Chapter 1

Introducing Accounting to Non-Accountants

In This Chapter

- Understanding the different needs for accounting
- Making and enforcing accounting rules
- Peering into the back office: The accounting department in action
- Transactions: The heartbeat of a business
- Taking a closer look at financial statements
- Mama, should you let your baby grow up to be an accountant?

Most medium to large businesses employ one or more accountants. Even a very small business needs at least a part-time accountant. Have you ever wondered why? What do these bean counters with the green eyeshades do, anyway? Probably what you think of first is that accountants keep the books — they keep the records of the financial activities of the business. This is true, of course. But accountants perform other very critical, but less well-known, functions in a business:

- Accountants carry out vital back-office operating functions that keep the business running smoothly and effectively — including payroll, cash inflows and cash payments, purchases and inventory, and property records.
- Accountants prepare tax returns, including the federal income tax return for the business, as well as payroll and property tax returns.
- Accountants determine how to measure and record the costs of products and how to allocate shared costs among different departments and other organizational units of the business.
- Accountants are the *professional profit scorekeepers* of the business world, meaning that they are the ones who determine exactly how much profit was earned, or just how much loss the business suffered, during

the period. Accountants prepare reports for the managers of a business which keep managers informed about costs and expenses, how sales are going, whether the cash balance is adequate, what the inventory situation is, and, the most important thing — accountants help managers understand the reasons for changes in the bottom-line performance of a business.

- Accountants prepare *financial statements* that help the owners and stockholders of a business understand where the business stands financially. Stockholders wouldn't invest in a business without a clear understanding of the financial health of the business, which regular financial reports (which are sometimes just called *the financials*) provide.

In short, accountants are much more than bookkeepers — they provide the numbers that are so critical in helping business managers make the informed decisions that keep a business on course toward its financial objectives.

Business managers, investors, and others who depend on financial statements should be willing to meet accountants halfway. People who use accounting information, like spectators at a football game, should know the basic rules of play and how the score is kept. The purpose of this book is to make you a knowledgeable spectator of the accounting game.

Accounting Everywhere You Look

Accounting extends into virtually every walk of life. You're doing accounting when you make entries in your checkbook and 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 some accounting in order to figure the return on capital invested. And every organization, profit-motivated or not, needs to know how it stands financially. Accounting supplies all that information.

Many different kinds of accounting are done by many different kinds of persons or entities for many different purposes:

- Accounting for organizations and accounting for individuals
- 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
- Past-historical-based accounting and future-forecast-oriented accounting (that is, budgeting and financial planning)
- Accounting where periodic financial statements are mandatory (businesses are the primary example) and accounting where such formal accounting reports are not required
- Accounting that adheres to cost (most 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 any free-market, capitalist economic system. It's equally necessary in a centrally 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, individuals, and other institutions in the economic system.

Some of the earliest records of history are the accounts of wealth and trading activity, and the need for accounting information was a main incentive in the development of the numbering system we use today. Professor William A. Paton, a well-known accounting professor at the University of Michigan for many years (and who lived to be over 100), expressed the purpose of accounting very well in his classic book, *Essentials of Accounting* (Macmillan):

> *In a broad sense accounting has one primary function: facilitating the administration of economic activity. This function has two closely related phases: (1) measuring and arraying economic data; [and] (2) communicating the results of this process to interested parties.*

The Basic Elements of Accounting

I like Professor Paton's short definition because it articulates the basic purpose of accounting. However, the definition does sidestep one aspect of accounting — *bookkeeping* (which you can find more about in Chapter 2). Accounting involves bookkeeping, which refers to the painstaking and detailed recording of economic activity and business transactions. But *accounting* is a much broader term than *bookkeeping* because *accounting* refers to the design of the bookkeeping system. It addresses the many problems in measuring the financial effects of economic activity. Furthermore, accounting includes the *financial reporting* of these values and performance measures to non-accountants in a clear and concise manner. Business managers and investors, as well as many other people, depend on financial reports for vital information they need to make good economic decisions.

Accountants design the *internal controls* in an accounting system, which serve to minimize errors in recording the large number of activities that a business engages in over the period. The internal controls that accountants design can detect and deter theft, embezzlement, fraud, and dishonest behavior of all kinds. In accounting, internal controls are the ounce of prevention that is worth a pound of cure.

An accountant seldom prepares a complete listing of all the details of the activities that took place during a period. Instead, he or she prepares a *summary financial statement,* which shows totals, not a complete listing of all the individual activities making up the total. Managers may occasionally need to search through a detailed list of all the specific transactions that make up the total, but this is not common. Most managers just want summary financial statements for the period — if they want to drill down into the details making up a total amount for the period, they ask the accountant for this more detailed backup information. Also, outside investors usually only see summary-level financial statements. For example, they see the total amount of sales revenue for the period but not how much was sold to each and every customer.

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. One basic type of accounting report prepared at the end of the period 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 above this financial statement. A balance sheet shows two sides of the business.

On the one side are listed the *assets* of the business, which are its economic resources being used in the business. On the other side of the balance sheet is a breakdown of where the assets came from, or the sources of the assets. The asset *values* reported in the balance sheet are the amounts recorded when the assets were originally acquired. For many assets these values are recent — only a few weeks or a few months old. For some assets their values as reported in the balance sheet are the costs of the assets when they were acquired many years ago.

Assets are not like manna from the heavens. They come from borrowing money in the form of loans that have to be paid back at a later date and from owners' investment of capital (usually money) in the business. Also, making profit increases the assets of the business; profit retained in the business is the third basic source of assets. If a business has, say, $2.5 million in total assets (without knowing which particular assets the business holds), I know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to $2.5 million.

In 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. 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.

The financial condition of the business in this example is summarized in the following *accounting equation* (in millions):

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$2.5 Assets = $1.0 Liabilities + $1.5 Owners' Equity
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Looking at the accounting equation you can see why the statement of financial condition is also called the balance sheet; the equal sign means the two sides have to balance.

Double-entry bookkeeping is based on the accounting equation — or the fact that the total of assets on the one side are counter-balanced by the total of liabilities, invested capital, and retained profit on the other side. Double-entry bookkeeping is discussed in Chapter 2.

Other financial statements are different than the balance sheet in one important respect: they summarize the significant *flows* of activities and operations over the period. Accountants prepare two types of summary flow reports for businesses:

- The **income statement** summarizes the inflows of assets from the sale of products and services during the period. The income statement also summarizes the outflow of assets for expenses during the period — leading down to the well-known *bottom line,* or final profit or loss for the period.
- The **cash flow statement** summarizes the business's cash inflows and outflows during the period. The first part of this financial statement calculates the net increase or decrease in cash during the period from the profit-making activities reported in the income statement.

The balance sheet, income statement, and cash flow statement 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. These three key financial statements are also used by the managers of a business to keep informed about what's going on and the financial position of the business. They are absolutely essential to 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 is not reported in the three basic financial statements. (Part III of this book explains these additional reports.)

JARGON ALERT

The jargon jungle of accounting

Financial statements include many terms that are reasonably clear and straightforward, like *cash, accounts receivable,* and *accounts payable.* However, financial statements also use words like *retained earnings, accumulated depreciation, accelerated depreciation, accrued expenses, reserve, allowance, accrual basis,* and *current assets.* This type of jargon in accounting is like ugly on an ape: It's everywhere you look.

Although accounting is often called the "language of business," accountants use some of the most baffling terminology you'll ever hear (well, medical terminology and some legal terms may be worse). Accountants know the definitions of their specialized vocabulary and they assume that non-accountants know all these terms as well. The result is that many financial statements seem to many business managers and investors to be written in Greek. Furthermore, financial statements do not come with a glossary — such as the one that you can find at the end of this book. If you have any doubt about a term as I go along in the book, please take a quick look in Appendix A, which defines many accounting terms in plain English.

Accounting and Financial Reporting Standards

Imagine if every business could invent its own accounting methods and terminology for measuring profit and for presenting financial statements. As an example from the academic world, what if I give a student an A for a course and a professor at another university gives a student a K? Keeping track of academic performance would be pretty tough without some recognized and accepted standards.

Experience and common sense have taught business and financial professionals that uniform financial reporting standards and methods are critical in a free-enterprise, private, capital-based economic system. A common vocabulary, uniform accounting methods, and full disclosure in financial reports are the goals. How well the accounting profession performs in achieving these goals is an open question, but few disagree that they are worthy goals to strive for.

The supremacy of GAAP (generally accepted accounting principles)

The most important financial statement and financial reporting standards and rules are called *generally accepted accounting principles (GAAP),* which describe the basic methods to measure profit and to value assets and liabilities, as well as what information should be disclosed in those financial statements released outside a business. Suppose you're reading the financial statements of a business. You're entitled to assume that the business has used GAAP in reporting its cash flows and profit and its financial condition at the end of a financial period — *unless* the business makes very clear that it has prepared its financial report on a comprehensive basis of accounting other than GAAP.

The word *comprehensive* here is very important. A financial report should be comprehensive, or all-inclusive — reflecting all the financial activities and aspects of the entity. If not, the burden is on the business to make very clear that it is presenting something less that a complete and comprehensive report on its financial activities and condition. But, even if the financial report of a business is comprehensive, its financial statements may be based on accounting methods other than GAAP.

If GAAP are not the basis for preparing its financial statements, a business should make very clear which other basis of accounting is being used and should avoid using titles for its financial statements that are associated with GAAP. For example, if a business uses a simple cash receipts and cash disbursements basis of accounting — which falls way short of GAAP — it should not use the terms *income statement* and *balance sheet.* These terms are part and parcel of GAAP, and their use as titles for financial statements implies that the business is using GAAP.

Financial reporting by government and other not-for-profit entities

In the grand scheme of things, the world of financial reporting can be divided into two hemispheres — for-profit entities (businesses) and not-for-profit entities. Although very prominent, business entities are just one of the main types of institutions in our society. Think of all the non-business institutions that you deal with and that affect your life — governmental, educational, religious, political, medical, cultural, and charitable.

A large body of authoritative rules and standards, called *generally accepted accounting principles,* or *GAAP* for short, have been hammered out over the years to govern accounting methods and financial reporting of business entities. To a lesser extent, accounting and financial reporting standards have evolved or been established for government and other not-for-profit entities. This book centers on business accounting methods and financial reporting. Financial reporting by government and other not-for-profit entities is a broad and diverse territory, which is beyond the scope of this book. I can say only a few words here, and that's it.

In dealing with government and other not-for-profit organizations, people generally don't demand financial reports from these entities. State and local government entities issue formal financial reports that are in the public domain — although very few taxpayers are interested in reading them. When you donate money to a charity, school, or church you don't generally get formal financial reports in return. On the other hand, many private, not-for-profit organizations issue formal financial reports to their members — credit unions, homeowner associations, country clubs, mutual insurance companies (owned by their policy holders), pension plans, labor unions, health care providers, and so on. The members or participants may have an equity interest or ownership share in the organization and, thus, they need financial reports to appraise them of their financial status with the entity.

In summary, government and other not-for profit entities should comply with the established accounting and financial reporting standards that apply to their type of entity. Being acquainted with business GAAP is a good starting point for understanding the financial reports of not-for-profit entities. ***Caution:*** Many not-for-profit entities use one or more accounting methods different than business GAAP, and the terminology in their financial reports is somewhat different than in the financial reports of business entities.

In brief, GAAP constitute the gold standard for preparing financial statements of business entities — although the gold is somewhat tarnished, which later chapters explain. Readers of a business's financial report are entitled to assume that GAAP have been followed in preparing the financial statements, unless the business makes very clear that it has not complied entirely with GAAP. If the deviations and shortfalls from GAAP are not disclosed, the business may have legal exposure to those who relied on the information in its financial report and suffered a loss attributable to the misleading nature of the information.

A practical example of GAAP: Why the rules are important

Business managers should know the basic features of GAAP — though certainly not all the technical details — so that they understand how profit is measured. Managers get paid to make profit, and they should be very clear on how profit is measured and what profit consists of. The amount of profit a business makes depends on how *profit* is defined and measured.

For example, a business records the purchase of products at cost, which is the amount it paid for the products. *Inventory* is the stockpile of products being held for sale to customers. Examples include clothes in a department store, fuel in the tanks in a gas station, food on the shelves in a supermarket, books in a bookstore, and so on. The cost of products is put in the inventory asset account and kept there until the products are sold to customers. When the products are eventually sold, the cost of the products are recorded as the cost of goods sold expense, at which time a decrease is recorded in the inventory asset account. The cost of products sold is deducted from the sales revenue received from the customers, which gives a first-step measure of profit. (A business has many other expenses that need to be factored in, which you can read about in later chapters.)

Now, assume that before the business sells the products to its customers, the replacement cost of many of the products being held in inventory awaiting sale increases. The replacement cost value of the products is now higher than the original, actual purchase cost of the products. The company's inventory is worth more, is it not? Perhaps the business could raise the sales prices that it charges its customers because of the cost increase, or perhaps not. In any case, should the increase in the replacement cost of the products be recorded as profit? The manager may think that this holding gain should be recorded as profit. But GAAP accounting standards say that no profit is earned until the products are sold to the customers.

What about the opposite movement in replacement costs of products — when replacement costs fall below the original purchase costs? Should this development be recorded as a loss, or should the business wait until the products are sold? As you'll see, the accounting rule that applies here is called *lower of cost or market,* and the loss is recorded. So the rule requires one method on the upside but another method on the downside. See why business managers and investors need to know something about the rules of the game? I should add that GAAP are not all crystal-clear, which leaves a lot of wiggle room in the interpretation and application of these accounting standards. But first a quick word about GAAP and income tax accounting.

Income tax and accounting rules

Generally speaking (and I'm being very general when I say the following), the federal income tax accounting rules for determining the annual taxable income of a business are in agreement with GAAP. In other words, the accounting methods used for figuring taxable income and for figuring business profit before income tax are in general agreement. Having said this, I should point out that several differences do exist. A business may use one accounting method for filing its annual income tax returns and a different method for measuring its profit both for management reporting purposes and for preparing its external financial statements to outsiders.

Flexibility in accounting standards

An often-repeated accounting story concerns three CPAs interviewing for an important position. The CPAs are asked one key question: "What's 2 plus 2?" The first candidate answers, "It's 4," and is told, "Don't call us, we'll call you." The second candidate answers, "Well, most of the time the answer is 4, but sometimes it's 3 and sometimes it's 5." The third candidate answers: "What do you want the answer to be?" Guess who got the job?

The point is that GAAP are not entirely airtight or cut-and-dried. Many accounting standards leave a lot of room for interpretation. *Guidelines* would be a better word to describe some accounting rules. Deciding how to account for certain transactions and situations requires flexibility, seasoned judgment, and careful interpretation of the rules. Furthermore, many estimates have to be made.

Sometimes, businesses use what's called *creative accounting* to make profit for the period look better. Like lawyers who know where to find loopholes, accountants sometimes come up with inventive solutions, but still stay within the guidelines of GAAP. I warn you about these creative accounting

Accounting depends on many estimates

The importance of estimates in financial accounting is illustrated in a footnote from a recent annual financial report of a well-known business:

"The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts. Examples of the more significant estimates include: accruals and reserves for warranty and product liability losses, post-employment benefits, environmental costs, income taxes, and plant closing costs."

Accounting estimates should be based on the best available information, of course, but most estimates are subjective and arbitrary to some extent. The accountant can choose either pessimistic or optimistic estimates, and thereby record either conservative profit numbers or more aggressive profit numbers.

techniques — also called *massaging the numbers* — at various points in this book. Articles in financial newspapers and magazines regularly focus on such accounting abuses.

Enforcing Accounting Rules

As I mentioned in the preceding sections, when preparing financial statements a business must follow generally accepted accounting principles (GAAP) — the authoritative ground rules for measuring profit and for reporting values of assets and liabilities. Everyone reading a financial report is entitled to assume that GAAP have been followed (unless the business clearly discloses that it is using another so-called comprehensive basis of accounting).

The basic idea behind GAAP is to measure profit and to value assets and liabilities *consistently* from business to business — to establish broad-scale uniformity in accounting methods for all businesses. The idea is to make sure that all accountants are singing the same tune from the same hymnal. The purpose is also to establish realistic and objective methods for measuring profit and putting values on assets and liabilities. The authoritative bodies write the tunes that accountants have to sing.

GAAP also include minimum requirements for *disclosure,* which refers to how information is classified and presented in financial statements and to the types of information that have to be added to the financial statements in the form of footnotes. Chapter 8 explains these disclosures that are required in addition to the three primary financial statements of a business (the income statement, balance sheet, and cash flow statement).

The official GAAP rule book is *big* — more than a thousand pages! Actually there are eight different sources of authoritative accounting rules in the United States. And, accounting rule-making is becoming more international in scope to keep up with the global operations of many businesses. These rules have evolved over many decades — some rules remaining the same for many years, some being superseded and modified from time to time, and new rules being added. Some think the rules have become too complicated and far too technical. If you flip through the GAAP rule book, you'll see why people come to this conclusion. However, if the rules are not specific and detailed enough, different accountants will make different interpretations which will cause inconsistency from one business to the next regarding how profit is measured and how assets and liabilities are reported in the balance sheet. So, the rule-makers are between a rock and a hard place, and they issue rules that are rather detailed and technical.

How do you know if a business actually has followed the rules faithfully? I think it boils down to two factors. First is the competency and ethics of the accountants who prepared the financial reports. No substitute exists for expertise and integrity. But accountants often come under intense pressure to massage the numbers from the higher-level executives they work for.

Which leads to the second factor that allows you to know of a business has obeyed the dictates of GAAP: Businesses have their financial statements audited by independent certified public accountants (CPAs). In fact, public businesses are required to have annual audits by outside CPAs, and many private businesses hire CPAs to do an annual audit, even if not legally required. Chapter 15 explains audits and why investors should carefully read the auditor's report on the financial statements.

The Accounting Department: What Goes On in the Back Office

As I discussed earlier in this chapter, bookkeeping (also called *record-keeping*) and financial reporting to managers and investors are the core functions of accounting. In this section, I explain another basic function of a business's accounting department: the back-office functions that keep the business running smoothly.

Most people don't realize the importance of the accounting department. That's probably because accountants do many of the back-office, operating functions in a business — as opposed to sales, for example, which is front-line 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 he or she owes to 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:

- **Payroll:** The total wages and salaries earned by every employee every pay period, which are called *gross wages* or *gross earnings,* have to be determined. 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.

  Next, accountants prepare payroll checks, which must also include various information that has to be reported to employees every pay period. The total amounts of withheld income tax and social security taxes, plus the employment taxes imposed on the employer, have to be paid over to federal and state government agencies right away. Retirement, vacation, sick pay, and other benefits earned by the employees also have to be updated every pay period. In short, payroll is a complex and critical function that the accounting department performs.

- **Cash inflows:** All cash received from sales and from all other sources 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 who has access to incoming cash receipts. (In larger organizations, the *Treasurer* may be responsible for some of these cash flow and cash-handling functions.)

- **Cash payments:** In addition to payroll checks, a business writes many other checks during the course of a year — to pay for a wide variety of purchases, to pay property taxes, to pay off 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 officers of the business 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.

- **Purchases 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 postage stamps 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.
- **Property accounting:** A typical business holds many different assets called *property* — 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 has to maintain 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.

The accounting department may be assigned other functions as well, but I think that 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.

Focusing on Business Transactions and Other Financial Events

JARGON ALERT

Understanding that a great deal of accounting focuses on business transactions is very important. *Transactions* are economic exchanges between a business and the persons and other businesses with which the business deals. Transactions are the lifeblood of every business, the heartbeat of activity that keeps the business going. Understanding accounting, to a large extent, means understanding the basic accounting methods and practices used to record the financial effects of transactions.

A business carries on economic exchanges with six basic groups:

- Its **customers,** who buy the products and services that the business sells.
- Its **employees,** who provide services to the business and are paid wages and salaries and provided with a broad range of benefits, such as a retirement plan, health and medical insurance, workers' compensation, and unemployment insurance.
- Its **suppliers** and **vendors,** who sell a wide range of things to the business, such as legal advice, electricity and gas, telephone service, computers, vehicles, tools and equipment, furniture, and even audits.
- Its **debt sources of capital,** who loan money to the business, charge interest on the amount loaned, and have to be repaid at definite dates in the future.
- Its **equity sources of capital,** the individuals and financial institutions who invest money in the business and expect the business to earn profit on the capital they invested.
- The **government,** or the federal, state, and local agencies that collect income taxes, payroll taxes, and property taxes from the business.

Figure 1-1 illustrates the interactions between the business and the other parties in the economic exchange.

Even a relatively small business generates a surprisingly large number of transactions, and all transactions have to be recorded. Certain other events that have a financial impact on the business have to be recorded as well. These are 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 have to be recorded:

- A business may lose a lawsuit and be ordered to pay damages. The liability to pay the damages has to be recorded.
- A business may suffer a flood loss that is uninsured. The water-logged assets may have to be written off, meaning that the recorded values of the assets are reduced to a 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 account.
- A business may decide to abandon a major product line and downsize its workforce, requiring that severance be paid to laid-off employees.

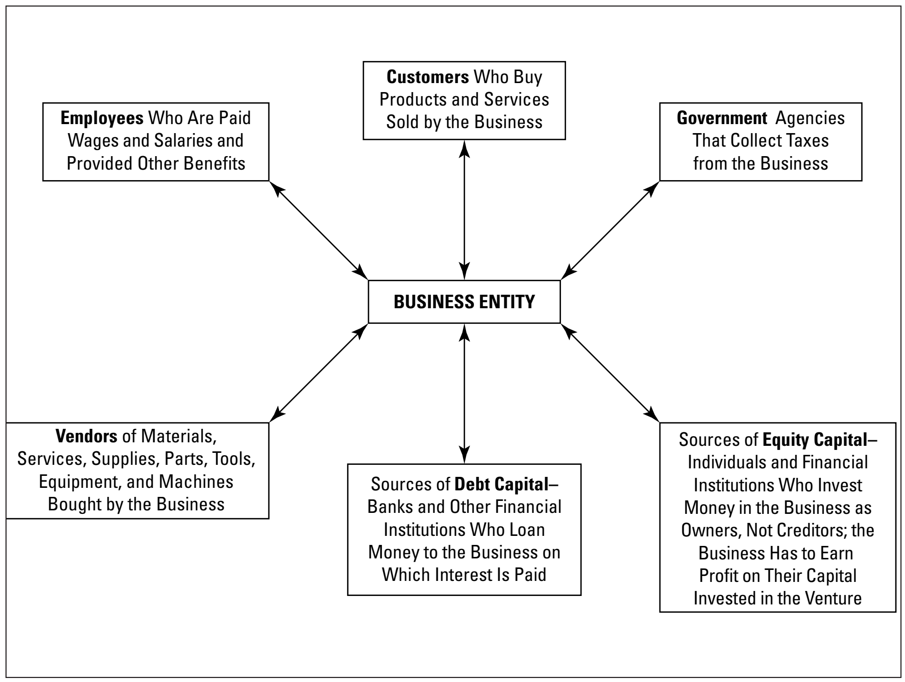

Figure 1-1: The six-spoke wheel of transactions between a business and the parties with which it engages in economic exchanges.

Taking a Closer Look at Financial Statements

JARGON ALERT

As I mention in the preceding sections, accountants prepare certain basic financial statements for a business. The three basic financial statements are the following:

- **Statement of financial condition (or balance sheet):** A summary of the financial position of the business at the end of the period.
- **Income statement:** A summary of sales revenue and expenses that determines the profit (or loss) for the period just ended. This is also called the *profit and loss statement,* or simply the *P&L statement.* (Alternative titles also include the *statement of operations* and the *statement of earnings.*)
- **Cash flow statement:** A summary of cash inflows and cash outflows for the period just ended.

This section gives you a description of these statements that constitute a business's financial center of gravity. I show you the general format and content of these three accounting reports. The president and chief executive officer of a business (plus other top-level managers and financial officers) are responsible for seeing that the financial statements are prepared according to financial reporting standards and that proper accounting methods have been used to prepare the financial statements.

If a business's financial statements are later discovered to be seriously in error or 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 should understand their responsibility for the financial statements and the accounting methods used to prepare the statements. In a court of law, they can't plead ignorance.

I frequently meet managers who don't seem to have a clue about the three primary 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. A manager *could* run the business and "land the plane safely," but knowing how to read the vital signs along the way is much more prudent.

In short, business managers at all levels — from the board of directors down to the lower rungs on the management ladder, and especially managers of smaller businesses who have to be a jack-of-all-trades in running the business — need to understand financial statements and the accounting methods used to prepare the statements. Also, lenders to a business, investors in a business, business lawyers, government regulators of business, entrepreneurs, employees who depend on the continued financial success of the business for their jobs, anyone thinking of becoming an entrepreneur and starting a business, and, yes, even economists should know the basics of financial statement accounting. I'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!

The balance sheet (or statement of financial condition)

The balance sheet is the essential financial statement that reports the main types of assets owned by a business. Assets are only half the picture, however. Almost all businesses borrow money. At the date of preparing the balance sheet, a business owes money to its lenders, who will be paid sometime in the future. Also, most businesses buy many things on credit and at the balance sheet date owe money to their suppliers which will be paid in the future. Amounts owed to lenders and suppliers are called *liabilities.* A balance sheet reports the main types of liabilities of the business, and separates between those due in the short-term and those due in the longer-term.

Could total liabilities be greater than a business's total assets? Well, not likely — unless the business has been losing money hand over fist. In the vast majority of cases a business has more total assets than total liabilities. Why? For two reasons: (1) its owners have invested money in the business, which is not a liability of the business; and, (2) the business has earned profit over the years and some of the profit has been retained in the business. (Profit increases assets.) The sum of invested capital from owners and retained profit is called *owners' equity.* The excess of total assets over total liabilities is traceable to owners' equity. A balance sheet reports the make-up of the owners' equity of a business.

You generally see the balance sheet in the following layout:

Basic Format of the Balance Sheet

Assets, or the economic resources the business owns; examples are cash on deposit in bank checking accounts, products held for sale to customers, and buildings.	**Liabilities,** which arise from borrowing money and buying things on credit. **Owners' Equity,** which arises from two sources: money invested by the owners, and profit earned and retained by the business.

One reason the balance sheet is called by this name is that the two sides balance, or are equal in total amounts:

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Total Recorded Amount of Assets = Total Recorded Amount of
          Liabilities + Total Recorded Amount of Owners'
          Equity
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Owner's equity is sometimes referred to as *net worth.* You compute net worth as follows:

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Assets - Liabilities = Net Worth
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Net worth is not a particularly good term, because it implies that the business is worth the amount recorded in its owners' equity accounts. Though the term may suggest that the business could be sold for this amount, nothing is further from the truth. (Chapter 6 presents more information about the recorded, or *book,* value of owners' equity reported in the balance sheet, and why current replacement costs of some assets may be higher than the book values of these assets. Chapter 14 discusses the market prices of stock shares, which are units of ownership in a business corporation.)

The income statement

The income statement is the all-important financial statement that summarizes the profit-making activities (or operations) of a business over a time period. In very broad outline, the statement is reported like this:

Basic Format of the Income Statement

Sales Revenue (from the sales of products and services to customers)

Less Expenses (which include a wide variety of costs paid by the business, including the cost of products sold to customers, wages and benefits paid to employees, occupancy costs, administrative costs, and income tax)

Equals Net Income (which is referred to as the bottom line and means final profit after all expenses are deducted from sales revenue)

The income statement gets the most attention from business managers and investors — not that they ignore the other two financial statements. The very abbreviated versions of income statements that you see in the financial press, such as in *The Wall Street Journal,* report only the top line (sales revenue) and the bottom line (net income). In actual practice, the income statement is more involved than the basic format shown here. Refer to Chapter 5 for more information on income statements.

The cash flow statement

The cash flow statement presents a summary of the sources and uses of cash in a business during a financial period. Smart business managers hardly get the word *profit* out of their mouths before mentioning *cash flow.* Successful business managers can tell you that they have to manage both profit *and* cash flow; you can't do one and ignore the other. Business is a two-headed dragon in this respect. Ignoring cash flow can pull the rug out from under a successful profit formula. Still, some managers become preoccupied with making profit and overlook cash flow.

For financial reporting, cash flows are divided into three basic categories:

Basic Format of the Cash Flow Statement

(1) Cash flow from the profit-making activities, or **operating activities,** for the period (***Note:*** *Operating means the profit-making transactions of the business.*)

(2) Cash inflows and outflows from **investing activities** for the period

(3) Cash inflows and outflows from the **financing activities** for the period

You determine the bottom-line net increase (or decrease) in cash during the period by adding the three types of cash flows shown in the preceding list.

Part 1 explains why net cash flow from sales revenue and expenses — the business's profit-making operating activities — is more or less than the amount of profit reported in the income statement. The *actual* cash inflows from revenues and outflows for expenses run on a different timetable than when the sales revenue and expenses are recorded for determining profit. It's like two different trains going to the same destination — the second train (the cash flow train) runs on a later schedule than the first train (the recording of sales revenue and expenses in the accounts of the business). Chapter 7 explains the cash flow analysis of profit as well as the other sources of cash and the uses of cash.

Part 2 of the cash flow statement sums up the major long-term investments made by the business during the year, such as constructing a new production plant or replacing machinery and equipment. If the business sold any of its long-term assets, it reports the cash inflows from these divestments in this section of the cash flow statement.

Part 3 sums up the financing activities of the business during the period — borrowing new money from lenders and raising new capital investment in the business from its owners. Cash outflows to pay off debt are reported in this section, as well as cash distributions from profit paid to the owners of the business.

The cash flow statement reports the net increase or net decrease in cash during the year (or other time period), caused by the three types of cash flows. This increase or decrease in cash during the year is never referred to as the *bottom line.* This important term is strictly limited to the last line of the income statement, which reflects net income — the final profit after all expenses are deducted.

Imagine you have a yellow (or pink) highlighter pen in your hand, and the three basic financial statements of a business are in front of you. What are the most important numbers to mark? Financial statements do *not* have any numbers highlighted; they do not come with headlines like newspapers. You have to find your own headlines. *Bottom-line profit* in the income statement is one number you would mark for sure. Another key number is *cash flow from operating activities* in the cash flow statement, or some variation of this number. Cash flow has become very important these days. Chapter 7 explains why this internal source of cash is so important and the various definitions of *cash flow* (did you think there was only one meaning of this term?).

Accounting as a Career

In our highly developed economy, many people make their living as accountants — and here I'm using the term *accountant* in the broadest possible sense. According to the *1998 Statistical Abstract of the United States* (Table No. 672, page 417), about 1.6 million people in the United States work force are accountants and auditors. A little more than half are women, which is quite an improvement compared to a generation ago. About one-third of these accountants work for independent establishments that offer their accounting and auditing services to the public. Businesses, government agencies, nonprofit organizations, and other organizations and associations employ the other two-thirds.

Because accountants work with numbers and details you hear references to accountants as bean counters, digit heads, number nerds, and other names I don't care to mention here. Accountants take these snide references in stride and with good humor. Actually, accountants come out among the most respected professionals in many polls.

Certified public accountant (CPA)

In the accounting profession, the mark of distinction is to be a *CPA,* which stands for *certified public accountant.* The term *public* means that the person has had some practical experience working for a CPA firm; it does not necessarily indicate whether that person is presently in *public* practice (as an individual CPA or as an employee or partner in a CPA firm that offers services to the public at large) rather than working exclusively for one organization.

To become a certified public accountant (CPA), you go to college, graduate with an accounting major in a five-year program (in most states), and pass the two-day national CPA exam, which is prepared and graded by the American Institute of Certified Public Accountants. You also must satisfy professional employment experience; this requirement varies from state to state but generally is one or two years. After satisfying the education, exam, and experience requirements, you get a CPA certificate to hang on your wall. More important, you get a permit from your state to practice as a CPA and offer your services to the public. States now require continuing education hours to be satisfied to maintain an active CPA permit.

The Controller: The chief accountant in an organization

After working for a CPA firm in public practice for a few years, most CPAs leave public accounting and go to work for a business or other organization. Usually, they start at a mid-level accounting position with fairly heavy accounting responsibilities, but some step in as the top accountant in charge of all accounting matters of a business. The top-level accountant in a business organization is usually called the *Controller.*

The Controller designs the entire accounting system of the business and keeps it up-to-date with changes in the tax laws and changes in the accounting rules that govern reporting financial statements to outside lenders and owners. Controllers are responsible for hiring, training, evaluating, promoting, and sometimes firing the persons who hold the various bookkeeping and accounting positions in an organization — which range from payroll functions to the several different types of tax returns that have to be filed on time with different government agencies.

The Controller is the lead person in the financial planning and budgeting process of the business organization. Furthermore, the Controller designs the accounting reports that all the various managers in the organization receive — from the sales and marketing managers to the purchasing and procurement managers. These internal reports should be designed to fit the authority and responsibility of each manager; they should provide information for managers' decision-making analysis needs and the information they need to exercise effective control.

The Controller also designs and monitors the accounting reports that go to the business's top-level vice presidents, the president, the chief executive officer of the business, and the board of directors. All tough accounting questions and problems get referred to the Controller. The Controller needs good people management skills, should know how to communicate with all the non-accounting managers in the organization, and at the same time should be an "accountant's accountant" who has deep expertise in many areas of accounting.

Smaller businesses may have only one or two accountants. The full-time bookkeeper or office manager may carry out many of the duties that would belong to the Controller in a larger organization. Smaller businesses often call in a CPA in public practice to advise their accountants. The CPA may function more or less as a part-time Controller for a small business, preparing the annual income tax returns and helping to prepare the business's external financial reports.