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straight-talking guide

# Understanding Business Accounting

# FOR DUMMIES<sup>®</sup>

2nd Edition

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Ernst & Young*

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Starting a Business For Dummies*

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**by John A Tracy and Colin Barrow**



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# *Dedication*

For all my grandchildren.

— **John A Tracy**





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# Introduction

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**W**elcome to *Understanding Business Accounting For Dummies*. We've written this book for people who need to understand accounting information and financial reports – *not* for accountants and bookkeepers (although they should find this book very interesting and a good refresher course). This book is for people who need to use and understand accounting information – business managers and entrepreneurs, for example, who need to make profit, turn profit into cash flow, and control the assets and liabilities of their business. If you're running a business or you're a business unit manager, we're probably preaching to the converted when we say that you need a basic familiarity with accounting and financial statements in order to make good business decisions.

Business investors, lawyers, business consultants – pretty much anyone who reads (or aspires to read) *The Financial Times* – can also benefit from a solid understanding of how to read financial reports and how accounting works.

## *About This Book*

*Understanding Business Accounting For Dummies* lifts the veil of obscure terminology and lays bare the methods of accounting. This book takes you behind the scenes and explains the language and methods of accounting in a down-to-earth and light-hearted manner – and *in plain English*.

Each chapter in this book is designed to stand on its own. Each chapter is self-contained, and you can jump from chapter to chapter as you please (although we encourage you to take a quick tour through the chapters in the order that we present them). We bet you'll discover some points that you may not have expected to find in a book about accounting.

## *Conventions Used in Financial Reports*

Much of this book focuses on profit and how a business makes profit. Because profit and other financial aspects of a business are reported in *financial statements*, understanding some basic notations and conventions used in these financial reports is important.

We use the following condensed profit and loss account to illustrate some conventions that you can expect to see when reading financial reports. (The actual format of a profit and loss account includes more information about expenses and profit.) These conventions are the common ways of showing figures in financial reports just as saying hello and shaking hands are common conventions that you can expect when you greet someone.

#### Abbreviated Profit and Loss Account

Sales revenue		£25,000,000
Cost of goods sold expense	<u>15,000,000</u>	
Gross margin	£10,000,000	
Marketing expenses	£4,000,000	
Other expenses	<u>2,000,000</u>	<u>6,000,000</u>
Profit		<u>£4,000,000</u>

- ✔ You read a financial statement from the top down. In this sample profit and loss account, for example, sales revenue is listed first followed by cost of goods sold expense because this particular expense is the first expense deducted from sales revenue. The other two expenses are listed below the first profit line, which is called gross margin.
- ✔ The sample profit and loss account includes two columns of numbers. Note that the 6,000,000 total of the two expenses in the left column is entered in the right column. Some financial statements display all figures in a single column.
- ✔ An amount that is deducted from another amount – like cost of goods sold expense in this sample profit and loss account – may have parentheses around the amount to indicate that it is being subtracted from the amount just above it. Or, financial statements may make the assumption that you know that expenses are deducted from sales revenue – so no parentheses are put around the number. You see expenses presented both ways in financial reports. But you hardly ever see a minus or negative sign in front of expenses – it’s just not done.
- ✔ Notice the use of pound signs in the sample profit and loss account. Not all numbers have a pound sign in front of the number. Financial reporting practices vary on this matter. We prefer to use pound signs only for the first number in a column and for a calculated number. In some financial reports, pound signs are put in front of all numbers, but usually they aren’t.

- ✔ To indicate that a calculation is being done, a single underline is drawn under the bottom number, as you see below the 15,000,000 cost of goods sold expense number in the sample profit and loss account.
- ✔ The final number in a column is usually double underlined, as you can see for the £4,000,000 profit number in the sample profit and loss account. This is about as carried away as accountants get in their work – a double underline. Again, actual financial reporting practices are not completely uniform on this point – instead of a double underline on a bottom-line number, the number may appear in **bold**.
- ✔ Sometimes statements note that the amounts shown are in thousands (this prevents clogging up neat little columns with loads of noughts). So if a statement noting ‘amounts in thousands’ shows £300, it actually means £300,000. And that can make quite a difference!

When we present an accounting formula that shows how financial numbers are computed, we show the formula in a different font with a grey screen, like this:

```
Assets = Liabilities + Owners' Equity
```

Terminology in financial reporting is reasonably uniform, thank goodness, although you may see a fair amount of jargon. When we introduce a new term in this book, we show the term in *italics* and flag it with an icon (see the section ‘Icons Used in This Book’ later in this Introduction). You can also turn to Appendix A to look up a term that you’re unfamiliar with.

## Some Assumptions

Whilst this book is designed for all of you who have that nagging feeling that you really should know more about accounting, we have made a few assumptions about you:

You don’t want to be an accountant, nor do you have any aspirations of ever sitting for the FCA (Fellow of the Institute of Chartered Accountants) exam. But you worry that ignorance of accounting may hamper your decision-making, and you know deep down that learning more about accounting would help.

We assume that you have a basic familiarity with the business world, but we take nothing for granted in this book regarding how much accounting you know. Even if you have some experience with accounting and financial statements, we think you’ll find this book useful – especially for improving your communication with accountants.

We assume that you need to *use* accounting information. Many different types of people (business managers, investors, and solicitors, to name but three) need to understand accounting basics – not all the technical stuff, just the fundamentals.

We assume that you want to know something about accounting because it's an excellent gateway for understanding how business works, and it gives you an indispensable vocabulary for moving up in the business and investment worlds. Finding out more about accounting helps you understand earnings reports, mergers and takeovers, frauds and pyramid schemes, and business restructurings.



Let us point out one other very practical assumption that we have regarding why you should know some accounting. We call it the *defensive* reason. A lot of people out there in the cold, cruel financial world may take advantage of you, not necessarily by illegal means, but by withholding key information and by diverting your attention away from unfavourable aspects of certain financial decisions. These unscrupulous characters treat you as a lamb waiting to be fleeced. The best defence against such tactics is to learn some accounting basics, which can help you ask the right questions and understand the financial points that tricksters don't want you to know.

## *How This Book Is Organised*

This book is divided into parts, and each part is further divided into chapters. The following sections describe what you can find in each part.

### *Part I: Accounting Basics*

Part I of *Understanding Business Accounting For Dummies* introduces accounting to non-accountants and discusses the basic features of bookkeeping and accounting record-keeping systems. This part also talks about taxes of all kinds that are involved in running a business, as well as accounting in the everyday lives of individuals.

### *Part II: Getting a Grip on Financial Statements*

Part II moves on to the end product of the business accounting process – financial statements. Three main financial statements are prepared every period – one for each financial imperative of business: making profit, keeping



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financial condition in good shape, and controlling cash flow. The nature of profit and the financial effects of profit are explained in Chapter 5. The assets, liabilities, and owners' capital invested in a business are reported in the balance sheet, which is discussed in Chapter 6. Cash flow from profit and the cash flow statement are explained carefully in Chapter 7. The last chapter in this part, Chapter 8, explains what managers have to do to get financial statements ready for the annual financial report of the business to its owners.

### ***Part III: Accounting in Managing a Business***

Business managers should know their financial statements like the backs of their hands. However, just understanding these reports is not the end of accounting for managers. Chapter 9 kicks off this part with an extraordinarily important topic – building a basic profit model – that clearly focuses on the key variables that drive profit. This model is absolutely critical for decision-making analysis.

Chapter 10 discusses accounting-based planning and control techniques, especially budgeting. Business managers and owners have to decide on the best business ownership structure, which we discuss in Chapter 11. Managers in manufacturing businesses should be wary of how product costs are determined – as Chapter 12 explains. This chapter also explains other economic and accounting costs that business managers use in making decisions. Chapter 13 identifies and explains the alternative accounting methods for expenses and how the choice of method has a major impact on profit for the period, and on the cost of stock and fixed assets reported in the balance sheet.

### ***Part IV: Financial Reports in the Outside World***

Part IV explains financial statement reporting for investors. Chapter 14 presents a speed-reading approach that concentrates on the key financial ratios to look for in a financial report. The scope of the annual audit and what to look for in the auditor's report are explained in Chapter 15, which also explains the role of auditors as enforcers of financial accounting and disclosure standards.

## *Part V: The Part of Tens*

This part of the book presents three chapters. Chapter 16 presents some practical ideas for managers to help them put their accounting knowledge to use whilst Chapter 17 lists various sources of finance available to the business. Chapter 18 gives business investors some handy tips on things to look for in a financial report – tips that can make the difference between making a good investment and a not-so-good one.

## *Part VI: Appendixes*

At the back of the book, you can find two helpful appendixes that can assist you on your accounting safari. Appendix A provides you with a handy, succinct glossary of accounting terms. Appendix B fills you in on the accounting software programs available for your business.

## *Icons Used in This Book*



This icon calls your attention to particularly important points and offers useful advice on practical financial topics. This icon saves you the cost of buying a yellow highlighter pen.



This icon serves as a friendly reminder that the topic at hand is important enough for you to put a note about it in the front of your wallet. This icon marks material that your college professor might put on the board before class starts, noting the important points that you should remember at the end of class.



Accounting is the language of business, and, like all languages, the vocabulary of accounting contains many specialised terms. This icon identifies key accounting terms and their definitions. You can also check the glossary (Appendix A) to find definitions of unfamiliar terms.



This icon is a caution sign that warns you about speed bumps and potholes on the accounting highway. Taking special note of this material can steer you around a financial road hazard and keep you from blowing a fiscal tyre. In short – watch out!



We use this icon sparingly; it refers to very specialised accounting stuff that is heavy going, which only an FCA could get really excited about. However, you may find these topics important enough to return to when you have the time. Feel free to skip over these points the first time through and stay with the main discussion.



This icon alerts you that we're using a practical example to illustrate and clarify an important accounting point. You can apply the example to your business or to a business in which you invest.



This icon points out especially important ideas and accounting concepts that are particularly deserving of your attention. The material marked by this icon describes concepts that are the underpinning and building blocks of accounting – concepts that you should be very clear about, and that clarify your understanding of accounting principles in general.



This icon lets you know about Web sites from which you can download free financial spreadsheets and tables. These can help take the grunt and groan out of number-crunching cash flow forecasts, 'what if' projections, and other tedious but vital repetitive calculations.

## *Where to Go from Here*

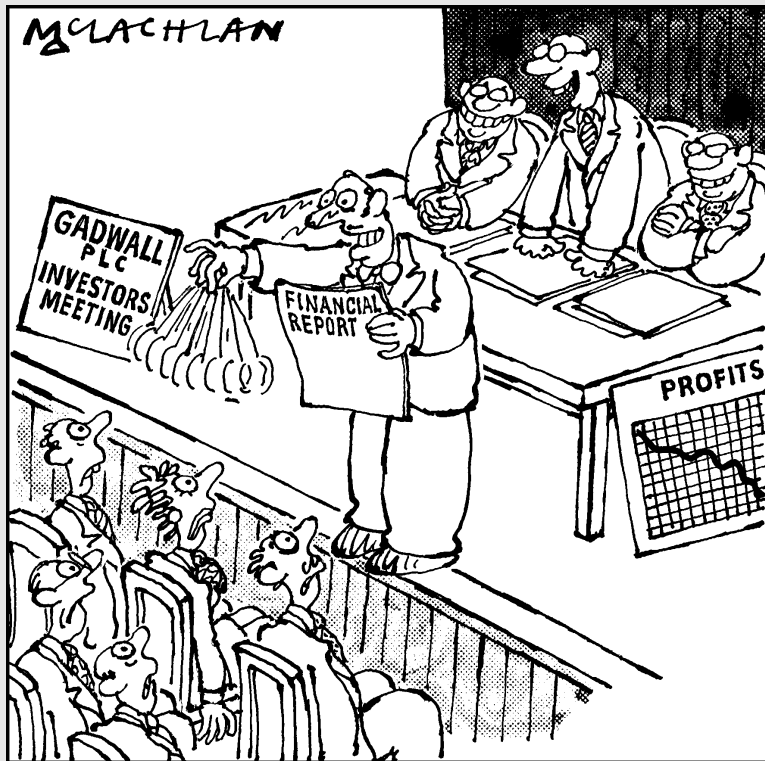
If you're new to the accounting game, by all means, start with Part I. However, if you already have a good background in business and know something about bookkeeping and financial statements, you may want to jump right into Part II of this book, starting with Chapter 5. Part III is on accounting tools and techniques for managers and assumes that you have a handle on the financial statements material in Part II. Part IV stands on its own; if your main interest in accounting is to make sense of and interpret financial statements, you can read through Part II on financial statements and then jump to Part IV on reading financial reports. If you have questions about specific accounting terms, you can go directly to the glossary in Appendix A.

We've had a lot of fun writing this book. We sincerely hope that it helps you become a better business manager and investor, and that it aids you in your personal financial affairs. We also hope that you enjoy the book. We've tried to make accounting as fun as possible, even though it's a fairly serious subject. Just remember that accountants never die; they just lose their balance. (Hey, accountants have a sense of humour, too.)



# Part I

# Accounting Basics



'So for all you eager investors, our latest financial report will be read to you by our new accountant, Mr Mesmero.'

## *In this part . . .*

**A**ccounting is important in all walks of life, and it's absolutely essential in the world of business. Accountants are the bookkeepers, scorekeepers, and occasionally the gatekeepers of business. Without accounting, a business couldn't function, wouldn't know whether it's making a profit or loss, wouldn't know its financial situation, or if it was in danger of running out of cash.

Bookkeeping – the record-keeping part of accounting – must be managed well to make sure that all the financial information needed to run the business is complete, accurate, and reliable, especially the numbers reported in financial statements and tax returns. Wrong numbers in financial reports and tax returns can cause all sorts of trouble.

Speaking of taxes, you can't take more than three or four steps before bumping into dreaded taxes. No one likes to pay taxes, but managers must collect and pay taxes as part of running a business. In addition to income taxes, accounting plays a bigger role in your personal financial affairs than you might realise. This part of the book explains all this and more.