Four basic accounting misconceptions that could be holding you and your business back

Issued by UCT Graduate School of Business

20 Feb 2017

If you don't want to be tripped up in meetings or have the wool pulled over your eyes by your employees when it comes to money matters you need to make sure you understand the basics of accounting.

There are many misconceptions around basic accounting that cause trouble for businesses and keep non-financial managers from spotting potential areas of risk in their business operations.

“Basic accounting can be really, well, basic,” says Associate Professor Mark Graham from the UCT Graduate School of Business. “You don’t need a degree in finance to understand it. The trick is knowing what you need to know, and parking the rest. You can’t be a senior manager or an entrepreneur without having a good grasp of the fundamentals.”

He explains that some of the common misconceptions around accountancy are:

Misconception #1: You need to understand debits and credits to understand accounting

No, you do not. Accounting can be understood by thinking and talking in terms of specific accounts increasing or decreasing. “Nevertheless, it is true that accountants talk in terms of debits and credits, so it can be helpful to speak in their language,” Professor Graham says.

Misconception #2: A debit is a bad thing

A debit –which is merely an accounting term for one side of an entry, is neither good nor bad. If you buy a car (i.e. an asset), the resulting debit would presumably be a good thing, while if you got a speeding fine (i.e. an expense), the resulting debit would more likely be a bad thing.

Misconception #3: There is a standard set of terminology in accounting

While there is a movement towards some standardisation of the language of accounting, many variations exist, says Professor Graham. For example, the following terms generally have the same meaning: profit and earnings; inventory and stock; accounts receivable, trade receivables and debtors; accounts payable, trade payables and creditors; bank and cash; retained earnings, retained income and accumulated profit. This means not being confused by the jargon, of which there can be a lot of in accounting.

“Accounting is the language of business and financial statements are the scorecard,” says chartered accountant Michael Harber’, a lecturer at UCT’s College of Accounting. “There can be no question that to be successful in business, it is necessary to be able to speak the language and know how to tell the score.”

Misconception #4: There is a “perfect” debt ratio

A debt ratio is defined as the ratio of total (long-term and short-term) debt to total assets, expressed as a decimal or percentage. To determine whether a ratio is good or bad, one must consider the particular business, says Harber. Businesses that are not cyclical and which have stable profits may be able to absorb more debt as they do not face the risk of being unable to pay their interest because of a downturn in profits. Another consideration is the stage of the economic cycle in which the business finds itself. If a business anticipates high profits when interest rates are low, the business could avail itself of more debt to take advantage of the positive effects of leverage. However, when interest rates rise and or when lower profits are expected, the same business should perhaps reduce debt levels to lower the risk of not being able to meet interest payments.

Professor Graham says that debunking these and other basic accounting myths is part of the four-day Finance for Non-Financial Managers Programme, which he runs at the GSB. Basic accounting takes up one of the four days, during which the Big Five are covered. “The Big Five of accounting are assets, liabilities, equity, income and expenses. Each of these relates differently to each company, corporation or partnership.

“A lot of what is considered basic accounting is really straight-forward and common sense, but it is shrouded in complicated language. This often confuses and intimidates newcomers to the world of finance. So we help people to see what is important to them in terms of basic accounting and how it relates to their business interests.”

For more information about the Finance for Non-Financial Managers programme contact Executive Education department at the UCT Graduate School of Business on 0860 UCT GSB or email execed@gsb.uct.ac.za.