IN THIS CHAPTER

- Appreciating how accounting is relevant to you
- Grasping how all economic activity requires accounting
- Understanding the accounting function's primary roles
- Watching an accounting department in action
- Shaking hands with business financial statements
- Realizing accounting is both an art form and science

Chapter 1

Accounting in Today's New Economy

There was a captive audience present when I (coauthor John) taught Accounting 101 because, then as well as now, all business school students have to take this course. In contrast, very few arts and science students elect the course, which is unfortunate. Accounting 101 teaches about business, including the nature of profit (which most people don't fully understand) and the fundamentals of capitalism.

The course is a very good training ground for becoming *financially literate.* Accounting is the language of business, finance, investing, and taxes. To be financially literate, you need to know basic accounting. These days, there's a big push to improve financial literacy, and a basic accounting course offers a useful framework for understanding and thinking about financial issues. Financial literacy is important to help ensure financial security for you and your family as you go through life and eventually enter into retirement.

In one sense, this book is the accounting course you never took. For business grads, the book presents an opportune review of topics you've gotten rusty on. We dare say that even accounting majors can glean many insights from this book. You don't need a college education to gain from this book, however. Like all the *For Dummies* books, this book delivers useful information in a plain-talking manner, with a light touch to keep it interesting.

As you go through life, you come face to face with a flood of accounting-generated information — more than you would ever imagine. Regrettably, much of this information isn't intuitive, and it doesn't come with a user's manual. In short, most of the accounting information you encounter isn't readily clear.

One main reason for learning some accounting is to understand its vocabulary and valuation methods so you can make more intelligent use of the information. Accountants are financial scorekeepers. In playing or watching any game, you need to know how the score is kept. The purpose of this book is to make you a knowledgeable spectator of and sometimes a participant in the accounting game.

REMEMBER

Let us point out another reason you should know accounting basics — the *defensive* reason. Many people in the cold, cruel financial world are on the prowl to take advantage of your lack of savvy about accounting. These unscrupulous characters treat you as a lamb waiting to be fleeced. An important defense against such tactics is to know some accounting, which helps you ask the right questions and understand the crucial points on which con artists want to keep you in the dark.

Checking Your Preconceptions about Accounting

You probably fall in with the majority of people who have preconceptions about accounting — which in fact may be way off the mark. For instance, most people think that you have to be good at math to understand accounting. Accounting deals with numbers, that's for sure, but by no means does it require calculus or other math — just arithmetic. Accountants make calculations and compare numbers. That's about it. We've never heard of an accountant taking the first derivative of an accounting equation or doing any other calculus computation.

The problem is that many people — perhaps even you — are number-phobic. They avoid anything to do with digits. They wouldn't think of doing their annual income tax return. Accountants deal in numbers. But be aware that every accounting number has a name or label attached. There are no naked numbers in accounting. The basic unit of information in accounting is the *account*, which consists of both

- A name
- Its amount or value

The vocabulary of accounting consists of accounts. Accountants communicate in terms of accounts.

Another preconception is that accountants have their heads buried in a torrent of details. Accountants have no choice; they have to be detail-oriented. At the same time, they have to see how the details fit into the overall scheme of things. The avalanche of details is condensed into accounting reports that disclose relatively few *aggregate* accounts. One reason for learning accounting is to understand what these collective accounts include.

Thinking about where assets come from

We explain later that accountants decide how to record transactions, which are economic exchanges (see the later section "Focusing on Transactions"). Many people aren't aware of the double duty of accountants in recording transactions. Accountants look at things from two points of view — the give and the take of the transaction. This is called *double-entry* accounting, which we explain in Chapter 3. The following example illustrates the two-sided nature of accounting.

Suppose a business reports $1,000,000 in total assets at the end of its most recent year. Most people, quite naturally, focus on the makeup of its assets (how much cash, for example). But the composition of its assets is only half the financial picture of a business. You've heard the expression that there are two sides to every story. Well, in accounting, there are two sides to the financial condition of a business.

Accounting deals with assets, of course. Accountants are equally concerned with the sources of the assets. In this example, the $1,000,000 in assets comes from three sources: $300,000 liabilities; $500,000 capital; and $200,000 surplus. You probably have a good idea of what liabilities are. *Capital* is money invested in the business by the owners. *Surplus* is profit that has been earned and not distributed to the owners. The sum of all three sources taken together equals the *total assets* of the business. The books are in balance.

Asking about profit

Businesses are profit motivated, so a natural question is "How much profit did the business earn over the last year?" Suppose the business had $120,000 surplus at the beginning of the year, and the business didn't distribute any of its profit to its owners during the year. Therefore, the business earned $80,000 profit for the

year: $120,000 surplus at start of year → $200,000 surplus at end of year = $80,000 gain in surplus, which is the profit for the year.

REMEMBER

One popular misconception is that earning profit increases cash by the same amount. Unfortunately, it's not as simple as that. Earning profit involves many assets and several liabilities. Cash is the main asset but not the only one affected by earning profit. One purpose of learning accounting is to understand the financial "fallout" from making profit. Profit consists of changes in assets and liabilities that, taken all together, increase the surplus of the business. The cash result from making profit is either higher or lower than the amount of profit. Isn't this interesting?

Sorting out stereotypes of accountants

We recently saw a cartoon in which the young son of clowns is standing in a circus tent and is dressed as a clown, but he's holding a briefcase. He's telling his clown parents that he's running away to join a CPA firm. This cartoon plays off the stereotype of a CPA (certified public accountant) as a boring "bean counter" who wears a green eyeshade, has no sense of humor, and possesses the personality of an undertaker (no offense to morticians). Maybe you've heard the joke that an accountant with a personality is one who looks at *your* shoes when he's talking to you instead his own shoes.

Like most stereotypes, there's an element of truth in this image of accountants. As a CPA and accounting professor for more than 40 years (coauthor John) and a financial and accounting consultant for more than 36 years (coauthor Tage), we've met and known a large number of accountants. Most accountants are not as gregarious as used-car salespeople (though some are). Accountants certainly are more detail-oriented than your average person, and they're a little more comfortable with complex calculations. Accountants are very good at one thing: Examining both sides of financial transactions — the give and the take, what was gotten and what was given. Accountants know better than anyone that, as economists are fond of saying, there's no such thing as a free lunch.

Because accountants work with numbers and details, you hear references to accountants as bean counters, digit heads, number nerds, and other names we don't dare mention here. Accountants take these snide references in stride and with good humor. Actually, accountants rank among the most respected professionals in many polls. Many people and businesses rely on their accountants for business, financial, and even investment advice. Accountants are much more than preparers of your tax returns.

If you walked down a busy street in Chicago, Denver, New York, or Los Angeles, we doubt that you could pick out the accountants. We have no idea whether accountants have higher or lower divorce rates, whether they go to church more frequently, whether most are Republicans or Democrats, or whether they generally sleep well at night. We do think overall that accountants are more honest in paying their income taxes, although we have no proof of this. (And yes, we know of a couple of accountants who tried to cheat on their federal income tax returns.)

Providing Vital Financial Information

In a nutshell, accountants "keep the books" of businesses — and of not-for-profit (NFP) and government entities also — by following systematic methods to record the financial activities of the entity. All this recordkeeping is done for one primary purpose: to create the database necessary for the preparation of complete, accurate, reliable, and timely financial reports, tax returns, and other types of financial communications. In *financial reports,* accounting information is presented in the form of *financial statements* that are packaged with other information such as explanatory footnotes and a letter from top management. Accountants design financial reports for *nonaccountants,* such as business owners, lenders, and investors.

Financial reports are sent to people who have a stake in the outcomes of the activities. If you own stock in Microsoft, for example, or you have money in a mutual fund, you receive regular financial reports. If you invest your hard-earned money in a private business or a real estate venture, or if you save money in a credit union, you receive regular financial reports. If you're a member of a nonprofit association or organization, you're entitled to receive regular financial reports. We hope you carefully read these financial reports, but if you don't — or if you do yet don't understand what you're reading — it could be that you don't understand the language of accounting.

One important reason for studying accounting is to make sense of the financial statements in the financial reports you get. We guarantee that Warren Buffett knows accounting and how to read financial statements. We sent him a copy of our book *How to Read a Financial Report* (John Wiley & Sons, Inc.). In his reply, he said he planned to recommend it to his "accounting challenged" friends.

Recognizing users of accounting information

People who use accounting information fall into two broad groups: *insiders (internal users)* and *outsiders (external users)*.

- Business managers are insiders; they have the authority and responsibility to run a business. They need a good understanding of accounting terms and the methods used to measure profit and put values on assets and liabilities. Accounting information is indispensable for planning and controlling the financial performance and condition of the business. Likewise, administrators of NFP and governmental entities need to understand the accounting terminology and measurement methods in their financial statements.
- The rest of us are outsiders. We aren't privy to the day-to-day details of a business or organization. We have to rely on financial reports from the entity to know what's going on. Therefore, we need to have a good grip on the financial statements included in the financial reports. For all practical purposes, financial reports are the only source of financial information we get directly from a business or other organization.

By the way, the employees of a business — even though they obviously have a stake in the success of the business — don't necessarily receive its financial reports. Only the investors in the business and its lenders are entitled to receive the financial reports. Of course, a business *could* provide this information to employees who aren't shareowners, but generally speaking, most businesses do not. The financial reports of public businesses are in the public domain, so their employees can easily secure a copy. However, most businesses don't automatically mail financial reports to all employees.

In your personal financial life, a little accounting knowledge is a big help for understanding investing in general, how investment performance is measured, and many other important financial topics. With some basic accounting knowledge, you'll sound much more sophisticated when speaking with your banker or broker. We can't promise you that learning accounting will save you big bucks on your income taxes, but it can't hurt and will definitely help you understand what your tax preparer is talking about.

REMEMBER

This is *not* a book on bookkeeping and recordkeeping systems. We offer a brief explanation of procedures for capturing, processing, and storing accounting information in Chapter 3. Even experienced bookkeepers and accountants should find some useful nuggets in that chapter. However, this book is directed to *users* of accounting information. We focus on the end products of accounting, particularly financial statements, and not on how information is accumulated. When buying a

new car, you're interested in the finished product, not details of the manufacturing process that produced it.

Using accounting in your personal financial life

We're sure you know the value of learning personal finance and investing fundamentals. (Given the big push these days on improving financial literacy, we recommend *Personal Finance For Dummies* and *Investing For Dummies* by Eric Tyson, MBA, both published by Wiley.) A great deal of the information you use in making personal finance and investment decisions is *accounting information.* However, we do have one knock on books in these areas: They don't make clear that you need a solid understanding of financial statements to make good use of the financial information.

REMEMBER

We've noticed that a sizable percent of the populace bash the profit motive and seem to think businesses should not make a profit. We would remind you, however, that you have a stake in the financial performance of the business you work for, the government entities you pay taxes to, the churches and charitable organizations you donate money to, the retirement plan you participate in, the businesses you buy from, and the healthcare providers you depend on. The financial performance and viability of these entities has a direct bearing on your personal financial life and well-being.

We're all affected by the profit performance of businesses, even though we may not be fully aware of just how their profit performance affects our jobs, investments, and taxes. For example, as an employee, your job security and your next raise depend on the business's making a profit. If the business suffers a loss, you may be laid off or asked to take a reduction in pay or benefits. Business managers get paid to make profit happen. If the business fails to meet its profit objectives or suffers a loss, its managers may be replaced (or at least not get their bonuses). As authors, we hope our publisher continues to make a profit so we can keep receiving our royalty checks.

Your investments in businesses, whether direct or through retirement accounts and mutual funds, suffer if the businesses don't turn a profit. We hope the stores we trade with make profit and continue in business. The federal government and most states depend on businesses making profit so they can collect income taxes from them.

Accounting extends into many nooks and crannies of your life. You're doing accounting when you make entries in your checkbook and when you fill out your federal income tax return. When you sign a mortgage on your home, you should understand the accounting method the lender uses to calculate the interest

amount charged on your loan each period. Individual investors need to understand accounting basics in order to figure their return on invested capital. And it goes without saying that every organization, profit-motivated or not, needs to know how it stands financially.

Seeing accounting at work

Accounting methods must fit the nature of the entity being accounted for and how the entity carries out its purpose. Accounting is not a case of one size fits all. Here's a quick sweep of the radar screen to give you an idea of different types of entities that accounting methods are adapted to:

- Accounting for profit-motivated businesses and accounting for nonprofit organizations (such as hospitals, homeowners' associations, churches, credit unions, and colleges)
- Income tax accounting while you're living and estate tax accounting after you die
- Accounting for farmers who grow their products, accounting for miners who extract their products from the earth, accounting for producers who manufacture products, and accounting for retailers who sell products that others make
- Accounting for businesses and professional firms that sell services rather than products, such as the entertainment, transportation, and healthcare industries
- Accounting where periodic financial statements are legally mandated (public companies are the primary example) and accounting where such formal accounting reports are not legally required
- Accounting that mainly adheres to historical cost (businesses) and accounting that records changes in market value (mutual funds, for example)
- Accounting in the private sector of the economy and accounting in the public (government) sector
- Accounting for going-concern businesses that will be around for some time and accounting for businesses in bankruptcy that may not be around tomorrow

Accounting is necessary in a free-market capitalist economic system. It's equally necessary in a centralized, government-controlled socialist economic system. All economic activity requires information. The more developed the economic system, the more the system depends on information. Much of the information comes from the accounting systems used by the businesses, institutions, individuals, and other players in the economic system.

TECHNICAL STUFF

Some of the earliest records of history are the accounts of wealth and trading activity. The need for accounting information was a main incentive in the development of the number system we use today. The history of accounting is quite interesting (but beyond the scope of this book).

Accounting's Two Primary Roles

REMEMBER

We aim to make this section of the book as easy to understand as possible by stating what should be obvious. That is, the accounting function in most businesses has two primary purposes:

- First, the accounting function and systems established must be able to produce complete, accurate, reliable, and timely ("CART") financial information on which businesses can base sound decisions.

  In today's intensely competitive global economy that is now supported by a broad ranging technology infrastructure that delivers information in split seconds, it has never been more important for accounting systems and the entire accounting function to produce and deliver vital financial information on a timely basis for review and management action.

- Second, a business's accounting function must be developed, implemented, managed, and periodically revised and updated to always be in the mindset of safeguarding company assets. Here, we are not just talking about preventing theft of liquid or hard assets such as an employee who may be embezzling cash or stealing inventory. Rather, the accounting function is now one of the critical gatekeepers associated with helping protect company intellectual property, shelter invaluable customer data and databases, preserve the integrity of critical financial information, control and direct the distribution of confidential financial operating results to the appropriate parties, and assist with critical risk management and insurance protection strategies, just to name a few.

As you progress through the rest of this book, it becomes abundantly clear that the accounting function has evolved into something much more than a bunch of bean counters, working with debits and credits, producing financial statements, and trying desperately to meet the annual income tax reporting deadlines. If the last 24 months has taught us anything, it is that the speed at which economic business models are now formulated, launched, disrupted, expanded, contracted, and potentially eliminated from the global market is in warp drive. Massive volumes of raw confidential business data are now considered one of the most valuable assets a company owns and monetizes to generate profits (aided by huge technological advancements). As such, accounting's role in producing CART financial

information in coordination with helping protect this data has never been more critical. Throughout this book, we provide examples and make references to accounting in the new, digital age; we start by diving into the digitization of accounting in Chapter 4 and a new era of risks.

Taking a Peek behind the Scenes

Every business and not-for-profit entity needs a reliable bookkeeping system (see Chapter 3). *Accounting* is a much broader term than *bookkeeping.* For one thing, accounting encompasses the problems in measuring the financial effects of economic activity. Furthermore, accounting includes the function of *financial reporting* to those who need the information. Business managers and investors and many other people depend on financial reports for information about the performance and condition of the entity.

Bookkeeping — also called *recordkeeping* — refers to the process of capturing, accumulating, organizing, storing, protecting, and accessing the financial information base of the entity. Of course, the financial information base should be complete, accurate, reliable, and timely. Every recordkeeping system needs quality controls built into it, which are called *internal controls* or *internal accounting controls.* When an error creeps into the system, it can be difficult to root out and correct. Data-entry controls are particularly important. The security of online and computer-based accounting systems has become a top priority of both for-profit businesses and not-for-profit entities. So-called cyber threats are a serious problem and can bring a big business to its knees, which we discuss further in Chapter 4.

REMEMBER

Accountants design the internal controls for the recordkeeping system, which serve to minimize errors in recording the large number of activities that an entity engages in over a specific time period. The internal controls that accountants design are also relied on to detect and deter theft, embezzlement, fraud, and dishonest behavior of all kinds. In accounting, internal controls are the ounce of prevention that's worth a pound of cure.

Most people don't realize the importance of the accounting department in keeping a business operating without hitches and delays. That's probably because accountants oversee many of the back-office functions in a business — as opposed to sales, for example, which is frontline activity, out in the open and in the line of fire. Go into any retail store, and you're in the thick of sales activities. But have you ever seen a company's accounting department in action?

Folks may not think much about these back-office activities, but they would sure notice if those activities didn't get done. On payday, a business had better not tell its employees, "Sorry, but the accounting department is running a little late this month; you'll get your checks later." And when a customer insists on up-to-date information about how much they owe the business, the accounting department can't very well say, "Oh, don't worry, just wait a week or so, and we'll get the information to you then."

Typically, the accounting department is responsible for the following:

- **Payroll:** The total wages and salaries earned by every employee every pay period, which are called *gross wages* or *gross earnings,* have to be calculated. Based on detailed private information in personnel files and earnings-to-date information, the correct amounts of income tax, Social Security tax, and several other deductions from gross wages have to be determined.

  Actually, a good deal of information has to be reported to employees each pay period, regarding withholdings and employee benefits. Retirement, vacation, sick pay, and other benefits earned by the employees have to be updated every pay period. Many employees do not get a payroll check. Instead, their money is sent electronically to the employee's bank account. The total amounts of withheld income tax, Social Security taxes, plus the employment taxes imposed on the employer, have to be paid to federal and state government agencies on time.

  In short, payroll is a complex and critical function that the accounting department performs, often with the assistance of the human resource department. ***Note:*** Many businesses outsource payroll functions to companies that specialize in this area.

- **Cash receipts:** All cash received from sales and from all other sources — whether via good old-fashioned cash or checks, credit cards, debit cards, electronic payments such as wire transfers or ACH, or other more modern payment vehicles such as PayPal — has to be carefully identified and recorded, not only in the cash account but also in the appropriate account for the source of the cash received. The accounting department makes sure that the cash is deposited in the appropriate checking accounts of the business and that an adequate amount of coin and currency is kept on hand for making change for customers. Accountants balance the checkbook of the business and control which persons have access to incoming cash receipts. (In larger organizations, the *treasurer* may be responsible for some of these cash-flow and cash-handling functions.)

- **Cash disbursements:** A business writes many other checks or processes numerous electronic payments (such as Automated Clearing House or ACH payments, wire transfers, and so on) during the course of a year — to pay for

a variety of purchases, to pay property taxes, to pay on loans, and to distribute some of its profit to the owners of the business, for example. The accounting department prepares all these checks for the signatures of the business officers who are authorized to sign checks. The accounting department keeps all the supporting business documents and files to know when the checks should be paid, makes sure that the amount to be paid is correct, and forwards the checks for signature. More and more businesses are switching to electronic methods of payments, which avoids the need for actually writing checks and mailing the checks. Electronic payments must be carefully protected to guard against hackers who would like to divert payments to themselves.

- **Procurement and inventory:** Accounting departments usually are responsible for keeping track of all purchase orders that have been placed for *inventory* (products to be sold by the business) and all other assets and services that the business buys, from light bulbs to forklifts. A typical business makes many purchases during the course of a year, many of them on credit, which means that the items bought are received today but paid for later. So this area of responsibility includes keeping files on all liabilities that arise from purchases on credit so that cash payments can be processed on time. The accounting department also keeps detailed records on all products held for sale by the business and, when the products are sold, records the cost of the goods sold.

- **Costing:** Costs are not as obvious as you might think. Tell someone that the cost of a new car is so many dollars, and most people accept the amount without question. Business owners and managers know better. Many decisions have to be made regarding which factors to include in the manufacturing cost of a product or in the purchase costs of products sold by retailers such as Costco and Walmart. Tracking costs is a major function of accounting in all businesses.

- **Property accounting:** A typical business owns many different substantial long-term assets that go under the generic name *property, plant, and equipment* — including office furniture and equipment, retail display cabinets, computers, machinery and tools, vehicles (autos and trucks), buildings, and land. Except for relatively small-cost items, such as screwdrivers and pencil sharpeners, a business maintains detailed records of its property, both for controlling the use of the assets and for determining personal property and real estate taxes. The accounting department keeps these property records.

- **Tax compliance:** The task of managing multiple tax accounting, reporting, and compliance functions usually falls on the shoulders of the accounting department. This extends well beyond simply completing annual income tax

returns because most businesses must deal with a slew of other tax reporting and compliance matters, including sales/use, property, excise, payroll, and multiple other forms of taxation, at multiple levels including federal, state, county, local, and municipal.

- **Liabilities accounting:** An entity must keep track of all relevant details about every liability it owes — from short-term purchases on credit to long-term notes payable. No entity can lose track of a liability and not pay it on time (or negotiate an extension) without hurting its credit rating.

REMEMBER

In most businesses and other entities, the accounting department is assigned other functions as well, but this list gives you a pretty clear idea of the back-office functions that the accounting department performs. Quite literally, a business could not operate if the accounting department did not do these functions efficiently and on time. And to repeat one point, to do these back-office functions well, the accounting department must design a good bookkeeping system and make sure that it's complete, accurate, reliable, and timely.

Focusing on Transactions

REMEMBER

The recordkeeping function of accounting focuses on *transactions*, which are economic exchanges between a business or other entity and the parties with which the entity interacts and makes deals. A good accounting system captures and records every transaction that takes place without missing a beat. Transactions are the lifeblood of every business, the heartbeat of activity that keeps it going. Understanding accounting, to a large extent, means understanding how accountants record the financial effects of transactions.

The financial effects of many transactions are clear-cut and immediate. On the other hand, figuring out the financial effects of some transactions is puzzling and dependent on future developments. The financial effects of some transactions can be difficult to determine at the time of the original transaction because the outcome depends on future events that are difficult to predict. We bring up this point because most people seem to think that accounting for transactions is a cut-and-dried process. Frankly, recording some transactions is more in the nature of "let's make our best assessment, cross our fingers, and wait and see what happens." The point is that recording the financial effects of some transactions is tentative and conditional on future events.

Separating basic types of transactions

A business is a whirlpool of transactions. Accountants categorize transactions into three broad types:

- **Profit-making transactions** consist of *revenue* and *expenses* as well as gains and losses outside the normal sales and expense activities of the business. We explain earlier in this chapter that one way to look at profit is as an increase in retained earnings (surplus). Another way of defining *profit* is as the amount of total revenue for the period minus all expenses for the period. Both viewpoints are correct.

  Included in this group of transactions are transactions that take place before or after the recording of revenue and expenses. For example, a business buys products that will be held for future sale. The purchase of the products is not yet an expense. The expense is not recorded until the products are sold. The purchase of products for future sale must, of course, be recorded when the purchase takes place.

- **Investing transactions** refers to the acquisition (and eventual disposal) of *long-term operating assets* such as buildings, heavy machinery, trucks, office furniture, and so on. Some businesses also invest in *financial assets* (bonds, for example). These are not used directly in the operations of the business; the business could get along without these assets. These assets generate investment income for the business. Investments in financial assets are included in this category of transactions.

- **Financing transactions** refers to raising capital and paying for the use of the capital. Every business needs assets to carry on its operations, such as a working balance of cash, inventory of products held for sale, long-term operating assets (as described in the preceding bullet point), and so on. Broadly speaking, the capital to buy these assets comes from two sources: debt and equity. *Debt* is borrowed money, on which interest is paid. *Equity* is ownership capital. The payment for using equity capital depends on the ability of the business to earn profit and have the cash flow to distribute some or all of the profit to its equity shareholders.

REMEMBER

Profit-making transactions, also called *operating activities*, are high frequency. During the course of a year, even a small business has thousands of revenue and expense transactions. (How many cups of coffee, for example, does your local coffee store sell each year? Each sale is a transaction.) In contrast, investing and financing transactions are generally low frequency. A business does not have a high volume of these types of transactions, except in very unusual circumstances.

Knowing who's on the other side of transactions

Another way to look at transactions is to look at the *counterparties* of the transactions; this term refers to the persons or entities that the business enters into an economic exchange with. A business interacts with a variety of counterparties. A business is the hub of transactions involving the following persons and entities:

- Its **customers,** who buy the products and services that the business sells; also, a business may have other sources of income, such as investments in financial assets (bonds, for example)
- Its **employees,** who provide services to the business and are paid wages and salaries and are provided with benefits, such as retirement plans, medical insurance, workers' compensation, and unemployment insurance
- **Independent contractors,** who are hired on a contract basis to perform certain services for the business; these services can be anything from hauling away trash and repairing plumbing problems to advising the business on technical issues and auditing by a CPA firm
- Its **vendors and suppliers,** who sell a wide range of things to the business, such as products for resale, electricity and gas, insurance coverage, telephone and internet services, and so on
- **Government entities,** which are the federal, state, and local agencies that collect income taxes, sales taxes, payroll taxes, and property taxes from or through the business
- **Sellers of the various long-term operating assets** used by the business, including building contractors, machinery and equipment manufacturers, and auto and truck dealers
- Its **debt sources of capital,** who loan money to the business, charge interest on the amount loaned, and are due to be repaid at definite dates in the future
- Its **equity sources of capital,** the individuals and financial institutions that invest money in the business as owners and who expect the business to earn profit on the capital they invest

Recording events

Certain other events that have a financial impact on the business have to be recorded as well. They're called *events* because they're not based on give-and-take bargaining — unlike the something-given-for-something-received nature of

economic exchanges. Events such as the following have an economic impact on a business and are recorded:

- A business may lose a lawsuit and be ordered to pay damages. The liability to pay the damages is recorded.
- A business may suffer a flood loss that is uninsured. The waterlogged assets may have to be written down, meaning that the recorded values of the assets are reduced to zero if they no longer have any value to the business. For example, products that were being held for sale to customers (until they floated down the river) must be removed from the inventory asset account.
- A business may decide to abandon a major product line and downsize its workforce, requiring that severance compensation be paid to the laid-off employees.

As we explain in more detail in Chapter 3, at the end of the year, the accountant conducts a special survey to ensure that all events and developments during the year that should be recorded have been recorded so that the financial statements and tax returns for the year are complete and correct.

Taking the Financial Pulse of a Business

We devote a good deal of space in this book to explaining *financial statements.* In Chapter 2, we explain the fundamental information components of financial statements, and then Part 2 gets into the nitty-gritty details. Here, we simply want to introduce you to the primary kinds of financial statements so you know from the get-go what they are and why they're so crucial.

REMEMBER

Financial statements are prepared at the end of each accounting period. A period may be one month, one quarter (three calendar months), or one year. Financial statements report *summary amounts*, or *totals.* Accountants seldom prepare a complete listing of the details of all the activities that took place during a period or the individual items making up a total amount. Business managers may need to search through a detailed list of all the specific transactions that make up a total amount, and when they want to drill down into the details, they ask the accountant for the more detailed information. But this sort of detailed listing is *not* a financial statement — although it may be very useful to managers.

The outside, nonmanager investors in a business receive summary-level financial statements. For example, investors see the total amount of sales revenue for the period but not how much was sold to each and every customer. Financial statements are based on the assumption that you, the reader, are not a manager of the business (see the earlier section "Recognizing users of accounting information").

The managers of the business should make good use of their financial statements, but they also need more detailed information beyond what's in the business's financial statements.

Meeting the balance sheet (statement of financial condition)

One type of financial statement is a "Where do we stand at the end of the period?" type of report. This is called the *statement of financial condition* or, more commonly, the *balance sheet.* The date of preparation is given in the header, or title, at the top of this financial statement. We present and explain a typical balance sheet in Chapter 2. Our purpose here is simply to present the basic content in a balance sheet.

A balance sheet summarizes the two opposite aspects of a business, which you could think of as the financial yin and yang of the business:

- **Assets:** One side of the balance sheet lists the *assets* of the business, which are the economic resources owned and being used in the business. The asset *values* reported in the balance sheet are the amounts recorded when the assets were originally acquired — although we should mention that an asset is written down below its historical cost when the asset has suffered a loss in value. (And to complicate matters, some assets are written up to their current fair values.) Some assets have been on the books only a few weeks or a few months, so their reported historical values are current. The values for other assets, on the other hand, are their costs when they were acquired many years ago.
- **Sources of assets:** On the other side of the balance sheet is a breakdown of where the assets came from, or their *sources.* Assets do not materialize out of thin air. Assets arise from three basically different sources:
  - **Creditors:** Businesses borrow money in the form of interest-bearing loans that must be paid back at a later date, and they buy things on credit that are paid for later. So part of total assets can be traced to creditors, which are the *liabilities* of a business.
  - **Owners:** Every business needs to have owners invest capital (usually money) in the business.
  - **Profit:** Businesses retain part or all of their annual profits, increasing the *surplus* of the business. We use this term earlier in "Thinking about where assets come from." In most balance sheets, surplus is called *retained earnings* or an equivalent title. From here on, we stick with the title *retained earnings.*

    One final definition: The total of owners' capital invested in the business and its retained earnings is labeled *owners' equity.*

REMEMBER

Given the basic sources of assets, the financial condition of a business is condensed as follows:

$Assets = $Liabilities + $Capital + $RetainedEarnings

The dollar signs are to remind you that for each item, there's a dollar amount that goes with it. This depiction of financial condition is referred to as the *accounting equation.* It stresses the point that the total amount of all assets equals the total amount of liabilities and owners' equity. One side cannot be heavier than the other side. An imbalance signals accounting errors in recording the transactions of the business.

Looking at the accounting equation, you can see why the statement of financial condition is called the *balance sheet;* the equal sign means the two sides balance or are equal in total amounts.

Suppose a business reports $2.5 million total assets (without going into the details of which particular assets the business holds). Knowing that total assets are on the books at $2.5 million, we also know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit adds up to $2.5 million.

TIP

Continuing with this example, suppose that the total amount of the liabilities of the business is $1.0 million. This means that the total amount of *owners' equity* in the business is $1.5 million, which equals total assets less total liabilities. This amount is also called the *net worth* of the business; to be more accurate, it should be called the *recorded net worth* of the business (which does not necessarily equal the present market value of the business). Without more information, we don't know how much of total owners' equity is traceable to capital invested by the owners in the business and how much is the result of profit retained in the business. But we do know that the total of these two sources of owners' equity is $1.5 million.

TIP

Double-entry bookkeeping is a centuries-old, very clever method for keeping the accounting equation in balance. We discuss double-entry bookkeeping in Chapter 3. Basically, double-entry bookkeeping simply means that both sides of transactions are recorded. For example, if one asset goes up, another asset goes down — or, alternatively, either a liability or owners' equity element goes up. In accounting, *double-entry* means *two-sided,* not that transactions are recorded twice.

A POP QUIZ

Here's a teaser for you. If a business's total assets equal $2.5 million and its total liabilities equal $1.0 million, we know that its total owners' equity is $1.5 million. ***Question:*** Could the owners have invested more than $1.5 million in the business? ***Answer:*** Yes. One possibility is that the owners invested $2.5 million, but the business has so far accumulated $1.0 million of losses instead of making a profit. The accumulated loss offsets the amount invested, so the owners' equity is only $1.5 million net of its cumulative loss of $1.0 million. The owners bear the risk that the business may be unable to make a profit. Instead of retained earnings, the business would report a $1.0 million *deficit* in its balance sheet.

Reporting profit and loss

REMEMBER

Everyone (including managers, lenders, and owners) is interested in whether the business enjoyed a profit or suffered a loss for the year. Suppose you have in your hands the balance sheet of a business showing the end of last year and the end of the year just ended. You can calculate profit or loss for the most recent year by computing the increase in retained earnings and adding the amount of distributions from profit during the year. Suppose the business's retained earnings increased $5.0 million during the year and it paid out $2.0 million cash from profit to its owners. Therefore, its profit for the year is $7.0 million.

Oh, you want to know its revenue and expenses for the year — not just the profit for the year. In fact, the standard practice in financial reporting is to present a financial statement that discloses the total revenue and total expenses for the period and ends with the profit (or loss) on the bottom line of the statement. The *income statement* summarizes sales revenue and other income, which are offset by the expenses and losses during the period. Deducting expenses from revenue and income leads down to the well-known *bottom line,* which is the final net profit or loss for the period and is called *net income* or *net loss* (or some variation of these terms). Alternative titles for this financial statement are the *statement of operations* and the *statement of earnings.* Inside a business, but not in its external financial reports, the income statement is commonly called the *P&L* (profit and loss) report.

TIP

Of course, the bottom line of the income statement should be the same amount that could be computed by adding the change in retained earnings and distributions to owners during the year from the profit.

Reporting cash flows and changes in owners' equity

Cash is king, as business managers and investors will tell you. More than a quarter of a century ago, the rule-making authority in financial accounting said a business should report a *statement of cash flows* to supplement the income statement and balance sheet. This financial statement summarizes the business's cash inflows and outflows during the period.

A highlight of this statement is the cash increase or decrease from profit (or loss) for the period. This key amount in the cash flow statement is called *cash flow from operating activities.* We explain the statement of cash flows in Chapters 2 and 8. Be warned early on that many argue that this cash flow figure is more important than bottom-line profit for the period. Well, we'll see about that!

REMEMBER

It becomes clear throughout this book that we harp on and emphasize the importance of the statement of cash flows because it offers critical financial information about how a business generates and consumes cash. What we have found over our vast experience is that while most parties (internal and external — both are equally guilty) jump right to the income statement to identify the growth in top-line sales revenue or how much bottom-line profit was generated, or focus on the balance sheet to evaluate the company's financial strength, the statement of cash flows tends to get passed over relatively quickly. *Why?* you may ask. It usually comes down to either the party being lazy, having a lack of understanding (as to the purpose of this statement), or believing that the statement of cash flows is overly complex and is not particularly important. All are poor excuses because, in order to truly understand accounting and a company's financial statements, the statement of cash flows should never be overlooked!

Also, it's common for many businesses to include a summary of changes in their owners' equity accounts during the year. Typically it's called a *statement of changes in stockholders' equity.* We could argue that it's not a full-fledged financial statement, but there's little point in arguing semantics here — although the other three financial statements (balance sheet, income statement, and cash flows statement) are "full-size" statements. Larger, public corporations are required to present this statement, whereas smaller, private businesses have more leeway in deciding whether to include such a summary. We explain the statement of changes in stockholders' equity in Chapter 2.

Remembering management's role

We explain more about the three primary financial statements (balance sheet, income statement, and statement of cash flows) in Chapter 2. They constitute the hard core of a financial report to those persons outside a business who need to stay informed about the business's financial affairs. These individuals have

invested capital in the business, or the business owes them money; therefore, they have a financial interest in how well the business is doing.

To keep informed about what's going on and the financial position of the business, the managers of a business also use these three key financial statements. These statements are essential in helping managers control the performance of a business, identify problems as they come up, and plan the future course of a business. Managers also need other information that isn't reported in the three basic financial statements. (In Chapter 13, we explain these additional reports.)

The three primary financial statements constitute a business's financial center of gravity. The president and chief executive officer of a business (plus other top-level officers) are responsible for seeing that the financial statements are prepared according to applicable financial reporting standards and according to established accounting principles and methods.

WARNING

If a business's financial statements are later discovered to be seriously in error or deliberately misleading, the business and its top executives can be sued for damages suffered by lenders and investors who relied on the financial statements. For this reason, business managers must understand their responsibility for the financial statements and the accounting methods used to prepare the statements. In a court of law, managers can't plead ignorance.

We've met more than one business manager who doesn't have a clue about his or her financial statements. This situation is a little scary; a manager who doesn't understand financial statements is like an airplane pilot who doesn't understand the instrument readouts in the cockpit. Such a manager *could* run the business and "land the plane safely," but knowing how to read the instrument panels along the way is much more prudent.

Business managers at all levels need to understand financial statements and the accounting methods used to prepare them. Also, lenders to a business, investors in a business, business lawyers, government regulators of business, entrepreneurs, anyone thinking of becoming an entrepreneur and starting a business, and, yes, even economists should know the basics of financial statement accounting. We've noticed that even experienced business journalists, who ought to know better, sometimes refer to the balance sheet when they're talking about profit performance. The bottom line is found in the income statement, not the balance sheet!

Accounting as a Form of Art

Throughout this book, you read references to accounting being more of a form of art than an exact science. We are not implying that accountants and the profession of accounting don't have to follow specific rules, standards, and guidelines; as you

see in Chapter 2, a very robust set of rules and authoritative organizations have been established to provide guidance to accountants in plying their trade.

However, it should be noted that accounting is by no means an exact science because accountants are constantly having to use estimates, complete complex financial analyses, and evaluate data (that always seems to be a moving target) when preparing financial information, reports, and statements. Further, economic conditions are constantly changing and evolving at what seems like the speed of light these days (such as with Covid-19's impact in 2020 and beyond), making the accountant's job even more challenging. You would be amazed at how even the slightest change in an assumption or data point used, such as increasing the interest rate used to calculate the estimated current value of future obligations, can impact the overall financial results of a business.

To reiterate one of our primary goals, the purpose of the concepts and topics presented in this book is not to provide a detailed overview of technical accounting rules or guidelines, such as the theory behind accounting for capital asset leases or applying Black-Scholes to account for stock option expense, but rather to offer a 10,000-foot overview of accounting and key concepts every business must address, starting with the following fundamental statement.

REMEMBER

To produce accurate financial information, every business must develop, implement, maintain, and manage a properly functioning accounting system that at its foundation relies on establishing, implementing, and adhering to agreed-upon accounting policies, procedures, and controls applied on a consistent basis and in accordance with generally accepted accounting principles (GAAP).

These generally accepted accounting principles are "a set of rules that encompass the details, complexities, and legalities of business and corporate accounting." These rules are established by various accounting organizations, boards, and groups, with the primary group being the Financial Accounting Standards Board (FASB), which uses GAAP as the foundation for its comprehensive set of approved accounting methods and practices.

There you have it — when producing financial information, businesses should adhere to GAAP as established by FASB. Seems simple enough, but as you work through the remainder of this book, it should become abundantly clear that GAAP is more or less a series of guidelines that businesses can use to provide a certain amount of leeway when actual financial information is produced. Or maybe the best way to think of it is referring to this quote from Captain Barbossa from the *Pirates of the Caribbean* franchise: "And thirdly, the code (translation to accounting — GAAP) is more what you'd call *guidelines* than actual *rules*." Yes, very good guidelines but guidelines nonetheless that provide accountants with a reasonable amount of leeway when preparing financial information.