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7th Edition

Accounting

for
dummies[®]

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Understand and
improve business profits

—
Advance your knowledge of
accounting in the digital age

—
Prepare and utilize
financial reports

John A. Tracy, CPA

Professor emeritus of accounting

Tage C. Tracy, CPA

Accounting and financial professional



Accounting

7th Edition

by John A. Tracy, CPA, and
Tage C. Tracy, CPA

for
dummies
A Wiley Brand

Accounting For Dummies®, 7th Edition

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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 reminds us of 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 no problem. But if you have to drive most places, you'd better know something about cars. Throughout your life, you do lots of "financial driving," and you should know something about accounting.

Sure, accounting involves numbers. So does watching your car mileage, knowing your blood pressure, 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, and these numbers are very 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, and we keep jargon and technical details to a minimum.

- » We carefully follow a step-by-step approach in explaining topics.
- » We include only topics that nonaccountants should understand. We avoid topics that only practicing accountants have to know.
- » We include candid discussions of sensitive accounting topics that go unmentioned in many books.
- » We combine our vast experience of both theoretical accounting (that is, how it is taught in the classroom) with actual practiced accounting (how accounting is applied in real-world businesses) to provide a deeper, more robust, and practical approach to understanding accounting.
- » 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 should mention one thing: This book is *not* an accounting textbook. Introductory accounting textbooks are dry as dust and overly detailed. However, textbooks have one useful feature: 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 and short problems in coauthor John's book *Accounting Workbook For Dummies* (Wiley).

A quick note: Sidebars (shaded boxes of text) dig into the details of a given topic, but they aren't crucial to understanding it. Feel free to skip them. You can also pass over the text accompanied by the Technical Stuff icon, as it offers some interesting but nonessential information about accounting.

Finally, within this book, you may note that some web addresses break across two lines of text. If you're

reading this book in print and want to visit one of these webpages, simply key in the address exactly as it's noted in the text, pretending the line break doesn't exist. If you're reading this as an ebook, you have it easy — just click the web address to be taken directly to the webpage.

Foolish Assumptions

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 the financial performance of your business if you don't understand your financial statements in the first place?
- » **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" these accounting reports that serve as a key point of reference for setting a market value on the business.
- » **Entrepreneurs:** As budding business managers, they 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 advisors to handle their money; even so, they need to understand the investment performance

reports they get, which use plenty of accounting terms and measures.

- » **Accountants, bookkeepers, and controllers:** Strengthening their knowledge of accounting should 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 the accounting vocabulary and accounting-based calculation methods.
- » **Anyone interested in following economic, business, and financial news:** Articles in *The Wall Street Journal* and other financial news sources are heavy with accounting terms and measures.
- » **Administrators and managers of government and not-for-profit entities:** Making profit is not the goal of these entities, but they have to stay within their revenue limits and keep on a sound financial footing.
- » **Politicians at local, state, and federal levels:** These folks pass many laws having huge financial consequences, and the better they understand accounting, the better informed their votes should be (we hope).
- » **Investment bankers, institutional lenders, and loan officers:** These folks should already know, but you would be amazed at how many times we've come across these types of professionals that still don't have a complete understanding of accounting.
- » **Business and finance professionals:** This includes lawyers and financial advisors, of course, but even clergy counsel members of their flock on financial matters occasionally.

Icons Used in This Book

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



REMEMBER This icon points out accounting ideas that are particularly deserving of your attention. These concepts are the undergirding and building blocks of accounting — concepts that you should be very clear about and that 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 highlighter.



WARNING Taking special note of Warning 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's heavy going, which only a CPA could get really excited about. However, you may find these topics interesting enough to return to them when you have the time. Feel free to skip these points and stay with the main discussion.

Beyond the Book

This book is packed with useful information, but if you’re looking for a compact overview of the most important points, check out the online Cheat Sheet. Go to www.dummies.com and search for “Accounting 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. We also want to note that all of the figures presented in this book have been prepared in Excel and can be obtained free of charge by reaching out to us and requesting a copy of the workbook file at tagetracy@cox.net.

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 Contents at a Glance and see which chapters pique your interest.

Perhaps you’re an investor who’s interested in finding out more about financial statements and the key financial statement ratios for investors. In that case, you might start with [Chapters 6, 7, and 8](#), which explain the three primary financial statements of businesses, and finish with [Chapter 11](#), on reading a financial report. (And don’t overlook [Chapter 20](#).)

Or maybe you’re a small-business owner/manager with a basic understanding of your financial statements, but you need to improve how you use accounting information for making key profit decisions and for planning and controlling your cash flow. You might jump right into [Chapters 15 and 17](#), which explain analyzing profit behavior and budgeting cash flows.

Part 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, nonprofit 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 record-keeping part of accounting — to ensure that the financial information of a business is timely, complete, accurate, and reliable, especially the numbers reported in financial statements and tax returns.

Understand why safeguarding company assets is an integral part of an accountant's job and how the digital age, the cloud, and technology are transforming the world of accounting.

Look at the various types of business legal entities, see how accounting differs for each one, and get some helpful hints on when different legal structures are best used.

Chapter 1

Accounting in Today's New Economy

IN THIS CHAPTER

- » **Appreciating how accounting is relevant to you**
- » **Grasping how all economic activity requires accounting**
- » **Understanding the accounting function's primary roles**
- » **Watching an accounting department in action**
- » **Shaking hands with business financial statements**
- » **Realizing accounting is both an art form and science**

There was a captive audience present when I (coauthor John) taught Accounting 101 because, then as well as now, all business school students have to take this course. In contrast, very few arts and science students elect the course, which is unfortunate. Accounting 101 teaches about business, including the nature of profit (which most people don't fully understand) and the fundamentals of capitalism.

The course is a very good training ground for becoming *financially literate*. Accounting is the language of business, finance, investing, and taxes. To be financially literate, you need to know basic accounting. These days, there's a big push to improve financial literacy, and a

basic accounting course offers a useful framework for understanding and thinking about financial issues.

Financial literacy is important to help ensure financial security for you and your family as you go through life and eventually enter into retirement.

In one sense, this book is the accounting course you never took. For business grads, the book presents an opportune review of topics you've gotten rusty on. We dare say that even accounting majors can glean many insights from this book. You don't need a college education to gain from this book, however. Like all the *For Dummies* books, this book delivers useful information in a plain-talking manner, with a light touch to keep it interesting.

As you go through life, you come face to face with a flood of accounting-generated information — more than you would ever imagine. Regrettably, much of this information isn't intuitive, and it doesn't come with a user's manual. In short, most of the accounting information you encounter isn't readily clear.

One main reason for learning some accounting is to understand its vocabulary and valuation methods so you can make more intelligent use of the information.

Accountants are financial scorekeepers. In playing or watching any game, you need to know how the score is kept. The purpose of this book is to make you a knowledgeable spectator of and sometimes a participant in the accounting game.



REMEMBER Let us point out another reason you should know accounting basics — the *defensive* reason. Many people in the cold, cruel financial world are on the

prowl to take advantage of your lack of savvy about accounting. These unscrupulous characters treat you as a lamb waiting to be fleeced. An important defense against such tactics is to know some accounting, which helps you ask the right questions and understand the crucial points on which con artists want to keep you in the dark.

Checking Your Preconceptions about Accounting

You probably fall in with the majority of people who have preconceptions about accounting — which in fact may be way off the mark. For instance, most people think that you have to be good at math to understand accounting. Accounting deals with numbers, that's for sure, but by no means does it require calculus or other math — just arithmetic. Accountants make calculations and compare numbers. That's about it. We've never heard of an accountant taking the first derivative of an accounting equation or doing any other calculus computation.

The problem is that many people — perhaps even you — are number-phobic. They avoid anything to do with digits. They wouldn't think of doing their annual income tax return. Accountants deal in numbers. But be aware that every accounting number has a name or label attached. There are no naked numbers in accounting. The basic unit of information in accounting is the *account*, which consists of both

- » A name
- » Its amount or value

The vocabulary of accounting consists of accounts. Accountants communicate in terms of accounts.

Another preconception is that accountants have their heads buried in a torrent of details. Accountants have no choice; they have to be detail-oriented. At the same time, they have to see how the details fit into the overall scheme of things. The avalanche of details is condensed into accounting reports that disclose relatively few *aggregate* accounts. One reason for learning accounting is to understand what these collective accounts include.

Thinking about where assets come from

We explain later that accountants decide how to record transactions, which are economic exchanges (see the later section “[Focusing on Transactions](#)”). Many people aren’t aware of the double duty of accountants in recording transactions. Accountants look at things from two points of view — the give and the take of the transaction. This is called *double-entry* accounting, which we explain in [Chapter 3](#). The following example illustrates the two-sided nature of accounting.

Suppose a business reports \$1,000,000 in total assets at the end of its most recent year. Most people, quite naturally, focus on the makeup of its assets (how much cash, for example). But the composition of its assets is only half the financial picture of a business. You’ve heard the expression that there are two sides to every story. Well, in accounting, there are two sides to the financial condition of a business.

Accounting deals with assets, of course. Accountants are equally concerned with the sources of the assets. In this example, the \$1,000,000 in assets comes from three sources: \$300,000 liabilities; \$500,000 capital; and

\$200,000 surplus. You probably have a good idea of what liabilities are. *Capital* is money invested in the business by the owners. *Surplus* is profit that has been earned and not distributed to the owners. The sum of all three sources taken together equals the *total assets* of the business. The books are in balance.

Asking about profit

Businesses are profit motivated, so a natural question is “How much profit did the business earn over the last year?” Suppose the business had \$120,000 surplus at the beginning of the year, and the business didn’t distribute any of its profit to its owners during the year. Therefore, the business earned \$80,000 profit for the year:
\$120,000 surplus at start of year → \$200,000 surplus at end of year = \$80,000 gain in surplus, which is the profit for the year.



REMEMBER One popular misconception is that earning profit increases cash by the same amount. Unfortunately, it’s not as simple as that. Earning profit involves many assets and several liabilities. Cash is the main asset but not the only one affected by earning profit. One purpose of learning accounting is to understand the financial “fallout” from making profit. Profit consists of changes in assets and liabilities that, taken all together, increase the surplus of the business. The cash result from making profit is either higher or lower than the amount of profit. Isn’t this interesting?

Sorting out stereotypes of accountants

We recently saw a cartoon in which the young son of clowns is standing in a circus tent and is dressed as a clown, but he's holding a briefcase. He's telling his clown parents that he's running away to join a CPA firm. This cartoon plays off the stereotype of a CPA (certified public accountant) as a boring "bean counter" who wears a green eyeshade, has no sense of humor, and possesses the personality of an undertaker (no offense to morticians). Maybe you've heard the joke that an accountant with a personality is one who looks at *your* shoes when he's talking to you instead his own shoes.

Like most stereotypes, there's an element of truth in this image of accountants. As a CPA and accounting professor for more than 40 years (coauthor John) and a financial and accounting consultant for more than 36 years (coauthor Tage), we've met and known a large number of accountants. Most accountants are not as gregarious as used-car salespeople (though some are). Accountants certainly are more detail-oriented than your average person, and they're a little more comfortable with complex calculations. Accountants are very good at one thing: Examining both sides of financial transactions — the give and the take, what was gotten and what was given. Accountants know better than anyone that, as economists are fond of saying, there's no such thing as a free lunch.

Because accountants work with numbers and details, you hear references to accountants as bean counters, digit heads, number nerds, and other names we don't dare mention here. Accountants take these snide references in stride and with good humor. Actually, accountants rank among the most respected professionals in many polls. Many people and businesses rely on their accountants for business, financial, and even investment

advice. Accountants are much more than preparers of your tax returns.

If you walked down a busy street in Chicago, Denver, New York, or Los Angeles, we doubt that you could pick out the accountants. We have no idea whether accountants have higher or lower divorce rates, whether they go to church more frequently, whether most are Republicans or Democrats, or whether they generally sleep well at night. We do think overall that accountants are more honest in paying their income taxes, although we have no proof of this. (And yes, we know of a couple of accountants who tried to cheat on their federal income tax returns.)

Providing Vital Financial Information

In a nutshell, accountants “keep the books” of businesses — and of not-for-profit (NFP) and government entities also — by following systematic methods to record the financial activities of the entity. All this recordkeeping is done for one primary purpose: to create the database necessary for the preparation of complete, accurate, reliable, and timely financial reports, tax returns, and other types of financial communications. In *financial reports*, accounting information is presented in the form of *financial statements* that are packaged with other information such as explanatory footnotes and a letter from top management. Accountants design financial reports for *nonaccountants*, such as business owners, lenders, and investors.

Financial reports are sent to people who have a stake in the outcomes of the activities. If you own stock in Microsoft, 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 if you save money in a credit union, you receive regular financial reports. If you're a member of a nonprofit association or organization, you're entitled to receive regular financial reports. We hope you carefully read these financial reports, but if you don't — or if you do yet don't understand what you're reading — it could be that you don't understand the language of accounting.

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. We sent him a copy of our book *How to Read a Financial Report* (John Wiley & Sons, Inc.). In his reply, he said he planned to recommend it to his "accounting challenged" friends.

Recognizing users of accounting information

People who use accounting information fall into two broad groups: *insiders (internal users)* and *outsiders (external users)*.

- » 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 financial performance and condition of the business. Likewise, administrators of NFP and governmental entities need to understand the accounting terminology and measurement methods in their financial statements.