UNDERSTANDING BASIC ACCOUNTING CONCEPTS

I. COMPREHENDING ACCOUNTING TERMS

Accounting is the process of recording and reporting financial transactions and summarizing the results in financial statements. Most professionals are familiar with the term GAAP or at least have heard the term used in some context. GAAP is an acronym for ñgenerally accepted accounting principles.ò These principles are established by the Financial Accounting Standards Board (FASB), a nonprofit organization started in 1973 (other organizations filled the role prior to FASB). The SEC has designated FASB as the organization responsible for setting accounting standards for public companies.

Financial statements are normally prepared ï and in many cases must be prepared ï using the accrual method of accounting. Under this method revenues are recognized in the period in which they are earned and expenses when the liability is incurred, even if the cash transaction takes place in another reporting period. However, many small businesses use the cash basis of accounting, where revenues and expenses are recognized only when actually paid. Many companies keep, at least informally, a second set of books for tax purposes. The tax laws allow for certain accounting treatments that have the effect of reducing taxable income, often through allowance of greater expenses that would be recognized under GAAP. Public companies are under pressure to report higher earnings but at the same time pay as little tax as possible, so of course the companies will take advantage of every option to reduce taxes. If the company shows a net loss on its tax return that loss can generally be carried over to offset income in future periods.

Throughout this discussion it will usually be assumed that reporting is done on the accrual basis for a corporation. The same basic concepts apply when accounting for a ñCò corporation, an ñSò corporation, a limited liability company or a partnership. The primary differences will be in the treatment of the equity accounts ï a topic that is addressed briefly but is not the focus of this paper.

II. COMMONLY USED TERMS

The following is a brief glossary of terms that the practitioner will frequently encounter when reviewing financial statements or addressing an accounting issue in another context.

Accelerated Depreciation

Method that records greater depreciation than straight-line depreciation in the early years and less depreciation than straight-line in the later years.

Accrual Basis

Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid. Publicly traded companies are required to use accrual basis accounting, as are many companies with sales over a minimum amount.

Accumulated Depreciation

Total depreciation pertaining to a group of assets from the time the assets were placed in services until the date of the financial statement or tax return. This total is the contra account to the related asset account. In other words, assets are valued on the financial statements net of depreciation that has been recognized on those assets.

Additional Paid in Capital

Amounts paid for stock in excess of its par value.

Amortization

This term includes: (1) the systematic allocation of the discount, premium, or issue costs of a bond to expense over the life of the bond; (2) the systematic allocation of an intangible asset to expense over a certain period of time; (3) the systematic reduction of a loan's principal balance through equal payment amounts which cover interest and principal repayment.

Audit

A professional examination of a companyôs financial statement by a CPA to determine that the statement has been presented fairly and prepared using GAAP.

Capital Expenditure

Outlay of money to acquire or improve capital assets such as buildings and machinery.

Capital Gain

Portion of the total gain recognized on the sale or exchange of a non-inventory asset which is not taxed as ordinary income. Capital gains have historically been taxed at a lower rate than ordinary income.

Capitalized Cost

Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, which are charged to expense during two or more accounting periods.

Capital Stock

Ownership shares of a corporation authorized by its Articles. The money value assigned to a corporation's issued shares.

Carryovers

Provision of tax law that allows current losses or certain tax credits to be utilized in the tax returns of future periods.

Cash Basis

Method of bookkeeping in which revenues and expenses are recognized when received or paid. Many small businesses, and particularly service providers like lawyers, use cash basis accounting.

Compilation

Presentation of financial statement data without the accountantôs assurance as to conformity with GAAP.

Cost of Goods Sold

Figure representing the cost of buying raw materials and producing finished goods.

Cost Basis

Original price of an asset, used in determining capital gain.

Credit

Entry on the right side of a double entry bookkeeping system. A credit reduces an asset account and increases a liability or revenue account.

Debit

Entry on the left side of a double entry bookkeeping system. A debit increases an asset or expense and reduces a liability or revenue account.

Depreciation

An expense recognized each year of the useful life of an asset.

Depreciation recapture

A method for the IRS to collect income tax on a gain realized by a taxpayer when the taxpayer disposes of an asset that had previously provided an offset to ordinary income for the taxpayer through depreciation.

Distributions

Payment by a business entity to its owners of items such as cash, assets, stock, or earnings.

Dividends

Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporationôs capital stock.

Double Taxation

The act of taxing corporate earnings twice, once as the net income of the corporation and again as dividends are distributed to stockholders

EBITDA

ñEarnings before interest, taxes, depreciation and amortization.ò It is generally regarded as a barometer of a companyôs actual operating performance and is very often used in evaluating potential acquisitions.

EPS

ñEarnings per share.ò A measure of performance calculated by dividing the net earnings of a company by the average number of shares outstanding during a period.

Equity

Generally, the difference between the total assets and the total liabilities of a business.

Financial Statements

Presentation of financial data including balance sheets, income (P&L) statements, and statements of cash flow.

Fixed Costs

Costs that remain constant within a defined range of activity, volume or time period.

FOB

Technically stands for ñfree on boardò and is either FOB shipping or FOB destination. Indicates the point at which title to goods passes.

GAAP

ñGenerally Accepted Accounting Principles,ò set by the U.S. Financial Accounting Standards Board. It consists of a set of conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.

<u>Fair Market Value</u>

Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.

<u>General Ledger</u>

Collection of all asset, liability, equity, revenue and expense accounts.

<u>Goodwill</u>

Premium paid in the acquisition of an entity over the fair over the value of its identifiable tangible and intangible net assets.

<u>Gross Margin</u>

The difference between net sales and costs of goods sold.

<u>Inventory</u>

Tangible property held for sale, or, or materials used in a production process to make a product.

<u>Intangible Asset</u>

An asset having no physical existence such as trademarks and patents.

<u>Limited liability company</u>

An entity with characteristics similar to a corporation but which can be treated for tax purposes as if it were a partnership.

<u>Lower of Cost or Market</u>

A method of reporting certain assets for financial reporting purposes. Ordinarily, "cost" is the purchase price of the asset and ñmarketò refers to its current replacement cost. According to GAAP certain assets (e.g. inventories) must be carried at lower of cost or market.

<u>Mark-to-Market</u>

A method of valuing assets that results in adjustment of an asset's carrying amount to its market value. This is a relatively new method that represents a departure from the more conservative historical cost principle prevalent in accounting. Many believe this results in a more accurate picture of a companyôs financial affairs, but it has also opened the door for abuse (e.g. Enron).

<u>Par value</u>

The least amount that a share of stock can be sold for, according to the terms and conditions that are found in the regulations of the issuing company. It provides a cushion of equity capital for creditors. If the stock falls below this value on an exchange it will be removed from active trading (of course, it may be removed sooner under the rules of the exchange). The designation of a par value does not in any way inhibit the upward price of the stock.

Retained Earnings

Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

S Corporation

A corporation which has elected subchapter S status under the Internal Revenue Code, which means it is not subject to federal income taxes. Instead, taxable income of the corporation is passed through to its stockholders as if it were a partnership.

Section 179

A provision of the Internal Revenue Code that allows a taxpayer to treat part or all of the business cost of a car as a current expense rather than taking depreciation deductions over a number of years.

Selling, General, and Administrative (SG&A) Expenses

Grouping of expenses reported on a companyộs income statement that do not relate directly to the production of goods or services.

Statement of Cash Flows

One of the basic financial statements required under GAAP. The statement reconciles the reported net income or loss, along with capital expenditures and non-cash expense items (e.g. depreciation) to the companyộs cash balance.

Tax Accounting

Accounting treatment that differs in certain respects from GAAP. For example, the Internal Revenue Code allows for accelerated depreciation of an asset or, subject to certain limits, an option to deduct the entire cost of an asset as an expense (section 179).

Treasury Stock

Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options or resold. Treasury stock is reported as a contra account after retained earnings in the stockholders' equity section (i.e. it reduces the net stockholders' equity balance).

Matching Principle

A fundamental concept of basic accounting whereby the reported revenue is matched with the expenses necessary to general that revenue in a given accounting period.

Overhead

Costs of a business that are not directly associated with the production or sale of goods or services.

Revenue Recognition

Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

Variable Overhead

The portion of overhead costs that changes proportionately with some measure of activity or output.

III. FINANCIAL STATEMENTS

Financial statements present the financial condition of the entity. The standard statements include (1) balance sheets; (2) income statements; and (3) cash flow statements. It is also very common to see a separate statement of shareholdersô equity, but for purposes of this paper only the first three are covered; shareholdersô (or ownersô) equity is a component part of the balance sheet and will be addressed under that topic.

1. Balance sheets. These statements can be considered snapshots. The purpose is to set forth a companyôs financial condition at any given point in time. The statement will show the assets a company has on hand and the obligations (liabilities) it has to creditors. The difference, i.e. assets minus liabilities, is the equity the owners have in the business. A balance sheet must be in balance at all times. Total assets must equal liabilities plus ownersô equity. If that equation doesnôt work thereôs an error in the balance sheet.

a. Assets. Assets are things that a company owns that have value. This typically means they can either be sold or used by the company to make products or provide services that can be sold. Assets include physical property, such as plants, trucks, equipment and inventory. It also includes things that canôt be touched but nevertheless exist and have value, such as trademarks and patents. Cash is an asset, as are stocks, bonds and virtually anything else that has value.

Assets are generally listed based on how quickly they will be converted into cash. Current assets are things a company expects to convert to cash within one year. A good example is inventory. Most companies expect to sell their inventory for cash within one year. Noncurrent assets are things a company does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include fixed assets, which are used to operate the business but are not available for sale in the normal course of business. Examples include automobiles, buildings and furniture.

b. Liabilities. Liabilities are amounts of money that a company owes to others. This can include all kinds of obligations, like money borrowed from a bank to launch a new product, rent for use of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities also include obligations to provide goods or services to customers in the future.

Liabilities are generally listed based on their due dates. Liabilities are classified as either current or long-term. Current liabilities are obligations a company expects to pay off within the year. Long-term liabilities are obligations due more than one year from the date of the balance sheet.

c. Ownersô equity. Ownersô equity is sometimes called capital or net worth. Itøs the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners, of the company. In a corporation the ownersô equity accounts may be called shareholdersô equity; if the business is a partnership the equity accounts would typically be called partnersô capital.

Shareholdersô equity is the amount owners invested in the companyøs stock plus or minus the companyøs earnings or losses since inception. Sometimes companies distribute earnings instead of retaining them. These distributions are called dividends in a typical corporation. Small businesses are often set up as partnerships, LLCs or S-Corporations. The accounting methods are essentially the same (putting aside the cash and accrual differences) except for the treatment of ownersô equity. S-Corporations are taxed as partnerships; LLCôs are frequently taxed as partnerships. Money that owners receive from the business other than salary is typically classified as a distribution which, for purposes of accounting for ownersô equity transactions, is treated similarly to a dividend.

A balance sheet shows a snapshot of a companyôs assets, liabilities and shareholdersô equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period. A balance sheet is mostly standard across various industries. There will be differences in the type of individual accounts but in almost all situations the balance sheet will follow this basic format:

ASSETS			
Current assets:			
Cash	1000		
Accounts receivable	5000		
Total current assets		6000	
Fixed assets			
Land	2000		
Building	4000		
Equipment and automobiles	2000		
Less accumulated depreciation	(3000)		
Total fixed assets		5000	
Other assets			
Intangible Property	2500		
Less accumulated amortization	(500)		
Total other assets		2,000	
Total assets			13,000
LIABILITIES			
Current liabilities			
Accounts payable	500		
Taxes payable	200		
Current portion of debt	1000		

Total current liabilities			1,700	
Long term liabilities				
Long term portion of debt		3,000		
Total long term liabilities			3,000	
Total liabilities				4,700
OWNERSôEQUITY				
Capital Stock	1,000			
Additional paid in capital	2,000			
Retained earnings	3,000			
Current year net income / loss	2,300			
Total Ownerõs Equity				8,300

At some point after year end the business will ñclose the books.ò Generally this means all adjustments have been made and the final results from the prior year can be calculated and reported. At that time the current year net income/loss shown above will (at the risk of oversimplifying) be rolled into the retained earnings account and the next period will start with a new retained earnings number. Absent some special event the capital stock, additional paid in capital and retained earnings numbers will not change until the end of a particular reporting period (usually December 31). For any interim reporting periods the current year net income from the income statement will be shown as a separate line item and will bring the totals into balance.

2. Income statements. Income statements show how much revenue a company collected (if on the cash basis) or earned (if on the accrual basis) during the period, along with the costs and expenses of running the business. Many businesses will run financial statements at the end of every month or quarter to track progress during the course of a year. The literal ñbottom lineò of the statement usually shows the companyõs net earnings or losses. This tells you how much the company earned or lost over the period.

A basic income statement usually follows this pattern:

Gross revenues (net of discounts etc)	15,000

Cost of goods sold		5,000	
Gross profit			10,000
Selling, general and administrative			
Salaries and taxes	3,000		
Rent	1,000		
Health insurance	500		
Advertising	1,500		
Depreciation and amortization	500		
Total S,G & A expenses			(6,500)
Net income from operations			3,500
Other expenses			
Interest expense	700		
Taxes	500		
Total other expenses			(1,200)
Net income			2,300

Income statements always begin at the top line with the amount of sales made during the period. This top line is often referred to as gross revenues or sales. Itôs called ñgrossò because expenses have not been deducted from it yet. So the number is ñgrossò or unrefined. For cash basis accounting the calculation is simple: the amount of cash collected from operations during the period. If the business uses the accrual basis of accounting the number will represent sales during the period whether or not cash was collected during that period.

The next section down the income statement represents various kinds of operating expenses. Although these lines can be reported in various orders, the next line after net revenues typically shows the costs of the sales (frequently stated as cost of goods sold). This number tells you the amount of money the company spent to produce the goods or services it sold during the accounting period. Determining what exactly should be included in costs of goods sold versus accounted for in another section (e.g. general and administrative expenses) is a very involved topic. In a simple situation consider a retail shop that buys inventory from manufacturers and sells it to customers. The cost of the inventory sold during a particular period would be included in the costs of goods sold line item.

The next line subtracts the costs of sales from the net revenues to arrive at a subtotal called ñgross profitò or sometimes ñgross margin.ò Itôs considered ñgrossò because there are certain expenses that havenôt been deducted from it yet.

The next section deals with operating expenses. These are expenses that go toward supporting a companyôs operations for a given period ï for example, salaries of administrative personnel and costs of researching new products. Marketing expenses are another example. Operating expenses are different from ñcosts of sales,ò which were deducted above, because operating expenses cannot be linked directly to the production of the products or services being sold.

Depreciation is also deducted from gross profit. Depreciation takes into account the wear and tear on some assets, such as machinery, tools and furniture, which are used over the long term. Companies spread the cost of these assets over the periods they are used. This process of spreading these costs is called depreciation or amortization. The ñchargeò for using these assets during the period is a fraction of the original cost of the assets. After all operating expenses are deducted from gross profit, you arrive at operating profit before interest and income tax expenses. This is often called ñincome from operations.ò

Next companies must account for items such as interest income and expense. Interest income is the money companies make from keeping their cash in interest-bearing savings accounts, money market funds and the like. On the other hand, interest expense is the money companies paid in interest for money they borrow. Some income statements show interest income and interest expense separately. Some income statements combine the two numbers. The interest income and expense are then added or subtracted from the operating profits to arrive at operating profit before income tax.

Finally, income tax is deducted and you arrive at the bottom line: net profit or net losses. (Net profit is also called net income or net earnings.) This tells you how much the company actually earned or lost during the accounting period. That number is then carried forward to the balance sheet as an adjustment to the ownersô equity section.

3. Statement of cash flows. Cash flow statements report a companyôs inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash.

A cash flow statement shows changes over time rather than absolute dollar amounts at a point in time. It uses and reorders the information from a companyôs balance sheet and income statement. The bottom line of the cash flow statement shows the net increase or decrease in cash for the period. Generally, cash flow statements are divided into three main parts. Each part reviews the cash flow from one of three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

a. Operating activities. The first part of a cash flow statement analyzes a companyôs cash flow from net income or losses. For most companies, this section of the cash flow statement reconciles the net income (as shown on the income statement) to the actual cash the company received from or used in its operating activities. To do this, it adjusts net income for any non-cash items (such as adding back depreciation expenses) and adjusts for any cash that was used or provided by other operating assets and liabilities.

b. Investing activities. The second part of a cash flow statement shows the cash flow from all investing activities, which generally include purchases or sales of long-term assets, such as property, plant and equipment, as well as investment securities. If a company buys a piece of machinery, the cash flow statement would reflect this activity as a cash outflow from investing activities because it used cash. If the company decided to sell off some investments from an investment portfolio, the proceeds from the sales would show up as a cash inflow from investing activities because it provided cash.

c. Financing activities. The third part of a cash flow statement shows the cash flow from all financing activities. Typical sources of cash flow include cash raised by selling stocks and bonds or borrowing from banks. Likewise, paying back a bank loan would show up as a use of cash flow.

The cash flow statement normally looks like this:

Operating Activities		
Net Income from operations	2,300	
Adjustments to reconcile net income to cash		
Depreciation and amortization	500	
Increase / decrease in AR	0	
Increase / decrease in AP	0	
Increase / decrease in inventories	0	
Net cash provided by operations		2,800
Investing activities		
Purchase of property	(X)	
Purchase of equipment	(X)	
Proceeds from sale of equipment	X	
Net cash from investing activities		0
Financing activities		
Principal payments on long term debt	(500)	
Cash received from borrowing	X	
Dividends paid	(X)	
Net cash from financing activities		(500)
Net cash increase (decrease)		2,300

4. Footnotes to financial statements. A company is required to include notes to its financial statements. The purpose of these notes is, simply enough, to assist the reader in understanding the financial condition of the company. The following topics are commonly covered in notes to the financial statements.

a. Significant accounting policies and practices. Companies are required to disclose the accounting policies that are most important to the portrayal of the companyôs financial condition and results.

b. Income taxes. The footnotes provide detailed information about the companyôs current and deferred income taxes. The information is broken down by level ï federal, state, local and/or foreign, and the main items that affect the companyôs effective tax rate are described.

c. Pension plans and other retirement programs. The notes contain specific information about the assets and costs of these programs, and indicate whether and by how much the plans are over- or under-funded.

d. Stock options. The notes also contain information about stock options granted to officers and employees, including the method of accounting for stock-based compensation and the effect of the method on reported results.

e. Managementôs Discussion and Analysis. The SECôs rules governing MD&A require disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information. The purpose of MD&A is to provide investors with information that the companyôs management believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. It is intended to help investors to see the company through the eyes of management.

It is also intended to provide context for the financial statements and information about the companyôs earnings and cash flows.

IV RELATIONSHIP BETWEEN FINANCIAL STATEMENTS

The financial statements should be read together. As we can see just from the simple example above, the net income from the income statement is carried over to the balance sheet to show the effect of the current periodôs results on the companyôs financial condition. The cash flow statement is then used to demonstrate how the companyôs cash position changed over the course of the period. For any type of ñofficialò reporting a company is required to show the prior periodôs results along with the current period. If you pick up a companyôs annual report you will see the balance sheet from the prior period alongside the current period balance sheet. The income statement and cash flow statement will show why the numbers on the balance sheet changed from prior periods.

For example, assume the company had a great year in terms of profit, but reinvested most of those profits into building a new plant. In that case (assume little else changed) you will see a significant increase in the fixed asset section of the balance sheet along with a significant increase in the ownersô equity section. Very simply put, this demonstrates that the ownersô investment is now worth more than it was the prior year. Even though the investors did not receive a large cash payout because the company retained the money, the value of their investment still rose to correspond with the increased net income.

Years ago it was common to read in the newspaper that the Dell corporation had stockpiled literally billions in cash. Dell, like many other companies that grew tremendously over the same time period, did not pay dividends. Even though the company reinvested much of its net income, it was still left with huge cash reserves. Alternatively, many companies have a long-standing policy of paying dividends to the stockholders. If you take a very simplified look at the balance sheet under these different approaches you would see that the paper value of the investment in Dell would appear to grown (i.e. the shareholdersô equity account would be increasing because Dell retained the net cash provided by operations); on the other hand, the shareholdersô equity in the dividend-paying company may look exactly the same as in the prior period but of course that investor received cash along the way. Only by looking at all the financial statements together can one get a real picture of the financial condition of the company.