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Paul Newton

Understanding Accounting Principles

PAUL NEWTON

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Understanding Accounting Principles
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PREFACE

This eBook explains all of the basic accounting concepts and terminology you will need to understand the three primary financial statements that appear in every organization's annual report and most internal monthly reports.

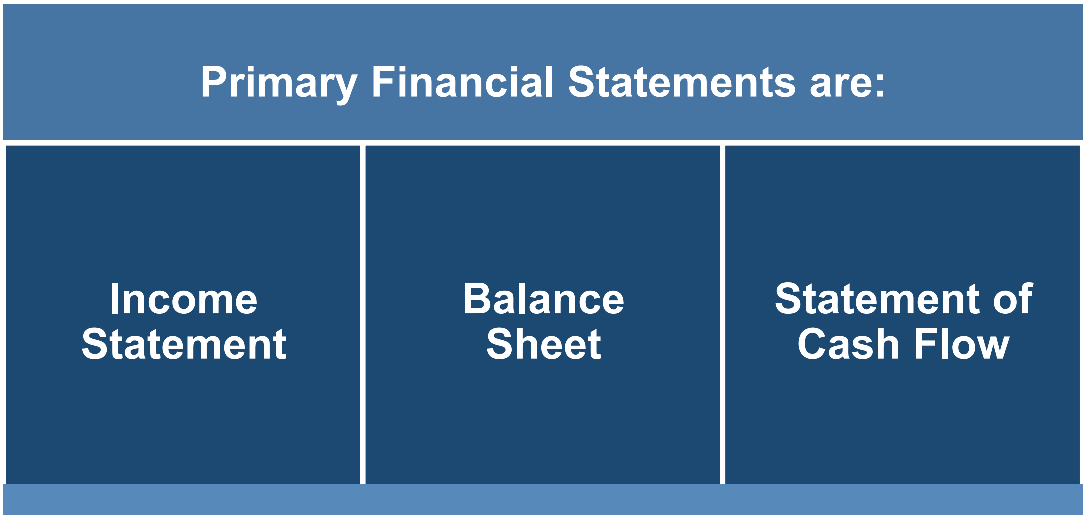
You will learn:

- The precise definition of essential accounting terms
- The purpose of the income statement, balance sheet, and cash flow statement
- The differences between cash-based and accrual-based accounting
- The 'revenue recognition' principle and the 'matching' principle
- How depreciation, prepayments, and bad debt are allowed for

INTRODUCTION

As a manager, you may be asked to produce or contribute towards an income statement for your own business unit. This provides senior management with an indication of how your business unit is performing against its targets over a specific period, for example quarterly. In addition, you will usually be expected to understand simple financial reports and communicate effectively with financial people in your own organization.

This eBook explains all of the basic accounting concepts and terminology you will need to understand the three primary financial statements that appear in every organization's annual report and most internal monthly reports as well.



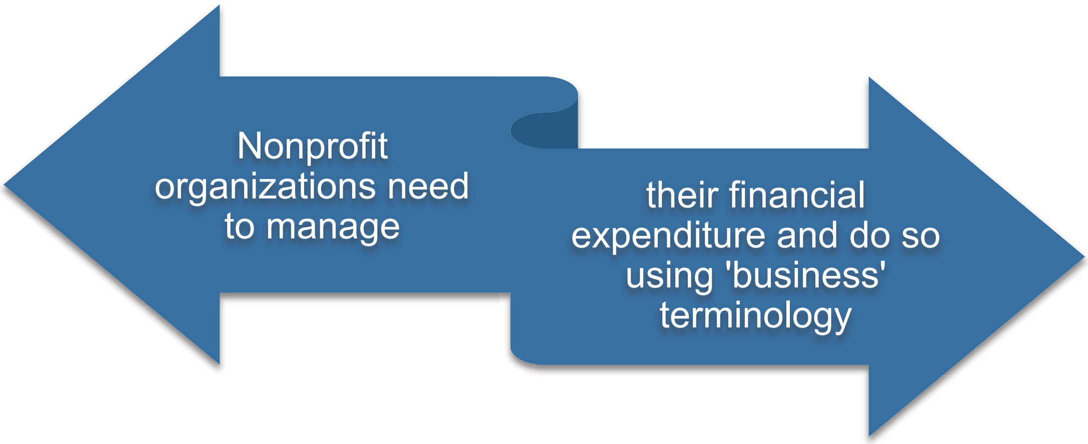
These are:

The Income Statement – An accounting of revenue, expenses, and profit for a given period. This can also be an internal document that can be used to make management decisions about almost any activity where you have a record of the money spent and the associated return.

The Balance Sheet – An itemized statement that summarizes the assets and liabilities of the business at a given date.

The Statement of Cash Flow – A report that shows the effect of all transactions that involved or influenced cash but did not appear on the income statement.

If you work in a nonprofit sector then do not be put off by words like 'business' and 'profit.' Even if your organization is not a business that exists to make a profit, it is still important to understand the basic principles of finance and management reporting so that you can monitor efficiency and control your budget effectively.



Your organization may not be concerned with sales and profit as such, but there will be some metrics for measuring the service delivered and the costs incurred in delivering it.

Financial reporting requires an understanding of: basic financial terms, the differences between cash-based and accrual accounting, and an appreciation of when revenue and costs are recognized. All of these topics are dealt with in this eBook, which is an ideal introduction to basic accounting principles.

Key Point

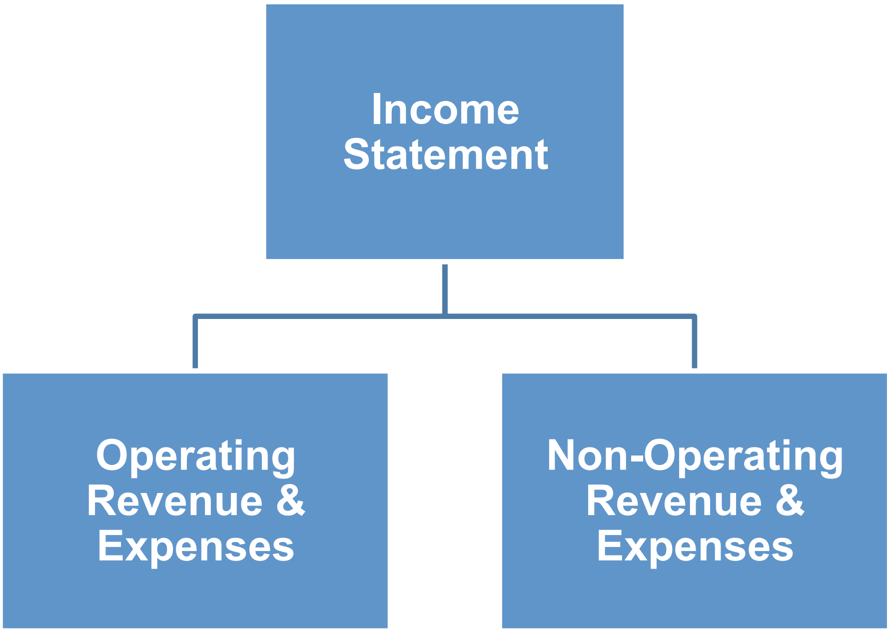
- You should make sure that you know the basic concepts and terminology needed to understand income statements, balance sheets, and statements of cash flow as these are widely used, even by nonprofit organizations.

1 BASIC ACCOUNTING CONCEPTS

The basic principles of accounting are best understood by considering some simple businesses and how they might document their financial activities.

1.1 AN INCOME STATEMENT

This is a financial statement that measures an organization's financial performance over a specific accounting period by giving a summary of how it incurs its revenues and expenses. It also shows the net profit or loss incurred over that period and is often referred to as a 'Profit and Loss' or 'Revenue and Expenses' statement.



An income statement consists of two sections: operating and non-operating activities.

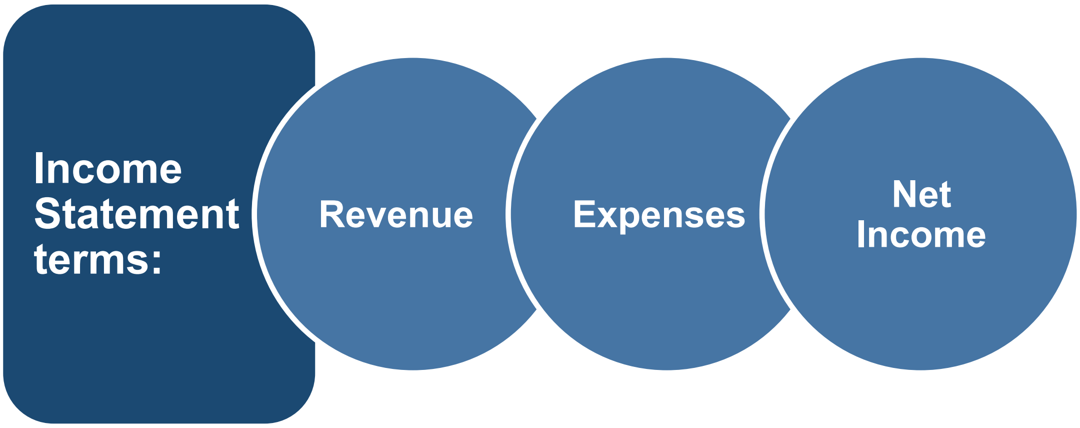
- The operating section details the revenue and expenses directly associated with business operations, for example the purchase of raw materials.
- The non-operating section details revenue and expenses that result from activities outside of normal business operations, for example the sale of an office or land.

This division of revenue and expenses into 'operating' and 'non-operating' is particular to each organization and is dealt with in detail in the eBook 'Understanding Income Statements,' which you can download from www.free-management-ebooks.com.

For the moment we will use a 'simple' income statement to illustrate the financial principles you need to be familiar with, since this type of income statement does not distinguish between 'operating' and 'non-operating' revenues and expenses.

1.1.1 A SAMPLE SIMPLE INCOME STATEMENT

This sample simple income statement covers a twelve-month period for 'Suzy's Signs,' a one-person business that designs signage. It details the amount of revenue and expense that comes in and goes out of the organization without distinguishing between operating and non-operating items.



The income statement uses three terms that can be defined as:

- **Revenue** – incoming assets in return for sold goods or services.
- **Expenses** – outgoing assets or liabilities incurred.
- **Net Income** – the difference between Revenue and Expenses. This shows whether you are generating a profit or you are operating at a loss.

In our example, Suzy runs her own design agency called Suzy's Signs. She works from her home office and offers a design service for customers who need a sign for their business premises. The design is done according to a brief supplied by the customer.

Once the design has been approved, Suzy obtains quotes for its manufacture from three suppliers. She then sends the design and the quotes to the customer including her invoice for the total number of hours spent on this design, based on an hourly rate of $45.

The following table gives you an example of what a simple income statement would look like for Suzy Sign's.

Suzy's Signs Income Statement Jan 1–Dec 31		
	$	**$**
Revenue (Design)		**8,000**
Less Expenses:		
Travel	420	
Stationery	140	
Telephone	80	
Broadband	120	
Miscellaneous	25	
Expenses Total	**785**	
Net Profit Before Tax		**7,215**

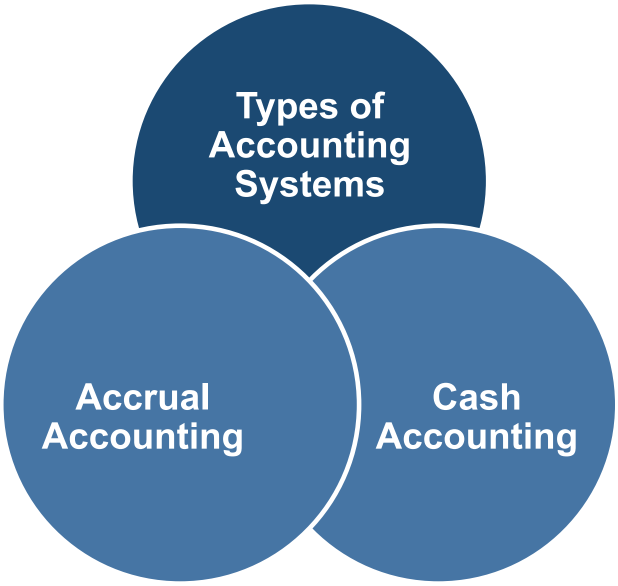
The net profit or loss is the difference between the income received and all of the costs paid out. In this case Suzy has made a profit for the year of $7,215.

She may need this information to give to the tax authorities or she could use it to compare this year's performance to last year's, or even to her expectations at the beginning of the year.

As simple as this document is, there are some practical issues that it raises. For example:

> Suzy sends out an invoice in December, but it has not been paid by 31 December.
> What does she do?
> Should the invoice amount appear on the statement or not, and does it matter?

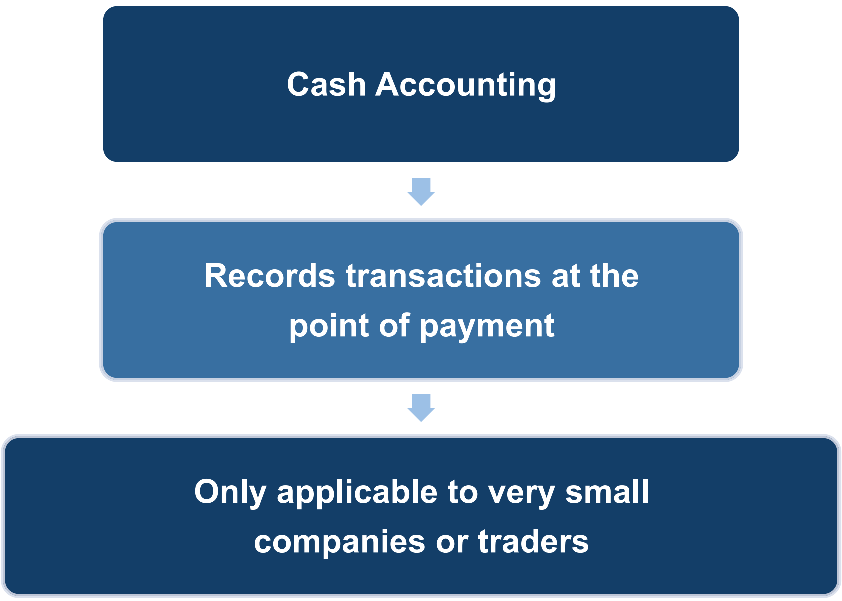
The answer to this question depends on the type of accounting that Suzy is using. There are two types, known as 'cash accounting' and 'accrual accounting.'



The practical implications of each type for your organization are explained in the next sections using our example of Suzy's Signs.

1.2 CASH ACCOUNTING

This is an accounting method where receipts are recorded on the date they are received, and the expenses on the date that they are actually paid. As a small business, Suzy has the option of 'cash accounting,' which means that she only needs to record transactions at the point of payment. In other words when the money leaves or is paid into her bank account.



So referring back to Suzy's query:

> If her December invoice is not paid until the following January, then she does not need to enter it on the income statement for this period.
>
> Similarly, if she received a bill in December (for example a phone bill) but she does not pay it until January, then that amount will not appear either.

Accounting rules stipulate that, with few exceptions, businesses should not use this method but should prepare their accounts on the 'accrual' basis. However, it is acceptable for very small companies to use the cash accounting method. In Suzy's case, cash accounting confers two advantages.

1. It reflects exactly what she has in her bank account.
2. It helps her cash flow.

Whilst the first point is obvious, the second point needs some explanation.

> In November and December Suzy raised invoices for $2,500 worth of work, which she is awaiting payment for.
>
> Under the cash accounting rules, she does not have to declare this income during the period and she will not have to pay any tax due on it until the end of the next accounting period (the period when the money will actually be paid into her account).
>
> This is counterbalanced by the fact that she cannot include any expenses. For example, her December telephone bill cannot be included until she has actually paid it, irrespective of the date on the invoice.

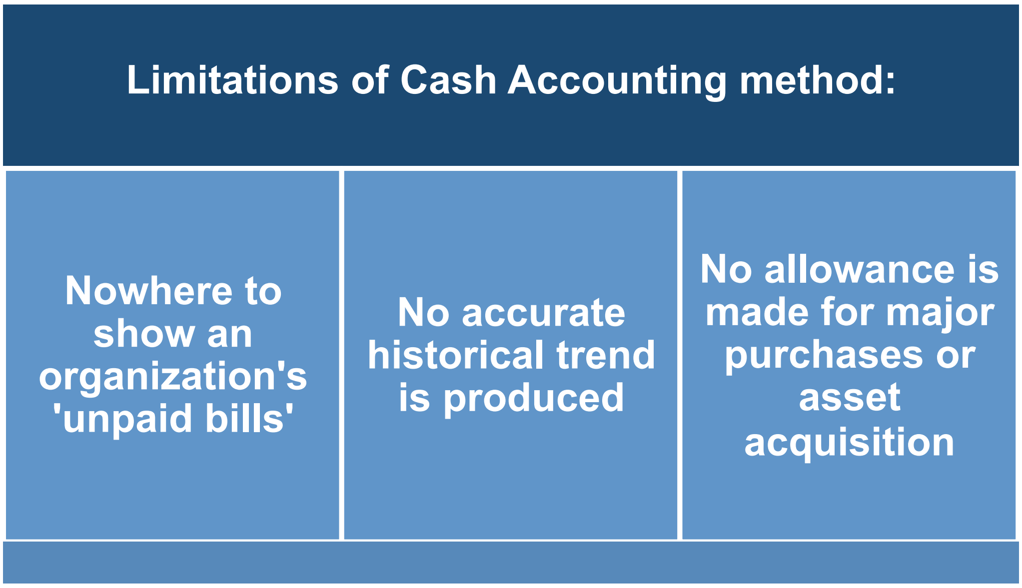
Suzy's business has relatively low expenses and because her clients can be slow to pay, cash accounting is probably the best option for her to use. By using cash accounting, she will only be paying tax on money she has actually received. It is also straightforward: if she uses a tax adviser, she could simply give him her checkbook and bank statements and he could calculate her tax liability from those two things alone.

Key Points

- Under cash accounting rules, transactions are recorded at the point of payment.
- Very small businesses and traders can use cash accounting.
- It reflects exactly what the business has in its bank account and can help with cash flow.

1.1.2 THE LIMITATIONS OF CASH ACCOUNTING

In cash-based accounting, expenses are not recorded until they have been paid, which means that there is nowhere on the books to show unpaid bills.



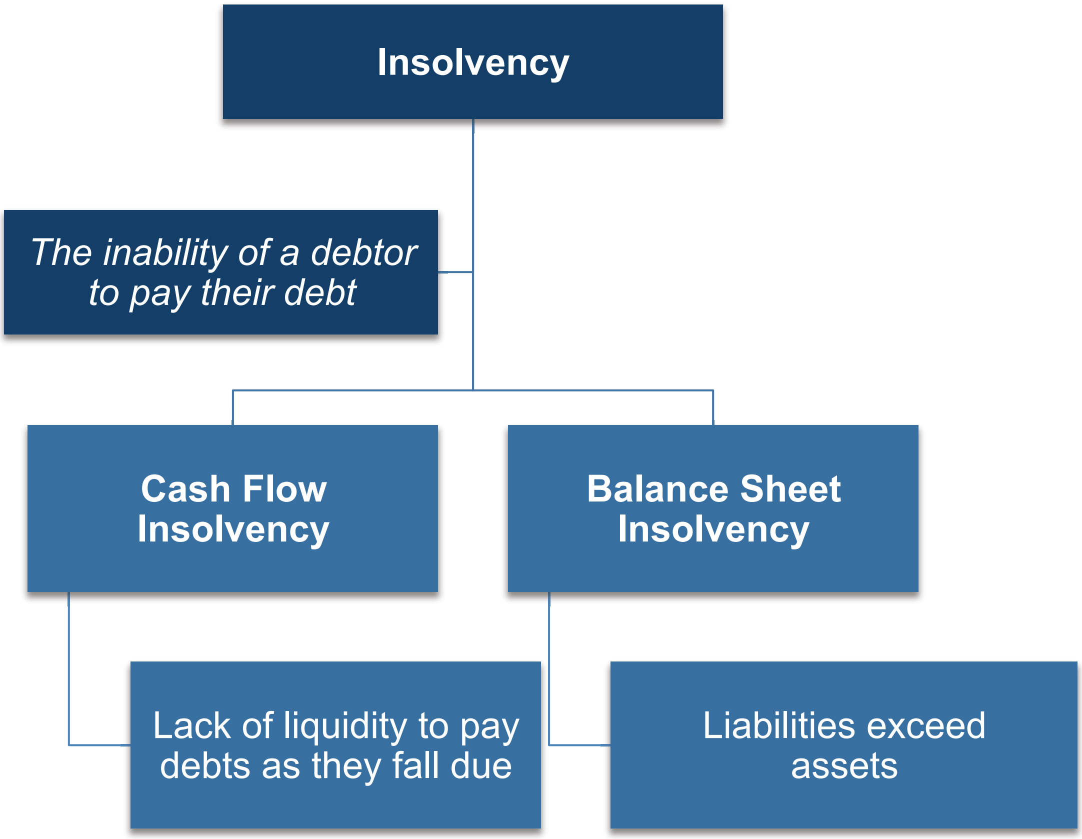
These limitations can create serious problems if the business is much more complex than Suzy's Signs. In fact, cash-based accounting can create a situation that leads to insolvency while reporting that the organization is making a profit.

When an organization is termed 'Insolvent' it means:

> The inability of a debtor to pay their debt and can result from either cash flow insolvency or balance sheet insolvency.

The definitions of these two types of insolvency are:

- **Cash flow insolvency** involves a lack of funds to pay debts as they fall due.
- **Balance sheet insolvency** involves having negative net assets. In other words, the business owes to others more than it has in assets including the money that it is owed.

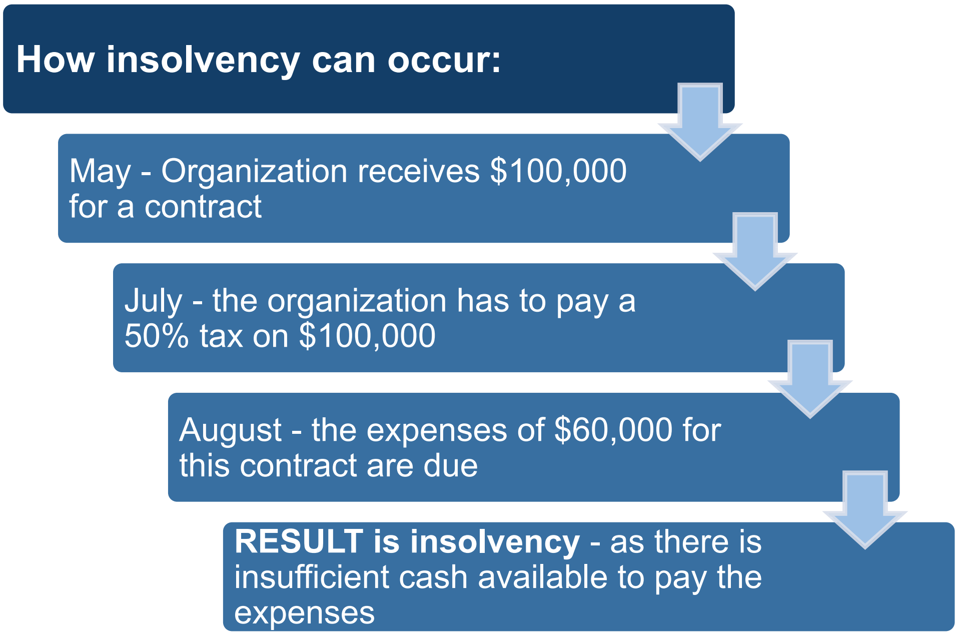

Insolvency
The inability of a debtor to pay their debt
Cash Flow Insolvency
Balance Sheet Insolvency
Lack of liquidity to pay debts as they fall due
Liabilities exceed assets

Many people confuse bankruptcy with insolvency and it is important to understand the difference.

> An organization may be cash flow insolvent but balance sheet solvent if it holds assets that it cannot turn into cash if it needs to do so.
>
> Conversely, an organization can have negative net assets showing on its balance sheet but still be cash flow solvent if ongoing revenue is able to meet debt obligations, and thus avoid default. (Many large corporations operate permanently in this state.)
>
> Bankruptcy is not the same as insolvency. It is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency.

To illustrate why cash-based accounting can lead to insolvency, imagine an organization that receives income prior to completion of the job, but where major costs are not paid out until after completion. This could lead to a situation where the organization receives say $100,000 in sales for the period, but most of the associated costs (say $60,000) do not appear on the income statement for that period.

Consequently, the income statement shows a profit for the period, which is overstated by the $60,000 in as yet unpaid costs. The organization is then taxed on this notional profit. Several weeks later, the $60,000 expenses need to be paid, but there is no cash available because it has already been paid out in tax. The organization is now insolvent.



This is a very simple example, but in many organizations there may be large amounts of money flowing through the business and profits may appear to be high. As time goes by, cash deficits accumulate year after year and with the unpaid expenses not recorded, the cash-based income statement will report that the business is profitable even though it may be insolvent.

Another problem with cash-based accounting is that it does not create an accurate historical trend of business operations. This is because transactions are recorded only when cash changes hands. It does not (as a rule) represent the sale date of goods or services. Major purchases or other asset acquisitions can also distort the picture.

This can be illustrated using the Suzy's Signs example and looking at her first three years income statement figures, shown in the table below. These cash-based net profit figures appear to show a steady growth year on year. But to fully understand her growth you need to know more about her costs.

Cash Accounting	
	Net Profit Before Tax
Year 1	6,500
Year 2	7,000
Year 3	7,300

What these figures are unable to show are:

- **Her set-up costs** – including office furniture, computer, printer, and stationery. These were allocated to her first year, even though she is still getting the benefit of these things in years two and three.
- **Her outstanding invoices** – by the end of her third year this amounts to $4,000. This is a substantial amount given the size of her business and yet it does not appear anywhere in the accounts.

In order to overcome the problems associated with cash-based accounting, most organizations use an alternative system called accrual accounting and this is dealt with next.

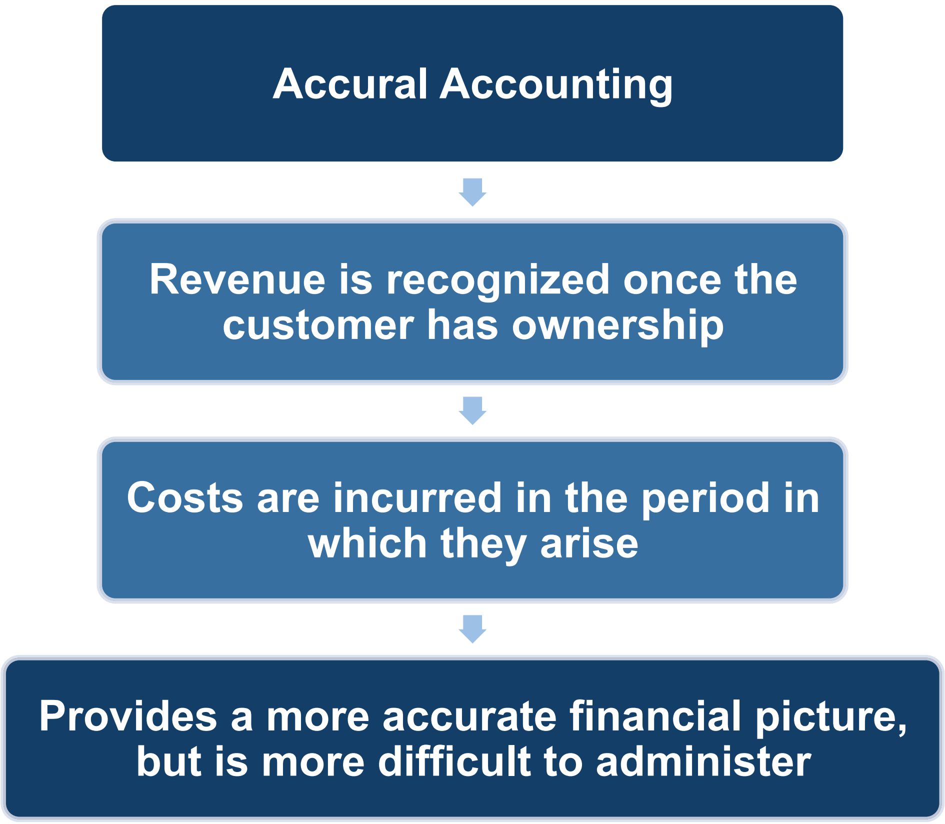
Key Points

- The main limitations of cash accounting are that: there is nowhere to show 'unpaid bills'; there is no way of seeing any historical trend in the figures; and no allowance is made for major purchases or asset acquisition.
- Cash-based accounting can create a situation that leads to insolvency while reporting that the organization is making a profit.

1.3 ACCRUAL ACCOUNTING

Accrual accounting is considered to be the standard accounting practice for most organizations, and is mandated for organizations of any real size.

If Suzy were using this method then she would need to include all of her invoiced amounts for the period as 'sales' even if she had not actually received payment by the period end. Similarly, if she has a bill with an invoice date within the period she must include it even though she knows that she won't be paying it until after the period end.



The accrual method recognizes a sale at the point at which the customer takes ownership of the goods or the point when the service is delivered, even though the cash isn't yet in the bank. Similarly, costs may be recognized before an invoice is received if the organization accepts that the cost has been incurred during the accounting period.

This method provides a more accurate picture of the organization's current condition, but it is more complex to administer when payments received are less than the amount invoiced. This can happen if the customer disputes the amount or simply refuses to pay. The need for the accrual method arose out of the increasing complexity of an organization's transactions and a desire for more accurate financial information.

Selling on credit and projects that provide revenue streams over a long period of time affect the organization's financial circumstances at the point of the transaction. It makes sense that this is reflected on the financial statements during the same reporting period that these transactions occurred.

Before looking at an example of an income statement using the accrual method, there are some financial terms that you need to know. You will also need to appreciate some accounting principles like the 'revenue recognition principle' and the 'matching principle.'

Key Points

- Accrual accounting is considered to be the standard accounting practice for most organizations, and is mandated for organizations of any real size.
- Revenue is recognized once the customer has ownership.
- Costs are incurred in the period in which they arise.
- It provides a more accurate financial picture, but is more difficult to administer.

2 BASIC FINANCIAL TERMS

All of the following terms have precise definitions when used in business accounting:

- Sales or revenue
- Cost of goods sold
- Expenses
- Gross profit
- Fixed assets
- Current assets
- Current liabilities
- Working capital
- Liquidity
- Debtor
- Creditor
- Bad Debt
- Depreciation
- Accrual Accounting

Even though you may be familiar with some of them, it is important to know their exact meanings otherwise you may find the rest of this eBook and the others in this series difficult to follow. For example, you may hear the terms 'revenues' and 'receipts' used interchangeably in casual office conversation. However, as far as business accounting is concerned they are different things and you will find yourself becoming confused if you don't appreciate the difference.

Read the following definitions carefully and make sure that you understand exactly what is meant by each of these accounting terms.

Sales or Revenue

Revenue is the income that flows into an organization, and it is often used almost synonymously with sales. In government and nonprofit organizations it includes taxes and grants.

Don't confuse revenues with receipts. Under the accrual basis of accounting, revenues are shown in the period they are earned, not in the period when the cash is collected. Revenues occur when money is *earned*; receipts occur when cash is *received*.

Cost of Goods Sold

This is the purchase cost of the merchandise that was subsequently sold to customers.

Expenses

Refers to the other costs that are not matched with sales as part of the cost of goods sold. They may be matched with a specific time, usually monthly, quarterly, or annually or they may also be one-off payments. Expenses include: staff wages, rent, utility bills, insurance, equipment, etc.

Gross Profit

Refers to what is left after you subtract the cost of goods sold from the sales. It is also called gross margin. For example, if an organization buys in an item for $50 and sells it for $75 (plus sales tax), then the gross profit will be $25.

Fixed Assets

This refers to all of those things that the business owns which will have a value to the business over a long period. This is usually understood to be any time longer than one year. It includes freehold property, plant, machinery, computers, motor vehicles, and so on.

Current Assets

This refers to assets with the value available entirely in the short term. This is usually understood to be a period of less than a year. This is either because they are what the business sells or because they are money or can quickly be turned into money. Examples include inventory/stock, money owing by customers, money in the bank, or other short-term investments.

Current Liabilities

This refers to those things that the business could be called upon to pay in the short term – within the year. Examples include bank overdrafts and money owing to suppliers.

Working Capital

This is the difference between current assets and current liabilities. An organization without sufficient working capital cannot pay its debts as they fall due. In this situation it may have to stop trading even if it is profitable.

Liquidity

This is the ability to meet current obligations with cash or other assets that can be quickly converted into cash in order to pay bills as they become due. In other words the organization has enough cash or assets that will become cash so that it is able to write checks without running out of money.

Debtor

A debtor is a person owing money to the business, for example a customer for goods delivered.

Creditor

A creditor is a person to whom the business owes money, for example a supplier, landlord, or utility organization.

Bad Debt

All reasonable means to collect a debt have been tried and have failed so the amount owed is written off as a loss and becomes categorized as an expense on an income statement. This results in net income being reduced.

Depreciation

Assets have a certain length of time in which they operate efficiently, referred to as 'an asset's useful life.' During this period the value of that asset depreciates due to age, wear and tear, or obsolescence. The loss in value is recorded in accounts as a non-cash expense, which reduces earnings whilst raising cash flow.

Accrual Accounting

Accrual accounting relies on two principles, which have already been alluded to:

> **The revenue recognition principle** states that revenues are recognized when they are realized or realizable, and are earned (usually when goods are transferred or services rendered), no matter when the payment is received.
>
> **The matching principle** states that expenses are recognized when goods are transferred or services rendered, and offset against recognized revenues, which were generated from those expenses, no matter when the cash is paid out.

These two principles are absolutely central to understanding how accrual accounting works and are described in detail in the next sections.

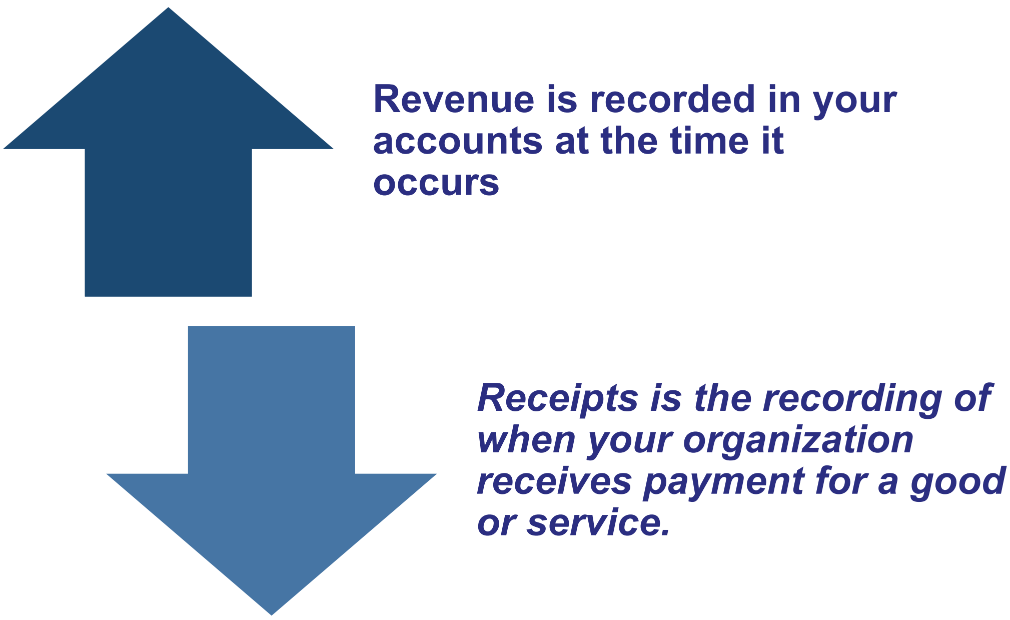
Key Points

- Terms like 'revenue,' 'expenses,' 'gross profit,' 'depreciation,' 'bad debt,' and 'fixed assets' have precise definitions when used in business accounting.
- You need to understand *exactly* what is meant by accounting terms like these.

2.1 THE REVENUE RECOGNITION PRINCIPLE

Organizations all have primary activities and it is the revenue or incomes generated by these activities that are referred to as 'sales' or 'sales revenue.' For example, a retailer will buy goods, which they then sell on. It is the sale of these products that creates their revenue.

For service organizations the primary activities are the acquisition of and selling of skills and expertise. These revenues are often referred to as fees earned, income, or service revenues.



Under accrual accounting, revenues are reported as they occur – that is 'when they are recognized' – and not when the payment is received. For instance, your organization sells its service to a customer for $5,000 in December, offering them 60 days to pay. Your accounts would show a revenue figure of this amount in December.

When at the end of February the invoice is paid your accounts would show a *receipt* of cash for that amount. It would also show a reduction in your accounts receivable (some organizations refer to this as 'collection'). It is important to appreciate the distinction between receipts and revenues so that the latter are only recorded once when the primary activity has been performed.

You also need to appreciate how the following will be represented in your organization's accounts:

- When a pre-payment or deposit is taken
- When payment is made in cash
- When funds are received in the form of a loan (e.g. from a bank)

Where your organization requests a payment (or deposit) for a service or product in advance of any work being performed this is known as a 'receipt.' Only once the customer's work begins will it be shown in your accounts as a 'revenue' item. For example:

> Your organization sells a product for $800 in May and requests a $200 partial payment at the time of sale, prior to delivery in June. This $200 appears in your accounts as a liability in May and only when the product has been delivered to the client will the accounts show $800 revenue.

In circumstances where organizations are concerned about a customer's ability to pay or their creditworthiness a deposit can be requested prior to the work starting. This deposit would be recorded in the same way as a pre-payment in your accounts, i.e. as a receipt.

In the event that your organization receives cash in direct exchange for its product or service this will be recorded in the accounts as both a 'receipt' and 'revenue.' This is because it has been given the cash 'receipt' on the same day the actual service or product (the 'revenue') occurred. For example:

> A dealership sells a car on April 23 for $650 cash. This sale would be represented in the dealer's accounts as both a 'receipt of $650' and 'revenue of $650' on that date.

In a situation where your organization needs to extend its mortgage or seeks a short-term loan, such funds are shown in your accounts as a 'receipt' and referred to as a current liability. There would not be 'revenue' for this amount within your accounts because no goods or services have been exchanged or performed. For example:

> The $12,500 extension to your organization's overdraft would be shown in your accounts only as a 'receipt' of $12,500 on the date such funds became available. It cannot be recorded as 'revenue' because it was not earned as a result of delivering a product a service.

Key Points

- Revenue is something that is generated by the business in exchange for goods or services.
- It does not include things like bank loans or overdraft facilities.
- Any payment for a service or product in advance of any work being performed is a 'receipt.'
- It only becomes a 'revenue' item once work (on behalf of the customer) actually begins.

2.2 THE MATCHING PRINCIPLE

Your organization may prefer to use the matching principle when deciding how to record its financial performance. This is because it enables your financial accounts to show a better evaluation of actual profitability and performance.

This principle achieves this by minimizing, wherever possible, the mismatch in timing between when your organization incurs costs and when it realizes its revenue. This still has to be attained whilst adhering to the accounting standards of recording costs as they occur and revenue when it is earned.

The degree to which this can be achieved will be influenced by how complex your operations are. The more complicated they are, the more difficulty your organization will have in 'matching' the date costs occur with the date revenue or income is received.

This is especially true in the case of provisions for bad debt and depreciation. It is difficult to be exact in such cases because they are influenced by numerous factors, and many, such as changes within the economic climate, are outside of an organization's control. The way in which an organization can interpret an item of high-value capital equipment designed for longevity is open to interpretation, and a new model or changes in technology can drastically alter its life span.

The accounting standards and regulations of your operating country will dictate how such items are represented in your organization's published accounts. If you are required to produce such figures for internal use then you need to adhere to its internal definitions.

Key Point

- The matching principle aims to minimize any mismatch in timing between when an organization incurs costs and when it realizes any associated revenue.

3 A SAMPLE INCOME STATEMENT – USING THE ACCRUAL METHOD

This example is based on a small organization that buys washing machines directly from the manufacturers, which it then sells online and through a network of retail distributors. Even though this organization has a straightforward business model it provides a good illustration of the issues you will need to consider when interpreting or compiling an income statement.

Here is the income statement for 'Wendy's Wholesale' for the first quarter of the year. The organization uses the accrual method of accounting.

Wendy's Wholesale Income Statement January 1–March 31		
	$	**$**
Revenue (Sales)		55,000
Stock at March 31	34,000	
Purchases	12,000	
SUB TOTAL	**46,000**	
Less Stock at January 1	(20,000)	
Costs to deduct from Revenue		(26,000)
GROSS PROFIT		**29,000**
Less Overheads:		
Wages	8,000	
Rent	1,500	
Electricity	700	
Insurance	500	
Distribution	800	
Other Expenses	1,800	
Reserve for Bad Debts	2,750	
Depreciation	200	
Less Total Overheads		(16,250)
NET PROFIT Before Tax		**12,750**

This income statement looks similar to that for Suzy's Signs except that there are some additional entries and considerations.

- Stock
- Gross Profit
- Net Profit
- Accruals (Costs not yet entered)
- Prepayments (Costs entered in advance)
- Bad Debt Reserve
- Depreciation

Each of these items is described below.

Stock

Wendy's must hold a stock of washing machines, so that they can be dispatched on the same day as they are ordered. An inaccurate net profit figure will result if costs include washing machines purchased but still in stock at the end of the period. This is allowed for by counting stock at the beginning and end of the period.

Counting stock can be done manually, if little stock is carried, but larger organizations will have these figures supplied by their computerized stock control system. A physical stock take is usually conducted periodically to avoid discrepancies accumulating and causing problems.

Gross Profit

An organization's gross profit is calculated by taking away the cost of producing and selling its goods sold from revenues earned.

Net Profit

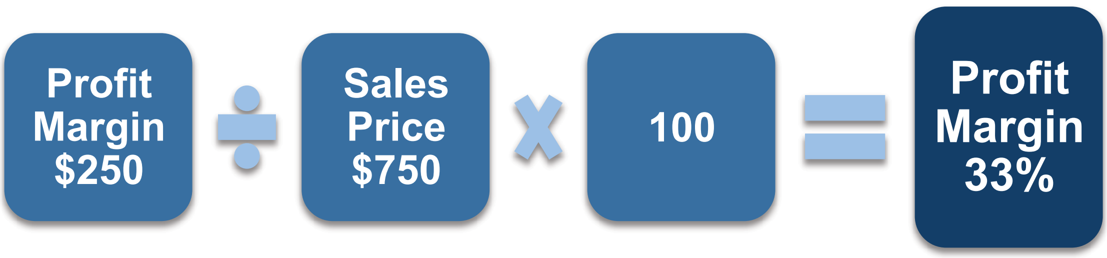
Net profit or 'net income' is calculated by subtracting all other overhead expenses from the gross profit.

Profit Margin

An organization's profit margin can be expressed as a ratio or by product as a percentage. The ratio is calculated as net profits (or net income) divided by revenue (sales). It measures how much out of every dollar of sales an organization actually keeps in earnings. For Wendy's this ratio would be:

When referring to the profit margin of an individual product it is the difference between the selling price and the cost price of the product. For example:

This is often expressed as a percentage where the difference between the selling price and the cost price is divided by the selling price. This answer is then multiplied by 100 to become a percentage. For example:



Accruals (Costs not yet entered)

An accrual is an allowance for costs that have not yet been invoiced. For example, Wendy's have not yet received their electricity bill for this quarter. Since the purpose of the income statement is to present an accurate picture of the finances for the period it needs to recognize this liability even though no invoice has been received. In this instance Wendy's would look at last year's bill for the same period, which was $667, and then enter a figure of $700 as a realistic estimate for the quarter.

Prepayments (Costs entered in advance)

A prepayment is the opposite of an accrual. Wendy's received an invoice from its insurers for $2,000 in January, which is their insurance premium for the year. In the income statement they would apportion this invoice into equal amounts for each quarter. So a figure of $500 is entered this quarter's expense on the income statement.

Bad Debt Reserve

Even though Wendy's has a carefully controlled policy of extending credit, sometimes one of its retailers becomes insolvent or bankrupt before the invoice is paid. This creates a 'bad debt,' which means that payment will never be collected and so becomes an expense. Technically, a bad debt becomes a bad debt when the chances of payment become so small as to be nonexistent.

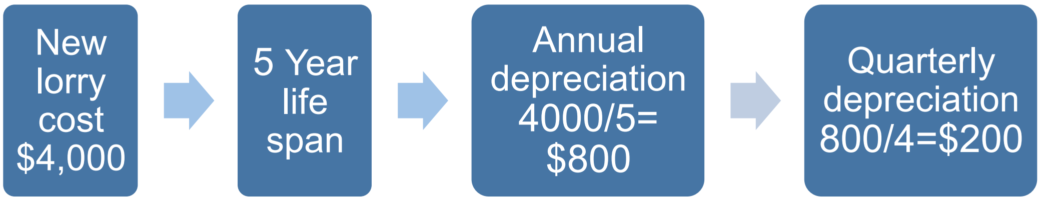
Many organizations know from experience the sort of percentage of total sales that will never be paid for. In Wendy's case they estimate a 5% bad debt expense has happened when the sale is made. Even though no check is actually written to cover this percentage, it exists as a total against which the actual bad debt can be subtracted from.

The way that bad debt is handled in the accounts is explained more fully in our free eBooks titled 'Understanding Income Statements' and 'Reading a Balance Sheet' which you can download free by visiting www.free-management-ebooks.com.

Depreciation

All organizations have fixed assets such as office and capital equipment, which have a useful and productive life longer than the period of an annual income statement. Many of these items have a useful life that will span several years.

It would be unreasonable to apportion the costs of these to the quarter in which they were purchased. This problem is overcome by charging only a portion of the cost of these assets to each quarter of their expected useful life.



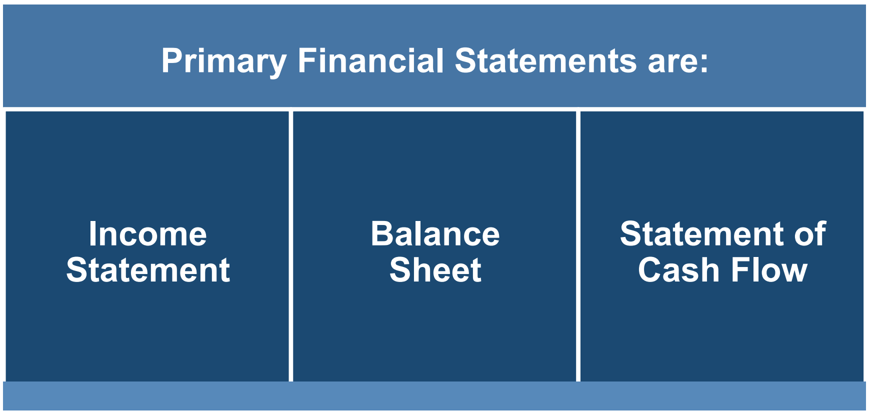
For example, Wendy's bought a new lorry for $4,000 in January and it has a productive life of five years. This allows for $800 a year ($4,000 divided by 5 years life) in depreciation, which for the quarterly income statement enables $200 to be entered under overheads as depreciation.

Key Points

- An accrual is an allowance for costs that have not yet been invoiced. In other words, a charge incurred in one accounting period that has not been paid by the end of it.
- A prepayment is a payment in advance for a good or service not yet received.
- Many organizations know from experience the sort of percentage of total sales that will never be paid for and make an allowance for this 'bad debt.'
- Depreciation is a method of allocating the cost of a tangible asset over its useful life.

4 SUMMARY

You should now have an understanding of basic financial terms, the differences between cash-based and accrual accounting, and an appreciation of when revenue and costs are recognized in the accounts. This is sufficient background information to be able to understand the financial statements that make up an organization's annual report and most internal monthly reports as well.



The most widely used financial statements are:

> **The Income Statement** – An accounting of revenue, expenses, and profit for a given period. This can also be an internal document that can be used to make management decisions about almost any activity where you have a record of the money spent and the associated return.
> **The Balance Sheet** – An itemized statement that summarizes the assets and liabilities of the business at a given date.
> **The Statement of Cash Flow** – A report that shows the effect of all transactions that involved or influenced cash but did not appear on the income statement.

This eBook has used the income statement as a basis for explaining the basic principles of accounting. If you need to interpret or prepare an income statement then you should read the free eBook 'Understanding Income Statements' which can be downloaded from www.free-management-ebooks.com.

Other free financial skills eBooks are:

- Reading a Balance Sheet
- Controlling Cash Flow
- Assessing Financial Performance
- Understanding Income Statements

5 REFERENCES

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