Making Everything Easier!™

Accounting Workbook

FOR DUMMIES®

- Choose the right accounting methods for you
- Assemble a balance sheet from scratch
- Record profit and loss with confidence
- Keep a handle on your assets and liabilities all year round

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Accounting Workbook For Dummies®

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Accounting Workbook For Dummies®

by Jane Kelly and John A. Tracy

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About the Authors

Jane Kelly trained as a Chartered Management Accountant while working in industry. Her roles ranged from Company Accountant in a small advertising business to Financial Controller of a national housebuilding company. Jane has subsequently specialised in both using and teaching others how to use Sage software and also teaching people the bookkeeping basics.

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John A. Tracy is Professor of Accounting, Emeritus, at the University of Colorado in Boulder. Before his 35-year tenure at Boulder, he was on the business faculty for 4 years at the University of California in Berkeley. He has served as staff accountant at Ernst & Young and is the author of several books on accounting and finance, including *Accounting For Dummies* (Wiley). Dr. Tracy earned his MBA and PhD degrees from the University of Wisconsin.

Dedication

From Jane: I would like to dedicate this book to my daughter, Megan. I hope that she will be proud of her mum and maybe even write a book of her own one day – even if it is about Disney princesses and fairies!

From John: In memory of Gordon B. Laing – a gentleman and editor of the first rank.

Authors' Acknowledgements

From Jane: I hope that this book will help many small businesses understand the basic concepts of accounting. I can't emphasis enough the importance of setting up proper systems. With the right accounting systems in place, you'll have a better chance of surviving the current economic climate. If you have any comments or suggestions about this book or maybe have a question, please contact `jane@sycamoreonline.com`.

I would like to thank all those at Wiley who have made this publication possible: here's to the next project.

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Thanks to all of you! I hope I have done you proud with *Accounting Workbook For Dummies*.

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We're proud of this book; please send us your comments through our Dummies online registration form located at www.dummies.com/register/.

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Introduction

First of all, we have to admit that accounting has an image problem. Be honest: What's the first thing that pops into your mind when you see the word 'accountant'? You probably think of a nerd wearing a bad suit. Well, we've never worn a bad suit, and can assure you that we're not nerds. We own iPods, have a good sense of humour and to be honest we're pretty normal!

This book offers a different take on accounting – one that offers new insights and perspectives. We don't go out of our way to be contrary or confrontational, but accounting isn't an exact science. Accounting is full of controversy and differences of opinion. In this book, we state our opinions forcefully and (we hope) clearly.

About This Book

Whether it's a small family business or a large corporate, every business keeps track of its financial activities and its financial condition. You can't run a business without an accounting system that tells you whether you're making a profit or suffering a loss, whether you have enough cash to continue or your bank account balance is approaching zero, and whether you're in good financial shape or are on the edge of bankruptcy.

Accounting Workbook For Dummies is largely about business accounting. It explains how business transactions are recorded in the accounts of a business and the financial statements that are prepared for a business to report its profit and loss, financial condition and cash flows. It also explains how business managers use accounting information for decision making. (The book doesn't delve into business income taxation, which is the province of professional accountants.)

Most business managers have limited accounting backgrounds, and most have their enthusiasm for learning more about accounting well under control. But, deep down, they're likely to think that they should know more about accounting. Business managers will find this book quite helpful even if they just dip their toes in.

If you're a business bookkeeper or accountant, you can use this book to review the topics you need to know well. It can help you upgrade your accounting skills and lay the foundation for further advancement. One great thing about *Accounting Workbook For Dummies* is that it offers alternative explanations of accounting topics that are different from the explanations in standard accounting textbooks. The many questions and problems (with clearly explained answers) offer an excellent way to test your knowledge, and nobody knows your exam results but you.

If you're a student presently enrolled in a beginning accounting course, you can use this book as a supplementary study guide to your textbook, one that offers many supplementary questions and exercises. Perhaps you took an accounting course a few years ago and need to brush up on the subject. This book can help you refresh your understanding of accounting and help you recall things forgotten.

Foolish Assumptions

Mastering accounting is like mastering many subjects: First, you must understand the lingo and the fundamentals. In accounting, you have to work problems to really get a grasp of the topic and technique. Passive reading just isn't enough. In writing this book, we've assumed that you aren't a complete accounting neophyte. We designed the book as a second step that builds on your basic accounting knowledge and experience. If you have no previous exposure to accounting, you may want to consider first reading *Accounting For Dummies* (Wiley).

You don't have to be a maths wizard to understand accounting; basic school algebra is more than enough. However, you do have to pay attention to details, just as you have to pay close attention to the words when you study Shakespeare. Accounting involves calculations, and using a business/financial calculator is very helpful. In our experience, many people don't take the time to learn how to use their calculators. But that's time well spent. In many of the questions and problems posed throughout the book, we explain how to use a scientific calculator for the solution.

How This Book Is Organised

Accounting Workbook For Dummies consists of four parts that cover topics including recordkeeping basics, financial statements, accounting for business managers, and investment accounting. We wrap it all up with some advice about financial statements and tips for management accounting.

Part I: Business Accounting Basics

The general theme of the chapters in this part is how an accountant records the transactions of a business (its financial activities) in an accrual-basis accounting system and how the effects of transactions are reported in the three primary financial statements of a business – the profit and loss statement, the balance sheet and the cash flow statement. This part also includes a review of the bookkeeping cycle, from recording original entries through the adjusting and closing entries at year-end.

Part II: Preparing Financial Statements

This part examines the accounting issues and procedures involved in preparing the three primary financial statements of a business. Compared with the standard textbook approach to these topics, we put much more emphasis on the interconnections between the three financial statements. The statements fit together like a tongue-and-groove joint, and the chapters focus on these connections. This part closes with the decisions every business must make in choosing which accounting methods to use for recording profit.

Part III: Managerial, Manufacturing and Capital Accounting

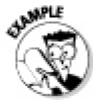
This part of the book examines how managers use accounting information when making business decisions. In addition to financial statements, managers need profit models for their decision-making analysis, and accountants should take the lead in designing useful profit models for managers. This part also explains how the product cost of manufactures is determined and the difficult accounting issues involved in measuring product cost. The last chapter of this part discusses the accounting measurement of interest and return on investment. Most people have a basic understanding of interest and return on investment, but when it gets right down to a specific situation, they're fuzzy on the details.

Part IV: The Part of Tens

Like all *For Dummies* books, *Accounting Workbook For Dummies* ends with a couple of chapters that provide tips to help you recall and apply important points sprinkled throughout the book. We provide two such chapters in this book – one being ten things you should know about business financial statements, and one being a ten-point checklist for management accountants.

Icons Used in This Book

Throughout this book, you can find useful 'pointers' that save you the trouble of buying a yellow highlighter pen and using sticky notes. These icons draw your attention to certain parts of the text. Think of them as road signs on your journey through accounting.



This icon marks the spot of an example question that explains and illustrates an important point. The answer follows the question. It’s a good idea to make sure that you understand the answer before attempting the additional questions on the topic. To get the most out of the example questions, don’t read the answer right away. First, try to answer the question, and then compare our answer with yours and how you got it.

This icon points out helpful information that might save time to make you a better accountant.

We use this icon to indicate that you need to bear these points in mind as you work your way through the book.

Simply put, this icon is a red flag that means ‘Watch out’. This warning sign means that the topic explained is a serious and troublesome issue in accounting, so pay close attention and handle it with care.

Where to Go from Here

Accounting Workbook For Dummies is designed to maximise modularity. Each chapter stands on its own feet to the fullest extent possible. Of course, it makes sense to read the chapters in order, but you can jump around as the spirit moves you.

You may be a business investor who's interested in interpreting return on investment (ROI) (Chapter 12), or you may want to review manufacturing cost accounting (Chapter 11). You may be a business manager who needs to know about analysing profit behavior (Chapter 10), or you may be confused about cash flow (Chapters 7 and 8). If you're a student studying for your first accounting exam, we suggest that you start with Part I and read the chapters in order.

In our view, a scientific calculator has become as essential as a TV remote control, and we highly recommend that you invest in one (a calculator, that is, not a remote control). Hewlett-Packard (HP) and Texas Instruments (TI) make very good ones. If you can avoid it, don't buy the cheapest model; the next one up usually has better financial functions and a good display.

Part I

Business 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 . . .

Accountants are the scorekeepers of business. Without accounting, a business couldn't function; it wouldn't know whether it's making a profit; and it wouldn't know its financial condition. Bookkeeping – the recording-keeping part of accounting – must be done well to make sure that all the financial information needed to run the business is complete, accurate and reliable. This part of the book walks you through the basic bookkeeping cycle – from making original entries through adjusting entries, to financial statements. Before jumping into the mechanics of bookkeeping, however, we explain the financial effects and the manifold effects of sales and expenses on assets and liabilities.

Chapter 1

Elements of Business Accounting

In This Chapter

- Working with the accounting equation
- Understanding the differences between cash- and accrual-based accounting
- Examining the three primary business financial statements
- Seeing the effects of crooked accounting on financial statements

The starting point in accounting is to identify the entity that you're accounting for. A business entity can be legally organised as a partnership, limited company (Ltd) or a public limited company (PLC). Alternatively, a business entity simply may consist of the business activities of an individual, in which case it's called a sole proprietorship. Regardless of how the business entity is legally established, it's treated as a separate entity or distinct person for accounting purposes.

Keeping the Accounting Equation in Balance

The accounting equation (Assets = Liabilities + Owners' capital) says a lot in very few words. This equation is like the visible part of an iceberg – loads of important points are hidden under the water.

Notice the two sides to the equation: assets on one side of the equals sign and claims against the assets on the other side. These claims arise from credit extended to the business (*liabilities*) and capital invested by owners in the business (*owners' capital*). (The claims of liabilities are significantly different to the claims of owners; liabilities have seniority and priority for payment over the claims of owners.)

Suppose that a business has £10 million total assets. These assets didn't fall down like manna from heaven (as one of the authors' old accounting professor was fond of saying). The money for the assets came from somewhere. The business's *creditors* (to whom the firm owes its liabilities) may have supplied, say, £4 million of its total assets. Therefore, the owners' capital sources provided the other £6 million.

Business accounting is based on the two-sided nature of the accounting equation. Both assets and sources of assets are accounted for, which leads, quite naturally, to *double entry accounting*. Double entry, in essence, means two-sided, and is based on the general economic exchange model, as follows: in economic transactions, something is given and something is received in exchange. For example, we recently bought an iPod from Apple Computer. Apple gave us the iPod and received our money. Another example involves a business that borrows money from its bank. The business signs a loan agreement promising to return the money at a future date and to pay interest over the time the money is borrowed. In exchange for the loan agreement, the business receives the money. (Check out Chapter 3 for how to implement double entry accounting.)

Q. Is each of the following equations correct? What key point does each equation raise?

a. £250,000 Assets = £100,000 Liabilities + £100,000 Owners' capital

b. £2,345,000 Assets = £46,900 Liabilities + £2,298,100 Owners' capital

c. £26,450 Assets = £675,000 Liabilities – £648,550 Owners' capital

d. £4,650,000 Assets = £4,250,000 Liabilities + £400,000 Owners' capital

A. Each accounting equation offers an important lesson.

a. Whoops! This accounting equation doesn't balance, and so clearly something's wrong. The Liabilities, owner's capital or some combination of both is £50,000 too low; or the two items on the right-hand side may be correct, in which case total assets are overstated £50,000. With an unbalanced equation such as this one, the accountant definitely needs to find the error or errors and make appropriate correcting entries.

b. This accounting equation balances, but, wow! Look at the very small size of liabilities relative to assets. This kind of contrast isn't typical. The liabilities of a typical business usually account for a much larger percentage of its total assets.

c. This accounting equation balances, but the business has a large negative owners' capital. Such a large negative amount of owners' capital means the business has suffered major losses that have wiped out almost all its assets. You wouldn't want to be one of this business's creditors (or one of its owners).

d. This accounting equation balances and is correct, but you should notice that the business is *highly leveraged*, which means that the ratio of debt to capital (liabilities divided by owners' capital) is very high, more than 10 to 1. This ratio is quite unusual.

1. Which of the following is the normal way to present the accounting equation?

a. Liabilities = Assets – Owners' capital

b. Assets – Liabilities = Owners' capital

c. Assets = Liabilities + Owners' capital

d. Assets – Liabilities – Owners' capital = 0

Solve It

2. A business has £485,000 total liabilities and £1,200,000 total owners' capital. What is the amount of its total assets?

Solve It

3. A business has £250,000 total liabilities. At start-up, the owners invested £500,000 in the business.

Unfortunately, the business has suffered a cumulative loss of £200,000 up to the present time. What is the amount of its total assets at the present time?

Solve It

4. A business has £175,000 total liabilities. At start-up, the owners invested £250,000 capital. The business has earned £190,000 cumulative profit since its creation, all of which has been retained in the business. What is the total amount of its assets?

Solve It

Distinguishing Between Cash- and Accrual-Based Accounting

Cash-based accounting refers to keeping a record of cash inflows and cash outflows. Individuals use cash-based accounting when keeping their chequebooks, because people need to know their day-to-day cash balance and need a journal of their cash receipts and cash expenditures during the year for filing their annual income tax returns.

Individuals have assets other than cash (such as cars, computers and homes), and they have liabilities (such as credit card balances and home mortgages). Hardly anyone we know keeps accounting records of their noncash assets and their liabilities (aside from putting bills to pay and receipts for major purchases in folders).

Most people keep a chequebook, and that’s all as regards their personal accounting.

Although it’s perfect for individuals, cash-based accounting just doesn’t make the grade for the large majority of businesses. Cash-based accounting doesn’t provide the information that managers need to run a firm or the information necessary to prepare business tax returns and financial reports. Some small businesses are able to use cash-based accounting for the filing of their VAT returns. There’s a turnover limit applied to VAT cash accounting; it can only be used if your estimated taxable turnover during the next tax year is not more than £1.35 million (correct at the time of writing).

> Most businesses apply *accrual-based accounting* methods. This method ensures that the business records revenue at the time the sale is made (rather than when the cash has been received for the goods), and records expenses to match with the sales revenue or at least in the period benefitted.

Most firms keep track of their cash inflows and outflows, of course, but accrual-based accounting allows them to record all the assets and liabilities of the business. Also, accrual-based accounting keeps track of the money the owners invested in the business and the accumulated profit retained in the business. In short, accrual-based accounting has a much broader scope than cash-based accounting.

A big difference between cash- and accrual-based accounting concerns how they measure annual profit of a business. With cash-based accounting, profit simply equals the total of cash inflows from sales minus the total