2nd Edition

Financial Accounting for dummies

A Wiley Brand

Learn how to read a financial statement line by line

Identify various accounting concepts companies use

Explore how accountants put technology to work

Maire Loughran, CPA
Adjunct Full Professor of Financial Accounting

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for dummies®
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by Maire Loughran, CPA

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Contents at a Glance

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Introduction

Accounting is known as the language of business because it communicates financial and economic facts about a business to all sorts of interested parties — both *internal* (employees of the company) and *external* (people not employed by the company in question). External users include investors, creditors, banks, and regulatory agencies such as the Internal Revenue Service and the U.S. Securities and Exchange Commission.

Zeroing in on the external users of accounting information, this book is about financial accounting. *Financial* accounting serves the needs of external users by providing them with understandable, materially correct financial statements. There are three financial statements: the income statement, balance sheet, and statement of cash flows. This book is a step-by-step guide on how to prepare all three.

You also find out the purposes of the financial statements:

- To report on the financial position of the company — what types of assets the company owns and what types of liabilities it owes.
- To show how well the company performs over a period of time, which is referred to as an *accounting period.* You measure performance by seeing whether the company made or lost money during the accounting period.

A lot of first-time accounting students tell me that they are afraid they won't do well in their financial accounting class because they haven't done well in math classes they've taken in the past. Forgot about the math — that's why you have a computer and a calculator! Financial accounting is less about adding and subtracting than using logic-based skills. Added to the mix is the importance of gaining a working understanding of the standards set in place by authoritative accounting bodies.

After years spent in the classroom as both a professor and student, I realize that many accounting textbooks are, well, boring. My purpose in writing this book is to breathe some life into the subject of financial accounting and make it more understandable.

About This Book

This book, like all *For Dummies* books, is written so that each chapter stands on its own. I always assume that whatever chapter you're reading is the first one you've tackled in the book. Therefore, you can understand the concepts I explain in each chapter regardless of whether it's your first chapter or your last.

However, certain terms and concepts pertain to more than one subject in this book. To avoid writing the same explanations over and over, whenever I reference a financial accounting term, method, or other type of fact that I fully explain in another chapter, I give you a brief overview and direct you to the spot where you can get more information. For example, I may suggest that you "see Chapter 11" (which, by the way, discusses the statement of cash flows).

Also, in this book I break financial accounting down to its lowest common denominator. I avoid using jargon that only accounting majors with several accounting classes already under their belts will understand. Please keep in mind that the list of financial accounting topics and methods I present in this book isn't all-inclusive. I simply can't cover every possible nuance and twist related to preparing financial accounting data and statements. This book is meant to illuminate the rather dry presentation of topics given in all the financial accounting textbooks from which I've taught, providing a perfect companion to the financial accounting textbook your professor is using.

Furthermore, I briefly discuss the Sarbanes-Oxley Act of 2002 (SOX) and the watchdog over the audits of publicly traded companies, the Public Company Accounting Oversight Board (PCAOB). If you have the time, I recommend reading *Sarbanes-Oxley For Dummies* by Jill Gilbert Welytok, JD, CPA (published by Wiley). This handbook walks you through the new and revised SOX laws.

Foolish Assumptions

I assume you don't have more than a rudimentary knowledge of accounting, and I'm guessing you're one of the following people:

- A college financial accounting student who just isn't getting it by reading (and rereading) the assigned textbook. (I've seen that deer-in-the-headlights look many times in my classroom.)
- A non-accounting student currently enrolled in either business or liberal arts who's considering changing his major to accounting.

» A business owner (particularly someone operating a small business with gross receipts of under $1 million) who wants to attempt preparing her own financial statements or just wants to have a better understanding about the financial statements prepared by the in-house or external accountant.

» A brand-new accountant working in financial accounting who needs a plain-talk refresher of accounting concepts.

Icons Used in This Book

Throughout the book, you see the following icons in the left margin:

TIP

Text accompanied by this icon contains useful hints that you can apply during your class (or on the job) to make your studies (or work) a bit easier and more successful.

REMEMBER

When you see this icon, warm up your brain cells, because it sits next to information you want to commit to memory.

WARNING

Looking for what not to do in the world of financial accounting? Check out paragraphs next to this icon because they alert you to what can trip you up while taking your class or working in the field.

TECHNICAL STUFF

This icon includes information that enhances the topic under discussion but isn't necessary to understand the topic.

Beyond the Book

In addition to what you're reading right now, this product also comes with a free access-anywhere Cheat Sheet that talks about the three key financial statements and covers important terms and definitions. To get this Cheat Sheet, simply go to `www.dummies.com` and search for *Financial Accounting For Dummies* Cheat Sheet in the Search box.

Where to Go from Here

Each chapter stands on its own, so no matter where you start, you won't feel like you're coming in on a movie halfway through. Your motivation for purchasing this book will likely dictate which chapters you want to read first and which you'll read only if you have some spare time in the future.

If you're a financial accounting student, flip to the chapter explaining a topic you're a little fuzzy on after reading your textbook. Business owners can get a good overview of the financial accounting process by starting with Chapters 1 and 3; these two chapters explain the nuts and bolts of financial accounting and its concepts. Otherwise, check out the table of contents or index for a topic that interests you, or jump in anywhere in the book that covers the financial accounting information you're wondering about.

1

Getting a Financial Accounting Initiation

IN THIS PART . . .

Discover why financial accounting is so important to many different individuals and businesses.

Get a brief overview of the three financial statements: the balance sheet, income statement, and statement of cash flows.

Learn information relevant to small business owners.

Meet the various financial accounting standard-setting and regulatory organizations, such as the Financial Accounting Standards Board (FASB) and the U.S. Securities and Exchange Commission (SEC).

IN THIS CHAPTER

» Figuring out why financial accounting matters

» Meeting the financial accounting stakeholders

» Introducing key financial accounting characteristics

» Accepting ethical responsibilities

Chapter 1
Seeing the Big Picture of Financial Accounting

I assume that you have a very good reason for purchasing this book; most people don't buy a title like *Financial Accounting For Dummies* on a whim in the bookstore. Most likely, you're taking your first financial accounting class and want to be sure you pass it, but perhaps you're a business owner wanting to get a better handle on financial statement preparation. Whatever your motivation, this chapter is your jumping board into the pool of financial accounting.

I explain what financial accounting is and why it's so important to many different individuals and businesses. I spell out the various users of financial accounting data and explain why they need that data. Finally, I briefly introduce four all-important characteristics of financial accounting: relevance, reliability, comparability, and consistency. Whether you're a financial accounting student or a business owner, you need to understand these crucial financial accounting terms from the very beginning.

Knowing the Purposes of Financial Accounting

Broadly speaking, *accounting* is the process of organizing facts and figures and relaying the result of that organization to any interested customers of the information. This process doesn't just relate to numbers spit out by a computer software program; it pertains to any type of reconciliation.

Here's an example from my own life of accounting that doesn't involve numbers or money: A teenager slinks in after curfew, and his parent asks for a complete accounting of why he is late. When the teenager tells the facts, you have information (his car broke down in an area with no cell coverage), the individual producing the information (the mischievous teen), and the interested customer, also known as the user of the information (the worried parent).

The subject of this book, financial accounting, is a subset of accounting. *Financial accounting* involves the process of preparing financial statements for a business. (Not sure what financial statements are? No worries — you can find an overview of them in the next section.) Here are the key pieces of the financial accounting process:

- **Information:** Any accounting transactions taking place within the business during the accounting period. This includes generating revenue from the sales of company goods or services, paying business-related expenses, buying company assets, and incurring debt to run the company.
- **Business entity:** The company incurring the accounting transactions.
- **Users:** The persons or businesses that need to see the accounting transactions organized into financial statements to make educated decisions of their own. (More about these users in the "Getting to Know Financial Accounting Users" section of this chapter.)

Preparing financial statements

If you're taking a financial accounting class, your entire course is centered on the proper preparation of financial statements: the income statement, balance sheet, and statement of cash flows. Financial accountants can't just stick accounting transaction data on the statements wherever they feel like. Many, many rules exist that dictate how financial accountants must organize the information on the statements; these rules are called *generally accepted accounting principles* (GAAP), and I discuss them in Chapter 4. The rules pertain to both how the financial accountant shows the accounting transactions and on which financial statements the information relating to the transactions appears.

Curious about the purpose of each financial statement? (I know the mystery is eating at you!) Here's the scoop on each:

- **Income statement:** This financial statement shows the results of business operations consisting of revenue, expenses, gains, and losses. The end product is net income or net loss. I talk about the income statement in Chapter 2, and then I cover it from soup to nuts in Chapter 10. For now (because I know the excitement is too much for you!), here are the basic facts on the four different income statement components:
  - *Revenue:* Gross receipts earned by the company selling its goods or services.
  - *Expenses:* The costs to the company to earn the revenue.
  - *Gains:* Income from non-operating-related transactions, such as selling a company asset.
  - *Losses:* The flip side of gains, such as losing money when selling the company car.

  REMEMBER

  A lot of non-accountants call the income statement a *statement of profit or loss* or simply a *P&L*. These terms are fine to use because they address the spirit of the statement.
- **Balance sheet:** This statement has three sections: assets, liabilities, and equity. Standing on their own, these sections contain valuable information about a company. However, a user has to see all three interacting together on the balance sheet to form an opinion approaching reliability about the company.

  Part 3 of this book is all about the balance sheet, but for now here are the basics about each balance sheet component:
  - *Assets:* Resources owned by a company, such as cash, equipment, and buildings.
  - *Liabilities:* Debt the business incurs for operating and expansion purposes.
  - *Equity:* The amount of ownership left in the business after deducting total liabilities from total assets.
- **Statement of cash flows:** This statement contains certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show cash sources and uses during a specific period of time — in other words, how a company brings in cash and for what costs the cash goes back out the door.

Showing historic performance

The information reflected on the financial statements allows its users to evaluate whether they want to become financially involved with the company. But the financial statement users cannot make educated decisions based solely on one set of financial statements. Here's why:

- The income statement is finite in what it reflects. For example, it may report net income for the 12-month period ending December 31, 2021. This means any accounting transactions taking place prior to or after this 12-month window do not show up on the report.
- The statement of cash flows is also finite in nature, showing cash ins and outs only for the reporting period.

While the balance sheet shows results from the first day the company opens to the date on the balance sheet, it doesn't provide a complete picture of the company's operations. All three financial statements are needed to paint that picture.

REMEMBER

Savvy financial statement users know that they need to compare several years' worth of financial statements to get a true sense of business performance. Users employ tools such as ratios and measurements involving financial statement data (a topic I cover in Chapter 14) to evaluate the relative merit of one company over another by analyzing each company's historic performance.

Providing results for the annual report

After all the hoopla of preparing the financial statements, *publicly traded companies* (those whose stock and bonds are bought and sold in the open market) employ independent certified public accountants (CPAs) to audit the financial statements for their inclusion in reports to the shareholders. The main thrust of a company's annual report is not only to provide financial reporting but also to promote the company and satisfy any regulatory requirements.

The preparation of an annual report is a fairly detailed subject that your financial accounting professor will review only briefly in class. Your financial accounting textbook probably contains an annual report for an actual company, which you'll use to complete homework assignments. I provide a more expansive look at annual reports in Chapter 16.

Getting to Know Financial Accounting Users

Well, who are these inquisitive financial statement users I refer to in this chapter? If you've ever purchased stock or invested money in a retirement plan, you number among the users. In this section, I explain why certain groups of people and businesses need access to reliable financial statements.

Identifying the most likely users

Financial statement users fall into three categories:

- Existing or potential investors in the company's stocks or bonds.
- Individuals or businesses thinking about extending credit terms to the company. Examples of creditors include banks, automobile financing companies, and the vendors from which a company purchases its inventory or office supplies.
- Governmental agencies, such as the U.S. Securities and Exchange Commission (SEC), which want to make sure the company is fairly presenting its financial position. (I discuss the history and role of the SEC in Chapter 4.)

And what other governmental agency is particularly interested in whether a company employs any hocus pocus when preparing its financial statements? The Internal Revenue Service (IRS), of course, because financial statements are the starting point for reporting taxable income.

Recognizing their needs

REMEMBER

All three categories of financial statement users share a common need: They require assurance that the information they are looking at is both materially correct and useful. *Materially correct* means the financial statements don't contain any serious or substantial misstatements. In order to be useful, the information has to be understandable to anyone not privy to the day-to-day activities of the company.

Investors and creditors, though sitting at different ends of the table, have something else in common: They are looking for a financial return in exchange for allowing the business to use their cash. Governmental agencies, on the other hand, don't have a profit motive for reviewing the financial statements; they just want to make sure the company is abiding by all tax codes, regulations, or generally accepted accounting principles.

Providing information for decision-making

REMEMBER

The onus is on financial accountants to make sure a company's financial statements are materially correct. Important life decisions may hang in the balance based on an individual investing in one stock versus another. Don't believe me? Talk to any individual close to retirement age who lost his or her whole nest egg in the Enron debacle.

Two of the three groups of financial statement users are making decisions based on those statements: investors and creditors.

Creditors look to the financial statements to make sure a potential debtor has the cash flow and potential future earnings to pay back both principal and interest according to the terms of the loan.

Investors fall into two groups:

- **Those looking for growth:** These investors want the value of a stock to increase over time. Here's an example of growth at work: You do some research about a little-known company that is poised to introduce a hot new computer product into the market. You have $1,000 sitting in a checking account that bears no interest. You believe, based on your research, that if you purchase some stock in this company now, you'll be able to sell the stock for $2,000 shortly after the company releases the computer product.
- **Those looking for income:** These investors are satisfied with a steady stock that weathers ebbs and flows in the market. The stock neither increases nor decreases in value per share by an enormous amount, but it pays a consistent, reasonable dividend. (Keep in mind that reasonableness varies for each person and his or her investment income goals.)

REMEMBER

You can make money in two ways: the active way (you work to earn money) and the passive way (you invest money to make more money). Passive is better, no? The wise use of investing allows individuals to make housing choices, educate their children, and provide for their retirement. And wise investment decisions can be made only when potential investors have materially correct financial statements for the businesses in which they're considering investing.