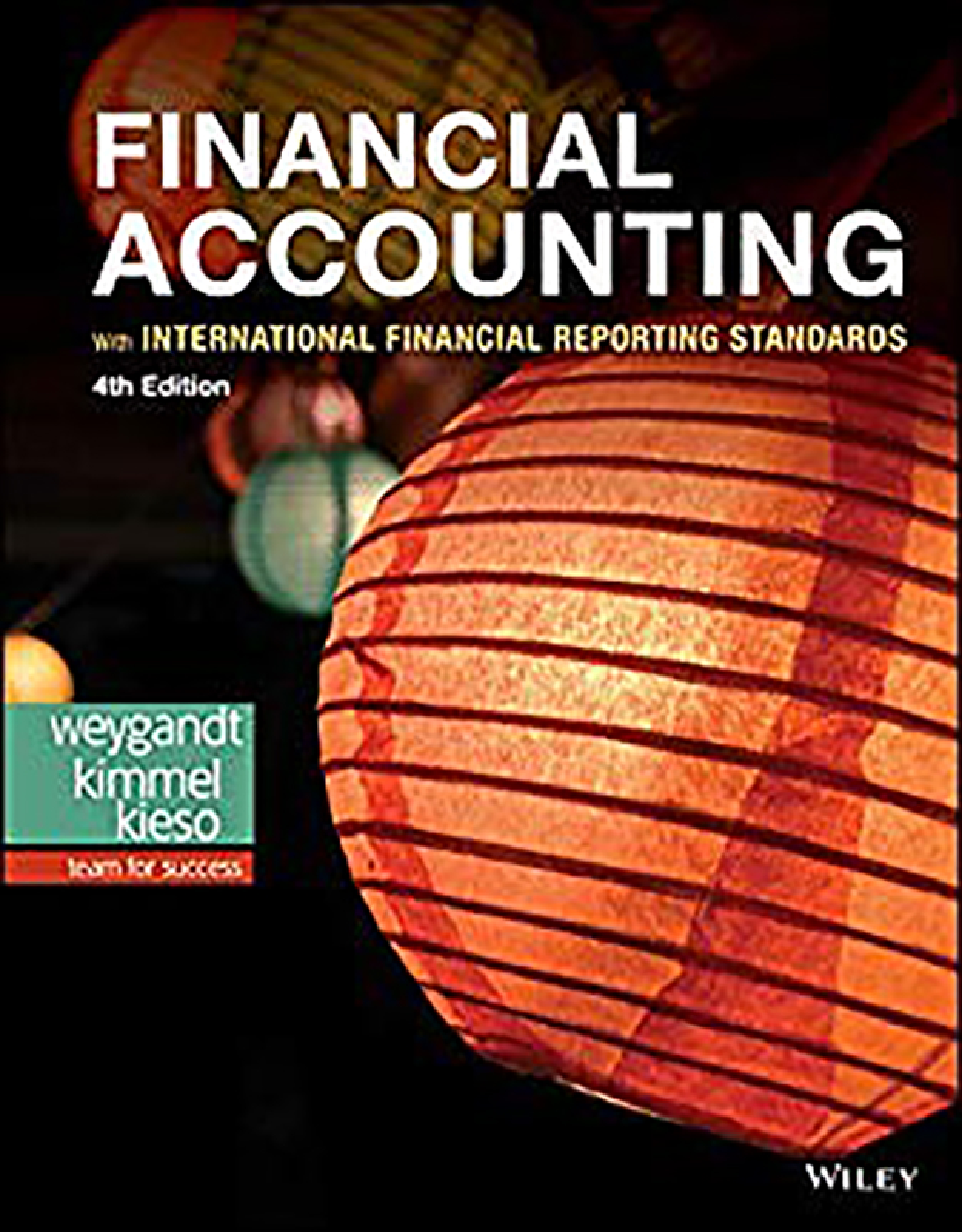

FINANCIAL ACCOUNTING

WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

4th Edition

weygandt
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Financial Accounting

with International Financial Reporting Standards

Fourth Edition

JERRY J. WEYGANDT PhD, CPA
University of Wisconsin—Madison
Madison, Wisconsin

PAUL D. KIMMEL PhD, CPA
University of Wisconsin—Milwaukee
Milwaukee, Wisconsin

DONALD E. KIESO PhD, CPA
Northern Illinois University
DeKalb, Illinois

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Enid, Merlynn, and Donna, for their love,
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Brief Contents

From the Authors

Dear Student,

WHY THIS COURSE? Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. A financial accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like **Samsung** or **adidas** or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.

> "Whether you are looking at a large multinational company like **Samsung** or **adidas** or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening."

WHY THIS TEXT? Your instructor has chosen this text for you because of the authors' trusted reputation. The authors have worked hard to write a text that is engaging, timely, and accurate.

HOW TO SUCCEED? We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this text provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the text itself, the book's companion website also offers various support resources.

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

Jerry J. Weygandt
Paul D. Kimmel
Donald E. Kieso

Author Commitment

Jerry Weygandt

JERRY J. WEYGANDT, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in *The Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of *The Accounting Review*; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of Bascom-Palmer Eye Institute—Naples and also on the board of Artis—Naples. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Educator Award.

Paul Kimmel

PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He teaches at the University of Wisconsin—Milwaukee and Madison, and has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award, the Reggie Taite Excellence in Teaching Award and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *The Accounting Review, Accounting Horizons, Advances in Management Accounting, Managerial Finance, Issues in Accounting Education, Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education. He has published papers and given numerous talks on incorporating critical thinking into accounting education, and helped prepare a catalog of critical thinking resources for the Federated Schools of Accountancy.

Don Kieso

DONALD E. KIESO, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done post doctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, then AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, as a member of the Board of Directors of Kishwaukee Community Hospital, and as Treasurer and Director of Valley West Community Hospital. From 1989 to 1993 he served as a charter member of the national Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvoso Award of Merit, the NIU Foundation's Humanitarian Award for Service to Higher Education, a Distinguished Service Award from the Illinois CPA Society, and in 2003 an honorary doctorate from Aurora University.

Hallmark Features

Financial Accounting provides a simple and practical introduction to the fundamentals of financial accounting. It explains the concepts you need to know. This edition continues this approach by offering even more explanations, illustrations, and homework problems to help students get a firm understanding of the accounting cycle.

DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

ACTION PLAN

- **Close revenue and expense accounts to Income Summary.**
- **Close Income Summary to Retained Earnings.**
- **Close Dividends to Retained Earnings.**

DO IT! 2 | Closing Entries

Hancock Heating has the following balances in selected accounts of its adjusted trial balance.

Accounts Payable	€27,000	Dividends	€15,000
Service Revenue	98,000	Share Capital—Ordinary	42,000
Rent Expense	22,000	Accounts Receivable	38,000
Salaries and Wages Expense	51,000	Supplies Expense	7,000

Prepare the closing entries at December 31.

Solution

Dec. 31	Service Revenue	98,000	
	Income Summary		98,000
	(To close revenue account to Income Summary)		
31	Income Summary	80,000	
	Salaries and Wages Expense		51,000
	Rent Expense		22,000
	Supplies Expense		7,000
	(To close expense accounts to Income Summary)		

Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

Practice Brief Exercises

Prepare the current assets section of a statement of financial position.

3. **(LO 4)** The statement of financial position debit column of the worksheet for Soon Cosmetics includes the following accounts (amounts in thousands): Accounts Receivable ₩25,000, Prepaid Insurance ₩7,000, Cash ₩8,000, Supplies ₩11,000, and Inventory ₩14,000. Prepare the current assets section of the statement of financial position, listing the accounts in proper sequence.

Solution

3.

Soon Cosmetics
Statement of Financial Position (partial)

Current assets	
Prepaid insurance	₩ 7,000
Supplies	11,000
Inventory	14,000
Accounts receivable	25,000
Cash	8,000
Total current assets	₩65,000

Infographic Learning

Over half of the text is visual, providing students alternative ways of learning about accounting. In addition, a new interior design promotes accessibility.

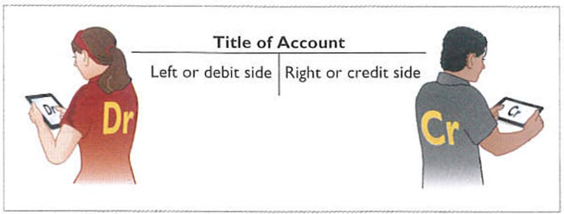

ILLUSTRATION 2.1
Basic form of account

Real-World Decision-Making

Real-world examples that illustrate interesting situations in companies and how accounting information is used are integrated throughout the text, such as in the opening Feature Story as well as the Insight boxes.

People, Planet, and Profit Insight Nestlé SA


Simon Rawles/Alamy

Creating Value

Appendix B contains the financial statements of **Nestlé SA** (CHE). Those financial statements report on the company's profitability and financial position. In addition to these financial statements, Nestlé, like many other companies today, also reports its achievements with regard to other, non-financial goals. In Nestlé's case, it calls these goals "Creating Shared Value." Nestlé has set objectives to help society in areas most directly related to its particular expertise: nutrition, water and environmental sustainability, and rural development. The company evaluates its progress in each area using objective measures. Examples of measures used are provided below.

Nutrition: Products meeting or exceeding Nutritional Foundation profiling criteria (as percentage of total sales) and products with increase in nutritious ingredients or essential nutrients.

Water and Environmental Sustainability: Quality of water discharged (average mg COD/l) and packaging weight reduction (tonnes).

Rural Development: Farmers trained through capacity-building programs and suppliers audited for food safety, quality, and processing.

To learn more about Nestlé's efforts to create shared value, go to the company's website.

What are some implications of Nestlé's decision to measure its results using objective measures and then publicly report these results? (Go to the book's companion website for this answer and additional questions.)

Additional Guidance

Throughout the text, marginal notes, such as **Helpful Hints**, **Alternative Terminology**, and **Ethics Notes**, are provided as additional guidance.

Correcting Entries—An Avoidable Step

Unfortunately, errors may occur in the recording process. Companies should correct errors, **as soon as they discover them**, by journalizing and posting **correcting entries**. If the accounting records are free of errors, no correcting entries are needed.

You should recognize several differences between correcting entries and adjusting entries. First, adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records are error-free. Second, companies journalize and post adjustments **only at the end of an accounting period**. In contrast, companies make correcting entries **whenever they discover an error** (see **Ethics Note**). Finally, adjusting entries always affect at least one statement of financial position account and one income statement account. In

ETHICS NOTE

When companies find errors in previously released income statements, they restate those numbers.

Contents

Appendix B Specimen Financial Statements: Nestlé SA B-1

Appendix C Specimen Financial Statements: Delfi Limited C-1

Appendix D Specimen Financial Statements: Apple Inc. D-1

Appendix E Time Value of Money E-1

Appendix F Accounting for Partnerships F-1

Appendix G Subsidiary Ledgers and Special Journals G-1

Thank You

Financial Accounting has benefited greatly from the input of those who have sent comments by letter or e-mail, ancillary authors, and proofers. We greatly appreciate the constructive suggestions and innovative ideas of reviewers and the creativity and accuracy of the ancillary authors and checkers.

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Florida Institute of Technology

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University of Wisconsin—Platteville

Larry Falcetto
Emporia State University

Heidi Hansel
Kirkwood Community College

Karen Hern
Grossmont College

Derek Jackson
St. Mary's University

Cynthia Lovick
Austin Community College

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University of Tampa

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Laura Prosser
Black Hills State University

Alice Sineath
Forsyth Technical Community College

Lynn Stallworth
Appalachian State University

Teresa Speck
St. Mary's University

Lakshmy Sivaratnam
Kansas City Kansas Community College

Shelia Viel
University of Wisconsin—Milwaukee

Dick Wasson
Southwestern College

Suzanne Wright
Pennsylvania State University

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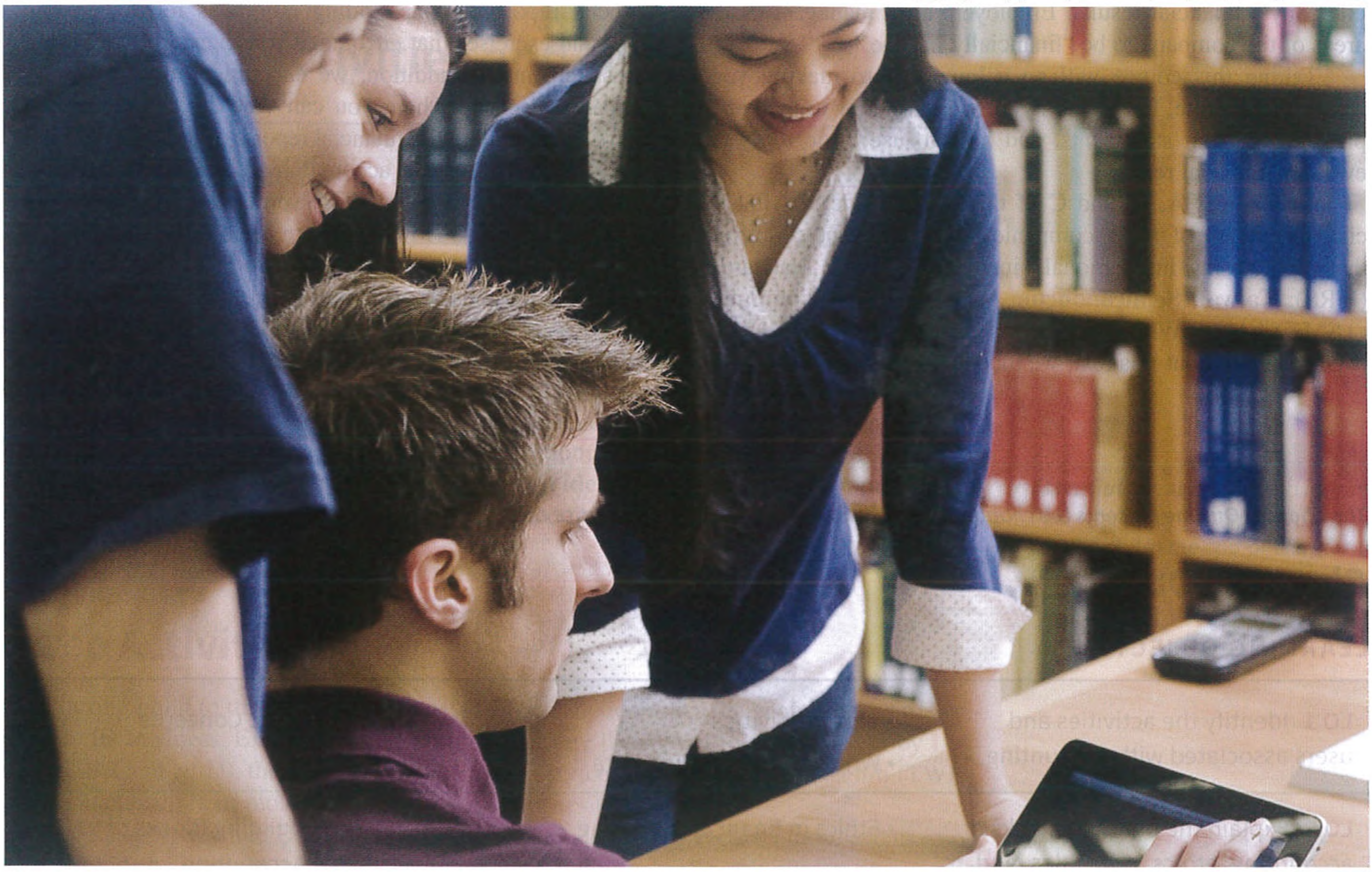
Jerry J. Weygandt
Madison, Wisconsin

Paul D. Kimmel
Milwaukee, Wisconsin

Donald E. Kieso
DeKalb, Illinois

CHAPTER 1



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Accounting in Action

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

Chapter Preview

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

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

Feature Story

Knowing the Numbers

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

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

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

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

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

Appendices A, B, and C of this text provide real financial statements of three companies from different countries that report using International Financial Reporting Standards (IFRS): **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN), **Nestlé SA** (CHE), and **Delfi Limited** (SGP). Throughout this text, we increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements. In addition, we encourage you to visit each company's website where you can view its complete annual report. In examining the financial reports of these three companies, you will see that the accounting practices of companies in specific countries that follow IFRS sometimes differ with regard to particular details. However, more importantly, you will find that the basic accounting principles are the same. As a result, by learning these basic principles as presented in this text, you will be well equipped to begin understanding the financial results of companies around the world.

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

Chapter Outline

LEARNING OBJECTIVES

LO 1 Identify the activities and users associated with accounting.	• Three activities • Who uses accounting data	**DO IT! 1** Basic Concepts
LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.	• Ethics in financial reporting • Accounting standards • Measurement principles • Assumptions	**DO IT! 2** Building Blocks of Accounting
LO 3 State the accounting equation, and define its components.	• Assets • Liabilities • Equity	**DO IT! 3** Equity Effects
LO 4 Analyze the effects of business transactions on the accounting equation.	• Accounting transactions • Transaction analysis • Summary of transactions	**DO IT! 4** Tabular Analysis
LO 5 Describe the five financial statements and how they are prepared.	• Income statement • Retained earnings statement • Statement of financial position • Statement of cash flows • Comprehensive income statement	**DO IT! 5** Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.

Accounting Activities and Users

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

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

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

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

Three Activities

As a starting point to the accounting process, a company identifies the **economic events relevant to its business**. Examples of economic events are the sale of food and snacks by **Unilever** (GBR and NLD), the providing of telephone services by **Chunghwa Telecom** (TWN), and the manufacture of motor vehicles by **Tata Motors** (IND).

Once a company like Unilever identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in monetary units. In recording, Unilever also classifies and summarizes economic events.

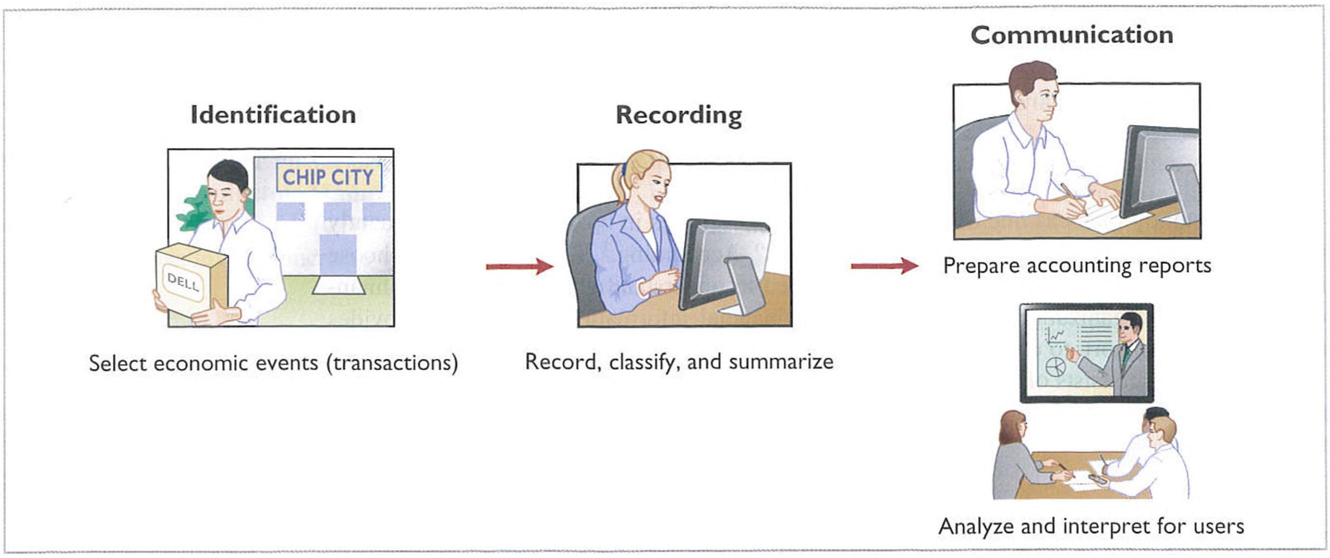
Finally, Unilever **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way. It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

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**. Appendix A of this text shows the financial statements of **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN). Appendix B illustrates the financial statements of **Nestlé SA** (CHE), and Appendix C includes the financial statements of **Delfi Limited** (SGP). We refer to these statements at various places throughout the text. (In addition, in the *A Look at U.S. GAAP* section at the end of each chapter, the U.S. company **Apple Inc.** is analyzed.) At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

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

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**[2]

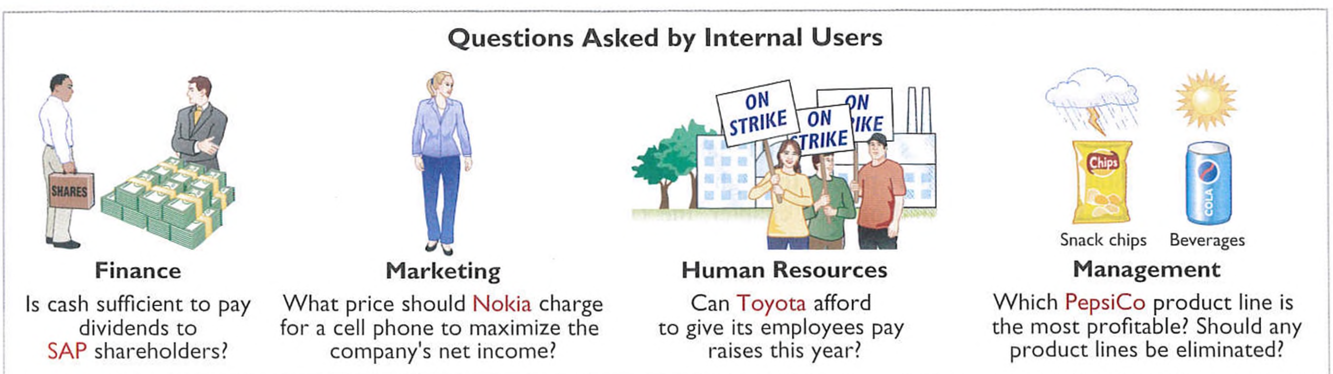
Who Uses Accounting Data

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

Internal Users

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

ILLUSTRATION 1.2 Questions that internal users ask



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

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

External Users

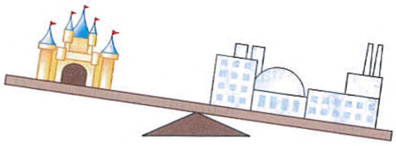
External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. **Illustration 1.3** shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 **Questions that external users ask**

Questions Asked by External Users

Investors

Is Lenovo earning satisfactory income?



Investors

How does Disney compare in size and profitability with Time Warner?

Creditors

Will Singapore Airlines be able to pay its debts as they come due?

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the **State Administration of Taxation in the People's Republic of China** (CHN), want to know whether the company complies with tax laws. **Regulatory agencies**, such as the **Financial Services Authority of Indonesia** (IDN), want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like **Tesla Motors, Inc.** (USA) will continue to honor product warranties and support its product lines. **Labor unions**, such as the **Indian National Trade Union Congress** (IND), want to know whether companies have the ability to pay increased wages and benefits to union members.

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

DO IT! 1 | Basic Concepts

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

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

ACTION PLAN

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

Solution

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

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

The Building Blocks of Accounting

LEARNING OBJECTIVE 2

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

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

Ethics in Financial Reporting

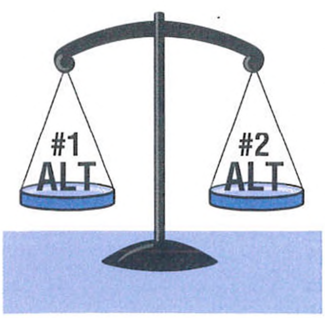
People won't gamble in a casino if they think it is "rigged." Similarly, people won't invest in the securities market if they think share prices are rigged. In recent years, the financial press has been full of articles about financial scandals at **Satyam Computer Services** (IND), **Toshiba** (JPN), **Pou Sheng International** (HKG), **Siwei** (CHN), and other companies. As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent share prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

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

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

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in **Illustration 1.4**.

ILLUSTRATION 1.4 **Steps in analyzing ethics cases and situations**



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

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

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

***Insight boxes** provide examples of business situations from various perspectives—ethics, investor, international, and company social responsibility. Guideline answers to the critical thinking questions and additional questions are available at the book's companion website.*

Ethics Insight Dewey & LeBoeuf LLP

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I Felt the Pressure—Would You?

"I felt the pressure." That's what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- "I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate."
- "I intentionally gave the auditors incorrect information in the course of the audit."

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Source: Ashby Jones, "Guilty Pleas of Dewey Staff Detail the Alleged Fraud," *Wall Street Journal* (March 28, 2014).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Go to the book's companion website for this answer and additional questions.)

Accounting Standards

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies. Presently, there are two primary accounting standard-setting bodies—the **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**. More than 130 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**. IFRSs are determined by the IASB. The IASB is headquartered in London, with its 15 board members drawn from around the world. Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP)**.

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies made efforts to reduce the differences between IFRS and U.S. GAAP. This process is referred to as **convergence**. Because convergence is such an important issue, we provide at the end of each chapter a section called *A Look at U.S. GAAP*, to provide a comparison with IFRS.

Global Insight

Toru-Hanai-Pool/
Getty Images, Inc.

The Korean Discount

If you think that accounting standards don't matter, consider these events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (Go to the book's companion website for this answer and additional questions.)

Measurement Principles

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

Helpful Hints *further clarify concepts being discussed.*

IFRS generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation (see **Helpful Hint**). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

Historical Cost Principle

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

Fair Value Principle

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market value information is usually readily available for these types of assets. In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to fair value, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

Assumptions

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

Monetary Unit Assumption

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

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

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

Economic Entity Assumption

An economic entity can be any organization or unit in society. It may be a company (such as **Maruti Suzuki** (IND)), a governmental unit (the Indonesian province of Papua), a municipality (Beijing), or a temple (the Temple of the Six Banyan Trees). The **economic entity**

assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Barb Su, owner of Barb's Bike Shop, must keep her personal living costs separate from the expenses of the business. Similarly, **Maxway Cycles Co.** (TWN) and **Asia Bicycle Trading Company** (TWN) are segregated into separate economic entities for accounting purposes (see **Ethics Note**).

Proprietorship. A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership. A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and accountants).

Corporation. A business organized as a separate legal entity under jurisdiction corporation law and having ownership divided into transferable shares is a **corporation**. The holders of the shares (shareholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Shareholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

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

ETHICS NOTE

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

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

Accounting Across the Organization

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Spinning the Career Wheel

One question that students frequently ask is, "How will the study of accounting help me?" A working knowledge of accounting is desirable for virtually *every field* of endeavor. Some examples of how accounting is used in other careers include the following.

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

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

Finance: Do you want to be a banker for **Shanghai Commercial and Savings Bank** (TWN) or a financial analyst for **ICBC** (CHN)? These fields rely heavily on accounting. In all of them, you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for **Hong Kong Property Services** (HKG)? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

How might accounting help you? (Go to the book's companion website for this answer and additional questions.)

ACTION PLAN

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

DO IT! 2 | Building Blocks of Accounting

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

1. Convergence refers to efforts to reduce differences between IFRS and U.S. GAAP.
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).
3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

Solution

1. True. **2.** True. **3.** False. The historical cost principle dictates that companies record assets at their cost. Under the historical cost principle, the company must also use cost in later periods. **4.** False. Faithful representation means that financial information matches what really happened; the information is factual. **5.** True.

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

The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

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

We can express the relationship of assets, liabilities, and equity as an equation, as shown in **Illustration 1.5**.

ILLUSTRATION 1.5
The basic accounting equation

Assets	=	Liabilities	+	Equity

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

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

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

Assets

As noted previously, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Taipei Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Taipei Pizza are tables, chairs, sound system, cash register, oven, tableware, and, of course, cash.

Liabilities

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

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

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

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

Equity

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

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

Share Capital—Ordinary

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

Retained Earnings

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

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

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Taipai Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales. Other titles for

HELPFUL HINT

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

and sources of revenue common to many businesses are sales, fees, services, commissions, interest, dividends, royalties, and rent.

HELPFUL HINT

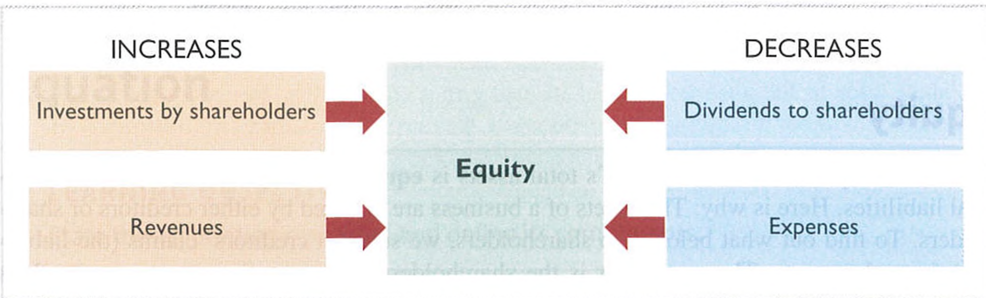
The effect of expenses is negative—a decrease in equity coupled with a decrease in assets or an increase in liabilities.

Expenses. **Expenses** are the cost of assets consumed or services used in the process of earning revenue. **They are decreases in equity that result from operating the business** (see **Helpful Hint**). Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used. For example, Taipai Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.), cost of beverages, wages expense, utilities expense (electric, gas, and water expense), telephone expense, delivery expense (gasoline, repairs, licenses, etc.), supplies expense (napkins, detergents, aprons, etc.), rent expense, interest expense, and property tax expense.

Dividends. Net income represents an increase in net assets which is then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a **dividend**. Dividends reduce retained earnings. However, dividends are **not expenses**. A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the shareholders).

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast, reductions (decreases) in equity result from expenses and dividends. These relationships are shown in **Illustration 1.6**.

ILLUSTRATION 1.6 **Increases and decreases in equity**



ACTION PLAN

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

DO IT! 3 | Equity Effects

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

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

Solution

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

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

Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.

Analyze business transactions | JOURNALIZE | POST | TRIAL BALANCE | ADJUSTING ENTRIES | ADJUSTED TRIAL BALANCE | FINANCIAL STATEMENTS | CLOSING ENTRIES | POST-CLOSING TRIAL BALANCE

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

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

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** (USA) stated, "We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area."

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

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

Accounting Transactions

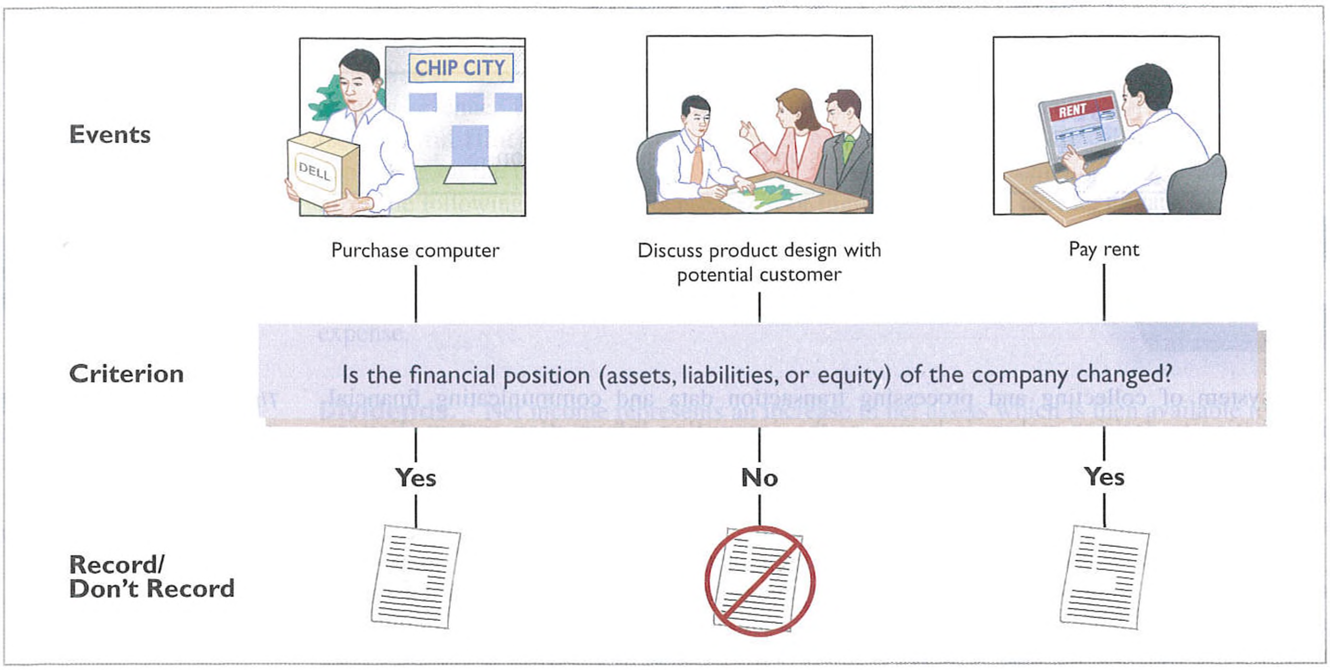
Transactions (**business transactions**) are a business's economic events recorded by accountants. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, Taipai Pizza's purchase of cooking equipment from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

Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions. Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. **Illustration 1.7** demonstrates the transaction identification process.

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

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

ILLUSTRATION 1.7 Transaction identification process

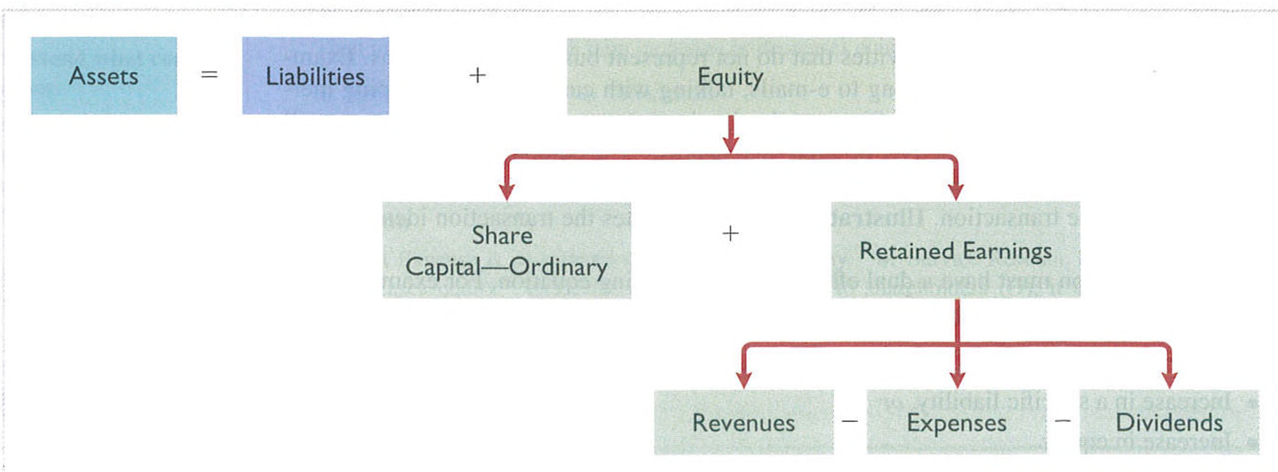


Two or more items could be affected. For example, as one asset is increased €10,000, another asset could decrease €6,000 and a liability could increase €4,000. Any change in a liability or ownership claim is subject to similar analysis.

Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte SA. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on equity. Recall that equity is comprised of two parts: share capital—ordinary and retained earnings. Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash. Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends. **Illustration 1.8** shows the **expanded accounting equation**.

ILLUSTRATION 1.8 Expanded accounting equation



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

HELPFUL HINT

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

Transaction (1). Investment by Shareholders. Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2020, they invest €15,000 cash in the business in exchange for €15,000 of ordinary shares. The ordinary shares indicates the ownership interest that the Neals have in Softbyte SA. This transaction results in an equal increase in both assets and equity.[3]

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

Equation Analysis

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

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, issued shares) is indicated. Why does this matter? Because investments by shareholders do not represent revenues, and they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations. Additional investments (i.e., investments made by shareholders after the corporation has been initially formed) have the same effect on equity as the initial investment.

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

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

Equation Analysis

	Assets			=	Liabilities	+	Equity
	Cash	+	Equipment	=			Share Capital
	€15,000						€15,000
(2)	−7,000		+€7,000				
	€ 8,000	+	€7,000	=			€15,000
	$\underbrace{\qquad}_{€15,000}$						

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

Transaction (3). Purchase of Supplies on Credit. Softbyte SA purchases headsets (and other computer accessories expected to last several months) for €1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October. This transaction is a purchase on account (a credit purchase). Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions.

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

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

Equation Analysis

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

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

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

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

Equation Analysis

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

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

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

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

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

Equation Analysis

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