

IN THIS CHAPTER

- » Recognizing how accounting is relevant to you
- » Grasping how all economic activity requires accounting
- » Understanding the accounting function's primary role
- » Following an accounting department in action
- » Shaking hands with business financial statements

Chapter **1**

Accounting in Today's Economy

Accounting is all about financial information — capturing it, recording it, configuring it, analyzing it, and reporting it to persons who use it. We don't say much about how accountants capture, record, and configure financial information in this book. But we talk a lot about how accountants communicate information in financial statements, and we explain the *valuation methods* or *measurement methods* accountants use — ranging from measuring profit and loss to putting values on a business's assets and liabilities.

As you go through life, you come face to face with accounting information more than you would ever imagine. Regrettably, much of this information is not self-explanatory or intuitive, and it does not come with a user's manual. Accounting information is presented with the assumption that you have a basic familiarity with the vocabulary of accounting and the accounting methods used to generate

the information. In short, most of the accounting information you encounter is not transparent. The main reason for studying accounting is to understand its vocabulary and its valuation and measurement methods so you can make more intelligent use of the information.

People who use accounting information should know the basic rules of play and how the financial score is kept, much like spectators at a hockey or baseball game. The purpose of this book is to make you a knowledgeable spectator of and sometimes a participant in the accounting game.



REMEMBER

You should know accounting basics for another reason, too — we call it the *defensive* reason. Some people in the financial world might take advantage of you, not necessarily by illegal means but by withholding key information and by diverting your attention from unfavourable aspects of certain financial decisions. The best defence against such tactics is to know some accounting, which can help you ask the right questions and understand the financial points that those who are trying to sway or convince you don't want you to know.

Knowing That Accounting Is Not Just for Accountants

One main source of accounting information is in the form of *financial statements* packaged with other information in a *financial report*. Accountants keep the books and record the financial activities of an entity (such as a business). From these detailed records, the accountant prepares financial statements that summarize the results of the activities.

Financial statements are sent to people who have a stake in the outcomes of the activities. If you own shares in BCE, for example, or you have money in a mutual fund, you receive regular financial reports. If you invest your hard-earned money in a private business or a real estate venture, or you save money in a bank, you receive regular financial reports. If you're a member of a not-for-profit association or organization, you're entitled to receive regular financial reports.



REMEMBER

One important reason for studying accounting is to make sense of the financial statements in the financial reports you get. We guarantee that Warren Buffett knows accounting and how to read financial statements.

Affecting both insiders and outsiders

People who need to know accounting fall into two broad groups: insiders and outsiders. Business managers are insiders; they have the authority and responsibility to run a business. They need a good understanding of accounting terms and the methods used to measure profit and put values on assets and liabilities. Accounting information is indispensable for planning and controlling the business's financial performance and condition. Likewise, administrators of not-for-profit and governmental entities need to understand the accounting terminology and measurement methods in their financial statements.



The rest of us are outsiders. We are not privy to the day-to-day details of a business or an organization. We have to rely on financial reports from the entity to know what's going on. Therefore, we need to have a good grip on the financial statements included in the financial reports. For all practical purposes, financial reports are the only source of financial information we get directly from a business or other organization.

By the way, the business's employees — even though they obviously have a stake in the business's success — do not necessarily receive its financial reports. Only the investors in the business and its lenders are entitled to receive the financial reports. Of course, a business *could* provide this information to those of its employees who are not shareowners, but generally speaking most businesses do not. The financial reports of public businesses are in the public domain, so their employees can easily view them on the Internet.

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

Keep in mind that this is *not* a book on bookkeeping and recordkeeping systems. We offer a brief explanation of procedures for capturing, processing, and storing accounting information in Chapter 3. Even experienced bookkeepers and accountants should find some nuggets in that chapter. However, this book is directed to users of accounting information. We focus on the end products of accounting, particularly financial statements, and not how information is accumulated. When buying a new car, you're interested in the finished product, not details of the manufacturing process that produced it.

Overcoming the stereotypes of accountants

A cartoon showed the young son of clowns standing in a circus tent dressed as a clown but holding a business briefcase. He is telling his clown parents that he is running away to join a CPA firm. Why is this funny? Because it plays off the stereotype of the CPA (Chartered Professional Accountant) as a “bean counter” who wears a green eyeshade and has the personality of an undertaker (no offence to morticians). Maybe you’ve heard the joke that an accountant with a personality is one who looks at *your* shoes when they are talking to you, instead of their own shoes.

Like most stereotypes, an element of truth exists in the preconceived image of accountants. We have met and known a large number of accountants, and most are not as gregarious as used-car sales people. Accountants certainly are more detail-oriented than your average person. However, you don’t have to be good at mathematics to be a good accountant, because they use very little math (no calculus and only simple algebra). Accountants are very good at one thing: They want to see both sides of financial transactions — the give and take. They know better than anyone that, as economists are fond of saying, there’s no such thing as a free lunch.

If you walked down a busy street in Vancouver, Toronto, or Montreal, we doubt that you could pick out the accountants. We have no idea whether accountants have higher or lower divorce rates than others, whether they go to church more frequently, or whether they generally sleep well at night. We do think that accountants are more honest in paying their income taxes than other people, although we have no proof of this.

CHARTERED PROFESSIONAL ACCOUNTANTS (CPA)

What is a *Chartered Professional Accountant* (CPA) and what does it take to obtain the CPA designation?

The CPA designation is a widely recognized and respected badge of a professional accountant. A person must meet ongoing educational and experience requirements and pass a national uniform exam to qualify to practice as a CPA.

Most CPAs are not in public practice; they work for business organizations, government agencies, and not-for-profit organizations, or they teach accounting (a plug for educators here, if you don’t mind!). CPAs in public practice are licenced to do audits of financial reports, and they also provide tax, management, and financial consulting services.

Relating accounting to your personal financial life

We're sure you know the value of understanding personal finance and investing fundamentals. Well, a great deal of the information you use in making personal finance and investing decisions is *accounting information*. One knock we have on books in these areas is that they often don't make clear that you need a basic understanding of accounting terminology and valuation methods to make good use of the financial information.



TIP

We recommend reading Eric Tyson and Tony Martin's two books: *Personal Finance For Canadians For Dummies*, 6th Edition (John Wiley & Sons, Inc., 2018), and *Investing For Canadians For Dummies*, 4th Edition (John Wiley & Sons, Inc., 2018).

You have a stake in the financial performance of the business you work for, the government entities you pay taxes to, the churches and charitable organizations you donate money to, the retirement plan you participate in, and the businesses you buy from. The financial performance and viability of these entities has a direct bearing on your personal financial life and well-being.



REMEMBER

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

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

Looking for Accounting in All the Right Places

Accounting extends into virtually every walk of life. You're doing accounting when you make electronic fund transfers and when you 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 accounting basics to figure their return on invested capital. And it goes without saying that every organization, profit-motivated or not, needs to know how it stands financially.

Check out this quick sweep to get an idea of the range of accounting:

- » Accounting for profit-motivated businesses and accounting for not-for-profit organizations (such as hospitals, condominium corporations, churches, universities, and colleges)
- » Income tax accounting while you are living, and planning for estate tax accounting before 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 legal, entertainment, transportation, and personal care industries
- » Accounting where periodic financial statements are legally mandated (public companies are the primary example) and accounting where such formal accounting reports are not legally required
- » Accounting that adheres to historical cost (mainly businesses), and accounting that records changes in market value (investment property firms, 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 nearing bankruptcy that might not be around tomorrow

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

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

Understanding Accounting's Two Primary Roles



REMEMBER

The accounting function in most businesses has two primary purposes:

- » The accounting function and systems must be able to produce complete, accurate, reliable, and timely (that is, CART) financial information on which businesses can base sound decisions. In today's intensely competitive global economy, it has never been more important for accounting systems to produce and deliver vital financial information on a timely basis for review and management action.
- » The accounting function must be developed, implemented, managed, and periodically revised and updated to safeguard company assets. We are not just talking about preventing theft of liquid or hard assets such as cash or inventory. Rather, the accounting function is now one of the critical gatekeepers associated with helping protect company intellectual property, shelter invaluable customer data and databases, preserve the integrity of critical financial information, control and direct the distribution of confidential financial operating results to the appropriate parties, and assist with critical risk management and insurance protection strategies . . . just to name a few.

As you progress through this book, it becomes clear that the accounting function has evolved into something much more than a bunch of bean counters, working with debits and credits, producing financial statements, and trying desperately to meet the annual income tax reporting deadlines. The COVID-19 pandemic showed that the speed at which economic business models are now formulated, launched, disrupted, expanded, contracted, and potentially eliminated from the global market is in warp drive. Massive volumes of raw confidential business data are now considered one of the most valuable assets a company owns and monetizes to generate profits (aided by huge technological advancements). As such, accounting's role in producing CART financial information in coordination with helping protect this data has never been more critical. Throughout this book, we provide examples and make references to accounting in the new, digital age (for example, Chapter 4 dives into the digitization of accounting and a new era of risks).

Taking a Peek Behind the Scenes

Every business, government, and not-for-profit entity needs a reliable bookkeeping system (see Chapter 3). Keep in mind that *accounting* is a much broader term than *bookkeeping*. For one thing, accounting encompasses the problems in measuring the financial effects of economic activity. Furthermore, accounting

includes the function of *financial reporting* of values and performance measures to those who need the information. Business managers and investors, and many other people, depend on financial reports for information about the performance and condition of the entity.

Bookkeeping refers to the process of accumulating, organizing, storing, and accessing the financial information base of an entity, which is needed for two basic purposes:

- » Facilitating the day-to-day operations of the entity
- » Preparing financial statements, tax returns, and internal reports to managers

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



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

We explain internal controls in Chapter 3. Here, we want to stress the importance of the bookkeeping system in operating a business or any other entity. These back-office functions are essential for keeping operations running smoothly, efficiently, and without delays and errors. This is a tall order, to say the least.

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

Folks might not think much about these back-office activities, but they would notice if those activities didn't get accomplished. On payday, a business had better not tell its employees, "Sorry, but the accounting department is running a little

late this month; your pay will be deposited to your account later.” And when a customer insists on up-to-date information about how much they owe 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 calculated. Based on detailed private information in personnel files and earnings-to-date information, the correct amounts for income taxes and several other deductions from gross wages have to be determined.

Stubs, or *pay statements*, report various information are produced each pay period and given to the employee. The total amounts of withheld income taxes, Canada or Quebec Pension Plans, and Employment Insurance premiums imposed on the employee and employer have to be paid to the federal government (and, in the case of Quebec, the provincial government) on time. Retirement, vacation, sick pay, and other benefits that employees earn 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 or banks 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 or received in the appropriate business chequing accounts and that the business keeps an adequate amount of cash to pay employees and suppliers on time. Accountants balance the business’s bank account and control who has access to incoming cash receipts. (In larger organizations, the *treasurer* might be responsible for some of these cash flow and cash-handling functions.)

» **Cash disbursements:** In addition to electronic payroll payments, a business writes many other cheques or processes numerous electronic payments during the course of a year to pay for a wide variety of purchases, to pay property taxes, to repay loan principal and interest, and to distribute some of its profits to the business’s owners, for example. The accounting department prepares all these cheques and transfers for authorization by business officers. The accounting department keeps all the supporting business documents and files to know when the payments should be made, makes sure that the amount to be paid is correct, and forwards the cheques or payment through electronic transfer for signature.

More and more businesses are switching to electronic methods of payments, which avoid the need for writing and mailing cheques. Electronic access to accounts must be carefully protected not only to guard against hackers but also to make sure that employees make only authorized payments.

- » **Purchasing 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 office supplies to forklifts. A typical business makes many purchases during the year, many of them on credit, which means that the business receives items bought today but pays for them later. This area of responsibility includes keeping files on all liabilities that arise from purchases on credit so that cash payments are processed on time. The accounting department also keeps detailed records on all products that the business holds for sale and, when the products are sold, records the cost of the goods sold.
- » **Costing:** Costs are not as obvious as you might think. Tell someone that the cost of a new car is so many dollars, and most people accept the amount without question. Business owners and managers know better. Many decisions have to be made regarding which factors to include in the manufacturing cost of a product or in the purchase costs of products sold by retailers such as Costco and Wal-Mart. Tracking costs is a major function of accounting in all businesses.
- » **Property accounting:** A typical business owns many different substantial long-term 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 wrenches, a business maintains detailed records of its property, both for controlling the use of the assets and for determining the appropriate amount of depreciation for accounting and tax calculations. The accounting department keeps these property records.
- » **Tax compliance:** The task of managing multiple tax accounting, reporting, and compliance functions usually falls on the shoulders of the accounting department. This extends well beyond simply completing annual income tax returns, because most businesses must deal with a slew of other tax reporting and compliance matters, including GST/HST (Goods and Services Tax and Harmonized Sales Tax), payroll, and other forms of taxation at the federal and provincial level.
- » **Liabilities accounting:** An entity must keep track of all relevant details about every liability it owes — from short-term purchases on credit to long-term notes payable. No entity can lose track of a liability and not pay it on time (or negotiate an extension) without hurting its credit rating.



REMEMBER

The accounting department serves other functions as well, but this list gives you a clear idea of the back-office functions that the accounting department performs. A business could not operate if the accounting department did not do these functions efficiently and on time. We repeat one point: To do these back-office functions well, the accounting department must design a good bookkeeping system and make sure that it is complete, accurate, reliable, and timely.

Focusing on Transactions



REMEMBER

Accounting focuses on transactions. A good bookkeeping system captures and records every transaction that takes place. *Transactions* are economic exchanges between a business or other entity and the parties with which the entity interacts and makes deals. Transactions are the lifeblood of every business, the heartbeat of activity that keeps it going. Understanding accounting, to a large extent, means understanding how accountants record the financial effects of transactions.

The financial effects of many transactions are clear-cut and immediate. However, figuring out the financial effects of other transactions is puzzling and dependent on future developments that can be difficult to predict. Accounting for transactions is not always a cut-and-dried process.

Separating basic types of transactions

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

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

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

» **Investing transactions** refer to the acquisition (and eventual disposal) of *long-term operating assets* such as buildings, heavy machinery, trucks, and office furniture. Some businesses also invest in *financial assets* (shares and

bonds, for example). These are not used directly in the operations of the business; the business could get along without these assets. These assets generate investment income for the business. Investments in financial assets are included in this category of transactions.

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



REMEMBER

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

Knowing who's on the other side of transactions

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

- » **Customers**, who buy the products and services that the business sells.
- » **Employees**, who provide services to the business in exchange for wages and salaries. The business provides employees with benefits, such as a retirement plan and dental and vision insurance, and pays for workers' compensation coverage and Employment Insurance premiums.
- » **Suppliers and vendors**, who sell a wide range of things to the business such as legal advice, products for resale, electricity and gas, and Internet and telephone services.
- » **Government entities**, which are the federal, provincial, and municipal agencies that collect income taxes, payroll-related taxes, GST/HST, and property taxes from the business.

- » **Debt sources of capital**, who loan money to the business and charge interest on the amount loaned that the business must repay at definite dates in the future.
- » **Equity sources of capital**, the individuals and financial institutions that invest money in the business and expect the business to earn profits on the capital they invest.

Recording events

Even a relatively small business generates a surprisingly large number of transactions, and all transactions have to be recorded. Other events that have a financial effect 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 effect on a business and are recorded:

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

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

Taking the Pulse of a Business: Financial Statements

We devote a good deal of space in this book to discussing financial statements. In Chapter 2, we explain the fundamental information components of financial statements, and then Part 2 gets into the nitty-gritty details. Here, we simply

want to introduce you to the three primary kinds of financial statements so you know from the get-go what they are and why they're so crucial.



REMEMBER

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

Outside investors in a business see only summary-level financial statements. For example, investors see the total amount of sales revenue for the period but not how much was sold to each customer.

Meeting the balance sheet (statement of financial position)

One type of accounting report is a “Where do we stand at the end of the period?” type of report. This report is called the *statement of financial position* or, more commonly, the *balance sheet*. The date of preparation is given in the header, or title, above this financial statement. We present and explain a typical balance sheet in Chapter 2; here we simply present the basic content in a balance sheet.

A balance sheet shows two sides of the business, which you could think of as the financial yin and yang of the business:

- » **Assets:** On one side of the balance sheet the business's *assets* are listed, which are the economic resources owned, controlled, and being used in the business. The asset *values* reported in the balance sheet are the amounts recorded when the assets were originally acquired — although we should mention that an asset is written down below its historical cost when the asset has suffered a loss or an impairment in value. (And to complicate matters, some assets are written up to their current fair values.) Some assets have been on the books only a few weeks or a few months, so their reported historical values are current. The values for other assets 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 come from two basically different sources: creditors and owners. First, the *creditors*: Businesses borrow money in the form of interest-bearing loans that have to be paid back at a

later date, and they buy things on credit that are paid for later. So, part of total assets can be traced to creditors, which are the *liabilities* of a business. Second are the *owners*: Businesses require that their owners invest capital (usually money) in the business. Also, businesses retain part or all of the annual profits they make, and profit increases the total business's assets. The total of invested capital and retained earnings is called *owners' equity*.

Suppose a business reports \$2.5 million in total assets (without going into the details of which particular assets the business holds). We know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to \$2.5 million. Otherwise, its books would be out of balance, which indicates bookkeeping errors.

Continuing with this example, suppose that the total amount of the business's liabilities 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 profits retained in the business. But we do know that the total of these two sources of owners' equity is \$1.5 million.

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

$$\text{\$Assets} = \text{\$Liabilities} + \text{\$Owners' Equity}$$

Looking at the accounting equation, you can see why the statement of financial position is called the *balance sheet*; the equal sign means the two sides balance.



REMEMBER

Double-entry bookkeeping is based on the accounting equation — the fact that the total of assets on the one side is counterbalanced by the total of liabilities, invested capital, and retained profits on the other side. Basically, double-entry bookkeeping simply means that both sides of transactions are recorded. For example, if one asset goes up, another asset goes down — or either a liability or owners' equity goes up. This is the economic nature of transactions. Double-entry means *two-sided*, not that the transactions are recorded twice. We discuss double-entry bookkeeping in Chapter 3.

Reporting profit and loss, and cash flows



REMEMBER

Other financial statements are different from the balance sheet in one important respect: They summarize the *flow* of activities over the period. (An example of a *flow number* is the total attendance at Toronto Blue Jays home games over the entire regular baseball season; the cumulative count of spectators passing through

the turnstiles over the season is the *flow*.) Accountants prepare two types of financial flow reports for a business:

- » The **income statement** summarizes the inflow from sales revenue that is offset by the outflows for the expense during the period. Deducting expenses from revenue leads down to the well-known *bottom line*, which is the final net profit or loss for the period and is called *net income* or *net loss* (or some variation of these terms). Alternative titles for this financial statement are the *statement of financial performance*, *statement of operations*, and the *statement of earnings*. Inside a business, but not in its external financial reports, the income statement is commonly called the *profit and loss statement*, or *P&L* report.
- » The **statement of cash flows** summarizes the business's cash inflows and outflows during the period. The accounting profession has adopted a three-way classification of cash flows for external financial reporting: cash flows from making sales and incurring expenses (commonly referred to as operations); cash flows from investing in long-lived assets and selling these assets; and cash flows from raising capital from debt and equity sources, returning capital to these sources, and making distributions from profit to owners.

Recognizing management's role

We explain more about the three primary financial statements (balance sheet, income statement, and statement of cash flows) in Chapter 2. They constitute the hard core of a financial report to those persons outside a business who need to stay informed about the business's financial affairs. These individuals have invested capital in the business, or the business owes them money; therefore, they have a financial interest in how well the business is doing.

The managers of a business, to keep informed about what's going on and the business's financial position, also use these three key financial statements. They are essential in helping managers control the performance of a business, identify problems as they come up, and plan the future course of a business. Managers also need other information that is not reported in the three basic financial statements. (In Part 4, we explain these additional reports.)

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



WARNING

If a business's financial statements are later discovered to be seriously in error or deliberately misleading, the business and its top executives can be sued for damages suffered by lenders and investors who relied on the financial statements. For this reason, business managers 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 have met more than one business manager who doesn't 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 more prudent.

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

