Chapter 1: Principles of Accounting

In This Chapter

- **Figuring out the purpose of accounting**
- **Reviewing the common financial statements**
- **Understanding the philosophy of accounting**
- **Discovering income tax accounting and reporting**

Any discussion of how to use QuickBooks to better manage your business begins with a discussion of the basics of accounting. For this reason, in this chapter and the next two chapters, I attempt to provide the same information that you may receive in an introductory college accounting course. Of course, I tailor the entire discussion to QuickBooks and the small business environment. What you'll read about here and in the next chapters of this book pretty much describes how accounting works in a small business setting using QuickBooks.

If you have had some experience with accounting, if you know how to read an income statement and balance sheet, or if you know how to construct a journal entry, you don't need to read the discussion provided by this chapter or the next. However, if you're new to accounting and business bookkeeping, take the time to carefully read this chapter. The chapter starts by giving a high-level overview of the purpose of accounting. Then, I review the common financial statements that any accounting system worth its salt produces. I also discuss some of the important principles of accounting and the philosophy of accounting. Finally, I talk a little bit about income tax law and tax accounting.

Purpose of Accounting

In the movie *Creator*, Peter O'Toole plays an eccentric professor. At one point, O'Toole's character attempts to talk a young student into working as an unpaid research assistant. When the student protests, noting that he needs 15 credit hours, O'Toole creates a special 15-credit independent study named "Introduction to the Big Picture." In the next section, I describe the "big picture" of accounting, which is really the appropriate place to begin a discussion of accounting. At its very core, accounting makes perfect, logical sense.

The big picture

The most important thing that you need to understand about accounting is that accounting provides financial information to stakeholders. Stakeholders are the people who do business with or interact with a firm; they include managers, employees, investors, banks, vendors, government authorities, and agencies who may tax a firm. Each of these stakeholders and their information requirements deserve a bit more discussion. Why? Because the information needs of these stakeholders determine what an accounting system needs to do.

Managers, investors, and entrepreneurs

The first category of stakeholders is the managers, investors, and entrepreneurs. This group needs financial information to determine whether a business is making money. This group also wants any information that gives insight into whether a business is growing or contracting, and how healthy or sick it is. In order to fulfill its obligations and duties, this group often needs detailed information. For example, a manager or entrepreneur may want to know which customers are particularly profitable — or unprofitable. An active investor may want to know which product lines are growing or contracting.

A related set of information requirements concerns asset and liability record keeping. An *asset* is something that the firm owns, such as cash, inventory, or equipment. A *liability* is some debt or obligation that the firm owes, such as bank loans and accounts payable.

Obviously, someone at a firm — perhaps a manager, bookkeeper, or accountant — needs to have very detailed records of the amount of cash that the firm has in its bank accounts, the inventory that the firm has in its warehouse or on its shelves, and the equipment that the firm owns and uses in its operations.

If you look over the preceding two paragraphs, nothing I've said is particularly surprising regarding the financial information requirements needed by a firm's management. It makes sense, right? Someone who works in a business, manages a business, or actively invests in a business needs good general information about the financial affairs of the firm and, in many cases, very detailed information about important assets (such as cash) and liabilities (such as bank loans).

External creditors

A second category of stakeholders includes outside firms that loan money to a business and credit reporting agencies that supply information to these

lenders. For example, banks want to know about the financial affairs and financial condition of a firm before lending money. The accounting system needs to produce the financial information that a bank requires in order to consider a loan request.

What information do lenders want? Lenders want to know that a business is profitable and enjoys a positive cash flow. Profits and positive cash flows allow a business to easily repay debt. In a worst case scenario, a bank or other lender also wants to see assets that can be liquidated to pay a loan — and also other debts that may represent a claim on the firm's assets.

Vendors also typically require financial information from a firm. A vendor often loans a firm money by extending trade credit. What's noteworthy about this is that vendors sometimes require special accounting. For example, one of the categories of vendors that a company such as Wiley Publishing, Inc. deals with is authors. In order to pay an author the royalty that he or she is entitled to, Wiley needs to put in a fair amount of work to calculate royalty-per-unit amounts and then report and remit these amounts to authors.

Other firms sometimes have similar financial reporting requirements for vendors. Franchisees (such as the man or woman who owns and operates the local McDonald's) pay a franchise fee based on revenues. Retailers may need to perform special accounting and reporting in order to enjoy rebates and incentives from the manufacturers of the products that they sell.

Government agencies

Predictable stakeholders requiring financial information from a business are the federal and state government agencies with jurisdiction over the firm. For example, every business in the United States needs to report on its revenues, expenses, and profits so that the firm can correctly calculate income tax due to the federal government and then pay that tax.

Firms with employees must also report to the federal and state government on wages paid to those employees — and pay payroll taxes based on metrics, such as number of employees, wages paid to employees, and unemployment benefits claimed by past employees.

Providing this sort of financial information to government agencies represents a key duty of a firm's accounting system.

Business form generation

In addition to the financial reporting described in the preceding paragraphs, accounting systems typically perform one other key task for businesses: producing business forms. For example, an accounting system almost always

produces the checks needed to pay vendors. In addition, an accounting system also prepares the invoices and payroll checks. More sophisticated accounting systems, such as those used by large firms, prepare many other business forms, including purchase orders, monthly customer statements, credit memos to customers, sales receipts, and so forth.

Every accounting function that I have described so far is performed ably by each of the versions of QuickBooks: QuickBooks, QuickBooks Pro, and QuickBooks Premier.

Reviewing the Common Financial Statements

With the background information just provided, I'm ready to talk about some of the common financial statements or accounting reports that an accounting system like QuickBooks produces. If you understand which reports you want your accounting system to produce, you should find it much easier to collect the raw data necessary to prepare these reports.

In the following paragraphs, I describe the three principal financial statements: the income statement, the balance sheet, and the statement of cash flows. I also briefly describe a fourth, catch-all category of accounting reports.

Don't worry — I'll go through this material slowly. You need to understand what financial statements and accounting systems are supposed to provide and what data these financial statements supply.

The income statement

Perhaps the most important financial statement that an accounting system produces is the income statement. The income statement is also known as a profit and loss statement. An income statement summarizes a firm's revenues and expenses for a particular period of time. *Revenues* represent amounts that a business earns by providing goods and services to its customers. *Expenses* represent amounts that a firm spends providing those goods and services. If a business can provide goods or services to customers for revenues that exceed its expenses, the firm earns a profit. If expenses exceed revenues, obviously, the firm suffers a loss.

To show you how this all works — and it's really pretty simple — take a look at Tables 1-1 and 1-2. Table 1-1 summarizes the sales that an imaginary business enjoys. Table 1-2 summarizes the expenses that the same business incurs for the same period of time. These two tables provide all the information necessary to construct an income statement.

Table 1-1	A Sales Journal
Joe	$1,000
Bob	500
Frank	1,000
Abdul	2,000
Yoshio	2,750
Marie	2,250
Jeremy	1,000
Chang	2,500
Total sales	$13,000

Table 1-2	An Expenses Journal
Purchases of dogs and buns	$3,000
Rent	1,000
Wages	4,000
Supplies	1,000
Total supplies	$9,000

Using the information from Tables 1-1 and 1-2, you can construct the simple income statement shown in Table 1-3. Because understanding the details of this income statement is key to your understanding of how accounting works and what accounting tries to do, I want to go into some detail discussing this income statement.

Table 1-3	Simple Income Statement
Sales revenue	$13,000
Less: Cost of goods sold	3,000
Gross margin	$10,000
Operating expenses	
Rent	$1,000
Wages	4,000
Supplies	1,000
Total operating expenses	6,000
Operating profit	$4,000

The first thing to note about the income statement shown in Table 1-3 is the sales revenue figure of $13,000. This sales revenue figure shows the sales generated for a particular period of time. The $13,000 figure shown in Table 1-3 comes directly from the Sales Journal shown in Table 1-1.

One important thing to recognize about accounting for sales revenue is that revenue gets counted when goods or services are provided, and not when a customer pays for the goods or services. If you look at the list of sales shown in Table 1-1, for example, Joe (the first customer listed) may have paid $1,000 in cash, but Bob, Frank, and Abdul (the second, third, and fourth customers) may have paid for their purchases with a credit card. Yoshio, Marie, and Jeremy (the fifth, sixth, and seventh customers listed) may not have even paid for their purchases at the time the goods or services were provided. These customers may have simply promised to pay for the purchases at some later date. However, this timing of the payment for goods or services doesn't matter. Accountants have figured out that you count revenue when goods or services are provided. Information about when customers pay for those goods or services, if you want that information, can come from lists of customer payments. Cost of goods sold and gross margins are two other values that you commonly see on income statements. Before I discuss cost of goods sold and gross margins, however, let me add a little more detail to this example. Suppose, for example, that the financial information shown in Tables 1-1, 1-2, and 1-3 shows the financial results from your business: the hot dog stand that you operate for one day at the major sporting event in the city where you live. Table 1-1 describes sales to customers (now hungry customers). Table 1-2 summarizes the one-day expenses of operating your super-duper hot dog stand.

In this case, the actual items that you sell — hot dogs and buns — are separately shown on the income statement as cost of goods sold. By separately showing the cost of the goods sold, the income statement can show what is called a *gross margin*. The gross margin is the amount of revenue left over after paying for the cost of goods. In Table 1-3, the cost of goods sold shows $3,000 for purchases of dogs and buns. The difference between the $13,000 of sales revenue and the $3,000 of cost of goods sold equals $10,000, which is the gross margin.

Knowing how to calculate gross margin allows you to estimate firm breakeven points and also to perform profit, volume, and cost analyses. All of these techniques are extremely useful for thinking about the financial affairs of your business. In fact, Book VI, Chapter 1 describes how you can perform these sorts of analyses.

The operating expenses portion of the simple income statement shown in Table 1-3 repeats the other information listed in the Expenses Journal. The

$1,000 of rent, the $4,000 of wages, and the $1,000 of supplies get totaled. These operating expenses are then subtracted from the gross.

Do you see, then, what an income statement does? An income statement reports on the revenues that a firm has generated. It shows the cost of goods sold and calculates the gross margin. It identifies and shows operating expenses, and finally, shows the profits of the business.

One other important point: Income statements summarize revenues, expenses, and profits for a particular period of time. Some managers and entrepreneurs, for example, may want to prepare income statements on a daily basis. Public companies are required to prepare income statements on a quarterly and annual basis. And taxing authorities, such as the Internal Revenue Service, require preparation both quarterly and annually.

Technically speaking, the quarterly statements required by the Internal Revenue Service don't need to report revenue. The Internal Revenue Service only requires quarterly statements of wages paid to employees. Only the annual income statements required by the Internal Revenue Service report both revenue and expenses. These are the income statements produced to prepare an annual income tax return.

Balance sheet

The second most important financial statement that an accounting system produces is a *balance sheet*. A balance sheet reports on a business's assets, liabilities, and owner contributions of capital at a particular point in time.

- The assets shown on a balance sheet are those items that are owned by the business, which have value, and for which money was paid.
- The liabilities shown on a balance sheet are those amounts that a business owes to other people, businesses, and government agencies.
- The owner's contributions of capital are the amounts that owners, partners, or shareholders have paid into the business in the form of investment or have reinvested in the business by leaving profits inside the company.

As long as you understand what assets and liabilities are, a balance sheet is easy to understand and interpret. Table 1-4, for example, shows a simple balance sheet. Pretend that this balance sheet shows the condition of the hot dog stand at the beginning of the day, before any hot dogs have been sold. The first portion of the balance sheet shows and totals the two assets of the hot dog stand business: the $1,000 of cash that may be in the cash register in a box under the counter, and the $3,000 of hot dogs and buns that you've purchased in order to sell during the day.

Table 1-4	A Simple Balance Sheet
Assets	
Cash	$1,000
Inventory	3,000
Total assets	$4,000
Liabilities	
Accounts payable	$2,000
Loan payable	1,000
Owner's equity	
S. Nelson, capital	1,000
Total liabilities and owner's equity	$4,000

Balance sheets can use several other categories to report assets: accounts receivable (these are amounts that customers owe), investments, fixtures, equipment, and long-term investments. In the case of a small owner-operated business, not all of these asset categories show up. But if you look at the balance sheet of a very large business — say one of the 100 largest businesses in the United States — you will see these sorts of other categories.

The liabilities section of the balance sheet shows the amounts that the firm owes to other people and businesses. For example, the balance sheet in Table 1-4 shows $2,000 of accounts payable and a $1,000 loan payable. Presumably, the $2,000 of accounts payable is the money that you owe to the vendors who have supplied your hot dogs and buns. The $1,000 loan payable represents some loan you've taken out — perhaps from some well-meaning and naive relative.

The owner's equity section shows the amount that the owner, the partners, or shareholders have contributed to the business in the form of original funds invested or profits reinvested. I should make one important point about the balance sheet shown in Table 1-4: This balance sheet shows how owner's equity looks when the business is a sole proprietorship. In the case of a sole proprietor, only one line is reported in the owner's equity section of the balance sheet. This line combines all contributions made by the proprietor — both amounts originally invested and amounts reinvested.

I talk a bit more about owner's equity accounting later in this chapter because the owner's equity sections look different for partnerships and corporations. Before I get into that, however, let me make two important observations about the balance sheet shown in Table 1-4. A balance sheet needs to *balance*. This means that the total assets must equal the total of the liabilities and owner's equity. In the balance sheet shown in Table 1-4, for example, total assets

shows as $4,000. Total liabilities and owner's equity also shows as $4,000. This equality is no coincidence. If an accounting system works right and the accountants and bookkeepers entering information into this system do their jobs right, the balance sheet balances.

Another observation worth making is that a balance sheet provides a snapshot of a business's financial condition at a particular point in time. For example, I mention in the introductory remarks related to Table 1-4 that the balance sheet in this table shows the financial condition of the hot dog stand business immediately before beginning the day's business activities. You can prepare a balance sheet for any point in time. It is key that you understand that a balance sheet is prepared for a particular point in time.

By convention, businesses prepare balance sheets to show the financial condition at the end of the period of time for which an income statement is prepared. For example, a business typically prepares an income statement on an annual basis. In this orthodox situation, a firm also prepares a balance sheet at the very end of the year.

At this point, I return to something that I alluded to previously in the chapter — the fact that the owner's equity section of a balance sheet looks different for different types of businesses.

Table 1-5 shows how the owner's equity section of a balance sheet looks for a partnership. In Table 1-5, I show how the owner's equity section of the hot dog stand business may appear if, instead of having a sole proprietor named S. Nelson running the hot dog stand, the business is actually owned and operated by three partners named Tom, Dick, and Harry. In this case, the partners' equity section shows the amounts originally invested and any amounts reinvested by the partners. As is the case with sole proprietorships, each partner's contributions and reinvested profits appear on a single line.

Table 1-5 Owner's Equity for a Partnership

Partners' equity	
Tom, capital	$500
Dick, capital	250
Harry, capital	250
Total partner capital	$1,000

Go ahead and take a look at Table 1-6. It shows how the owner's equity section looks for a corporation.

Table 1-6	Owner's Equity for a Corporation
Shareholders' equity	
Capital stock, 100 shs at $1 par	$100
Contributed capital in excess of par	400
Retained earnings	500
Total shareholder's equity	$1,000

This next part is a little bit weird. For a corporation, the amounts that show in the owner's equity or shareholder's equity section actually fall into two major categories: *retained earnings* and *contributed capital*. Retained earnings represent profits that the shareholders have left in the business. Contributed capital is the money originally contributed by the shareholders to the corporation.

The retained earnings thing makes sense, right? That's just the money — the profits — that investors have reinvested in the business.

The contributed capital thing is more complicated. Here's how it works: If you buy a share of stock in some new corporation — for say, $5 — typically some portion of that price per share is for par value. Now don't ask me to justify par value. It really stems from business practices that were common a century or more ago. Just trust that typically, if you pay some amount — again, say $5 — for a share, some portion of the amount that you pay — maybe 10 cents a share or $1 a share — is for par value.

In the owner's equity section of a corporation's balance sheet, capital that's contributed by original investors is broken down into the amounts paid for this mysterious par value and the amounts paid in excess of this par value. For example, in Table 1-6, you can see that $100 of shareholder's equity or owner's equity represents amounts paid for par value. Another $400 of the amounts contributed by the original investors represents amounts paid in excess of par value. The total shareholder's equity, or total corporate owner's equity, equals the sum of the capital stock par value, the contributed capital and excess of par value, and any retained earnings. So in Table 1-6, the total shareholder's equity equals $1,000.

Statement of cash flows

Now I come to the one tricky financial statement: the statement of cash flows.

Before I begin, I have one comment to make about the statement of cash flows: As an accountant, I've worked with many bright managers and business people. No matter how much handholding and explanation I or other accountants provide, some of these smart people never quite get some of

the numbers on the statement of cash flows. In fact, many of the students who major in accounting never (in my opinion, at least) quite get how a statement of cash flows really works.

For this reason, don't spend *too* much time spinning your wheels on this statement or trying to understand what it does. QuickBooks does supply a statement of cash flows, but you don't need to use this statement. In fact, QuickBooks will produce cash basis income statements, which get you almost the same information — and in a more easy-to-understand format.

I think the best way to explain what a statement of cash flows does is to ask you to look again at the balance sheet shown in Table 1-4. This is the balance sheet for the imaginary hot dog stand at the beginning of the day.

Now take a look at Table 1-7, which shows the balance sheet at the end of the day, after operations for the hot dog stand have ended. Notice that at the start of the day, cash equals $1,000, and at the end of the day, cash equals $5,000. The statement of cash flows explains why cash changes from the one number to the other number over a period of time. In other words, a statement of cash flows explains how cash goes from $1,000 at the start of the day to $5,000 at the end of the day.

Table 1-7 Another Simple Balance Sheet

Assets	
Cash	$5,000
Inventory	0
Total assets	$5,000
Liabilities	
Accounts payable	$0
Loan payable	0
Owner's equity	
S. Nelson, capital	5,000
Total liabilities and owner's equity	$5,000

Table 1-8, not coincidentally, shows a statement of cash flows that explains how cash flowed for your imaginary hot dog stand business. You need to understand this statement, presumably, if you're reading this book. I am going to start at the bottom of the statement and work up.

Table 1-8 A Simple Statement of Cash Flows	
Operating activities	
Net income	$4,000
Decrease in accounts payable	(2,000)
Adjustment: decrease in inventory	3,000
Net cash provided by operating activities	$5,000
Financing activities	
Decrease in notes payable	(1,000)
Net cash provided (used) by financing activities	(1,000)
Increase in cash	4,000
Cash balance at start of period	1,000
Cash balance at end of period	$5,000

By convention, accountants show negative numbers inside parentheses. These parentheses more clearly flag negative values than a simple minus sign.

The last three lines of the statement of cash flows are all easily understandable. The cash balance at the end of the period, $5,000, shows what cash the business holds at the end of the day. The cash balance at the start of the period, $1,000, shows the cash that the business holds at the beginning of the day. Both the cash balance at the start of the period and the cash balance at the end of the period tie to the cash balance values reported on the two balance sheets. (Look at Table 1-4 and Table 1-7 to corroborate this assertion.) Clearly, if you start the period with $1,000 and end the period with $5,000, cash has increased by $4,000. That's an arithmetic certainty. No question there, right?

The financing activities of the statement of cash flows shows how firm borrowing and firm debt repayment affect the firm cash flow. If the hot dog stand business uses its profits to repay the $1,000 loan payable — and, in this case, this is what happened — this $1,000 cash outflow shows up in the financing activities portion of the statement of cash flows as a negative $1,000.

The top portion of the statement of cash flows is often the trickiest to understand. Note, however, that I've talked about everything else in this statement. So, with a strong push, you'll fight your way through to an understanding of what is going on here.

The operating activities portion of the statement of cash flows essentially shows the cash that comes from the profit. If you look at Table 1-8, for example, you see that the first line in the operating activities portion of the statement of cash flows is net income for $4,000. This is the net income amount

reported on the income statement for the period. However, the net income or operating profit reported on the business's income statement isn't necessarily the same thing as cash income or cash profit. A variety of factors need to be adjusted in order to convert this net income amount to what's essentially a cash operating profit amount.

For example, in the case of the hot dog stand business, if you use some of the profits to pay off all of the accounts payable, this payoff uses up some of your cash profit. This is exactly what Table 1-8 shows. You can see that the decrease in the accounts payable from $2,000 to $0 over the day required, quite logically, $2,000 of the net income. Another way to think about this is that essentially, you used up $2,000 of your cash profits to pay off accounts payable. Remember that the accounts payable is the amount that you owed your vendors for hot dogs and buns.

Another adjustment is required for the decrease in inventory. The decrease in inventory from the start of the period to the end of the period produces cash. Basically, you're liquidating inventory. Another way to think about this is that although this inventory — the hot dogs and buns in our example — shows up as an expense for the day's income statement, it isn't purchased during the day. It doesn't consume cash during the day; it was purchased at some point in the past.

When you combine the net income, the accounts payable adjustment, and the inventory adjustment, you get the net cash provided by the operating activities. In Table 1-8, these three amounts combine to $5,000 of cash provided by the operations.

After you understand the details of the financing and operating activities areas of the statement of cash flows, the statement makes sense. Net cash provided by the operating activities equals $5,000. Financing activities reduce cash by $1,000. This means that cash actually increased over the period by $4,000, which explains why cash starts the period at $1,000 and ends the period at $5,000.

Other accounting statements

Thinking back to the discussion at the very start of the chapter, you can probably come up with some examples of several other popular or useful accounting reports. And, not surprising, a good accounting system such as QuickBooks produces most of these reports. For example, one very common report or financial statement that you'll want to see is a list of the amounts that your customers owe you. It's a good idea, for example, to prepare and review such reports on a regular basis to make sure that you don't have customers turning into collection problems.

Table 1-9 shows how the simplest sort of accounts receivable report may look: Each customer is named along with the amount owed.

Table 1-9 An Accounts Receivable Report at End of Day

Customer	*Amount*
W. Churchill	$45.12
G. Patton	34.32
B. Montgomery	12.34
H. Petain	65.87
C. de Gaulle	43.21
Total receivables	$200.86

Table 1-10 shows another common accounting report — an inventory report that the hot dog stand may have at the start of the day. An inventory report like the one shown in Table 1-10 would probably name the various items held for resale, the quantity held, and the amount or value of the inventory item. A report such as this is useful to make sure that you have the appropriate quantities of inventory in stock. (Think of how useful such a report would be if you really were planning to sell thousands of hot dogs at major sporting events in your hometown.)

Table 1-10 An Inventory Report at Start of Day

Item	*Quantity*	*Amount*
Kielbasa	2000	$900.00
Bratwurst	2000	1,000.00
Plain buns	2000	500.00
Sesame buns	2000	600.00
Total inventory		$3,000.00

Putting it all together

By now, you should understand what an accounting system does. When you boil everything down to its essence, it's straightforward, isn't it? Really, an accounting system just provides you with the financial information that you need to run your business.

Let me add a tangential but important point. QuickBooks supplies all this accounting information. For the most part, preparing these sorts of financial statements in QuickBooks is pretty darn easy. But you have to learn a bit more.

You'll find it helpful to learn about accounting and bookkeeping. However, I will go over that information in the coming chapters. Also, note that the big picture stuff covered in this chapter is the most important knowledge that you need. If you understand the ideas described in this chapter, the battle is more than half won.

Curious about different business forms?

Curious about the differences among a sole proprietorship, a partnership, and a corporation? A *sole proprietorship* is formed automatically in most states and in most industries when an individual decides to go into business. In many jurisdictions, the sole proprietor needs to acquire or apply for a business license from the state or local city government. Other than that modest hurdle, sole proprietorship requires no other special prerequisites.

A *partnership* is formed automatically when two or more people enter into a joint business or investment activity for the purpose of making a profit. As is the case with a sole proprietorship, partnerships typically need to acquire a business license from the state and perhaps the federal government. Partnership formation doesn't necessarily require any additional paperwork or legal maneuvering. However, if you do enter into a partnership, most attorneys (probably all attorneys) will tell you that you do so at a certain amount of risk if you don't have an attorney draw up a partnership agreement that outlines the duties and rights and responsibilities of the partners. However, it is important to note that you can actually form a partnership simply by collaborating in business with someone. The law books are full of stories of people, for example, who have inadvertently created partnerships merely by collaborating on some project, sharing office space, or working together in some activity.

In comparison, most states allow several other business forms, including *corporations,* limited liability companies, and limited liability partnerships. These other business forms require considerably more work to set up, the assistance of a good attorney, and payment of at least several hundred — and possibly several thousand — dollars in legal and licensing fees. The unique feature of most of these other business forms, however, is that the corporation or limited liability company or limited liability partnership becomes a separate legal entity. In many cases, this separate legal entity protects investors from creditors who have a claim on the assets of the business. In comparison, in a sole proprietorship or a partnership, the sole proprietor and the partners are liable for the debts and obligations of the proprietorship or the partnership.

If you have questions about the correct business form in which to operate, talk with a good local attorney. He or she can assist you in choosing the appropriate business form and in considering both the legal and tax aspects of choosing a particular form. As a general rule, more sophisticated business forms such as corporations, limited liability companies, or limited liability partnerships deliver significant legal and tax benefits to investors and managers. Unfortunately, these more sophisticated business forms also require considerably more legal and accounting fiddle-faddling.

The philosophy of accounting

Maybe the phrase "philosophy of accounting" is too strong, but accounting does rest on a rather small set of fundamental assumptions and principles. People often refer to these fundamentals as generally accepted accounting principles.

I want to quickly summarize what these principles are. I find — and I bet you find the same thing — that understanding the principles gives context and makes accounting practices more understandable. With this in mind, let me go through the half dozen or so key accounting principles and assumptions.

Revenue principle

The *revenue principle*, which is also known as the *realization principle*, states that revenue is earned when the sale is made. The sale is made, typically, when goods or services are provided. A key component of the revenue principle, when it comes to the sale of goods, is that revenue is earned when legal ownership of the goods passes from seller to buyer.

On the same token, note that revenue isn't earned when you collect cash for something. It turns out, perhaps counterintuitively, that counting revenue when cash is collected doesn't give the business owner a good idea of what sales really are. Some customers may pay deposits early, before actually receiving the goods or services. Often customers want to use trade credit, paying a firm at some point in the future for goods or services. Because cash flows can fluctuate wildly — even something like a delay in the mail can affect cash flow — you don't want to use cash collection from customers as a measure of sales. Besides that, you can easily track cash collections from customers. So why not have the extra information about when sales actually occur?

Expense principle

The *expense principle* states that an expense occurs when the business uses goods or receives services. In other words, the expense principle is the flip side of the revenue principle. As is the case with the revenue principle, if you receive some goods, simply receiving the goods means that you have incurred the expense of the goods. Similarly, if you received some service — services from your lawyer, for example — you have incurred the expense. It doesn't matter that your lawyer takes a few days or a few weeks to send you the bill. You incur an expense when goods or services are received.

Matching principle

The *matching principle* is related to the revenue and the expense principles. The matching principle states that when you recognize revenue, you should

match related expenses with the revenue. The best example of when the matching principle comes into play concerns the case of businesses that resell inventory. In our hot dog stand example, you should count the expense of a hot dog and the expense of a bun on the day when you sell that hot dog and that bun. Don't count the expense when you buy the buns and the dogs. Count the expense when you sell them. In other words, match the expense of the item with the revenue of the item.

Accrual-based accounting, which is a term you have probably heard, is what you get when you apply the revenue principle, the expense principle, and the matching principle. In a nutshell, accrual-based accounting means that you record revenue when a sale is made and record expenses when goods are used or services are received.

Cost principle

The *cost principle* states that amounts in your accounting system should be quantified, or measured, by using historical cost. For example, if you have a business and the business owns a building, that building, according to the cost principle, shows up on your balance sheet at its historical cost. You don't adjust the values in an accounting system for changes in a fair market value. You use the original historical costs.

I should admit that the cost principle is occasionally violated in a couple of ways. The cost principle is adjusted through the application of depreciation, which I discuss in the next chapter. Also, sometimes fair market values are used to value assets, but only when assets are worth less than they cost.

Objectivity principle

The *objectivity principle* states that accounting measurements and accounting reports should use objective, factual, and verifiable data. In other words, accountants, accounting systems, and accounting reports should rely on as little subjectivity as possible.

An accountant will always want to use some data that's objective (even if it's bad) rather than use subjective data (even if the subjective data is arguably better). The idea is that objectivity becomes a protection against the corrupting influence that subjectivity can introduce into a firm's accounting records.

Continuity assumption

The *continuity assumption* — accountants call it an *assumption* rather than a *principle* for reasons unbeknownst to me — states that accounting systems assume that a business will continue to operate. The importance of the continuity assumption becomes most clear if you consider the ramifications of

assuming that a business won't continue. If a business won't continue, it becomes very unclear how one should value assets if the assets have no resale value. This sounds like gobbledygook, but think about the implicit continuity assumption built into the balance sheet for the hot dog stand at the beginning of the day. (This is the hot dog stand balance sheet that shows up in Table 1-4.)

Implicit in that balance sheet is the assumption that the $3,000 worth of hot dogs and hot dog buns has some value because they can be sold. If a business won't continue operations, no assurance exists that any of the inventory can be sold. If the inventory can't be sold, what does that say about the owner's equity value shown in the balance sheet?

You can see, I hope, the sorts of accounting problems that one gets into if one can't assume the business will continue to operate.

Unit-of-measure assumption

The *unit-of-measure assumption* assumes that a business's domestic currency is the appropriate unit of measure for the business to use in its accounting. In other words, the unit-of-measure assumption states that it's okay for U.S. businesses to use U.S. dollars in their accounting. And it's okay for U.K. businesses to use pounds sterling as the unit of measure in their accounting system. The unit-of-measure assumption also states, implicitly, that even though inflation and occasionally deflation changes the purchasing power of the unit of measure used in the accounting system, that's still okay. Sure, inflation and deflation foul up some of the numbers in a firm's financial statements. But the unit-of-measure assumption says that's usually okay — especially in light of the fact that no better alternatives exist.

Separate entity assumption

The *separate entity assumption* states that a business entity, like a sole proprietorship, is a separate entity, a separate thing from its business owner. And the separate entity assumption says that a partnership is a separate thing from the partners who own part of the business. The separate entity assumption, therefore, enables one to prepare financial statements just for the sole proprietorship or just for the partnership. As a result, the separate entity assumption also relies on a business being separate and distinct and definable as compared to its business owners.

These are the basic accounting principles that underlie business accounting. Implicit in the earlier discussions in this chapter, and the discussions in the coming chapters of this book, and those of the other books in this all-in-one desk reference, are these principles and assumptions. It is no exaggeration to say that they permeate almost everything about business accounting.

A Few Words about Tax Accounting

I'm not going to talk much about tax accounting or tax preparation in this book. However, one of the key reasons that you do accounting and use a program such as QuickBooks is to make your tax accounting easier. That's obvious. So a fair question is this: How does what I've said so far relate to income tax return preparation?

This is a tough question to answer. Tax laws don't map to generally accepted accounting principles. Generally accepted accounting principles are not the same thing as income tax law.

However, if you use good basic accounting practices as you operate QuickBooks, you get financial information that can usually be used to easily prepare your tax returns, especially if you get some help from your CPA.

If you want, you can also use income tax rules to fine-tune your accounting and bookkeeping. This practice, which is technically known as an *other comprehensive basis of accounting (OCBOA)*, is generally considered an appropriate way to perform accounting for small and medium enterprises.

If you have more specific questions about the right way to prepare a financial statement using generally accepted accounting principles, and for use in preparing an income tax return, consult your CPA or your tax advisor. Applying generally accepted accounting principles or tax laws in specific situations requires an understanding of the specific circumstances and the industry in which a firm operates. Given the one-way nature of the communication in this book — me chattering away at you — I can't provide that sort of detailed commentary here. Sorry, buddy. . . .