



Demystify business accounting with this
straight-talking guide

Understanding Business Accounting

FOR
DUMMIES[®]

2nd Edition

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A Reference for the Rest of Us![®]

 **UK Edition**

Understanding Business Accounting For Dummies,[®] 2nd Edition

Table of Contents

[Introduction](#)

[About This Book](#)

[Conventions Used in Financial Reports](#)

[Some Assumptions](#)

[How This Book Is Organised](#)

[Part I: Accounting Basics](#)

[Part II: Getting a Grip on Financial Statements](#)

[Part III: Accounting in Managing a Business](#)

[Part IV: Financial Reports in the Outside World](#)

[Part V: The Part of Tens](#)

[Part VI: Appendixes](#)

[Icons Used in This Book](#)

[Where to Go from Here](#)

[Part I: Accounting Basics](#)

[Chapter 1: Introducing Accounting to Non-Accountants](#)

[Accounting Everywhere You Look](#)

[The Basic Elements of Accounting](#)

Accounting and Financial Reporting Standards

The importance of GAAP and evolving accounting standards

Why the GAAP rules are important

Income tax and accounting rules

Flexibility in accounting standards

Enforcing Accounting Rules

Protecting investors: Sarbanes-Oxley and beyond

The Accounting Department: What Goes On in the Back Office

Focusing on Business Transactions and Other Financial Events

Taking a Closer Look at Financial Statements

The balance sheet

The profit and loss account

The cash flow statement

Accounting as a Career

Chartered Accountant (CA)

The Financial Controller: The chief accountant in an organisation

Chapter 2: Bookkeeping 101: From Shoe Boxes to Computers

Bookkeeping versus Accounting

Pedalling through the Bookkeeping Cycle

Managing the Bookkeeping and Accounting System

Categorise your financial information: The chart of accounts

Standardise source document forms and procedures

Don't be penny-wise and pound-foolish: The need for competent, trained personnel

Protect the family jewels: Internal controls

Keep the scale in balance with double-entry accounting

Check your figures: End-of-period procedures checklist

[Keep good records: Happy audit trails to you!](#)

[Look out for unusual events and developments](#)

[Design truly useful accounting reports for managers](#)

[Double-Entry Accounting for Non-Accountants](#)

[The two-sided nature of a business entity and its activities](#)

[Recording transactions using debits and credits](#)

[Juggling the Books to Conceal Embezzlement and Fraud](#)

[Chapter 3: Taxes, Taxes, and More Taxes](#)

[Taxing Wages and Property](#)

[Putting the government on the payroll: Employer taxes](#)

[Taxing everything you can put your hands on: Property taxes](#)

['Cause I'm the Tax Man: Value Added Tax](#)

[Taxing Your Bottom Line: Company Taxes](#)

[Different tax rates on different levels of business taxable income](#)

[Profit accounting and taxable income accounting](#)

[Deductible expenses](#)

[Non-deductible expenses](#)

[Equity capital disguised as debt](#)

[Chapter 4: Accounting and Your Personal Finances](#)

[The Accounting Vice You Can't Escape](#)

[The Ins and Outs of Figuring Interest and Return on Investment \(ROI\)](#)

[Individuals as borrowers](#)

[Individuals as savers](#)

[Individuals as investors](#)

[An Accounting Template for Retirement Planning](#)

[Part II: Getting a Grip on Financial Statements](#)

Chapter 5: Profit Mechanics

Swooping Profit into One Basic Equation

Measuring the Financial Effects of Profit-Making Activities

Preparing the balance sheet equation

Exploring the Profit-Making Process One Step at a Time

Making sales on credit

Depreciation expense

Unpaid expenses

Prepaid expenses

Stock (or Inventory) and cost of goods sold expense

So Where's Your Hard-Earned Profit?

Reporting Profit to Managers and Investors: The Profit and Loss Account

Reporting normal, ongoing profit-making operations

Reporting unusual gains and losses

Putting the profit and loss account in perspective

Chapter 6: The Balance Sheet from the Profit and Loss Account Viewpoint

Coupling the Profit and Loss Account with the Balance Sheet

Sizing Up Assets and Liabilities

Sales revenue and debtors

Cost of goods sold expense and stock

SA&G expenses and the four balance sheet accounts that are connected with the expenses

Fixed assets and depreciation expense

Debt and interest expense

Income tax expense

The bottom line: net profit (net income) and cash dividends (if any).

Financing a Business: Owners' Equity and Debt

Reporting Financial Condition: The Classified Balance Sheet

Current (short-term) assets

Current (short-term) liabilities

Costs and Other Balance Sheet Values

Growing Up

Chapter 7: Cash Flows and the Cash Flow Statement

The Three Types of Cash Flow

Setting the Stage: Changes in Balance Sheet Accounts

Getting at the Cash Increase from Profit

Computing cash flow from profit

Getting specific about changes in assets and liabilities

Presenting the Cash Flow Statement

A better alternative for reporting cash flow from profit?

Sailing through the Rest of the Cash Flow Statement

Investing activities

Financing activities

Free Cash Flow: What on Earth Does That Mean?

Scrutinising the Cash Flow Statement

Chapter 8: Getting a Financial Report Ready for Prime Time

Reviewing Vital Connections

Statement of Changes in Owners' Equity and Comprehensive Income

Making Sure that Disclosure Is Adequate

Types of disclosures in financial reports

Footnotes: Nettlesome but needed

Other disclosures in financial reports

Keeping It Private versus Going Public

[Nudging the Numbers](#)

[Fluffing up the cash balance by 'window dressing'](#)

[Smoothing the rough edges off profit](#)

[Browsing versus Reading Financial Reports](#)

[Part III: Accounting in Managing a Business](#)

[Chapter 9: Managing Profit Performance](#)

[Redesigning the External Profit and Loss Account](#)

[Basic Model for Management Profit and Loss Account](#)

[Variable versus fixed operating expenses](#)

[From operating profit \(EBIT\) to the bottom line](#)

[Travelling Two Trails to Profit](#)

[First path to profit: Contribution margin minus fixed expenses](#)

[Second path to profit: Excess over break-even volume contribution margin per unit](#)

[Calculating the margin of safety](#)

[Doing What-If Analysis](#)

[Lower profit from lower sales – but that much lower?](#)

[Violent profit swings due to operating leverage](#)

[Cutting sales price, even a little, can gut profit](#)

[Improving profit](#)

[Cutting prices to increase sales volume: A very tricky game to play!](#)

[Cash flow from improving profit margin versus improving sales volume](#)

[A Final Word or Two](#)

[Chapter 10: Business Budgeting](#)

[The Reasons for Budgeting](#)

[The modelling reasons for budgeting](#)

[Planning reasons for budgeting](#)

[Management control reasons for budgeting](#)

[Other benefits of budgeting](#)

[Budgeting and Management Accounting](#)

[Budgeting in Action](#)

[Developing your profit strategy and budgeted profit and loss account](#)

[Budgeting cash flow from profit for the coming year](#)

[Capital Budgeting](#)

[Calculating payback](#)

[Discounting cash flow](#)

[Calculating the internal rate of return](#)

[Staying Flexible with Budgets](#)

[Chapter 11: Choosing the Right Ownership Structure](#)

[From the Top Line to the Bottom Line](#)

[What Owners Expect for Their Money](#)

[Companies](#)

[Partnerships and limited partnerships](#)

[Sole proprietorships](#)

[Limited companies \(Ltd\) and public limited companies \(plc\)](#)

[Choosing the Right Legal Structure for Tax Purposes](#)

[Companies](#)

[Partnerships, limited liability partnerships, and sole proprietorships](#)

[Deciding which legal structure is best](#)

[Chapter 12: Cost Conundrums](#)

[Previewing What's Coming Down the Road](#)

[What Makes Cost So Important?](#)

Sharpening Your Sensitivity to Costs

Direct versus indirect costs

Fixed versus variable costs

Breaking even

Relevant versus irrelevant (sunk) costs

Separating between actual, budgeted, and standard costs

Product versus period costs

Putting Together the Pieces of Product Cost for Manufacturers

Minding manufacturing costs

Allocating costs properly: Not easy!

Calculating product cost

Fixed manufacturing costs and production capacity

Excessive production output for puffing up profit

A View from the Top Regarding Costs

Chapter 13: Choosing Accounting Methods

Decision-Making Behind the Scenes in Profit and Loss Accounts

Calculating Cost of Goods Sold and Cost of Stock

The FIFO method

The LIFO method

The average cost method

Identifying Stock Losses: Net Realisable Value (NRV)

Appreciating Depreciation Methods

Collecting or Writing Off Bad Debts

Reconciling Corporation Tax

Two Final Issues to Consider

Part IV: Financial Reports in the Outside World

Chapter 14: How Investors Read a Financial Report

Financial Reporting by Private versus Public Businesses

Analysing Financial Reports with Ratios

Gross margin ratio

Profit ratio

Earnings per share, basic and diluted

Price/earnings (P/E) ratio

Dividend yield

Book value per share

Return on equity (ROE) ratio

Current ratio

Acid-test ratio

Return on assets (ROA) ratio

Frolicking through the Footnotes

Checking for Ominous Skies on the Audit Report

Finding Financial Facts

Public company accounts

Private company accounts

Scoring credit

Chapter 15: Professional Auditors and Advisers

Why Audits?

Who's Who in the World of Audits

What an Auditor Does Before Giving an Opinion

What's in an Auditor's Report

True and fair, a clean opinion

Other kinds of audit opinions

[Do Audits Always Catch Fraud?](#)

[Looking for errors and fraud](#)

[What happens when auditors spot fraud](#)

[Auditors and GAAP](#)

[From Audits to Advising](#)

[Part V: The Part of Tens](#)

[Chapter 16: Ten Ways Savvy Business Managers Use Accounting](#)

[Make Better Profit Decisions](#)

[Understand That a Small Sales Volume Change Has a Big Effect on Profit](#)

[Fathom Profit and Cash Flow from Profit](#)

[Profit accounting methods are like hemlines](#)

[The real stuff of profit](#)

[Govern Cash Flow Better](#)

[Call the Shots on Your Management Accounting Methods](#)

[Build Better Budgets](#)

[Optimise Capital Structure and Financial Leverage](#)

[Develop Better Financial Controls](#)

[Minimise Tax](#)

[Explain Your Financial Statements to Others](#)

[Chapter 17: Ten Places a Business Gets Money From](#)

[Major Stock Markets](#)

[Minor Stock Markets](#)

[Private Equity](#)

[Business Angels](#)

[Banks: Long-Term Money](#)

[Banks: Short-Term Money](#)

[Leasing and Hire-Purchase](#)

[Factoring and Invoice Discounting](#)

[Grants and Incentives](#)

[Using the Pension Fund](#)

[Chapter 18: Ten \(Plus One\) Questions Investors Should Ask When Reading a Financial Report](#)

[Did Sales Grow?](#)

[Did the Profit Ratios Hold?](#)

[Were There Any Unusual or Extraordinary Gains or Losses?](#)

[Did Earnings Per Share Keep Up with Profit?](#)

[Did the Profit Increase Generate a Cash Flow Increase?](#)

[Are Increases in Assets and Liabilities Consistent with the Business's Growth?](#)

[Are There Any Signs of Financial Distress? Will the Business Be Able to Pay Its Liabilities?](#)

[Are There Any Unusual Assets and Liabilities?](#)

[How Well Are Assets Being Utilised?](#)

[What Is the Return on Capital Investment?](#)

[What Does the Auditor Say?](#)

[Part VI: Appendixes](#)

[Appendix A: Glossary: Slashing through the Accounting Jargon Jungle](#)

[Appendix B: Accounting Software](#)

[Money 2007, www.microsoft.co.uk](#)

[MYOB, www.myob.co.uk](#)

[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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Authors'

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Dedication

For all my grandchildren. —John A Tracy

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Introduction

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