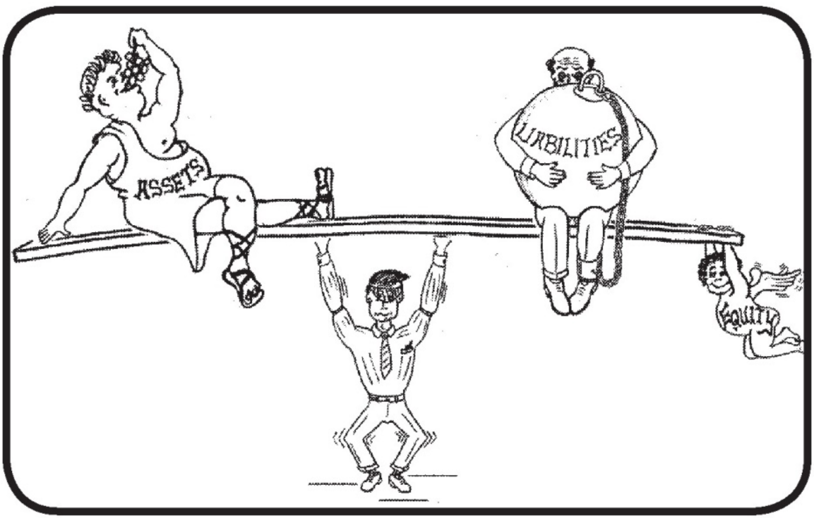
Financial Accounting: A MERCIFULLY BRIEF Introduction



Michael Sack Elmaleh

CPA, CVA, MS, MA

Illustrated by Jeremy David Delaval Willis

"A concise and readable introduction to financial accounting."

"Elmaleh brings life to a dry topic."

"Using easy to understand examples the author gives you the "why" behind accounting principles not just the how."

"The author brings a refreshing candor missing from traditional accounting texts: he is not afraid to speak about accounting's inherent limitations and weaknesses."

"This book does not bog the reader down in bookkeeping details. The author keeps the reader focused on accounting's basic aims: measuring economic performance and condition."

"You would not expect to be apply the adjectives 'irreverent', 'funny' or 'mischievous' to an accounting text but they can be applied to this one."

Published by Epiphany Communications
Coral Gables, Florida

ISBN: 0-9764744-0-9

Printed in the United States of America

Library of Congress Cataloging-in-Publication Data
Elmaleh, Michael Sack

Financial accounting: A mercifully brief introduction/Michael Sack Elmaleh

p. cm

Includes index

ISBN: 0-9764744-0-9

Visit our home page at http://www.understand-accounting.net

About the Author

Nearly thirty years of practical accounting experience have erased most of the ill effects of the author's formal education. That education included a BA in psychology and philosophy, an MS in accounting and an MA in philosophy all from the University of Wisconsin. As revenge on academia, the author has served as an adjunct instructor at three colleges, teaching courses in accounting, economics, finance, statistics, and mathematics. Currently, the author is trying to figure out how to get over the ill effects of nearly thirty years in accounting. Writing this book has helped.

Acknowledgements

The author would like to thank Jed Sanborn, CPA, Robert Walter, and Joseph Sack for reviewing early drafts of this text and offering valuable suggestions and encouragement. I also thank students in my accounting classes who alerted me to the need for this book. Special thanks go to my most talented copy editor, Barbara Wyatt, who despite an incredibly demanding schedule, made time to ensure that no comma was misplaced or omitted. Thanks also to my illustrator, Jeremy Willis; who had an uncanny knack of capturing precisely the bizarre visual images I needed to supplement this text. The quotation of Frank Knight is taken from Peter Bernstein's *Against the Gods: The Remarkable Story of Risk,* John Wiley and Sons, Inc.

Foreword: Why a Mercifully Brief Introduction to Accounting?

Most introductory accounting texts focus very heavily on the mechanics of accounting. Much attention is given to journalizing transactions, getting the debits and credits in the right place, and compiling financial statements in the proper form. Today, even the smallest business can afford reasonably good accounting software that handles the bookkeeping mechanics adequately. What accounting software cannot do is interpret the information contained in financial statements.

The emphasis on mechanics leaves relatively little time, particularly in compressed learning formats to question the quality and usefulness of financial statement information. These are the issues, I think, small business owners and non-accountants most need to explore.

In order to address the meaning of financial statement information, some understanding of bookkeeping mechanics is required, but not to the extent included in traditional textbooks. This book explains just enough of the mechanics needed to consider the reliability and usefulness of accounting information.

This book also differs from the traditional texts in another way. When traditional introductory texts discuss the uses of financial statements, the focus is almost exclusively on the *positive* value of the information content. Not nearly enough attention is given to the *limitations* of accounting information. In this era when stock prices react wildly to every slight fluctuation in reported or expected quarterly earnings, it is important for non-accountants to begin to appreciate these limitations. This book discusses financial accounting's strengths and weaknesses.

Finally, many, if not most, introductory accounting texts use examples from large and small businesses. In this book I have chosen to introduce the fundamental principles of financial accounting in the context of small businesses only. I have done this for two reasons. First, I believe that the small business environment is easier for non-accountants to understand.

Second, small firms comprise about 99% of the over 40 million businesses that are now operating in the United States. Marketing considerations suggest a book to benefit this larger market.

Contents

Chapter 1 - Introduction

Measurement problems are sometimes more than accountants can bear.

In This Chapter

- **Just what is Economic Performance and Economic Condition?**
- **Money: Accounting's Unstable Measurement Unit**
- **Measurement Error: Management's Motivation for Mendacity**
- **Why Bother with Accounting at All?**
- **The World According to GAAP**

Accounting’s Surprisingly Difficult Measurement Problems

"Oh, well, if you cannot measure, measure anyhow."

Frank Knight

Financial accounting consists of the rules and procedures used to measure the economic performance and condition of a business firm. The most widely used rules are Generally Accepted Accounting Principles (GAAP). GAAP strives to answer two basic questions: how did the business do last year, and what did the business own and owe at the end of the year? The answers to these questions are summarized in two basic reports, the income statement and the balance sheet. The income statement lists revenue earned and expenses incurred during the year. The balance sheet lists asset, liability and equity amounts as of the end of the year.

If you have even a passing knowledge of business and economics answering these questions might not seem that difficult. In fact, determining a firm's economic performance and condition often is very difficult. Unfortunately, financial statements rarely are able to give completely definitive and precise answers to what seem to be simple economic questions. Why would this be so?

Accounting's measurement problems derive primarily from three factors that I will discuss briefly. First, it is difficult to pin down exact criteria for measuring economic performance and economic condition. Second, accounting uses money as its fundamental measurement unit, and money's unit value is not stable over time. Third, accounting rule makers have to allow for the fact that business managers often are motivated to distort economic reality rather than reflect it accurately.

Just What is Economic Performance and Economic Condition?

In terms of economic performance, our simplest criterion for doing well surely involves looking at cash flows. A business does well if it brings in more cash than it spends and vice versa. But as you will soon see, for all but the very simplest of businesses such a measurement approach can be very problematic.

As shown in a later example, negative cash flow is not necessarily equivalent to poor economic performance and vice versa. Because of these problems accountants have had to develop a more abstract concept of economic profitability which creates its own problems.

Accounting encounters even more difficulty in trying to pin down a firm's economic condition. To determine economic condition, we want to find out about the firm's assets and their values. But there is more than one standard of value. Should accountants use current market values for assets owned or the original cost incurred to acquire them? Rarely are these values the same and there are advantages and disadvantages to both standards.

There also is legitimate controversy about what should be counted as assets on the balance sheet. For example, should the value of personnel or intangible assets, such as patents, trademarks and goodwill, be measured and included? If so, how do we measure their value?

Money: Accounting's Unstable Measurement Unit

In accounting the unit of measurement is money. Money is a medium of exchange that has value only to the extent that it can be traded for goods and services. But, money is not a stable unit of measurement because its exchange value varies with time. What one dollar buys today in goods and services is almost never the same as what that same dollar purchased last year or will purchase two years from now. Such changes in the exchange values of money are referred to as inflation or deflation depending upon the direction of the change.

The practical ramifications of this instability of money as a measuring unit are pervasive. If a company had net income last year of $100,000 was its economic performance the same as it was five years ago when its income statement also showed a $100,000 net income? Decidedly not, if the purchasing power of the dollar changed significantly in the intervening five years.

Questions about economic condition are also affected by the instability of money as a measurement unit. For example, consider two companies each with $800,000 of assets and $500,000 of liabilities. In the case of one company all its debt must be repaid within one year, while the other company's debt does not have to repaid for ten years.

Are the economic conditions of the companies the same? Again, decidedly not, because the purchasing power of the dollar will change over the next ten years.

GAAP rule makers have struggled greatly with the questions of how and when these changes in the value of money should be reflected.

Measurement Error: Management's Motivation for Mendacity

Measurement error is unavoidable. But it would be nice if we could assume that almost everybody involved in the accounting measurement process was highly motivated to avoid errors. Sadly, this is not the case because business managers often wish to avoid accurate measurements if such accuracy would lead to significant damage to their career and finances. Facing such ruin managers will be strongly tempted to avoid fair and accurate measurements. Managers will seek to "cook the books".

There are two important ramifications for accounting stemming from this motivational bias. First, in order for financial reports to have any credibility at all they have to be verified by independent auditors. This is an expensive and often imperfect process. Second, in formulating GAAP, the rule makers have to carefully consider how any proposed measurement procedures might be subverted by manager’s intent on providing a skewed view of economic performance or condition. The practical consequence of this is that the accounting rules that might be most logical and simple are often not adopted because these rules also tend to be the easiest ones for managers to manipulate.

If Reliable Accounting Measurements Are So Hard to Achieve, Why Bother with Accounting at All?

Accounting measurements, despite the inherent limits discussed throughout this book, usually can assist in reliably evaluating the economic performance and condition of a business. But in order to achieve a more comprehensive evaluation of a business *economic information not included in financial statements must be considered.*

You cannot accurately assess the economic condition or the performance of a business by simply looking at its financial statements. You must combine financial statement information with information about the economic environment in which the business operates. You must understand the firm's products and services. You must know about the firm's competitive position. You must understand the risks the business faces. And you sometimes have to make assessments about a firm's strengths and weaknesses that cannot easily be quantified.

The World According to GAAP

Generally Accepted Accounting Principles (GAAP) were not handed down to the accounting profession from God through some Old Testament prophet. Rather, the accounting profession has delegated to a series of committees the responsibility for promulgating specific rules. Currently the responsibility falls to the Financial Accounting Standards Board (FASB).

The Securities and Exchange Commission (SEC) is a regulatory agency of the federal government that can also set accounting principles for companies whose shares trade on various stock exchanges. Historically, the SEC has not intervened in setting accounting rules but has left the task largely to the FASB. Occasionally even the Congress has attempted to intervene in setting accounting rules.

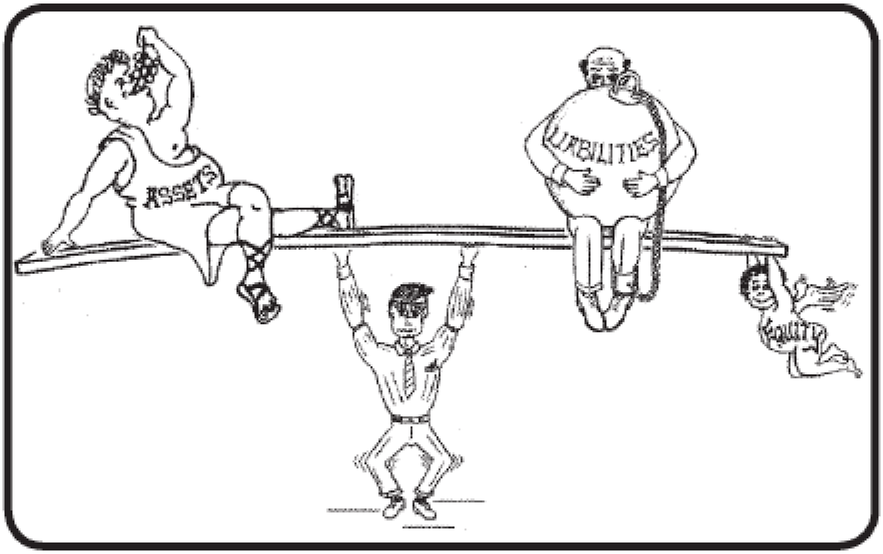
Who Enforces GAAP?

Any company that is listed on a stock exchange has to prepare its financial statements in conformity with GAAP.

Independent Certified Public Accountants (CPAs) must be hired to audit these accounting records and financial statements to ensure that these statements have been prepared in conformity with GAAP. GAAP acquires its leverage through these auditing requirements. Failure to provide financial statements in accordance with GAAP would jeopardize the credibility of a firm's financial statements and adversely affect the price of company stock.

Generally, non-publicly traded private businesses have no legal obligation to follow GAAP in preparing financial accounting reports. Non-publicly traded companies sometimes are required to use GAAP by banks or other lenders who require access to periodic financial reports. Sometimes these lenders require that CPAs audit these financial statements. Small firms often use GAAP rules for generating financial statements on a voluntary basis because these rules provide the best framework for developing useful information about economic performance and condition.

Chapter 2



Accounting is not for the weak kneed.

This Chapter

- **The Fundamental Accounting Equation**
- **Accounts: Sub-Categorical Imperatives**
- **Revenue and Expenses and Equity: Articulating the Connection**

The Balancing Act: Assets = Liabilities + Equity

Businesses usually own assets. Assets are things that can be used to generate revenue through the sale of goods and services. Assets include cash, inventory, furniture and equipment, and accounts receivable. A business may also own intangible assets such as patents, trademarks and goodwill.

GAAP assumes that all assets of a business are either owned outright by the business owners or are subject to the claims of creditors. Creditors are anyone that has loaned money to the business. Loans and other forms of extended credit are called *liabilities.* The portion of assets not subject to claims by creditors is called *equity.*

In the GAAP framework there must be a continuous equilibrium between assets on the one side and the total of liabilities and equity on the other side. This is represented by the fundamental equation of accounting:

$$\textit{Assets} = \textit{Liabilities} + \textit{Equity}$$

This equation is also the basis for the most basic of accounting reports, the aptly named *Balance Sheet*. A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date. This equation must always be in balance.

Examples:

If a business has $ 1,000 of assets at a particular time those assets must be matched by the total of the claims of creditors and owners. Here are two of an infinite number of acceptable balance sheets:

The El Maroq Co.
Balance Sheet

Assets	$ 1,000
Liabilities	$ 500
Equity	500
Total Liabilities and Equity	$ 1,000

The Raqco Co.
Balance Sheet

Assets	$ 1,000
Liabilities	$ 800
Equity	200
Total Liabilities and Equity	$ 1,000

It is possible for liabilities to exceed assets. If so the equity must be negative for the total of liabilities and equities to equal the positive total assets.

The Lowe Co.
Balance Sheet

Assets	$ 1,000
Liabilities	$ 1,100
Equity	(100)
Total Liabilities and Equity	$ 1,000

A business whose liabilities exceed its assets is termed ***insolvent.***

Equity as Residual Claims

In the GAAP framework equity is simply the difference between assets and liabilities. The owner has positive equity only to the extent that assets exceed liabilities. If a business has $1,000 of assets and $600 of liabilities the $600 of liabilities are, in effect, a claim on the assets. Equity is the difference between the assets and liabilities, or $400.

Equity =Assets - Liabilities

By common law, if a business ceases operations the priority claims on assets go to outside creditors. The claims of owners can be realized only after outside creditors' claims are satisfied. As such, equity represents the owners' residual claim on business assets.

Accounts: Sub-Categorical Imperatives

The fundamental accounting equation analyzes a business in terms of three categories: ***assets, liabilities*** and ***equity.*** It is useful to break these categories into sub-categories called ***accounts.*** Here are typical accounts by category. Detailed descriptions and examples of accounts will be found in later chapters of the book.

Assets

Cash: The balance of coins and currency on hand and funds held in checking, savings and money market accounts.

Accounts Receivable: Customers' promises to pay later for goods or services already provided.

Prepaid Expenses: Payments toward an expense that a business will not benefit from until sometime later, e.g., a one-month rental deposit.

Inventory: Goods sold to customers.

Fixed Assets: Tangible assets expected to last over a year that enable a business to provide goods or services.

Liabilities

Accounts Payable: A firm's promise to pay later for services or goods already received.

Notes Payable: Loans made to a business.

Withheld Taxes: Taxes withheld from employees' wages.

Accrued Payroll Taxes: Employer's share of payroll taxes owed.

Deferred Revenue: Cash collected by a business now for services or goods to be provided later, e.g., a year's magazine subscription collected by a magazine publisher in advance.

Equity

The equity section of a balance sheet has different account names, depending upon the legal structure of the business. A business may have *unlimited liability* or *limited liability.* Limited liability businesses include corporations, limited liability companies (LLCs), or limited liability partnerships (LLPs). The distinguishing feature of a limited liability firm is that the owners' personal liability for firm actions is limited to the amount they have invested. Usually such businesses have to be registered or incorporated in a particular state and must comply with that state's laws regarding its legal structure.

Unlimited liability firms include sole proprietorships and general partnerships. In these firms the owners have unlimited liability for the actions of the business. The distinction between limited and unlimited liability businesses boils down to the extent to which an owner can be sued for the actions of the business.

Example. The *Threadbare Tire Company* has manufactured tires that were so defective that certain customers lost life and limb in various car accidents. Suppose the estates of the deceased successfully sued the company for $5 million. Let's further suppose that Threadbare has net business assets of only $3 million. If Threadbare were a limited liability company, the owners would have no obligation to pay the $2 million needed to satisfy the remaining judgement against the company. If, on the other hand, Threadbare were an unlimited liability company, the owners would be responsible for satisfying the remaining judgement.

Proprietorship Equity

An unincorporated business with one owner is a *sole* proprietorship. Its equity categories are broken down as follows:

Owner's Equity: Cash or property contributed to a business by its owner.

Owner's Withdrawals: Cash or property distributed to an owner from the business.

Partnership Equity

An unincorporated business with more than one owner is a partnership. If a partnership has two owners, the equity section would contain the following accounts:

Partner A Equity: Property or cash contributed by partner A to the partnership.

Partner A Withdrawals: Property or cash distributed by the partnership to partner A.

Partner B Equity: Property or cash contributed by partner B to the partnership.

Partner B Withdrawals: Property or cash distributed by the partnership to partner B.

Separate pairs of similar accounts would be required for any additional partners in the partnership. Sometimes Owner or Partnership Equity accounts are labeled "Partner Capital" or "Owner Capital". Owner or Partnership Withdrawals accounts are sometimes labeled as simply "Owner Draws" or "Partner Draws".

Shareholder Equity

A limited liability business is usually called a *corporation.* Its owners are called *shareholders,* because they are issued *common stock* certificates that represent their share of ownership in the business. The equity section of an incorporated business would be broken down into at least these sub-accounts:

Common Stock: The original amounts of cash and/or property shareholders contribute to a business in exchange for common shares.

Dividends Paid: Cash or property paid to shareholders from business net income.

Retained Earnings: The amount of net income not distributed to shareholders.

Revenue and Expenses and Equity: Articulating the Connection

There is a close relationship between the economic condition of a business and its economic performance. Generally, businesses that do well, end up well off. Good performance generates a good economic condition. Profits generate assets; losses eat up assets and generate liabilities. This connection between economic performance and economic condition is built into the basic accounting equation, which always requires that assets equal the sum of liabilities and equity.

Changes in Equity: Revenues and Expenses

Changes in equity occur when the owner contributes to or draws money from the business. But such transactions are relatively infrequent. More frequently changes in equity occur through earning revenue and incurring expenses.

A business generates revenue when it exchanges goods or services with its customers in return for money or other assets. A business incurs expenses by exchanging its assets for goods and services it needs to generate revenue. A business realizes net income or profit if its revenues exceed expenses. If its expenses exceed revenue, the business incurs a loss.

Revenue and expenses are *sub-categories of equity.* In generating revenue and expense, assets and liabilities are always affected. For example, if a business renders a service in exchange for cash, assets (cash) increase. However, to maintain the basic accounting equation, either the liability or the equity side must increase by an equal amount. But in selling services no liability is incurred. So, this means that equity must increase. *An increase in revenue must lead to an increase in equity.*

Similarly, if a business incurs a cash expense, an asset, cash, has decreased. So, the other side of the accounting equation must decrease as well. Because paying cash to meet an expense is not equivalent to paying off a debt, there is no decrease in liabilities. So, the incurring of an expense must be accompanied by a change in equity. In fact, *all incurred expenses lead to reductions in equity.*

Note that sometimes a business receives assets from lenders or from its owners. The receipt of such assets is not revenue. Only assets received from customers or clients in exchange for goods or services constitute revenue. Similarly, the disbursement of assets to repay loans or distributions to owners are not expenses. Only disbursement of assets used to generate revenue are considered expenses.

This table illustrates the relationship between the basic categories in the accounting equation.

Revenue and Expense Accounts

Just as there are sub-categories of assets, liabilities and equity, there are numerous sub-categories of revenue and expense. The collection of all asset, liability, equity, revenue and expense accounts is called the *general ledger* accounts. Some of the more typical revenue and expense accounts are the following:

Revenue

Sales: income from selling goods to customers.

Interest Income: income from lending money or extending credit to customers.

Rental Income: income from leasing property.

Service Fees: income from the provision of services such as law, medicine, and accounting.

Expenses

Cost of Goods Sold: costs of products sold to customers.

Salaries and Wages: payments to employees for services provided.

Rent: payments for the use of real property.

Utilities: payments for heating, electric, and other utility services.

Office Expense: a broad category of expenses related to office administration.

Payroll Taxes: the employer's share of Social Security, Medicare and unemployment taxes associated with salaries and wages.

Professional Fees: costs of services provided by outside advisors, such as attorneys and accountants.

Advertising: costs associated with the promotion of a firm's products or services.

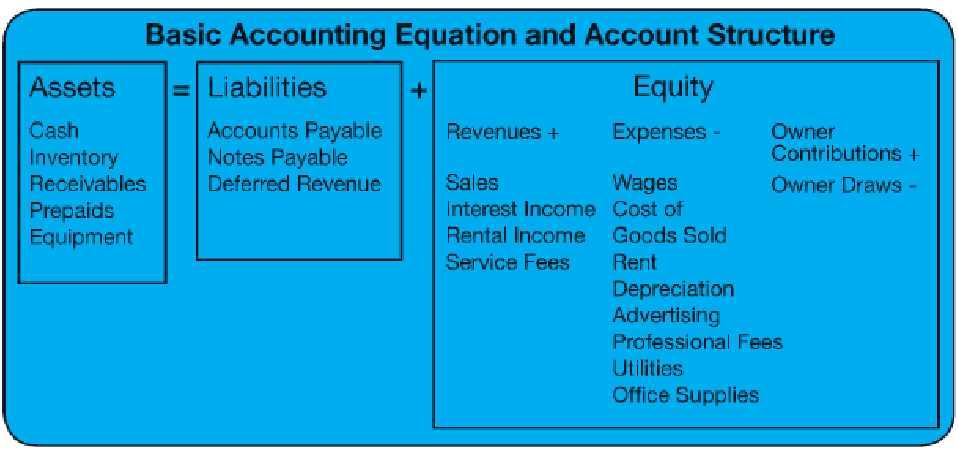
Phone: costs for telephone services.

Repairs and Maintenance: costs of repairs and maintenance to property and equipment.

Travel: costs for use of automobiles, other transportation, and lodging expenses associated with business travel.

Meals and Entertainment: costs of business related meals and entertainment.

Depreciation: the portion of a fixed asset's original cost recognized in a specific accounting period.



The Income Statement

Even though revenue and expense transactions change equity, the specific changes in revenue and expense account balances are reflected in a separate fundamental financial statement called the *income* *statement*.

Sometimes the income statement is referred to as the *profit and loss* statement or simply the "P & L". The income statement addresses the question of economic performance. Did the firm do well (make a profit) or do badly (incur a loss)? The earning of revenue and incurring of expenses is so central to the operation of a business that it requires this separate report to monitor operating results.

The income statement reflects the changes in the revenue and expense accounts over a certain period, usually not more than a year, or less than a month. The balance sheet, on the other hand, reports the assets, liabilities and equity at a specific point in time, usually at the end of a year, quarter or month.

Example. Mort Thanatopolis, a licensed mortician, has decided to open a funeral home specializing in very low-cost funerals. The business will be called "*Can U Dig It?*" Here is a list of his first month's cash transactions:

December l, Mort opens a business checking account with a deposit of $5,000 of his own funds.

December 3, Mort pays $1,000 for l,000 extra large, heavy duty, plastic bags.

December 5, Mort borrows $1,500 from his sister Morticia.

December 5, Mort purchases $500 of newspaper advertising.
December 8, Mort collects $1,200 in fees for three funeral services.

December 9, Mort pays $155 to a local minister to officiate at the three funerals.

December l0, Mort uses 3 plastic bags at the funerals.

The table below illustrates the effect of these transactions on the fundamental accounting equation:

	Assets		Liabilities	Owners Equity	
Transaction #	Cash	Funeral Supplies	Note Payable	Mort Capital	Type of Equity Transaction
01-Dec	5,000			5,000	owner investment
03-Dec	(1,000)	1,000			
05-Dec	1,500		1,500		
05-Dec	(500)			(500)	advertising expense
08-Dec	1,200			1,200	service revenue
09-Dec	(155)	-	-	(155)	contract labor
10-Dec	-	(3)	-	(3)	funeral suplies
Balances	6,045	997	1,500	5,542	

Notice that the basic accounting equation is maintained after each transaction. In the first transaction an asset is increased by $5,000 while equity increases by the same amount. In some transactions, like the second, only one side of the equation is changed. One asset, cash, decreased, while another asset, funeral supplies, increased by the same amount. In the third transaction, cash increased and so did a liability in the same amount. The final four transactions involved revenue and expenses, which are increases and decreases in equity.

The revenue transaction increased both cash and equity by the same amount. The expenses decreased both assets and equity by the same amount. These transactions and final account balances lead to the following simple balance sheet and income statement.

Can U Dig It?
Balance Sheet
12/31/04

Assets		
Cash	$	6,045
Funeral Supplies		997
Total Assets	$	7,042
Liabilities		
Note Payable	$	1,500
Equity		
Mort Capital		5,542
Total Liabilities & Equity	$	7,042

Can U Dig It?
Income Statement
For the Month Ended 12/31/2004

Revenue	$ 1,200
Expenses	
Funeral Supplies	3
Advertising	500
Contract Labor	155
Total Expenses	658
Net Income	$ 542

Summary

- Business firms have assets, liabilities and equity. Assets are the productive resources a firm uses to generate revenue. Liabilities are the firm's debts owed creditors. Equity represents the owners share of assets net of liabilities.

- At all times the fundamental equation must hold:

  Assets = Liabilities + Equity.

- Firms generate revenue from the sale of goods and services. In generating revenue, the firm acquires assets like cash and accounts receivable. In order to generate revenue most firms must incur expenses which usually mean the reduction in cash or increase in liabilities.

- Revenue increases owner's equity; expenses decrease owner's equity.

- The total of assets, liabilities and equity as of the end of accounting period is reported on the balance sheet. The revenue earned, and expenses incurred, during the accounting period is reported on the income statement.

- It is useful to breakdown assets, liabilities, equity, revenue and expense into sub-categories called accounts.

Exercises

1. Define assets, liabilities and equity.

2. Give two examples of accounts for each of the above.

3. What is the mathematical relationship between assets, liabilities and equity?

4. Define revenue and expense.

5. Give three examples of accounts from each of the above.

6. What is the relationship between equity and revenue and expense?

7. If a business has $5,000 of assets and $1,000 of liabilities what must its equity equal?

8. Is it possible for a business to have more liabilities than assets?

9. What are the advantages of limited liability businesses? Discuss briefly the societal costs and benefits to allowing limited liability businesses. Most states do not allow limited liability protection for professional services such as law, medicine and accounting? Why would these states deny these professionals such protection?

Problems

1. For the following transactions indicate whether owner's equity increases, decreases or stays the same:

a. An owner contributes $500 to a business.

b. A business purchases an asset for $1,000 cash.

c. A business borrows $2,500 from a bank.

d. A business collects $200 in revenue.

e. A business incurs $100 of expense.

2. Rusty Blade opened a low budget surgery clinic called *Cut It Out*. After the first year of operations the business had the following asset, liability, equity and revenue and expense balances.

Cash	$27,400
Surgical Equipment	30,000
Note Payable	30,400
Blade Equity	5,000
Surgical Revenue	75,000
Salary Expense	35,000
Office Rent	12,000
Utility Expenses	2,400
Malpractice Insurance	3,600

Prepare the balance sheet and income statement for the business. Note that the ending equity balance must equal the owner's capital contribution plus the annual net income.