

## Chapter 1

# Accounting: The Language of Business, Investing, Finance, and Taxes

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### *In This Chapter*

- ▶ Realizing how accounting is relevant to you
  - ▶ Grasping how all economic activity requires accounting
  - ▶ Watching an accounting department in action
  - ▶ Shaking hands with business financial statements
  - ▶ Mapping a career in accounting
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**I** had a captive audience when I taught Accounting 101 because, then as well as now, all business school students have to take this course. In contrast very few arts and science students elect the course, which is their loss. Accounting 101 teaches about business, including the nature of profit (which most people don't understand) and the fundamentals of capitalism. The course is a very good training ground for becoming *financially literate*. These days there is a big push to improve financial literacy, and a basic accounting course offers a useful framework for understanding and thinking about financial issues.

In one sense this book is the accounting course you never took. For business grads the book presents an opportune review of topics you've gotten rusty on. I dare say that even accounting majors can glean a lot of insights from this book. You don't need a college education to gain from this book, however. Like all the *For Dummies* books, this book delivers useful information in a plain-talking manner, with a light touch to keep it interesting.

As you go through life, you come face to face with a torrent of accounting information — more than you would ever imagine. Regretfully, much of this information is not inherently intuitive, and it does not come with a user's manual. In short, most of the accounting information you encounter is not readily transparent.

One main reason for learning some accounting is to understand its vocabulary and valuation methods, so you can make more intelligent use of the information. Accountants are financial scorekeepers. In playing or watching any game, you need to know how the score is kept. The purpose of this book is to make you a knowledgeable spectator of the accounting game.



Let me point out another reason you should know accounting basics — I call it the *defensive* reason. A lot of people in the cold, cruel financial world are on the prowl to take advantage of your lack of savvy about accounting. These unscrupulous characters treat you as a lamb waiting to be fleeced. The best defense against such tactics is to know some accounting, which helps you ask the right questions and understand the crucial points about which con artists want to keep you in the dark.

## Accounting's Main Jobs: Providing Vital Information to Non-Accountants

In a nutshell, accountants “keep the books” of a business, and for not-for-profit and government entities also, by following systematic methods to record all the financial activities and prepare *summaries*. Accountants then communicate this summary information to *non-accountants*, such as business owners, lenders, and investors. In particular, accounting information is presented in the form of *financial statements* that are packaged with other information such as explanatory footnotes and a letter from top management in what is called a *financial report*.

Financial statements are sent to people who have a stake in the outcomes of the activities. If you own stock in General Electric, 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 credit union, you receive regular financial reports. If you are a member of a nonprofit association or organization, you're entitled to receive regular financial reports. I hope you carefully read these financial reports, but if you don't — or if you do yet don't understand what you're reading — it could be that you don't understand the language of accounting.



In summary, one important reason for studying accounting is to make sense of the financial statements in the financial reports you get. I guarantee that Warren Buffett knows accounting and how to read financial statements. I sent him a copy of my *How To Read A Financial Report* (John Wiley & Sons). In his reply, he said he planned to recommend it to his “accounting challenged” friends.

## *Distinguishing among different users of accounting information*

People who use accounting information 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 financial performance and condition of the business. Likewise, administrators of nonprofit 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 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 employees of a business — even though they obviously have a stake in the success of the business — 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 secure a copy. However, financial reports are not automatically mailed to all employees of a public business.

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



Keep in mind that this is *not* a book on bookkeeping and recordkeeping systems. I offer a brief explanation of procedures for capturing, processing, and storing accounting information in Chapter 3. Even experienced bookkeepers and accountants should find some useful nuggets in that chapter. However, this book is directed to *users* of accounting information. I focus on the end products of accounting, particularly financial statements, and not on 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*

I recently saw a cartoon in which the young son of clowns is standing in a circus tent and is dressed as a clown, but he is holding a business briefcase. He is telling his clown parents that he is running away to join a CPA firm. This cartoon has a touch of humor because it plays off the stereotype of a CPA (certified public accountant) as a boring “bean counter” who wears a green eyeshade, has no sense of humor, and possesses the personality of an undertaker (no offense to morticians). Maybe you’ve heard the joke that an accountant with a personality is one who looks at *your* shoes when he is talking to you, instead his own shoes.

Like most stereotypes, there’s an element of truth in the preconceived image of accountants. As a CPA and accounting professor for more than 40 years, I have met and known a large number of accountants. Most accountants are not as gregarious as used-car sales people (though some are). Accountants certainly are more detail-oriented than your average person, and maybe a little more math-focused. However, you don’t have to be a mathematics whiz to be a good accountant because accountants 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. Accountants 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 Chicago, New York, or Los Angeles, I doubt that you could pick out the accountants. I have no idea whether accountants have higher or lower divorce rates, whether they go to church more frequently, whether most are Republicans or Democrats, or if they generally sleep well at night. I do think overall that accountants are more honest in paying their income taxes than other people, although I have no proof of this. (And, yes, I know of a couple of accountants who tried to cheat on their federal income tax returns.)

## *Making good use of accounting in your personal financial life*

I’m sure you know the value of learning personal finance and investing fundamentals. (Given the big push these days on improving financial literacy I recommend *Personal Finance For Dummies* and *Investing For Dummies* by Eric Tyson, MBA, both published by Wiley.) Well, a great deal of the information you use in making personal finance and investing decisions is *accounting information*. I do have one knock on books in these areas: They don’t make clear that you need a basic understanding of accounting terminology and valuation methods in order to make good use of the financial information.

I have noticed that a sizable percent of the populace bash the profit motive and seem to think businesses should not make a profit. I would remind you, however, that 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, the businesses you buy from, and the healthcare providers you depend on. The financial performance and viability of these entities has a direct bearing on your personal financial life and well-being.



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 may be laid off or asked to take a reduction in pay or benefits. Business managers get paid to make profit happen. If the business fails to meet its profit objectives or suffers a loss, its managers may be replaced (or at least not get their bonuses). As an author, I hope my publisher continues to make a profit so I can keep receiving my royalty checks.

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

## *Recognizing the Broad Sweep of Accounting Everywhere You Look*

Accounting extends into many nooks and crannies of your 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 accounting basics in order 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.

Here's a quick sweep to give you an idea of the broad range accounting covers:

- ✓ 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 when 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 (budgeting and financial planning)
- ✓ 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 (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 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 quite interesting (but beyond the scope of this book).

## *Taking a Peek Behind the Scenes*

Every business 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 that 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, protecting, and accessing the financial information base of an entity, which is needed for two broad 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 complete, accurate, 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.



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 a specific time period. The internal controls that accountants design are also 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.

I explain internal controls in Chapter 3. Here, I 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 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 calculated. 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, or prepared separately if net pay is sent electronically to the employee's bank account. 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. *Note:* 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 which persons have 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 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 on 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.

- ✓ **Costing:** Costs are not as obvious as they look. 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 what factors to include in the manufacturing cost of a product, and 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 that go under the generic names *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 maintains 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.

In most businesses and other entities, the accounting department is 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. And to repeat one point: To do these back-office functions well, the accounting department must design a good book-keeping system and make sure that it is accurate, complete, and timely.

## Focusing on Transactions



The recordkeeping function of accounting focuses on *transactions*, which are economic exchanges between a business or other entity and the parties with which the entity interacts and makes deals. A good accounting system captures and records every transaction that takes place without missing a beat. 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. On the other hand, figuring out the financial effects of some transactions is puzzling and dependent on future developments. The financial effects of some transactions can be difficult to determine at the time of the original transaction because the outcome depends on future events that are difficult to predict. I bring this point because most people seem to think that accounting for

transactions is a cut-and-dried process. Frankly, recording some transactions is more in the nature of “let’s make our best assessment, cross our fingers, and wait and see what happens.” The point is that recording the financial effects of some transactions is tentative and conditional on future events.

A business is a whirlpool of transactions; accountants categorize transactions into three basic types:

- ✓ **Profit-making transactions**, which consist of *revenue* and *expenses*. Profit is the sum total of revenue for the period minus all expenses for the period. *Note*: Profit is not a transaction but rather a calculated amount that depends on how revenue and expenses are recorded.
- ✓ **Investing transactions**, which refer to the acquisition (and eventual disposal) of *long-term operating assets* such as buildings, heavy machinery, trucks, office furniture, and so on. Some businesses also invest in *financial assets*, (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**, which 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 products held for sale, long-term operating assets (as described in the previous *investing transactions* bullet point), and so on. 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 ability of the business to earn profit and have the cash flow to distribute some or all of the profit to its equity shareholders.

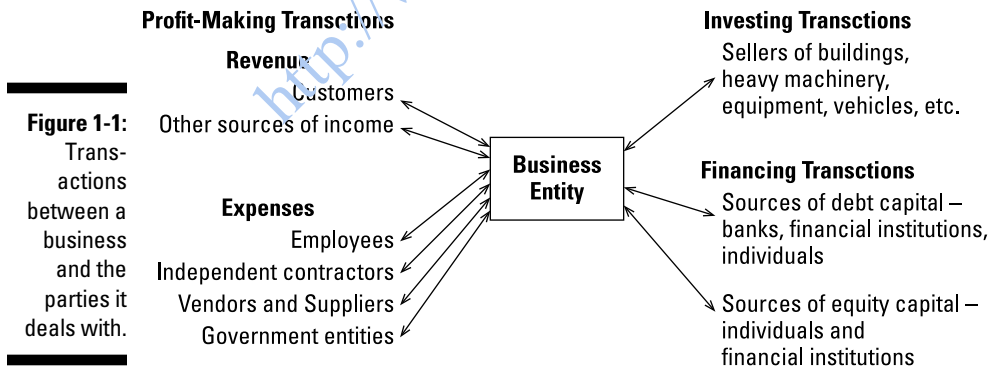


Profit-making transactions, also called *operating activities*, are high frequency. During the course of a year even a small business has thousands of revenue and expense transactions. (How many cups of coffee, for example, does your local coffee store sell each year? Each sale is a transaction.) In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

Figure 1-1 gives you some idea of the range of persons and entities that a business deals with, such as engages in economic exchanges with. A business is the hub of transactions involving the following persons and entities:

- ✓ Its **customers**, who buy the products and services that the business sells. Also, a business may have other sources of income, such as from investments in financial assets (bonds, for example).

- ✔ Its **employees**, who provide services to the business and are paid wages and salaries and provided with benefits, such as a retirement plan, medical insurance, workers' compensation, and unemployment insurance.
- ✔ **Independent contractors**, who are hired on a contract basis to perform certain services for the business. These services can be everything from hauling away trash and repairing plumbing problems to high-priced consultants who advise the business on technical issues to audits by a CPA firm.
- ✔ Its **vendors and suppliers**, who sell a wide range of things to the business, such as products for resale, electricity and gas, insurance coverage, telephone and Internet services, and so on.
- ✔ **Government entities**, which are the federal, state, and local agencies that collect income taxes, sales taxes, payroll taxes, and property taxes from or through the business.
- ✔ **Sellers of the various long-term operating assets** used by the business, including building contractors, machinery and equipment manufacturers, and auto and truck dealers.
- ✔ 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 as owners and who expect the business to earn profit on the capital they invest.



**Figure 1-1:** Transactions between a business and the parties it deals with.

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 are recorded:

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

As I explain in more detail in Chapter 3, at the end of the year the accountant conducts a special survey to ensure 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

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



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. 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 may 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.

The outside, nonmanager investors in a business receive 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 and every customer. Financial statements are based on the assumption that you, the reader, are not a manager of the business (see “Distinguishing different users of accounting information” earlier in this chapter.) The managers of the business should make good use of their financial statements, but they also need more detailed information beyond what’s in the business’s financial statements.

## *Meeting the balance sheet and the accounting equation*

One type of financial statement 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, which I suppose you could think of as the financial yin and yang of the business:

- ✓ **Assets:** On one side of the balance sheet the *assets* of the business are listed, which are the economic resources owned 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 I should mention that an asset is written down below its historical cost when the asset has suffered a loss 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, 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 do not materialize out of thin air. Assets arise 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*: Every business needs to have owners invest capital (usually money) in the business. In addition, businesses retain part or all of the annual profits they make, and profit increases the total assets of the business. The total of invested capital and retained profit is labeled *owners’ equity*.

To help visualize the two-sided nature of the balance sheet let's put all assets on the left tray of a balance scale and put liabilities and owners' equity on the right tray (see Figure 1-2). The total weight of all assets equals the total weight of liabilities and owners' equity. One side cannot be heavier than the other side. An imbalance signals accounting errors in recording the transactions of the business. This fundamental axiom of accounting is also summarized in the *accounting equation*, as follows:

**Figure 1-2:**  
The fundamental balance, or equality of assets and sources of the assets.

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities \& Owner}}$$

Suppose a business reports \$2.5 million total assets (without going into the details of which particular assets the business holds). Knowing that total assets are on the books at \$2.5 million, we also 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. This amount is also called the *net worth* of the business; to be more accurate should be called the *recorded net worth* of the business (which does not necessarily equal the present market value of the business). 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):

$$\$2.5 \text{ assets} = \$1.0 \text{ liabilities} + \$1.5 \text{ owners' equity}$$

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

## A pop quiz

Here's a teaser for you. If a business's total assets equal \$2.5 million and its total liabilities equal \$1.0 million, we know that its total owners' equity is \$1.5 million. *Question:* Could the owners have invested more than \$1.5 million in the business? *Answer:* Yes. One possibility is that the owners invested \$2.5 million, but the business has so far accumulated \$1.0 million of losses instead of making profit. The

accumulated loss offsets the amount invested, so the owners' equity is only \$1.5 million net of its cumulative loss of \$1.0 million. The \$1.0 million of cumulative loss is down the rat hole. The owners bear the risk that the business may be unable to make a profit. A loss falls on the owners and, accordingly, causes a decrease in the owners' equity amount reported in the balance sheet.



*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 profit on the other side. I discuss double-entry bookkeeping in Chapter 3. 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, alternatively, either a liability or owners' equity goes up. This is due to the economic nature of transactions. In accounting double-entry means *two-sided*, not that the transactions are recorded twice.

## Reporting profit and loss, and cash flows



Other financial statements are regularly prepared, and they are fundamentally different from the balance sheet: They summarize the *flows* of activities over the period. (An example of a *flow number* is the total attendance at Colorado Rockies baseball games over its entire 82 home game regular season; the cumulative count of spectators passing through the turnstiles over the season is the flow.) Accountants prepare two types of flow reports for a business:

- ✓ The **income statement** summarizes the inflows from sales revenue and other income, which are offset by the outflows for expenses during the period. Deducting expenses from revenue and income 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 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 matching the three basic type of business transactions I discuss in the above section *Focusing on Transactions*: cash flows from making sales and incurring expenses; cash flows from investing in assets and selling assets; and cash flows from raising capital from debt and equity sources, returning capital to these sources, and making distributions from profit to owners.

## *Respecting the importance of this troika*

I 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 financial position of the business, also use these three key financial statements. The three financial statements 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 III of this book, I explain these additional reports.)

The three primary financial statements constitute a business's financial center 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.



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.

I have met more than one business manager who doesn't have a clue about his or her 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.

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. 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!

## *Mapping 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 2 million people make their living as bookkeepers, accountants, and auditors. They work as independent practitioners, or 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 rank among the most respected professionals in many polls.

### *Certified public accountant (CPA) and specialties*

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 experience working for a CPA firm, or other qualifying experience depending on the state in which the person lives. The CPA credential 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. For example, I have a CPA certificate in Colorado, but I'm on inactive status because I have retired and do not offer my services to the public.

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.

As a person gains experience in public accounting he or she may decide to qualify for one of the specialization designations offered by the American Institute of Certified Public Accountants (AICPA). For example, you could qualify as a personal financial consultant, or as a forensic expert. (I don't list all the specializations or their requirements here.) The idea is to better "advertise" your special qualifications in a particular area of practice. Keep in mind one critical point: The CPA license is regulated by the state. Each state has specific requirements regarding how to become a CPA; the specializations, on the other hand, are created and regulated by the AICPA, which is a private organization.

## ***Introducing a new kid on the block: Chartered Global Management Accountant (CGMA)***

Over the years certified public accountants have worn three hats: as independent auditors, as tax experts, and as management accountants. The first two hats rest on the heads of CPAs very well. Most people you meet probably know the auditing and tax roles of CPAs. I bet you did. But the third hat doesn't fit so well on the head of a CPA who has joined the management team of a business. As an auditor and tax professional a CPA needs *independence*, to be in a position to stand back and judge impartially whether the accounting methods used by a business conform to established accounting standards and tax laws. However, once a CPA becomes a member of management, he or she no longer is independent from the business. (I should mention in passing that CPAs also serve as independent business consultants, in addition to their auditing and tax functions.)

Taking a job with a business does not strip the CPA designation from a person. As the Controller of a business, for example, you can still refer to yourself as a CPA. (But you are not independent of the business.) Over the years various organizations have developed credentials that management accountants can earn by additional education or experience (or some of both). The two primary purposes of these credentialing programs are to improve the abilities of professional management accountants, and, second, to create an acronym or "brand" that is widely known. See the sidebar *The CPA as a brand*.

## The CPA as a brand

The CPA title has gained broad recognition and respect. When I mention to people that I'm a CPA I don't have to explain what a CPA is. It's generally understood what a CPA is. Now I certainly don't mean to sound critical here, but the blunt truth of the matter is that accountants don't have the status and recognition without the CPA after their name. Many highly qualified

accountants work for businesses, non-profit organizations, and government entities. They may have other designations after their names, which attest to their qualifications. The problem is that these particular qualifications are not widely understood. In contrast the CPA is a "brand" that people understand.

Recently the American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA) in the United Kingdom and the Republic of Ireland joined forces to sponsor and promote a new professional designation called the *Chartered Global Management Accountant*, or *CGMA* for short. A member in good standing of the AICPA can gain the CGMA designation by meeting experience requirements in the fields of internal auditing, management accounting (both in profit and non-profit entities), and business consulting. Starting in 2015 a qualifying examination will be required. The CGMA initiative has just gotten off the ground at the time of revising this book. It's too early to tell how successful it will be. But you probably want me to make a bold (and reckless) prediction, don't you? Let's just say I have my doubts.

## *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 book-keeping 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 chief financial officer, the president, the chief executive officer, and the board of directors. All the tough accounting questions and problems get referred to the controller although he or she may not make the final decision.

Smaller businesses may employ 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 its 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, or chief financial officer (CFO)*. The accounting functions in a business are integrated with and work in close coordination with its financial, treasury, and secretary functions.

## *A springboard to other careers*

Many CPAs move on to other careers. A recent article in 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 with a CPA firm is a good springboard to many careers. I started out working for a large CPA firm and then a local firm. I gained valuable insights into the accounting practices and problems of a wide variety of businesses. Most young women and men would tell you that their experiences working for a CPA firm were invaluable. After an audit is completed many companies offer the CPAs working on the audit well-paid positions in the business. Who knows, you might end up being the author of *Accounting For Dummies*, although I should warn you that my coauthor and son, Tague, has first dibs on continuing this book.

By the way, if you're interested in accounting, you may think about getting a Ph.D. in accounting and becoming an accounting professor. After a few years in public accounting, I went back to school, got my Ph.D., and spent the rest of my career in higher education. These days, the starting salaries for new assistant professors of accounting are well into six digits!