LEARNING MADE EASY

3rd Edition

Accounting For Canadians

for dummies®
A Wiley Brand

Analyze and manage profits

Understand financial statements and accounting standards

Prepare and use financial reports

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Accounting For Canadians

3rd Edition

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Contents at a Glance

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Introduction

You may know individuals who make their living as accountants. You may be thankful that they're the accountants and you're not. You may prefer to leave accounting to the accountants, and think that you don't need to know anything about accounting. This attitude evokes the old Greyhound Bus advertising slogan "Leave the Driving to Us." Well, if you could get around everywhere you wanted to go on the bus, that would be okay. But if you have to drive most places, you'd better know something about cars. You do a lot of "financial driving," so you should know something about accounting as well.

Sure, accounting involves numbers. So does watching your car mileage, knowing your vital health statistics, keeping track of your bank balance, negotiating the interest rate on your home mortgage, monitoring your retirement fund, and bragging about your kid's grade point average. You deal with numbers all the time. Accountants provide *financial numbers.* These numbers are important in your financial life. Knowing nothing about financial numbers puts you at a serious disadvantage. In short, financial literacy requires a working knowledge of accounting, which this book provides.

About This Book

Here are some advantages this book offers over other accounting texts:

- We explain accounting in plain English with a minimum of jargon and technical details. (We also provide a glossary of accounting terms in the back of the book.)
- We carefully follow a step-by-step approach in explaining topics.
- We include only topics that non-accountants should understand; we avoid topics that only practising accountants have to know.
- We provide frank discussions of certain sensitive topics that go unmentioned in many accounting books.
- We've set up the book so you can read the chapters in any order you please. You can tailor your reading plan to give priority to the chapters of most interest to you and read other chapters as time permits.

We want to emphasize that this book is *not* an accounting textbook. Introductory accounting textbooks are ponderous, dry as dust, and overly detailed. However, textbooks have one advantage: They include exercises and problems. If you have the time, you can gain additional insights and test your understanding of accounting by working the exercises in *Accounting Workbook For Dummies* (Wiley).

Foolish Assumptions

Although we assume that you have a basic familiarity with the business world, we take nothing for granted 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 because it should provide insights you haven't thought of before.

We've written this book with a wide audience in mind. You should find yourself more than once in the following list of potential readers:

- **Business managers (at all levels):** Trying to manage a business without a good grip on financial statements can lead to disaster. How can you manage your business's financial performance if you don't even understand the financial statements?
- **Business buyers and sellers:** Anyone thinking of buying or selling a business should know how to read its financial statements and how to "true up" the accounting reports that serve as the basis for setting a market value on the business.
- **Entrepreneurs:** As budding business managers, entrepreneurs need a solid grasp of accounting basics.
- **Active investors:** Investors in marketable securities, real estate, and other ventures need to know how to read financial statements both to stay informed about their investments and to spot any signs of trouble.
- **Passive investors:** Many people let the pros manage their money by investing in mutual funds or using investment advisers. Even so, they need to understand the investment performance reports they get, which use plenty of accounting terms and measures.
- **Accountants to be:** This book is a good first step for anyone considering a career in professional accounting.
- **Bookkeepers:** By strengthening their knowledge of accounting, bookkeepers can improve their effectiveness and value to the organization and advance their careers.

- **People who want to take control of their personal finances:** Many aspects of managing your personal finances involve accounting vocabulary and the accounting-based calculation methods.
- **Anyone interested in economic, business, and financial news:** Articles in the *Financial Post* and other financial news sources are heavy with accounting terms and measures.
- **Administrators and managers of government and not-for-profit entities:** Although making profit is not the goal of these entities, the focus is still on the bottom line because the entity has to stay within its revenue limits and keep on a sound financial footing.
- **Politicians at municipal, provincial, and federal levels:** These men and women pass many laws having significant financial consequences, and the better they understand accounting, the better their votes should be (we hope).
- **Investment bankers, institutional lenders, and loan officers:** We don't have to tell these folks that they need to understand accounting; they already know.
- **Business and finance professionals:** This group includes lawyers and financial advisers, of course, but even clergy counsel their flock on financial matters occasionally.

We could put others in the preceding list. But we think you get the idea that many different people need to understand the basics of accounting.

Icons Used in This Book

The following icons can help you find information quickly and easily.

REMEMBER

This icon points out important ideas and accounting concepts that are particularly deserving of your attention. The material this icon marks describes concepts that are the undergirding and building blocks of accounting — be clear about these concepts because they will clarify your understanding of accounting principles in general.

TIP

This icon calls your attention to useful advice on practical financial topics. It saves you the cost of buying a yellow highlighter.

WARNING

This icon is like 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 tire. In short — watch out!

TECHNICAL STUFF

We use this icon sparingly; it refers to specialized accounting stuff that is heavy going, which only a professional accountant 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 and stay with the main discussion.

Beyond the Book

This book is packed with useful information, but if you're looking for a super-compact overview of the most important points, check out the online Cheat Sheet. Simply go to `www.dummies.com` and search for "Accounting For Canadians For Dummies Cheat Sheet" in the Search box. You'll find FAQs on financial statements, accounting tips for business managers, and definitions of key accounting terms.

Where to Go from Here

There's no law against starting on page 1 and reading through to the last page. However, you may first want to scan the book's Table of Contents and see which chapters pique your interest.

Perhaps you're an investor who is very interested in finding out more about financial statements and the key financial statement ratios for investors. If so, you might start with Chapters 4, 5, and 6, which explain the three primary financial statements of businesses, and finish with Chapter 10, on reading a financial report. (And don't overlook Chapter 16.)

Perhaps you're a small business owner or manager with a basic understanding of your financial statements, but you need to improve how you use accounting information for making your key profit decisions, and for planning and controlling your cash flow. You might jump right into Chapters 12 and 14, which explain the analysis of profit behaviour and budgeting cash flows.

The book is not like a five-course dinner, where you have to eat the food in the order in which it is served. Instead, it's more like a buffet line from which you can pick and choose, and eat in whatever order you like.

1

Opening the Books on Accounting

IN THIS PART . . .

Discover how accountants are the financial information gatekeepers in the economy and why accounting is so important for for-profit businesses, not-for-profit organizations, and government agencies.

Find out how a business or other entity prepares its financial statements, its tax returns, and the reports to its managers. Know how to make sure these documents conform to established standards.

Get the lowdown on bookkeeping — the recordkeeping part of accounting — to ensure that a business's financial information is timely, complete, accurate, and reliable, especially the numbers reported in financial statements and tax returns.

IN THIS CHAPTER

- » Realizing how accounting is relevant to you
- » Grasping how all economic activity requires accounting
- » Watching an accounting department in action
- » Shaking hands with business financial statements
- » Considering an accounting career

Chapter 1

Accounting: The Language of Business, Investing, Finance, and Taxes

Accounting is all about financial information — capturing it, recording it, configuring it, analyzing it, and reporting it to persons who use it. We don't say much about how accountants capture, record, and configure financial information in this book. But we talk a lot about how accountants communicate information in financial statements, and we explain the *valuation methods* or *measurement methods* accountants use — ranging from measuring profit and loss to putting values on a business's assets and liabilities.

As you go through life, you come face to face with accounting information more than you would ever imagine. Regrettably, much of this information is not self-explanatory or intuitive, and it does not come with a user's manual. Accounting information is presented with the assumption that you have a basic familiarity with the vocabulary of accounting and the accounting methods used to generate the information. In short, most of the accounting information you encounter is not transparent. The main reason for studying accounting is to understand its vocabulary and its valuation and measurement methods so you can make more intelligent use of the information.

People who use accounting information should know the basic rules of play and how the financial score is kept, much like spectators at a hockey or baseball game. The purpose of this book is to make you a knowledgeable spectator of the accounting game.

REMEMBER

You should know accounting basics for another reason, too — we call it the *defensive* reason. Some people in the financial world might take advantage of you, not necessarily by illegal means but by withholding key information and by diverting your attention from unfavourable aspects of certain financial decisions. The best defence against such tactics is to know some accounting, which can help you ask the right questions and understand the financial points that con artists don't want you to know.

Accounting Is Not Just for Accountants

One main source of accounting information is in the form of *financial statements* packaged with other information in a *financial report.* Accountants keep the books and record the financial activities of an entity (such as a business). From these detailed records, the accountant prepares financial statements that summarize the results of the activities.

Financial statements are sent to people who have a stake in the outcomes of the activities. If you own shares in BCE, for example, or you have money in a mutual fund, you receive regular financial reports. If you invest your hard-earned money in a private business or a real estate venture, or you save money in a bank, you receive regular financial reports. If you're a member of a not-for-profit association or organization, you're entitled to receive regular financial reports.

REMEMBER

In summary, one important reason for studying accounting is to make sense of the financial statements in the financial reports you get. We guarantee that Warren Buffett knows accounting and how to read financial statements.

Affecting both insiders and outsiders

People who need to know accounting fall into two broad groups: insiders and outsiders. Business managers are insiders; they have the authority and responsibility to run a business. They need a good understanding of accounting terms and the methods used to measure profit and put values on assets and liabilities. Accounting information is indispensable for planning and controlling the business's financial performance and condition. Likewise, administrators of not-for-profit and governmental entities need to understand the accounting terminology and measurement methods in their financial statements.

REMEMBER

The rest of us are outsiders. We are not privy to the day-to-day details of a business or an organization. We have to rely on financial reports from the entity to know what's going on. Therefore, we need to have a good grip on the financial statements included in the financial reports. For all practical purposes, financial reports are the only source of financial information we get directly from a business or other organization.

By the way, the business's employees — even though they obviously have a stake in the business's success — do not necessarily receive its financial reports. Only the investors in the business and its lenders are entitled to receive the financial reports. Of course, a business *could* provide this information to those of its employees who are not shareowners, but generally speaking most businesses do not. The financial reports of public businesses are in the public domain, so their employees can easily view them on the Internet.

In our personal financial lives, a little accounting knowledge is a big help for understanding investing in general and how investment performance is measured, as well as many other important financial topics. With some basic accounting knowledge, you'll sound more sophisticated when speaking with your banker or broker. We can't promise that understanding accounting will save you big bucks on your income taxes, but it can't hurt and will definitely help you know what your tax preparer is talking about.

Keep in mind that this is *not* a book on bookkeeping and recordkeeping systems. We offer a brief explanation of procedures for capturing, processing, and storing accounting information in Chapter 3. Even experienced bookkeepers and accountants should find some nuggets in that chapter. However, this book is directed to users of accounting information. We focus on the end products of accounting, particularly financial statements, and not how information is accumulated. When buying a new car, you're interested in the finished product, not details of the manufacturing process that produced it.

Overcoming the stereotypes of accountants

A cartoon showed the young son of clowns standing in a circus tent dressed as a clown but holding a business briefcase. He is telling his clown parents that he is running away to join a CPA firm. Why is this funny? Because it plays off the stereotype of the CPA (Chartered Professional Accountant) as a "bean counter" who wears a green eyeshade and has the personality of an undertaker (no offence to morticians). Maybe you've heard the joke that an accountant with a personality is one who looks at *your* shoes when he is talking to you, instead of his own shoes.

Like most stereotypes, an element of truth exists in the preconceived image of accountants. We have met and known a large number of accountants, and most are not as gregarious as used-car sales people. Accountants certainly are more detail-oriented than your average person. However, you don't have to be good at mathematics to be a good accountant, because they use very little math (no calculus and only simple algebra). Accountants are very good at one thing: They want to see both sides of financial transactions — the give and take. They know better than anyone that, as economists are fond of saying, there's no such thing as a free lunch.

If you walked down a busy street in Vancouver, Toronto, or Montreal, we doubt that you could pick out the accountants. We have no idea whether accountants have higher or lower divorce rates than others, whether they go to church more frequently, or whether they generally sleep well at night. We do think that accountants are more honest in paying their income taxes than other people, although we have no proof of this.

Relating accounting to your personal financial life

We're sure you know the value of understanding personal finance and investing fundamentals. (We can recommend *Personal Finance For Canadians For Dummies*, 5th Edition, and *Investing For Canadians For Dummies*, 3rd Edition, by Eric Tyson and Tony Martin, both published by Wiley.) Well, a great deal of the information you use in making personal finance and investing decisions is *accounting information.* One knock we have on books in these areas is that they often don't make clear that you need a basic understanding of accounting terminology and valuation methods to make good use of the financial information.

You have a stake in the financial performance of the business you work for, the government entities you pay taxes to, the churches and charitable organizations you donate money to, the retirement plan you participate in, and the businesses you buy from. The financial performance and viability of these entities has a direct bearing on your personal financial life and well-being.

REMEMBER

We're all affected by the profit performance of businesses, even though we may not be fully aware of just how their profit performance affects our jobs, investments, and taxes. For example, as an employee your job security and your next raise depend on the business making a profit. If the business suffers a loss, you might be laid off or asked to take a reduction in pay or benefits. Business managers get paid to make profits happen. If the business fails to meet its profit objectives or suffers a loss, its managers might be replaced (or at least not get their bonuses). As authors, we hope our publisher continues to make a profit so we can keep receiving royalty cheques.

Your investments in businesses, whether direct or through retirement accounts and mutual funds, suffer if the businesses don't turn a profit. We hope the stores we trade with make profits and continue in business. The federal government and many provinces depend on businesses making profits to collect income taxes from them.

Looking for Accounting in All the Right Places

Accounting extends into virtually every walk of life. You're doing accounting when you make electronic fund transfers and when you 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 accounting basics to figure their return on invested capital. And it goes without saying that every organization, profit-motivated or not, needs to know how it stands financially.

Check out this quick sweep to get an idea of the range of accounting:

- Accounting for organizations and accounting for individuals
- Accounting for profit-motivated businesses and accounting for not-for-profit organizations (such as hospitals, condominium corporations, churches, banks, and colleges)
- Income tax accounting while you are living, and even at death
- Accounting for farmers who grow their products, accounting for miners who extract their products from the earth, accounting for producers who manufacture products, and accounting for retailers who sell products that others make

- Accounting for businesses and professional firms that sell services rather than products, such as the legal, entertainment, and transportation industries
- Past-historical-based accounting and future-forecast-oriented accounting (budgeting, forecasting and financial planning)
- Accounting where periodic financial statements are legally mandated (public companies are the primary example) and accounting where such formal accounting reports are not legally required
- Accounting that adheres to historical cost (mainly businesses), and accounting that records changes in market value (investment property firms, for example)
- Accounting in the private sector of the economy and accounting in the public (government) sector
- Accounting for going-concern businesses that will be around for some time and accounting for businesses in bankruptcy that might not be around tomorrow

Accounting is necessary in a free-market, capitalist economic system. It's equally necessary in a centralized, government-controlled, socialist economic system. All economic activity requires information. 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, institutions, individuals, and other players in the economic system.

Some of the earliest records of history are the accounts of wealth and trading activity. The need for accounting information was a main incentive in the development of the numbering system we use today. The history of accounting is interesting (but beyond the scope of this book).

Taking a Peek behind the Scenes

Every business, government, and not-for-profit entity needs a reliable bookkeeping system (see Chapter 3). Keep in mind that *accounting* is a much broader term than *bookkeeping.* For one thing, accounting encompasses the problems in measuring the financial effects of economic activity. Furthermore, accounting includes the function of *financial reporting* of values and performance measures to those who need the information. Business managers and investors, and many other people, depend on financial reports for information about the performance and condition of the entity.

Bookkeeping refers to the process of accumulating, organizing, storing, and accessing the financial information base of an entity, which is needed for two basic purposes:

- Facilitating the day-to-day operations of the entity
- Preparing financial statements, tax returns, and internal reports to managers

Bookkeeping (also called *recordkeeping*) can be thought of as the financial information infrastructure of an entity. Of course the financial information base should be complete, accurate, and timely. Every recordkeeping system needs quality controls built into it, which are called *internal controls* or *internal accounting controls.*

REMEMBER

Accountants design the internal controls for the bookkeeping system, which serve to minimize errors in recording the large number of activities that an entity engages in over the period. The internal controls that accountants design are also relied on to detect errors and deter theft, embezzlement, fraud, and dishonest behaviour of all kinds. In accounting, internal controls are the ounce of prevention that is worth a pound of cure.

We explain internal controls in Chapter 3. Here, we want to stress the importance of the bookkeeping system in operating a business or any other entity. These back-office functions are essential for keeping operations running smoothly, efficiently, and without delays and errors. This is a tall order, to say the least.

Most people don't realize the importance of the accounting department in keeping a business operating without hitches and delays. That's probably because accountants oversee many of the back-office functions in a business — as opposed to sales, for example, which is front-line activity, out in the open and in the line of fire. Go into any retail store, and you're in the thick of sales activities. But have you ever seen a company's accounting department in action?

Folks might not think much about these back-office activities, but they would notice if those activities didn't get accomplished. On payday, a business had better not tell its employees, "Sorry, but the accounting department is running a little late this month; your pay will be deposited to your account later." And when a customer insists on up-to-date information about how much he or she owes to the business, the accounting department can't very well say, "Oh, don't worry. Just wait a week or so and we'll get the information to you then."

Typically, the accounting department is responsible for the following:

- **Payroll:** The total wages and salaries earned by every employee every pay period, which are called *gross wages* or *gross earnings,* have to be calculated. Based on detailed private information in personnel files and earnings-to-date information, the correct amounts for income taxes and several other deductions from gross wages have to be determined.

Stubs, or *pay statements,* report various information are produced each pay period and given to the employee. The total amounts of withheld income taxes, Canada or Quebec Pension Plans, and Employment Insurance premiums imposed on the employee and employer have to be paid to the federal government (and, in the case of Quebec, the provincial government) on time. Retirement, vacation, sick pay, and other benefits that employees earn have to be updated every pay period.

In short, payroll is a complex and critical function that the accounting department performs. Many businesses outsource payroll functions to companies or banks that specialize in this area.

- **Cash collections:** All cash received from sales and from all other sources has to be carefully identified and recorded, not only in the cash account but also in the appropriate account for the source of the cash received. The accounting department makes sure that the cash is deposited in the appropriate business chequing accounts and that the business keeps an adequate amount of coin and currency on hand for making change for customers. Accountants balance the business's bank account and control who has access to incoming cash receipts. (In larger organizations, the *treasurer* might be responsible for some of these cash flow and cash-handling functions.)
- **Cash payments (disbursements):** In addition to electronic payroll payments, a business writes many other cheques during the course of a year to pay for a wide variety of purchases, to pay property taxes, to repay loan principal and interest, and to distribute some of its profits to the business's owners, for example. The accounting department prepares all these cheques for the signatures of the business officers who are authorized to sign cheques. The accounting department keeps all the supporting business documents and files to know when the cheques should be paid, makes sure that the amount to be paid is correct, and forwards the cheques for signature.

  More and more businesses are switching to electronic methods of payments, which avoid the need for writing and mailing cheques. Electronic access to accounts must be carefully protected not only to guard against hackers but also to make sure that employees make only authorized payments.
- **Purchasing and inventory:** Accounting departments usually are responsible for keeping track of all purchase orders that have been placed for *inventory* (products to be sold by the business) and all other assets and services that the business buys — from office supplies to forklifts. A typical business makes many purchases during the year, many of them on credit, which means that the business receives items bought today but pays for them later. This area of responsibility includes keeping files on all liabilities that arise from purchases on credit so that cash payments are processed on time. The accounting department also keeps detailed records on all products that the business holds for sale and, when the products are sold, records the cost of the goods sold.

- **Costing:** Costs are not as obvious as you might think. Tell someone that the cost of a new car is so many dollars, and most people accept the amount without question. Business owners and managers know better. Many decisions have to be made regarding which factors to include in the manufacturing cost of a product or in the purchase costs of products sold by retailers such as Costco and Wal-Mart. Tracking costs is a major function of accounting in all businesses.
- **Property accounting:** A typical business owns many different substantial long-term assets called *property, plant, and equipment* — including office furniture and equipment, retail display cabinets, computers, machinery and tools, vehicles (autos and trucks), buildings, and land. Except for relatively small-cost items, such as screwdrivers and wrenches, a business maintains detailed records of its property, both for controlling the use of the assets and for determining the appropriate amount of depreciation for accounting and tax calculations. The accounting department keeps these property records.
- **Liabilities accounting:** An entity must keep track of all relevant details about every liability it owes — from short-term purchases on credit to long-term notes payable. No entity can lose track of a liability and not pay it on time (or negotiate an extension) without hurting its credit rating.

The accounting department serves other functions as well, but this list gives you a clear idea of the back-office functions that the accounting department performs. A business could not operate if the accounting department did not do these functions efficiently and on time. We repeat one point: To do these back-office functions well, the accounting department must design a good bookkeeping system and make sure that it is accurate, complete, and timely.

Focusing on Transactions

REMEMBER

Accounting focuses on transactions. A good bookkeeping system captures and records every transaction that takes place. *Transactions* are economic exchanges between a business or other entity and the parties with which the entity interacts and makes deals. Transactions are the lifeblood of every business, the heartbeat of activity that keeps it going. Understanding accounting, to a large extent, means understanding how accountants record the financial effects of transactions.

The financial effects of many transactions are clear-cut and immediate. However, figuring out the financial effects of other transactions is puzzling and dependent on future developments that can be difficult to predict. Accounting for transactions is not always a cut-and-dried process.

Separating basic types of transactions

A business is a whirlpool of transactions. Accountants categorize transactions into three broad types:

- **Profit-making transactions** consist of *revenue* and *expenses* as well as gains and losses outside the normal sales and expense activities of the business. We explain earlier in the chapter that one way to look at profit is as an increase in retained earnings. Another way of defining *profit* is as the amount of total revenue for the period minus all expenses for the period. Both viewpoints are correct.

  Included in this group of transactions are those that take place before or after the recording of revenue and expenses. For example, a business buys merchandise that will be held for future sale. The purchase of the merchandise is not yet an expense. The expense is not recorded until the merchandise is sold. The purchase of merchandise for future sale must be recorded when the purchase takes place.

- **Investing transactions** refer to the acquisition (and eventual disposal) of *long-term operating assets* such as buildings, heavy machinery, trucks, and office furniture. Some businesses also invest in *financial assets* (shares and bonds, for example). These are not used directly in the operations of the business; the business could get along without these assets. These assets generate investment income for the business. Investments in financial assets are included in this category of transactions.

- **Financing transactions** refer to raising capital and paying for the use of the capital. Every business needs assets to carry on its operations, such as a working balance of cash, inventory of merchandise held for sale, and long-term operating assets (as described in the preceding bullet point). Broadly speaking, the capital to buy these assets comes from two sources: debt and equity. *Debt* is borrowed money, on which interest is paid. *Equity* is ownership capital. The payment for using equity capital depends on the capability of the business to earn profits and have the cash flow to distribute some or all of the profit to its shareholders.

TIP

Profit-making transactions, also called *operating activities*, are high frequency. During the year, even a small business has thousands of revenue and expense transactions. (How many cups of coffee, for example, does your local coffee store sell each year? Each sale is a transaction.) In contrast, investing and financing transactions are generally low frequency. A business does not have a high volume of these types of transactions, except in unusual circumstances.