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# **Financial Accounting**

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- Identify the various accounting concepts and methods that companies can employ
- Recognize how investors and creditors use financial reports to make decisions

## **Maire Loughran**

*Adjunct Full Professor of Financial &  
Managerial Accounting*

*Certified Public Accountant*



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**by Maire Loughran, CPA**



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Maire is a full adjunct professor who teaches graduate and undergraduate auditing, accounting, and taxation classes. Interested in many different business-related fields, she has written *Auditing For Dummies* (a Wiley publication), a training manual for a Microsoft product, and a guide to starting a home-based business, as well as the Arts and Crafts Business Guide for About.com, a part of The New York Times Company.



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## *Dedication*

To my much-loved son Joey, who serves his country aboard the USS *Harry S. Truman*: I am prouder of you than mere words can ever describe. And to my late husband Jeff, so long gone from our lives but never absent from our hearts.

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# Introduction

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**A**ccounting is known as the language of business because it communicates financial and economic facts about a business to all sorts of interested parties — both *internal* (employees of the company) and *external* (people not employed by the company in question). External users include investors, creditors, banks, and regulatory agencies such as the Internal Revenue Service and the U.S. Securities and Exchange Commission.

Zeroing in on the external users of accounting information, this book is about financial accounting. *Financial* accounting serves the needs of external users by providing them with understandable, materially correct financial statements. There are three financial statements: the income statement, balance sheet, and statement of cash flows. This book is a step-by-step guide on how to prepare all three.

You also find out the purposes of the financial statements:

- ✔ To report on the financial position of the company — what types of assets the company owns and what types of liabilities it owes.
- ✔ To show how well the company performs over a period of time, which is referred to as an *accounting period*. You measure performance by seeing whether the company made or lost money during the accounting period.

A lot of first-time accounting students tell me that they are afraid they won't do well in their financial accounting class because they haven't done well in math classes they've taken in the past. Forgot about the math — that's why you have a computer and a calculator! Financial accounting is less about adding and subtracting than using logic-based skills. Added to the mix is the importance of gaining a working understanding of the standards set in place by authoritative accounting bodies.

After years spent in the classroom as both a professor and student, I realize that many accounting textbooks are, well, boring. My purpose in writing this book is to breathe some life into the subject of financial accounting and make it more understandable.

## About This Book

This book, like all *For Dummies* books, is written so that each chapter stands on its own. I always assume that whatever chapter you're reading

is the first one you've tackled in the book. Therefore, you can understand the concepts I explain in each chapter regardless of whether it's your first chapter or your last.

However, certain terms and concepts pertain to more than one subject in this book. To avoid writing the same explanations over and over, whenever I reference a financial accounting term, method, or other type of fact that I fully explain in another chapter, I give you a brief overview and direct you to the spot where you can get more information. For example, I may suggest that you "see Chapter 13" (which, by the way, discusses the statement of cash flows).

Also, in this book I break financial accounting down to its lowest common denominator. I avoid using jargon that only accounting majors with several accounting classes already under their belts will understand. Please keep in mind that the list of financial accounting topics and methods I present in this book isn't all-inclusive. I simply can't cover every possible nuance and twist related to preparing financial accounting data and statements. This book is meant to illuminate the rather dry presentation of topics given in all the financial accounting textbooks from which I've taught, providing a perfect companion to the financial accounting textbook your professor is using.

Furthermore, I briefly discuss the Sarbanes-Oxley Act of 2002 (SOX) and the watchdog over the audits of publicly traded companies, the Public Company Accounting Oversight Board (PCAOB). If you have the time, I recommend reading *Sarbanes-Oxley For Dummies* by Jill Gilbert Welytok, JD, CPA (published by Wiley). This handbook walks you through the new and revised SOX laws.

## Conventions Used in This Book

Following are some conventions I use that you'll want to bear in mind while reading this book:

- ✔ I introduce new terms in *italic* with an explanation immediately following. For example, *liquidity* refers to a company's ability or lack thereof to meet current financial obligations. To put it even more simply, does the company have enough cash to pay its bills?
- ✔ Many accounting terms have acronyms (which you'll soon be bandying about with your fellow students after you gain some familiarity or experience with the topic). The first time I introduce an acronym in a chapter, I spell it out and place the acronym in parentheses. For example, I may discuss the American Institute of Certified Public Accountants (AICPA).
- ✔ I use **bold** text to highlight key words in bulleted lists.

- ✓ All Web addresses are in `monofont` typeface so that they're set apart from the rest of the text. When this book was printed, some Web addresses may have needed to break across two lines of text. If that happened, rest assured that I haven't put in any extra characters (such as hyphens) to indicate the break. So when using one of these Web addresses, just type in exactly what you see in this book, pretending as though the line break doesn't exist.

## *What You're Not to Read*

I would love it if you read every word of this book, but I realize that people lead busy lives and sometimes just want to get the specific information they need. So if you're under a time crunch, you can safely skip the following without jeopardizing your understanding of the subject at large:

- ✓ **Material marked with a Technical Stuff icon:** These paragraphs contain extra financial accounting information that, while useful, isn't critical to your understanding of the topic at hand.
- ✓ **Sidebars:** These gray-shaded boxes contain asides that I think you'll find interesting but that, again, aren't vital to understanding the material your professor discusses in class.

## *Foolish Assumptions*

I assume you don't have more than a rudimentary knowledge of accounting, and I'm guessing you're one of the following people:

- ✓ A college financial accounting student who just isn't getting it by reading (and rereading) the assigned textbook. (I've seen that deer-in-the-headlights look many times in my classroom.)
- ✓ A non-accounting student currently enrolled in either business or liberal arts who's considering changing his major to accounting.
- ✓ A business owner (particularly someone operating a small business with gross receipts of under \$1 million) who wants to attempt preparing her own financial statements or just wants to have a better understanding about the financial statements prepared by the in-house or external accountant.
- ✓ A brand-new accountant working in financial accounting who needs a plain-talk refresher of accounting concepts.

## *How This Book Is Organized*

To help you find the financial accounting facts you need, this book is organized into parts that break down the subject of financial accounting into easily digestible portions that relate to one another.

### *Part I: Getting a Financial Accounting Initiation*

This part introduces you to the world of financial accounting. You receive an initiation into the purpose, constraints, and responsibilities of financial accountants; various financial accounting career options; and the business classes you need to pursue these careers. I also provide an overview of the three financial statements. For the business owner, it provides information about the education, training, certification, and experience of the stranger who comes into your business asking about private accounting facts.

### *Part II: Reviewing Some Accounting Basics*

In this part, I lay the foundation of your financial accounting class. You learn how to enter accounting transactions into a company's books through the use of journal entries. You also find out about the general ledger, which is the place where accountants record the impact of transactions taking place in a business during a particular accounting cycle. Finally, you find out about the two different methods of accounting, cash and accrual — though I concentrate on accrual because this is the method financial accountants use.

### *Part III: Spending Quality Time with the Balance Sheet*

This section contains three chapters, each explaining a different section of the balance sheet. The three sections of the balance sheet are assets, liabilities, and equity, and together they show the financial position of a company. *Assets* are resources a company owns, *liabilities* show claims payable by the company or debts against those assets, and *equity* is the difference between assets and liabilities, which equals the total of each owner's investment in the business.



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