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UK Edition

4th Edition

Understanding Business Accounting

for dummies®

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The latest technology to manage the bottom line

Take the worry out of taxes

Control profit and cash flow to budget with confidence

Colin Barrow

Author of *Starting a Business For Dummies*

John A. Tracy, CPA

Author of *Accounting For Dummies*

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Introduction

Welcome to *Understanding Business Accounting For Dummies*, 4th Edition. We've written this book for people who need to understand accounting information and financial reports, quickly. Unsurprisingly, the business climate at the end of the first decade of the 21st Century has made this a hot topic – not quite in the Brexit/Donald Trump league, but every bit as daunting in its own way. While it's *not* for accountants and bookkeepers, they should find this book very interesting and a good refresher course. It may also be a valuable learning resource for accountants and bookkeepers to use with their non-accountant fellow managers to help bring them up to speed.

This book is for people who need to use and understand accounting information – business managers and entrepreneurs, for example, who need to raise money, make profit, turn profit into cash flow, and control the assets and liabilities of their venture. 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 and business consultants – pretty much anyone who is affected by the financial performance of the business they work for or trade with – 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 (£s)

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

- 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. 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 indented, 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.

Foolish Assumptions

While 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 that 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 company reports, mergers and takeovers, frauds and pyramid schemes, and business restructurings.

TIP

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. 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 frauds don't want you to know.

Icons Used in This Book

For Dummies books always include little icons in the margins to draw your attention to paragraphs of particular significance:

TIP

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.

REMEMBER

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 also identifies key accounting terms and their definitions, as well as key accounting concepts.

WARNING

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!

TECHNICAL STUFF

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 if you want to stay with the main discussion.

EXAMPLE

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.

Beyond the Book

In addition to the material in the print or ebook you're reading right now, you can also find some access-anywhere goodies on the web. Check out the free Cheat Sheet at `www.dummies.com` by searching for 'Understanding Business Accounting For Dummies UK Edition Cheat Sheet' in the Search box.

Where to Go from Here

If you're new to the accounting game, by all means start with Part 1. However, if you already have a good background in business and know something about book-keeping and financial statements, you may want to jump right into Part 2 of this book, starting with Chapter 5. Part 3 is on accounting tools and techniques for managers, and it assumes that you have a handle on the financial statements material in Part 2. Part 4 stands on its own; if your main interest in accounting is to make sense of and interpret financial statements, you can read through Part 2 on financial statements and then jump to Part 4 on reading financial reports. If you have questions about specific accounting terms, you can go directly to the glossary in the appendix.

We've had a lot of fun writing all the editions of 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 much 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 – though you may have to wait until you reach Chapter 6 to get the joke.)

1 Accounting Basics

IN THIS PART . . .

Discover the ways that an understanding of business accounting can help your business.

Understand the differences between bookkeeping and accounting.

Work out how to pay taxes as an employer and a property owner.

Make sense of your financial position as an individual who is also a taxpayer, an investor, a borrower and a retirement planner.

IN THIS CHAPTER

» Understanding the different needs for accounting

» Making and enforcing accounting rules

» Peering into the back office: The accounting department in action

» Transactions: The heartbeat of a business

» Taking a closer look at the key financial statements

» Should you let your toddler grow up to be an accountant?

Chapter 1

Introducing Accounting to Non-Accountants

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

» Accountants carry out vital back-office operating functions that keep the business running smoothly and effectively including payroll, cash receipts and cash payments, purchases and stock, and property records.

» Accountants prepare tax returns, including VAT (value-added tax) returns for the business, as well as payroll. They also file reports at Companies House, which stores all the information companies are legally required to supply.

And here's the good bit – Companies House makes that information available for anyone to view (see `www.gov.uk/government/organisations/companies-house`).

- Accountants determine how to measure and record the costs of products and how to allocate shared costs among different departments and other organisational units of the business.
- Accountants are the *professional profit scorekeepers* of the business world, meaning that they are the ones who determine exactly how much profit was earned, or just how much loss the business suffered, during the period. Accountants prepare reports for business managers, keeping them informed about costs and expenses, how sales are going, whether the cash balance is adequate and what the stock situation is.
- Accountants prepare *financial statements* that help the owners and shareholders of a business understand where the business stands financially. Shareholders wouldn't invest in a business without a clear understanding of the financial health of the business, which regular financial reports (sometimes just called *the financials*) provide.

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

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

Accounting Everywhere You Look

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

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

- Accounting for organisations and accounting for individuals
- Accounting for profit-motivated businesses and accounting for non-profit organisations (such as hospitals, housing associations, churches, schools and colleges)
- Income tax accounting while you're living and estate tax accounting after you die
- Accounting for businesses and professional firms that sell services rather than products, such as the entertainment, transportation and healthcare industries
- Past-historical-based accounting and future-forecast-oriented accounting (that is, budgeting and financial planning)
- Accounting that adheres to cost (most businesses) and accounting that records changes in market value (investment funds, for example)
- Accounting in the private sector of the economy and accounting in the public (government) sector

Accounting is necessary in any economic system. The more developed the economic system, the more the system depends on information. Much of the information comes from the accounting systems used by the businesses, individuals and other institutions in the economic system.

The Basic Elements of Accounting

Accounting involves bookkeeping, which refers to the painstaking and detailed recording of economic activity and business transactions. But *accounting* is a much broader term than *bookkeeping* because accounting refers to the design of the bookkeeping system. It addresses the many problems in measuring the financial effects of economic activity. Furthermore, accounting includes the *financial reporting* of these values and performance measures to non-accountants in a clear and concise manner.

REMEMBER

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

Financial statements

An accountant rarely prepares a complete listing of all the details of the activities that took place during a period. Instead, he or she prepares a *summary financial statement*, which shows totals, not a complete listing of all the individual activities making up the total. Mostly, managers just want summary financial statements for the period – if they want to drill down into the details making up a total amount for the period, they ask the accountant for this more detailed backup information. Also, outside investors usually only see summary-level financial statements. For example, they see the total amount of sales revenue for the period but not how much was sold to each and every customer. Because a company's accounts are available to the public at Companies House, businesses only reveal what they absolutely have to by law.

REMEMBER

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

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

Assets are not like manna from heaven. They come from borrowing money in the form of loans that have to be paid back at a later date and from owners' investment of capital (usually money) in the business. Also, making profit increases the assets of the business; profit retained in the business is the third basic source of assets. If a business has, say, £2.5 million in total assets (without knowing which particular assets the business holds), you know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to £2.5 million.

In this particular example, suppose that the total amount of the liabilities of the business is £1.0 million. This means that the total amount of *owners' equity* in the business is £1.5 million, which equals total assets less total liabilities. Without more information, we don't know how much of total owners' equity is traceable to capital invested by the owners in the business and how much is the result of profit retained in the business. But we do know that the total of these two sources of owners' equity is £1.5 million. The financial condition of the business in this example is summarised in the following *accounting equation* (in millions):

£2.5 Assets = £1.0 Liabilities + £1.5 Owners' Equity

Looking at this accounting equation, you can see why the statement of financial condition is also called the balance sheet; the equal sign means the two sides have to balance.

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

Summary flow reports

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

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

The balance sheet, profit and loss account, and cash flow statement constitute the hard core of a financial report to those persons outside a business who need to stay informed about the business's financial affairs. These individuals have invested capital in the business, or the business owes them money and therefore they have a financial interest in how well the business is doing. These three key financial statements are also used by the managers of a business to keep themselves informed about what's going on and the financial position of the business. They are absolutely essential to helping managers control the performance of a business, identify problems as they come up, and plan the future course of a business. Managers also need other information that is not reported in the three basic financial statements. (Part 3 of this book explains these additional reports.)

THE JARGON JUNGLE OF ACCOUNTING

TIP

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

Accounting and Financial Reporting Standards

Experience and common sense have taught business and financial professionals that uniform financial reporting standards and methods are critical in a free-enterprise, private, capital-based economic system. A common vocabulary, uniform accounting methods and full disclosure in financial reports are the goals. How well the accounting profession performs in achieving these goals is an open question, but few disagree that they are worthy goals to strive for.

The emergence of International Financial Reporting Standards (IFRS)

The accounting professional bodies, with a little prodding from governments, are responsible for ensuring that accounting reports conform to what are known as Generally Accepted Accounting Practices (GAAP). A newish entrant, International Accounting Standards, is challenging that term itself as GAAP rules have been interpreted differently on different continents and indeed largely ignored on others.

The rule book has to be adapted to accommodate changes in the way that business is done. For example, international business across frontiers is now the norm, so rules on handling currency and reporting taxable profits in different countries have to be accommodated within a company's accounts in a consistent manner.

Although you aren't usually expected to know all the rules – unless you're the accountant responsible for preparing your organisation's figures – try to get up-to-date before any meetings where the subject is likely to come up. You can keep track of changes in company reporting rules on the Institute of Chartered