers on how to allocate resources to promote 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, ministry of finance or treasury, or even the parliament.

As an accountant, you might also decide to work in the not-for-profit sector. Colleges, universities, public and private 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 specially designed for work in the not-for-profit sector.

Education

Finally, 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 of education, 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 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 analytic skills and extensive training. Your CPA credential gives you a distinct advantage in the job market and instant credibility and respect in the workplace. It's a plus when dealing with other professionals such as bankers, attorneys, auditors, and federal regulators. In addition, your colleagues in private industry tend to defer to you when dealing with complex business matters, particularly those involving financial management.

The Hottest Growth Areas in Accounting

Recent legislation, such the US Sarbanes-Oxley Act of 2002, or similar legislation in many other parts of the world, has brought rising demand for accountants of all kinds. In addition to strong overall demand, certain areas of accounting are especially hot.

Sustainability Reporting

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

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

Assurance Services

Assurance services are services provided by a CPA that improve the quality of information, or its context, for decision makers. Such information can be financial or non-financial, and it can be about past events or about ongoing processes or 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 by providing assurance services in areas ranging from electronic commerce to elder care, comprehensive risk assessment, business valuations, 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 are becoming commonplace. Countries in Eastern Europe and Latin America, which previously had closed economies, are opening up and 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 to money laundering and improper capitalization of expenses.

Whether you seek a career in business, government, the not-for-profit sector, or a charity, **accounting** has a career for you. Every organization, from the smallest mom-and-pop music retailer to the biggest government in the world, needs accountants to help manage its resources. Global trade demands accountability, and ever-more complex tax laws mean an ever-increasing need for the skills and services of accountants.

1 Conceptual Framework and Financial Statements

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SPOTLIGHT: Samsung Electronics www.samsung.com

From its inception in 1938 as a small export business in Korea, Samsung Electronics has grown from selling dried fish, vegetables, and fruit to become one of the world's leading electronics companies. Samsung, which means "three stars" in Korean, now specializes in digital appliances and media, semiconductors, memory, and system integration. The digital age has brought revolutionary change—and opportunity—to global business, and Samsung has responded with advanced technologies, competitive products, and constant innovation.

As you would expect, Samsung sells a lot of products, from television, audio and video equipment, home appliances to various computer-related products and accessories. In fact, Samsung's total sales revenue in the financial year ended December 31, 2011 was in excess of 165,000 billion Korean Won (abbreviated KRW, or denoted by ₩, which translates to about 143 billion United States Dollars, or USD). After deducting the cost of sales and other expenses, Samsung's 2011 net income was ₩13,734 billion. From its operating activities, Samsung generated cash flows of about ₩22,918 billion. Its assets grew from ₩134,289 in 2010 to ₩155,631 billion in 2011.

These terms may be foreign to you now, but after you read this chapter, you will gain more 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, it's the Consolidated Income Statement of Samsung. 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.

Samsung Electronics Co. Ltd.
Consolidated Income Statement (Adapted)
Financial Year Ended December 31, 2011 and 2010

	(In billions of Korean Won, KRW or ₩)	2011	2010
1	Sales	165,001.8	154,630.3
2	Cost of sales	112,145.1	102,666.8
3	Gross profit	52,856.7	51,963.5
4	Research and development expenses	9,979.8	9,099.4
5	Selling, general and administrative expenses	27,421.9	26,243.1
6	Other operating income	2,421.9	1,755.4
7	Other operating expenses	1,627.1	1,079.9
8	Operating profit	16,249.7	17,296.5
9	Share of profit or loss of associates and joint ventures	1,399.2	2,267.1
10	Finance income	7,403.5	7,465.1
11	Finance expense	7,893.4	7,700.1
12	Profit before income tax	17,159.0	19,328.6
13	Income tax expense	3,424.9	3,182.1
14	Profit for the year	13,734.1	16,146.5

Source: Samsung

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 users of financial statements. We will also look at the bodies responsible for issuing accounting standards. We discuss the judgment process that is necessary to make good accounting decisions. We 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 the financial statements, as well as how user groups typically use the information contained in them to make business decisions.

LEARNING OBJECTIVES

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

2 **Learn** underlying concepts, assumptions and principles of accounting

3 **Apply** the accounting equation to business organizations

4 **Evaluate** business operations

5 **Use** information in financial statements to make business decisions, which are informed by economic, legal, and ethical guidelines

Business Decisions

Samsung'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. Samsung's management also use financial information to help it 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 at Samsung's Consolidated Income Statement. Let's start with its "bottom line" on line 14. Samsung calls it "Profit for the year" but other businesses may use terms such as net income or net profit. Net income is the excess of revenues over expenses. We can see that Samsung earned ₩13,734 billion profit for the year ended December 31, 2011. That's good news because it means that Samsung had ₩13,734 billion more revenues than expenses for the year, despite the tough economic conditions since the global financial crisis of 2008. Despite an increase in sales revenue of almost 7%, Samsung's 2011 net income was ₩2,412 billion (about 15%) less than the results achieved in 2010, as cost of sales, research and development, selling, and general and administrative expenses all went up as well.

Suppose we have ₩1 billion to invest. What information would we need before deciding to invest in Samsung? Let's see how accounting works!

Accounting is the Language of Business

OBJECTIVE

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

Italian merchants in Genoa, Florence, and Venice were at the epicentre of trade between Europe and the Middle East in the 13th and 14th centuries. As trading ventures grew, individual merchants were not able to provide the capital necessary to conduct business ventures on their own. The concept of "shareholders" was thus born, and along with it the need to report on the venture's financial status to investors. Luca Pacioli, a contemporary of Leonardo da Vinci, documented the so-called "Venice method" in 1494 and it quickly spread to become what we now know as double-entry accounting, which forms the basis of financial reporting to shareholders.

A CLOSER LOOK

If you want to know more about the history of accounting (it can be quite fascinating!), check out this article by John R. Alexander at www.acaus.org and click on "The History of Accounting" on the menu. Alternatively, you can go to this URL directly: www.acaus.org/content.aspx?page_id=22&club_id=825456&module_id=39138.

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 them to decision makers who make decisions that will impact on business activities. Indeed, accounting is "the language of business." The better our understanding of the language, the better we can understand what is happening with our finances, our businesses, or our investments!

Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a part of mathematics. Accounting includes some elements of bookkeeping, but accounting extends to the use of information produced by bookkeeping. Exhibit 1-1 illustrates the flow of accounting information and helps illustrate accounting's role in business. The accounting process begins and ends with people making decisions.

EXHIBIT 1-1 | The Flow of Accounting Information

Two Perspectives of Accounting: Financial Accounting and Management Accounting

Both *external* and *internal users* of accounting information exist. We can therefore classify accounting into two branches. **Financial accounting** provides information for decision makers outside the **reporting entity**, such as investors, creditors, government agencies, and the public. This text focuses on financial accounting.

Management accounting provides information for Samsung's managers. Examples of management accounting information include budgets, forecasts, and projections that are used in making strategic decisions of the entity. Managers of an entity 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 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 the public accounting firms. These firms offer various services to the 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 industry you will have to make decisions in your day-to-day activities, most of which will require you to understand, prepare, or work within constraints of some form of financial reports and budgets. On an individual 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** typically has a single owner, called the proprietor. **Facebook** started out in the Harvard University's college dormitory room of Mark Zuckerberg; it was originally intended as internal Harvard software to help students recognize faces on campus. 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. Partnerships are therefore 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**, **Ernst & Young**, **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. 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 do many more business transactions and are larger in terms of assets, income, and number of employees. Most well-known companies, such as Samsung Group, **Starbucks**, **Google**, **Toyota**, and **Nokia**, 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 UK 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 legislation 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.

Accounting Standards

In science, we assign numerals to represent properties of material systems according to 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 which apply throughout the universe, accounting rules tend to vary in different jurisdictions. Until recently, one of the major challenges of conducting global business has been the fact that different countries have adopted different accounting standards for business transactions. Historically, the major developed countries (the United States, the UK, Japan, Germany, Australia, etc.) have all had their own versions of accounting standards (usually referred to in general as GAAP, **Generally Accepted Accounting Principles**). 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.

The potential solution to this problem lies with the International Accounting Standards Board (IASB) and **International Financial Reporting Standards** (IFRSs). 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. Whilst IASB now produces IFRSs, previously issued International Accounting Standards (IASs) 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 are simply referred to as IFRSs. In addition, these standards may be relabeled somewhat differently in different countries. For example, in Singapore, they are called FRS (Financial Reporting Standards), in Australia, they are labeled AASB after its national Australian Accounting Standards Board, in South Africa, they are called GRAP (Generally Recognized Accounting Principles), 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 IFRSs from the IASB's 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 IFRSs and some other useful resources.

These standards are now being used by most countries around the world. Since its inception, more than 120 countries and territories around the world have either required or permitted the use of IFRSs for financial reporting, especially for listed companies. Other major economies, including the United States, Japan, India, and China, are on different pathways of IFRS convergence. As this gains momentum, you can expect to hear more about the adoption and use of IFRSs, as well as global harmonization of accounting standards, in the future. 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 learned in this accounting course will still apply.

A CLOSER LOOK

The IASB and United States' Financial Accounting Standards Board (FASB) signed a Memorandum of Understanding in 2002 to achieve convergence of IFRSs and US GAAP, resulting in a common set of high-quality global standards. Since 2007, non-US companies listed in the United States are able to report using IFRS (without reconciliation to US GAAP). Despite progress in many joint projects, the convergence progress seemed to have suffered some setbacks with FASB promoting alternative strategies to convergence, including a "condorsement" (a made-up word meant to be somewhere between convergence and endorsement) approach.

The advantages to adopting one common set of standards are clear. Companies in jurisdictions that have mandated or allowed the use of IFRS compliant standards, 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 in the same industries from across the globe, and companies will only have to prepare one set of financial statements, instead of multiple versions. Thus, in the long run, global use of IFRS should reduce costs of doing global business.

The Conceptual Framework

OBJECTIVE

2 **Learn** underlying concepts, assumptions, and principles of accounting

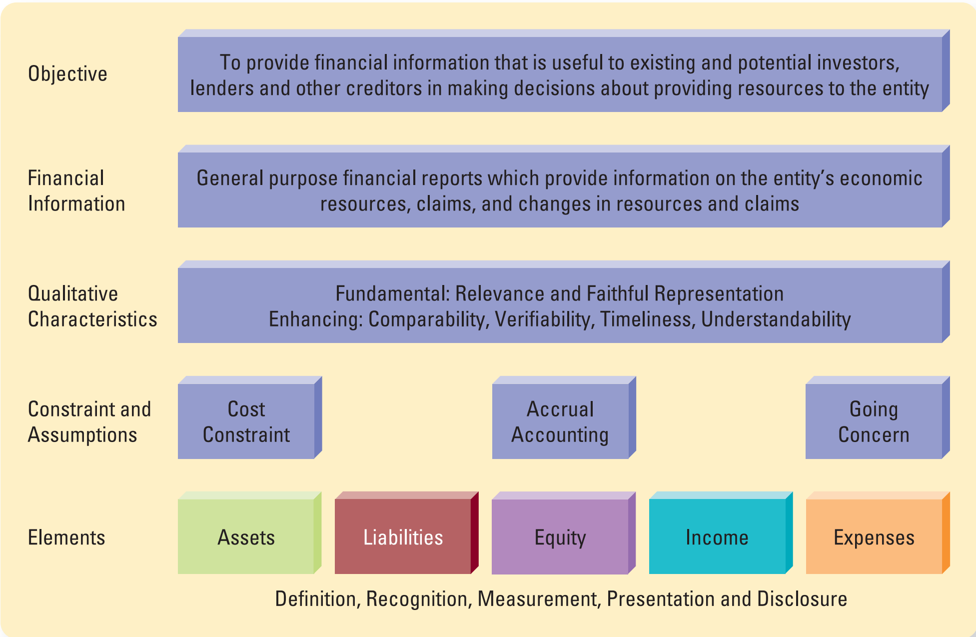
A **conceptual framework** lays the foundation for resolving the big issues in accounting. You can think of it as the "Why, Who, What, How" of financial reporting. The *Conceptual Framework for Financial Reporting* (we will refer to it as the "Conceptual Framework") prescribes the nature, function, and boundaries within which financial accounting and reporting operate. The *Conceptual Framework* (last updated in 2010) is a joint publication by the IASB and FASB in the review of existing and development of new accounting standards. You can access the *Conceptual Framework* from the IASB's website (www.ifrs.org). In this chapter, references are made to the *Conceptual Framework* (2010) paragraphs in square brackets. Your instructor may alternatively direct you to a copy of the Framework as applicable in your jurisdiction.

A CLOSER LOOK

The current *Conceptual Framework* is still a "work in progress" and is very much subject to further developments. Whilst a number of chapters are now completed, there are still certain sections that are either uncompleted or temporarily carried over from its older edition. This revision project is undertaken jointly by the IASB and FASB. Refer to www.ifrs.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm for additional information on the various stages of the project.

The *Conceptual Framework's* focus is on **general purpose financial statements**, which are prepared and presented (at least) 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 and such financial statements should, therefore, be prepared and presented with their needs in view. 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 Accounting



Why is Financial Reporting Important?

The *Conceptual Framework* [OB2] 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 [OB12]. Users evaluate financial statements to make decisions such as whether or not to make additional investment into the entity, provide credit and financing, or assess management's performance.