Chapter 1

Introducing Accounting to Non-Accountants

In This Chapter

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

Most medium to large businesses employ one or more accountants. Even a very small business could find value in having at least a part-time accountant. Have you ever wondered why? Probably what you think of first is that accountants keep the books and the records of the financial activities of the business. This is true, of course. But accountants perform other very critical, but less well-known, functions in a business:

- Accountants carry out vital back-office operating functions that keep the business running smoothly and effectively including payroll, cash receipts and cash payments, purchases and stock, and property records.
- Accountants prepare tax returns, including VAT (value-added tax) returns for the business, as well as payroll and investment tax returns.
- Accountants determine how to measure and record the costs of products and how to allocate shared costs among different departments and other organisational units of the business.
- Accountants are the *professional profit scorekeepers* of the business world, meaning that they are the ones who determine exactly how much profit was earned, or just how much loss the business suffered, during the period. Accountants prepare reports for business managers, keeping

them informed about costs and expenses, how sales are going, whether the cash balance is adequate, what the stock situation is and, the most important thing, accountants help managers understand the reasons for changes in the bottom-line performance of a business.

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

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

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

Accounting Everywhere You Look

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

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

- Accounting for organisations and accounting for individuals.
- Accounting for profit-motivated businesses and accounting for non-profit organisations (such as hospitals, housing associations, churches, schools, 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 health care industries.
- Past-historical-based accounting and future-forecast-oriented accounting (that is, budgeting and financial planning).
- Accounting where periodic financial statements are mandatory (businesses are the primary example) and accounting where such formal accounting reports are not required.
- Accounting that adheres to cost (most businesses) and accounting that records changes in market value (investment funds, for example).
- Accounting in the private sector of the economy and accounting in the public (government) sector.
- Accounting for going-concern businesses that will be around for some time and accounting for businesses in bankruptcy that may not be around tomorrow.

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

The Basic Elements of Accounting

JARGON ALERT

Accounting involves bookkeeping, which refers to the painstaking and detailed recording of economic activity and business transactions. But *accounting* is a much broader term than *bookkeeping* because accounting refers to the design of the bookkeeping system. It addresses the many problems in measuring the financial effects of economic activity. Furthermore, accounting includes the *financial reporting* of these values and performance measures to non-accountants in a clear and concise manner. Business managers and investors, as well as many other people, depend on financial reports for vital information they need to make good economic decisions.

JARGON ALERT

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

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

Financial statements are prepared at the end of each accounting period. A period may be one month, one quarter (three calendar months), or one year. One basic type of accounting report prepared at the end of the period is a 'Where do we stand at the end of the period?' type of report. This is called the *balance sheet.* The date of preparation is given in the header, or title above this financial statement. A balance sheet shows two aspects of the business.

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

Assets are not like manna from heaven. 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) you know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to £2.5 million.

In this particular 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 summarised in the following *accounting equation* (in millions):

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

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

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

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

The balance sheet, profit and loss account, and cash flow statement constitute the hard core of a financial report to those persons outside a business who need to stay informed about the business's financial affairs. These individuals have invested capital in the business, or the business owes them money and therefore they have a financial interest in how well the business is doing. These three key financial statements are also used by the managers of a business to keep themselves informed about what's going on and the financial position of the business. They are absolutely essential to helping managers control the performance of a business, identify problems as they come up, and plan the future course of a business. Managers also need other information that is not reported in the three basic financial statements. (Part III of this book explains these additional reports.)

The jargon jungle of accounting

Financial statements include many terms that are reasonably clear and straightforward, like *cash, debtors,* and *creditors.* However, financial statements also use words like *retained earnings, accumulated depreciation, accelerated depreciation, accrued expenses, reserve, allowance, accrual basis,* and *current assets.* This type of jargon in accounting is perhaps too common: It's everywhere you look. If you have any doubt about a term as you go along in the book, please take a quick look in Appendix A, which defines many accounting terms in plain English.

Accounting and Financial Reporting Standards

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 importance of GAAP and evolving accounting standards

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

The word *comprehensive* here is very important. A financial report should be comprehensive, or all-inclusive – reflecting all the financial activities and aspects of the entity. If not, the burden is on the business to make very clear that it is presenting something less 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 *profit and loss account* 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 later chapters explain. Readers of a business's financial report are entitled to assume that GAAP (and any accounting standards that have evolved from 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.

Why the GAAP rules are important

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

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

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

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

Income tax and accounting rules

Generally speaking (and we're being very general when we say the following), HM Revenue & Customs' 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, we should point out that several differences do exist. A business may use one accounting method for filing its annual income tax returns and a different method for measuring its profit, both for management reporting purposes and for preparing its external financial statements to outsiders.

Flexibility in accounting standards

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

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

Sometimes, businesses use what's called *creative accounting* to make profit for the period look better. Like lawyers who know where to find legal loopholes, accountants sometimes come up with inventive solutions but still stay within the guidelines of GAAP. We warn you about these creative accounting techniques – also called *massaging the numbers* – at various points in this book. Articles in financial newspapers and magazines regularly focus on such accounting abuses.

Enforcing Accounting Rules

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

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

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

The Accounting Standards Board, the body responsible for setting accounting standards in the UK, is undertaking a programme of gradually ripping up UK GAAP and replacing it with international financial reporting standards. Today, companies with outside shareholders in the UK and across Europe have bitten the bullet and are adopting international accounting standards, known as International Financial Reporting Standards (IFRS). International standards sound like a great idea – especially with the introduction of a single European currency and the emergence of pan-European equity markets. In fact most financial directors of public companies want to be able to adopt IFRS ahead of time. The UK's Accounting Standards Board is pressing ahead with a programme to 'converge' UK accounting standards so that they match the international standards – almost. You can keep track of changes in company reporting rules on the Institute of Chartered Accountants' Web site at `www.icaew.com` (click on Accounting and corporate reporting and then on UK GAAP).

You could ask if the move to IFRS is such a big deal? In reality, this programme is not an accounting revolution, but a journey from one comprehensive basis of GAAP to another. GAAP remains the preferred option for the majority of the 1.4 million private companies and 3 million partnerships and sole traders in the UK. Only the 3,500 or so companies listed on UK stock markets are changing to IFRS.

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

Which leads to the second factor that allows you to know if a business has obeyed the dictates of accounting standards. Businesses have their financial statements audited by independent chartered or management accountants. In fact, limited companies are required by law to have annual audits and many private businesses hire accountants to do an annual audit, even if not legally required. The Companies Act 2006 has introduced some tough rules on how auditors, amongst others, should report on company accounts. Chapter 15 explains audits and why investors should carefully read the auditor's report on the financial statements.

Protecting investors: Sarbanes-Oxley and beyond

A series of high profile financial frauds in US-based businesses such as Enron and WorldCom in the mid–late 1990's badly shook people's confidence in US businesses. In response, the US government introduced the Sarbanes-Oxley Act, known less commonly but better understood as 'the Public Company Accounting Reforms and Investor Protection Act – 2002'.

The central tenet of the Sarbanes-Oxley Act is to ensure truthfulness in financial reporting – a quest the accounting profession has been pursuing since Pacioli set out the rules of double-entry bookkeeping five centuries ago. The act closes the loopholes that creative accountants opened up, which made it difficult (and sometimes impossible) for shareholders to see how a business was performing until after the baddies had made off with the loot. The act applies to any business with shares listed on an American stock market that does business in the US – not just to US companies. The act is extremely complicated, so check out `www.sarbanes-oxley.com` for the lowdown on that act.

The British version, 'the Companies (Audit, Investigations, and Community Enterprise) Act – 2004', is causing the accounting profession to clutch their collective heads. This knock-on effect from Sarbanes-Oxley means that all companies selling shares to the public have to make changes to their accounts and accounting standards. You can read up on the UK rules at the Office of the Public Sector Information Web site (go to `www.opsi.gov.uk` and click on 'Legislation', 'UK', 'Acts', 'Public Acts 2004', and finally on 'Companies [Audit, Investigations and Community Enterprise] Act 2004').

The Accounting Department: What Goes On in the Back Office

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

Most people don't realise the importance of the accounting department. That's probably because accountants do many of the back-office, operating functions in a business – as opposed to sales, for example, which is front-line activity, out in the open, and in the line of fire.

Typically, the accounting department is responsible for:

- **Payroll:** The total wages and salaries earned by every employee every pay period, which are called *gross wages* or *gross earnings,* have to be determined. In short, payroll is a complex and critical function that the accounting department performs: the correct amounts of income tax, social security tax, and other deductions from gross wages have to be calculated.
- **Cash inflows:** All cash received from sales and from all other sources has to be carefully identified and recorded, not only in the cash account but also in the appropriate account for the source of the cash received. In larger organisations, the *Chief Accountant* may be responsible for some of these cash flow and cash-handling functions.
- **Cash payments:** A business writes many cheques during the course of a year to pay for a wide variety of items including local business taxes,

paying off loans, and the distribution of some of its profit to the owners of the business. The accounting department prepares all these cheques for the signatures of the officers of the business who are authorised to sign cheques, and keeps the relevant supporting documents and files for the company's records.

- **Purchases and stock:** Accounting departments are usually responsible for keeping track of all purchase orders that have been placed for stock (products to be sold by the business) and all other assets and services that the business buys – from postage stamps to forklift trucks. 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.
- **Capital accounting:** A typical business holds many different assets called *capital* – including office furniture and equipment, retail display cabinets, computers, machinery and tools, vehicles, buildings, and land. The accounting department keeps detailed records of these items.

The accounting department may be assigned other functions as well, but we think that this list gives you a pretty clear idea of the back-office functions that the accounting department performs. Quite literally, a business could not operate if the accounting department did not do these functions efficiently and on time.

Focusing on Business Transactions and Other Financial Events

JARGON ALERT

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

A business carries on economic exchanges with six basic groups:

- Its **customers,** who buy the products and services that the business sells.
- Its **employees,** who provide services to the business and are paid wages and salaries and provided with a broad range of benefits such as a pension plan and paid holidays.
- Its **suppliers** and **vendors,** who sell a wide range of things to the business, such as legal advice, electricity and gas, telephone service, computers, vehicles, tools and equipment, furniture, and even audits.

- Its **debt sources of capital,** who loan money to the business, charge interest on the amount loaned, and have to be repaid at definite dates in the future.
- Its **equity sources of capital,** the individuals and financial institutions who invest money in the business and expect the business to earn profit on the capital they invest.
- The **government agencies** that collect income taxes, payroll taxes, value-added tax, and excise duties 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 should be recorded.
- A business may suffer a flood loss that is uninsured. The water-logged assets may have to be written off, meaning that the recorded values of the assets are reduced to nil if they no longer have any value to the business.
- A business may decide to abandon a major product line and downsize its workforce, requiring that severance be paid to laid-off employees.

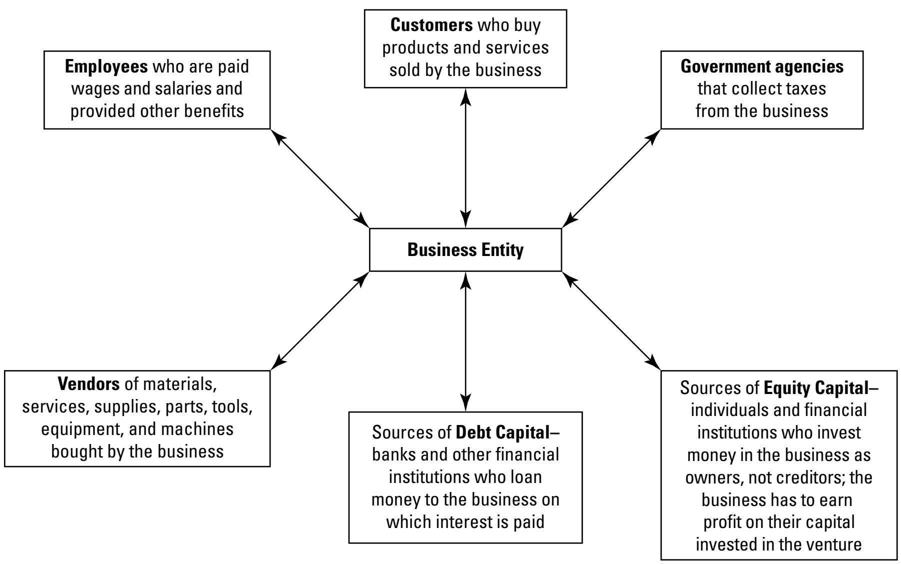

Figure 1–1: The six-spoke wheel of transactions between a business and the parties with which it engages in economic exchanges.

Taking a Closer Look at Financial Statements

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

- **Balance Sheet:** A summary of the financial position of the business at the end of the period.
- **Profit and loss account:** A summary of sales revenue and expenses that determines the profit (or loss) for the period just ended. This is also called the *income statement,* or simply abbreviated down to the *P&L statement.* (Alternative titles also include the *operating statement* and the *earnings statement*.)
- **Cash flow statement:** A summary of cash inflows and cash outflows for the period just ended.

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

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

We frequently meet managers who don't seem to have a clue about the three primary statements. This situation is a little scary; a manager who doesn't understand financial statements is like an aeroplane pilot who doesn't understand the instrument readouts in the cockpit. A manager *could* run the business and 'land the plane safely', but knowing how to read the vital signs along the way is much more prudent.

In short, business managers at all levels – from the board of directors down to the lower rungs on the management ladder, and especially managers of smaller businesses who have to be a jack-of-all-trades in running the business – need to understand financial statements and the accounting methods used to prepare the statements. Also, lenders to a business, investors in a business, business lawyers, government regulators of business, entrepreneurs, employees who depend on the continued financial success of the business for their jobs, anyone thinking of becoming an entrepreneur and starting a business, and, yes, even economists, should know the basics of financial statement accounting. We've noticed that even experienced business journalists, who ought to know better, sometimes refer to the balance sheet when they're talking about profit performance. The bottom line is found in the profit and loss account, not the balance sheet!

The balance sheet

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

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

You generally see the balance sheet in the following layout:

Basic Format of the Balance Sheet

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

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

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

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

The profit and loss account

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

Basic Format of the Profit and Loss Account

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

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

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

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

The cash flow statement

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

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

Basic Format of the Cash Flow Statement

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

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

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

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

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

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

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

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

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* in the profit and loss account is one number you would mark for sure. Another key number is *cash flow from operating activities* in the cash flow statement, or some variation of this number. Cash flow has become very important these days. Chapter 7 explains why this internal source of cash is so important and the various definitions of *cash flow* (did you think there was only one meaning of this term?).

Accounting as a Career

In our highly developed economy, many people make their living as accountants – and here we're using the term *accountant* in the broadest possible sense. Despite the introduction of new technology, the number of people employed in accountancy as a profession has shown extensive growth in the past three decades. Accountants work in many areas of business and the public sector in roles ranging from sole practitioner to chief executive of a multinational company. In public practice firms, from small high street to large international practices, accountants provide professional services to a wide range of fee-paying clients from the private individual to large commercial and public sector organisations. These services include audit/assurance, accountancy, tax, business advisory, and other management services. In commerce/industry and the public sector, chartered accountants work in a variety of financial management and financial reporting roles. It is possible for accountants to set up their own firm or become a partner in a private practice. This requires a Practising Certificate, which is awarded by one of the relevant qualifying bodies to accountants with at least two years' experience. There are also opportunities to work abroad.

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

Chartered Accountant (CA)

In the accounting profession, the mark of distinction is to be a *CA*, which stands for *chartered accountant.* The majority of chartered accountants train in public practice and the first three years are devoted to achieving the chartered qualification. The training involves completion of professional exams together with a period of structured work experience. The professional exam training is provided by the Institute of Chartered Accountants in England and Wales (ICAEW) (`www.icaew.co.uk`), which is the largest, the Institute of Chartered Accountants of Scotland (ICAS) (`www.icas.org.uk`), and the Institute of Chartered Accountants in Ireland (ICAI) (`www.icai.ie`) – Dublin Office. The structure of the exams and methods of training delivery vary slightly between the institutes and full details can be found on their Web sites. However, the qualifications cover broadly similar syllabuses and are of equal status and recognition, all leading to the designation 'chartered accountant' (ACA or CA). The syllabuses cover subjects such as accounting, audit, business finance, taxation, law, and business management, which are assessed primarily through formal exams. Chartered accountants must remain up-to-date on technical and business issues, so there is a strong emphasis on continuing professional development after qualification.

Other professional bodies that train accountants and are useful to know about include the Chartered Institute of Management Accountants (`www.cimaglobal.com`), who focus on accounting for and in business, the Chartered Institute of Public Finance and Accountancy (`www.cipfa.org.uk`), who specialise in the public sector, and the Association of Accounting Technicians (`www.aat.org.uk`), whose 36,000 members assist chartered accountants in their work, or can themselves join a chartered institute after further study.

The Financial Controller: The chief accountant in an organisation

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

The Financial 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 organisation – 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 organisation. Furthermore, the Financial Controller designs the accounting reports that all the various managers in the organisation 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 executives, the chief executive officer of the business, and the board of directors. All tough accounting questions and problems get referred to the Controller. The Controller needs good people management skills, should know how to communicate with all the non-accounting managers in the organisation, and at the same time should be an 'accountant's accountant' who has deep expertise in many areas of accounting.

Smaller businesses may have only one or two 'accountants'. The full-time bookkeeper or office manager may carry out many of the duties that would belong to the Controller in a larger organisation. Smaller businesses often call in a chartered accountant in public practice to advise their accountants. The chartered accountant 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.