Chapter 1

Strolling Through the Field of Accounting

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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
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- Mama, should you let your baby grow up to be an accountant?

Medium and 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 record the financial activities of the business — which is true, of course.

In fact, accountants perform many other vital, though less well appreciated, functions. First and foremost, accountants are the *profit scorekeepers* of business. The importance of measuring profit cannot be overstated. Every business has to know how much profit it earns (or how much loss it suffers) during a given period. Even not-for-profit organizations need to know how their revenues stack up against their expenses for the period. Beyond profit accounting and bookkeeping, accountants perform many other key business functions:

- 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 and state income tax returns for the business, as well as payroll, sales, 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 *prepare reports for the managers* of a business that are absolutely critical for their planning and control functions. For example, managers have to be informed about costs and expenses, how sales are going, whether the cash balance is adequate, and what the inventory situation is. Perhaps most importantly, accountants help managers understand the reasons for changes in the profit performance of a business.
- Accountants prepare *financial statements* that inform the owners of a business regarding where the business stands financially. Owners wouldn't invest in a business without a clear understanding of its financial health, which regular financial reports (sometimes just called *the financials*) provide.

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

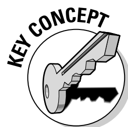
Accounting Everywhere You Look

Accounting extends into virtually every walk of life. You're doing accounting when you make entries in your checkbook and when you fill out your federal income tax return. When you sign a mortgage on your home, you should understand the accounting method the lender uses to calculate the interest amount charged on your loan each period. Individual investors need to understand some accounting in order to figure their return on invested capital. And every organization, profit-motivated or not, needs to know how it stands financially.

Many different kinds of accounting are done by many different kinds of persons and 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 mainly (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 a 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, institutions, and other players in the economic system.

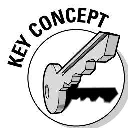
Some of the earliest records of history are the accounts of wealth and trading activity, and the need for accounting information was a main incentive in the development of the numbering system we use today. Professor William A. Paton, a well-known accounting professor at the University of Michigan for many years (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.*

For example, accountants measure the profit or loss of a business for the period and communicate the determinants of the profit or loss in a formal financial statement called the *income statement*.

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 3). Accounting requires bookkeeping, which refers to the painstaking and detailed recording of economic activity and business transactions. But *accounting* is a much broader term than *bookkeeping.* Accounting 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 interested parties in a clear manner. Business managers and investors, and many other people, depend on financial reports for vital information they need to make economic decisions.



Accountants design the *internal controls* for the 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 are relied on to detect and deter theft, embezzlement, fraud, and dishonest behavior of all kinds. In accounting, internal controls are the ounce of prevention that is worth a pound of cure.

An accountant seldom reports 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* that shows totals, not each individual activity making up the total. Managers occasionally need to search through a detailed list of all the specific transactions that make up the total. But, generally, 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. Outside investors see only summary-level financial statements. For example, in the income statement, investors see the total amount of sales revenue for the period but not how much was sold to each and every customer.

Financial statements are 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:

- **Assets:** On one side of the balance sheet, the *assets* of the business are listed, which are the economic resources being used in the business. The asset *values* reported in the balance sheet are the amounts recorded when the assets were originally acquired — although I should mention that an asset is written down below its historical cost when the

asset has suffered a loss in value. Some assets have been on the books only a few weeks or a few months, so their reported historical values are current. The values for other assets, on the other hand, are their costs when they were acquired many years ago.

- **Sources of assets:** On the other side of the balance sheet is a breakdown of where the assets came from, or their *sources.* Assets 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.

  Continuing with this example, suppose that the total amount of the liabilities of the business is $1.0 million. This means that the total amount of *owners' equity* in the business is $1.5 million, which equals total assets less total liabilities. 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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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,* 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 learn 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 I use in this book, please take a quick look in the Appendix, which defines many accounting terms in plain English.

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 balance.

Double-entry bookkeeping is based on the accounting equation — 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. I discuss double-entry bookkeeping in Chapter 3.

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

- The **income statement** summarizes the revenue inflows and the expense outflows during the period. These lead down to the well-known *bottom line,* which is the final profit or loss for the period and is called *net income* or *net earnings* (or some variation of these terms).
- The **statement of cash flows** 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 that are reported in the income statement. The net cash effect from its profit or loss for the period can be much more or much less than the amount of profit (or loss).

The balance sheet, income statement, and statement of cash flows 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. The managers of a business, to keep informed about what's going on and the financial position of the business, also use these three key financial statements. 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.)

Accounting and Financial Reporting Standards

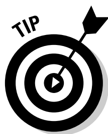
Imagine the chaos if every business could invent its own accounting methods and terminology for measuring profit and for presenting financial statements. As an example from the academic world, what if I give a student an A in a course and a professor at another university gives a student a K? Keeping 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 generally accepted accounting principles (GAAP)

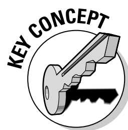
The authoritative standards and rules that govern financial accounting and financial reporting are called *generally accepted accounting principles (GAAP)*. I explain who creates and catalogues these principles in the section "Enforcing Accounting Rules" later in this chapter.

When 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 than 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.



In brief, GAAP constitute the gold standard for preparing financial statements of business entities (although the gold is somewhat tarnished, as I discuss in later chapters). 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.

Financial reporting by government and 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 and healthcare, cultural, and charitable.

As I explain in this chapter, a large body of authoritative rules and standards, called *generally accepted accounting principles (GAAP),* have been hammered out over the years to govern accounting methods and financial reporting of business entities. Accounting and financial reporting standards have also evolved and 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.

People generally don't demand financial reports from government and other not-for-profit organizations. 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 always 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, homeowners' associations, country clubs, mutual insurance companies (owned by their policy holders), pension plans, labor unions, healthcare 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 apprise 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. ***Caution:*** Many not-for-profit entities use one or more accounting methods different than business GAAP — in some cases very different — and the terminology in their financial reports is somewhat different than in the financial reports of business entities.

Income tax and accounting rules

Generally speaking (and I'm being *very* general here), 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 annual profit both for management reporting purposes and for preparing its external financial statements to outsiders.

Some people argue that certain accounting methods permitted in the calculation of federal income tax have had an unhealthy impact on GAAP. If a particular accounting method is allowed for determining annual taxable income, the path of least resistance is for a business to use the same method for preparing its financial statements. For example, the income tax law permits accelerated methods to depreciate a wide range of fixed, or long-lived, assets — for example, machines, tools, autos and trucks, and office equipment (but not buildings). Other depreciation methods may make more sense, but many businesses use accelerated depreciation methods both in their income tax returns and in their financial statements.

Flexibility versus fraud in applying accounting standards and rules

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 gets the job.

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

Sometimes, a business may resort to what's called *creative accounting* to make profit for the period look better, or to record profit instead of a loss. This is like making a silk purse out of a sow's ear. 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 techniques — also called *massaging the numbers* — at various points in this book. Massaging the numbers can get out of control and become accounting fraud, also called *cooking the books*. Massaging the numbers has some basis in honest differences regarding interpreting the facts. Cooking the books goes way beyond interpreting facts; this fraud consists of *inventing* facts and good old-fashioned chicanery. I say more on accounting fraud in Chapters 8 and 15.

Depending on estimates and assumptions

The importance of estimates and assumptions in financial statement accounting is illustrated in a standard footnote you see in many annual financial reports:

"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. One key assumption made in preparing financial statements is called the *going-concern assumption*. The accountant assumes that the business is not facing imminent shutdown of its operations and the forced liquidations of its assets, and that it will continue as usual for the foreseeable future.

International accounting and financial reporting standards

The European Union (EU) was established to form a more open and barrier-free community for economic trading and financial dealings across its members' borders. The EU realized that it needed more uniform accounting and financial reporting standards across all its member nations. To this end, the International Accounting Standards Board (IASB) was founded in 2001. The basic mission of the IASB is to bring about harmonization of accounting methods throughout the EU. This is a tall order, to say the least. Its deadline for accomplishing this goal was set for 2005.

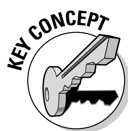
About 7,000 public companies have their securities listed on the several stock exchanges in the EU countries — compared with about 10,000 public companies whose securities are traded on stock exchanges in the United States. In many regards, the IASB runs in a manner similar to the Financial Accounting Standards Board (FASB) in the United States, and the two have very similar missions. (In fact, the two have recently announced a joint effort to revisit the difficult issue of pension accounting. That ought to be interesting because pension accounting is a contentious and controversial issue.) Both these standard-setters have faced strong political and business criticism regarding some of their pronouncements.

Looking down the road two or three decades, perhaps we shall see the internationalization of accounting and financial reporting standards, in which one

worldwide set of authoritative rules will be in force that apply to all companies in all countries. But this may be pie-in-the-sky thinking. A more modest goal, which I think is realistic, is the gradual harmonization of accounting and financial reporting standards in the United States and those in the EU.

Enforcing Accounting Rules

As I mention in the preceding sections, when preparing financial statements a business should 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.

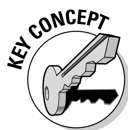
Who are these "authoritative bodies"? In the United States the highest-ranking authority in the private sector for making pronouncements on GAAP — and for keeping these accounting standards up-to-date — is the Financial Accounting Standards Board (FASB). The public accounting profession provides most of the money for the FASB. Also, the federal Securities and Exchange Commission (SEC) has broad powers over accounting and financial reporting standards for publicly-traded companies. The SEC can, and on rare occasions does, override the FASB.

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 the disclosures that are required in addition to the three primary financial statements of a business (the income statement, balance sheet, and statement of cash flows).

The official set of GAAP rules is *big* — more than a thousand pages! 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. Like lawyers who have to keep up on the latest court cases, accountants have to keep up with the latest developments at the FASB and SEC.

Some people think the rules have become too complicated and far too technical. If you flip through the GAAP rulebook, 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 that 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 FASB is between a rock and a hard place. For the most part it issues rules that are rather detailed and technical.

How do you know if a business actually follows the rules faithfully? I think it boils down to two factors. First is the competency and ethics of the accountants who prepare 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. They may commit fraud in order to keep their jobs or get promotions or big raises.



Which leads to the second factor that allows you to know if 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. An audit adds credibility to a financial report, and you can generally rely on the auditor's opinion. But, as I explain in Chapter 15, an audit does not provide an ironclad guarantee that the financial statements are entirely free of errors and are not distorted by accounting fraud.

The Accounting Department: What Goes On in the Back Office

As I discuss earlier in this chapter, bookkeeping (also called *record-keeping*) and financial reporting to managers and investors are 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 frontline activity, out in the open and in the line of fire. Go into any retail store, and you're in the thick of sales activities. But have you ever seen a company's accounting department in action?

Folks may not think much about these back-office activities, but they would sure notice if those activities didn't get done. On payday, a business had better not tell its employees, "Sorry, but the accounting department is running a little late this month; you'll get your checks later." And when a customer insists on up-to-date information about how much 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 the following:

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

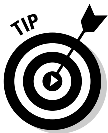
  "Stubs," which report various information to employees each pay period, have to be attached to payroll checks. The total amounts of withheld income tax and social security taxes, plus the employment taxes imposed on the employer, have to be paid to federal and state government agencies on time. Retirement, vacation, sick pay, and other benefits earned by the employees have to be updated every pay period. In short, payroll is a complex and critical function that the accounting department performs. Many businesses outsource payroll functions to companies that specialize in this area.
- **Cash collections:** 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 (disbursements):** In addition to writing 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 business officers who are authorized to sign checks. The accounting department keeps all the supporting business documents and files to know when the checks should be paid, makes sure that the amount to be paid is correct, and forwards the checks for signature.

- **Procurement and inventory:** Accounting departments usually are responsible for keeping track of all purchase orders that have been placed for *inventory* (products to be sold by the business) and all other assets and services that the business buys — from 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 owns many different assets called *property, plant, and equipment* — including office furniture and equipment, retail display cabinets, computers, machinery and tools, vehicles (autos and trucks), buildings, and land. Except for relatively small-cost items, such as screwdrivers and pencil sharpeners, a business 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 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

You should understand that a great deal of accounting focuses on business transactions. *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 types of persons or entities:

- 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 are due to be repaid at definite dates in the future.
- Its **equity sources of capital,** the individuals and financial institutions that invest money in the business and expect the business to earn profit on the capital they invest.
- The **government,** or the federal, state, and local agencies that collect income taxes, sales 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.

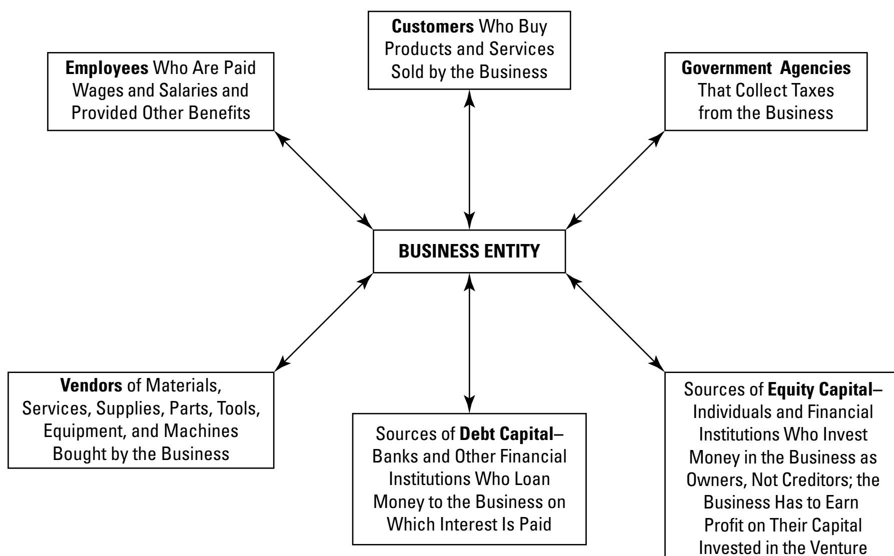


Figure 1-1: The six-spoke wheel of transactions between a business and the parties with which it engages in economic exchanges.

- A business may suffer a flood loss that is uninsured. The water-logged assets may have to be *written down,* 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.

Taking a Closer Look at Financial Statements

As I mention earlier in the chapter, accountants prepare certain basic financial statements for a business. The three basic financial statements they prepare are:

- **Income statement:** A summary of sales revenue and expenses that determine the profit (or loss) for the period just ended. Alternative titles include the *statement of operations* and the *statement of earnings.* (Inside a business, but not in its external financial reports, an income statement may be called a *profit and loss statement,* or *P&L report.*)
- **Statement of financial condition (or balance sheet):** A summary of a business's assets, liabilities, and owners' equity in order to present its financial position at the end of the period.
- **Statement of cash flows:** A summary of cash sources and uses for the period just ended.

In this section I discuss these statements, which 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 officers) are responsible for seeing that the financial statements are prepared according to financial reporting standards and using proper accounting methods.

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 their financial statements. This situation is a little scary; a manager who doesn't understand financial statements is like an airplane pilot who doesn't understand the instrument readouts in the cockpit. Such a manager *could* run the business and "land the plane safely," but knowing how to read the vital signs along the way is much more prudent.

In short, business managers at all levels — from the chief executive down to the lower rungs on the management ladder, and especially managers of smaller businesses who have to be jacks-of-all-trades — need to understand financial statements and the accounting methods used to prepare them. Also, lenders to a business, investors in a business, business lawyers, government regulators of business, entrepreneurs, 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 income (earnings, or operating) statement

The income statement is the all-important financial statement that summarizes the profit-making activities 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), plus any other income the business may have

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, marketing expenditures, occupancy costs, administrative costs, interest expense, 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)

Net income is also called *net earnings*, or other variations on this theme. *Operating statement* may be a more accurate name than *income statement* because it denotes the operations (making sales and incurring expenses) that go into making profit. The term "income" could possibly suggest that only income is being reported in the statement and not expenses.

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 the top line (sales revenue) and the bottom line (net income) and not much more. 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 balance sheet (statement of financial condition)

It could be called the *statement of assets, liabilities, and owners' equity,* but the popular name for this financial statement is *balance sheet* and its more formal name is the *statement of financial condition*. Just a reminder: Profit is not reported in the balance sheet; profit for the period is found in the income statement.

Assets are reported on one side of this financial statement, or at the top. Assets are a varied lot. You have *cash*, which every business needs of course. Businesses that sell products carry an *inventory* of products awaiting sale to customers. Businesses need long-term resources that are categorized as *property, plant, and equipment;* this group includes buildings, vehicles, tools, machines, and other resources needed in their operations. All these, and more, go under the collective name "assets."

Most businesses borrow money on the basis of interest-bearing notes or other credit instruments. Also, 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. Liabilities are not intermingled among assets — liabilities are reported in one or more separate sections in the balance sheet.

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 its 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 the measure of owners' equity in the balance sheet.

You generally see a balance sheet in the following basic layout:

Basic Format of the Balance Sheet	
Assets, which are the economic resources the business owns; examples are cash on deposit in bank checking accounts, products held for sale to customers, and real estate.	**Liabilities,** which arise from borrowing money and buying things on credit. **Owners' Equity,** which arises from money invested by its 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:

```
Total Amount Recorded for Assets = Total Amount
Recorded for Liabilities + Total Amount Recorded
for Owners' Equity
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The value reported for owner's equity in a balance sheet is sometimes referred to as *net worth* because:

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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 statement of cash flows

The statement of cash flows presents a summary of the business's sources and uses of cash during a financial period. Smart business managers hardly get the word *net income* (or 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, the cash flows of a business are divided into three basic categories:

Basic Format of the Statement of Cash Flows

(1) Cash flow from profit-making activities, or **operating activities,** for the period

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

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

All three cash flow sources and uses determine the *net* increase or decrease in cash during the period. 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.

Part 1 of this statement 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 from 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 different 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 statement of cash flows sums up the 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 statement of cash flows.

Part 3 sums up the financing activities of the business during the period — borrowing new money from lenders and raising new capital 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.

Imagine you have a 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* (i.e., net income) in the income statement is one number you would mark for sure. Another key number is *cash flow from operating activities* in the statement of cash flows. Cash flow has become very

important these days. Chapter 7 explains why this internal source of cash is so important and different definitions of *cash flow* (did you think there was only one meaning of this term?).

Considering Accounting Careers

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. If you look in the *Statistical Abstract of the United States* you'll see that upwards of two million people make their living as bookkeepers, accountants, and auditors. They work for businesses, government agencies, nonprofit organizations, and other organizations and associations.

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 dare 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 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 for one organization.

To become a CPA, you go to college, graduate with an accounting major in a five-year program (in most states), and pass the national, computer-based CPA exam. 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 require continuing education hours to maintain an active CPA permit.

Many CPAs move on to other careers. An article in the July 2004 issue of the *Journal of Accountancy* featured former CPAs who moved on to other interesting careers. One became a Harley-Davidson dealer, another a high school teacher, another an auto racing track owner, another a physical fitness coaching business owner, and one even became a stand-up comedian whose stage name is "Debitman." Serving time as a CPA is a good springboard to many careers, even being the author of *Accounting For Dummies.*

The controller: The chief accountant in an organization

The top-level accounting officer 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 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, and the board of directors. All tough accounting questions and problems get referred to the controller.

Smaller businesses may have only one accountant. In many cases a small company's full-time bookkeeper or office manager carries out many of the duties that would be done by the controller in a larger organization. Smaller businesses often call in a CPA for advice and help. 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.

State incorporation laws typically require that someone in the business be designated the *treasurer*, who has fiduciary responsibilities. Also, these laws usually require that someone be designated the *secretary.* The organizational charts of larger businesses usually put their controller under their *vice president for finance*. The accounting functions in a business are integrated with and work in close coordination with its financial, treasury, and secretary functions.