



Demystify business accounting with this  
straight-talking guide

# Understanding Business Accounting

FOR  
**DUMMIES**<sup>®</sup>

2nd Edition

**John A. Tracy**

*Former staff accountant at  
Ernst & Young*

**Colin Barrow**

*Venture capitalist and author of  
Starting a Business For Dummies*

**A Reference for the Rest of Us!**<sup>®</sup>

 **UK Edition**

# Understanding Business Accounting For Dummies,<sup>®</sup> 2nd Edition

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[TAS Books, www.tassoftware.co.uk](#)

[QuickBooks 2008, www.intuit.co.uk/quickbooks/](#)

[Instant Accounting, www.sage.co.uk](http://www.sage.co.uk)

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**by John A Tracy and  
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## About the Authors

**John A Tracy** is Professor of Accounting, Emeritus, in the College of Business and Administration at the University of Colorado in Boulder. Before his 35-year tenure at Boulder he was on the business faculty for four 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, including *The Fast Forward MBA in Finance* and *How To Read a Financial Report*. Dr Tracy received his MBA and PhD degrees from the University of Wisconsin and is a CPA in Colorado.

**Colin Barrow** is Head of the Enterprise Group at Cranfield School of Management, where he teaches entrepreneurship on the MBA and other programmes. He is also a visiting professor at business schools in the US, Asia, France, and Austria. His books on entrepreneurship and small business have been translated into fifteen languages including Russian and Chinese. He worked with Microsoft to incorporate the business planning model used in his teaching programmes into the software program, Microsoft Business Planner, now bundled with Office. He is a regular contributor to newspapers, periodicals, and academic journals such as *The Financial Times*, *The Guardian*, *Management Today*, and the *International Small Business Journal*.

Thousands of students have passed through Colin's start-up and business growth programmes, raising millions in new capital and going on to run successful and thriving enterprises. He is a non-executive director of two venture capital funds, on the board of several small businesses, and serves on a number of Government Task Forces.

# Authors'

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## **Dedication**

For all my grandchildren. —John A Tracy

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# Introduction

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Welcome 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 15,000,000 sold expense

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. 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 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