Financial accounting and reporting

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Contents

Introduction 4
Learning Outcomes 5
1 Definitions of bookkeeping, accounting and reporting 6
1.1 Bookkeeping 6
1.2 Accounting and reporting 8
2 Reasons for and objectives of accounting 11
2.1 Stewardship 11
2.2 Accountability 11
2.3 Planning and decision making 11
2.4 Control 12
3 Management and financial accounting 13
4 The main elements of accounting information 14
4.1 Income and expenses 15
4.2 Assets and liabilities 16
4.3 The balance sheet 18
5 The main financial statements 20
Conclusion 21
Keep on learning 22
Glossary 23
References 29
Acknowledgements 29

Introduction

This free course, *Financial accounting and reporting*, serves as an introduction to financial accounting, introducing the basic terminology, purpose and different types of accounting. You will learn about what accounting is, the purposes for which accounting information is used, how to distinguish between management and financial accounting, the components of accounting information, and the main financial reports in which this information is presented to its users.

You will also have a clear understanding of how accountants act as processors and purveyors of information for decision making, of the needs of those who use accounting information, and of the role performed by accountants. Accounting does not exist for its own sake or in a vacuum: there must be a reason why accounting is being done. This course is also meant to enable you to understand the relevance of the course to your own career. For example, if you are thinking about becoming a professionally qualified accountant or studying business or management, or using knowledge of accounting in your own work situation or your own business.

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This OpenLearn course provides a sample of level 2 study in Business & Management.

Learning Outcomes

After studying this course, you should be able to:

- define bookkeeping and accounting
- explain the general purposes and functions of accounting
- explain the differences between management and financial accounting
- describe the main elements of financial accounting information – assets, liabilities, revenue and expenses
- identify the main financial statements and their purposes.

1 Definitions of bookkeeping, accounting and reporting

First of all, you need to be aware of some of the basic terminology in this subject area. There are several different terms in common use under the general umbrella of accounting and they are often used by people interchangeably without distinguishing the meanings of these terms. Some of the most important are considered in this section, namely **bookkeeping**, **accounting** and **reporting**.

1.1 Bookkeeping

Bookkeeping is the process of recording transactions in the financial records of a business entity. Before transactions are recorded, they need to be classified according to their type so that similar items can be recorded in the same record or **account**. For example, a business entity will keep records of sales and purchases of goods or services, each classified according to their nature. Originally records detailing similar types of transactions were kept together in a book or ledger, with one or more pages dedicated to a particular kind of transaction, for example, sales of specific goods. Therefore, records often are collectively referred to as the 'books' of a business.

Bookkeeping goes back many hundreds, even thousands, of years. It began because people needed to record business transactions as a means of keeping track of who owed them money and to whom they owed money, and of knowing whether businesses were financially successful or not. For many years, bookkeeping was based on common sense – businesses recorded the data they considered necessary in order to obtain the information they required. 'Bookkeeping' as a term is used to denote not only recording transactions in the way described here, but also frequently as an abbreviation for **double-entry bookkeeping**, a particular system of recording transactions devised about 500 years ago, and first written about by an Italian monk called Luca Pacioli. Today, double-entry bookkeeping remains the most widespread method of bookkeeping.

Figure 1 Portrait of Luca Pacioli (c.1445–c.1514) Mathematician and Friend of Leonardo da Vinci, 1495 by Jacopo de'Barbari (1440/50–a.1515) Museo e Gallerie Nazionale di Capodimonte, Naples, Italy/Bridgeman Art Library.

It is the job of the **bookkeeper** to maintain the books of a business and keep them up to date. This is done by ensuring that transactions are recorded in a timely and logical manner, either chronologically, as they occur, or by dealing with like items in batches, for example, recording all sales of a particular good in a defined period of time (day, week or month, according to the needs of a business). Recording may be done manually using paper and pen, but it is now more commonly done by using a computerised bookkeeping or accounting program.

Recording items in individual accounts (see above) is also referred to as **posting**, and a computer program can ensure that all necessary records are completed quickly and accurately (provided that data have been entered correctly, of course!).

Link between accounting and writing

Arguably the need felt by the Sumerian civilisation in Mesopotamia to keep account of livestock was also the origin of writing, as this account was recorded. The concept of 'wealth' is much older than that of 'money'. Livestock was often regarded as an indication of wealth – which is still the case in some developing countries. Anyone who has read Alexander McCall Smith's *The No. 1 Ladies' Detective Agency*, set in Botswana in recent years, will recall that Mma Ramotse was bequeathed a herd of 180 prime cattle by her father, who had regarded them as an investment.

As a result of posting transaction details to individual accounts in this way, each account will show a history or list of transactions that have occurred, so the management of a business can keep track of them individually. It can also track movements (increases and decreases in the volume of transactions recorded) over a period of time (e.g., to monitor sales of a new product). Businesses also need to know how well they are faring in all aspects, and the existence of accounts enables them to draw up a formal report to show this. The list of monetary transactions in an individual account can be totalled so, for example, the total sales of a good in a particular period can be determined. This totalling of individual accounts also may reveal that one side of a double-entry account exceeds another in value. This enables a **balance** to be calculated. The individual account balances for all accounts are then listed in a separate document, which is known as a **trial balance**. The process of **balancing off** individual accounts and drawing up a trial balance is an important part of determining whether a business has made a profit or loss overall.

Activity 1

Imagine a business recorded what it had sold, to whom, the date it was sold, the price at which it was sold, and the date it received payment from the customer, along with similar data concerning the purchases made by the business.

What information do you think that the business could produce from these data? Take ten minutes or so to type your answer.

Provide your answer...

Feedback

These data would enable the business to know how much it had sold and how much it had purchased, how much cash it had received and paid, how much was owing to it and how much was owed by it (both in respect of any individual customer or supplier and in respect of the overall business transactions), and whether it was making a profit or a loss over a particular time period. It might also be possible to compare how much had been sold to the customer and purchased from the supplier with amounts sold and purchased previously.

1.2 Accounting and reporting

Accounting is a process which identifies, organises, classifies, records, summarises and communicates information about economic events, usually, but not exclusively, in monetary terms. While accounting is often considered as including bookkeeping as well, it is much wider than bookkeeping. It may also be regarded as a transformative process in that it turns the raw data recorded in bookkeeping into useful information. Data lack meaning until they have been processed into meaningful information. What good is it to know that a book cost a bookshop £10? Those data will only become information when they are combined with something else that enables you to assess them within a relevant context, such as how much the book would have cost had the bookshop bought it from a different supplier or how much profit the bookshop made when it sold the book to a customer.

The communication aspect of accounting involves the reporting of information about a business to interested parties, such as owners and managers. Results of all transactions over a period of time need to be summarised, presented and interpreted in order to assess a business's performance and its financial position at a given date. The period of time for which results are calculated is referred to as an **accounting period** or **period of account**. An accounting period can be any length of time, and the length may be determined by the reason for which a set of results is required, for example, to provide management with information, to support an application for a bank loan, etc. Commonly, however, an accounting period is of a year's duration, and however often businesses produce sets of results, they will always produce an annual set of results, as these are required for specific purposes, such as for taxation or, in the case of companies, filing with a regulatory authority. Only in certain well defined circumstances will sets of results for periods other than a year be accepted for these specific purposes. For example, the first accounting period for companies in the UK must be more than six months, but no more than 18 months.

The date on which an annual accounting period ends is referred to as the business's **accounting reference date** or **closing date**. For UK business entities, this date can be any date in the year and does not have to coincide with a calendar year, though this is not necessarily the case elsewhere. The form in which results are presented is usually twofold: a calculation of the business's overall profit or loss for its accounting period, referred to as an **income statement** or **profit and loss statement/account**; and a **statement of financial position** as at the end of the accounting period, also called a balance sheet. In this course we will use the terms 'income statement' and 'balance sheet'. The income statement and balance sheet together are often referred to as the **financial statements** or **set of accounts**.

Different accounting terminology

The different names for the different parts of financial statements have arisen as a result of different customs, rules and regulations over the years, when we look especially at the impact of the **International Accounting Standards Board (IASB)** and the introduction of **International Accounting Standards (IASs)** and **International Financial Reporting Standards (IFRSs)**. 'Profit and loss account' was for many years a common term, but it was felt to be less than precise, particularly when, for example, it was used by entities which did not have a profit motive, such as charities. IAS 1, the international accounting standard which deals with the presentation of financial statements, therefore, introduced the term 'income statement', which can be more universally applied. At the same time, it suggested the replacement of another, much older term, 'balance sheet', by the term 'statement of financial position'. IAS 1, however, did not make adoption of the new terms mandatory. 'Income statement' has been widely adopted, but not 'statement of financial position'. While many professional accounting training manuals use the latter, it is not yet widely used by businesses, which still continue to use the term 'balance sheet'. In this course, we therefore use the terms 'income statement' and 'balance sheet'. In addition to widespread use, the term 'balance sheet' is also useful when learning accounting as it helps remind you that a balance sheet itself should 'balance', that is, both halves/sides should add up to the same figure, and that certain individual account balances will be included there.

Although businesses produce formal income statements and balance sheets for, and at the end of, accounting periods, they can do so at any time, and often produce them more regularly to help managers monitor and control business activities and make decisions, as mentioned above. This adds further dimensions to accounting, as it helps look to the future, rather than focusing on transactions that have already occurred, and in this sense accounting has a management function, as a part or sub-set of the wider **management information system (MIS)** of a business. In this context, accounting is sometimes referred to as an **accounting information system (AIS)** or in short, **accounting system**.

Activity 2

Earlier it was mentioned that it might not be very useful to know only that a book cost a bookshop £10. What other data do you think could be used in order to convert the data about the cost of the book into information? Take ten minutes or so to think about this and type your answer.

Provide your answer...

Feedback

You may have suggested any of the following:

- the selling price of the book
- the amount the bookshop could have purchased the book for elsewhere
- the time it took to receive the book from the publisher after the bookshop ordered it
- the condition of the book when it arrived in the bookshop
- the length of time before payment was effected.

These are all good answers, and there are probably many others. In each case, they provide the means of assessing something:

- the profit that will be made if the book is sold
- whether the bookshop paid a ‘good’ price for the book
- how far in advance the bookshop should order the book if it wants it to be available for customers on a particular date
- whether the supplier packages books appropriately
- possibly, whether the business is likely to be given credit by the supplier in future.

Information is data processed for a purpose. Once data have been converted into information, you can then use that information to help you make a decision, which will require the exercise of judgement. You cannot take meaningful decisions with data. This process can be expressed as follows:

Decision = Purpose + Information + Judgement

Note that while the bookkeeper will record data, it is the accountant who (as the definition of ‘accounting’ suggests) will convert data into information which serves a purpose, that is, is useful. To be useful, information must be timely, relevant, complete and of good quality. It can only possess these qualities if the underlying data have been recorded properly.

2 Reasons for and objectives of accounting

The main purpose of accounting is to provide financial information to managers and owners of businesses (as we have already seen) and a variety of other interested parties. This financial information fulfils different objectives, namely stewardship, accountability, planning and decision making and control, as discussed in the next sections.

2.1 Stewardship

Persons who run or manage businesses are not always those who have invested money and/or resources in the business. They manage money and/or resources which are owned by others, and act as **stewards** (or **agents**) on behalf of owners (sometimes called **principals**). The concept of stewardship places an obligation on stewards to provide financial information relating to the resources which they control, but do not own (see Figure 2 below).

Arrows denote flow of resources, information and directions of responsibility.

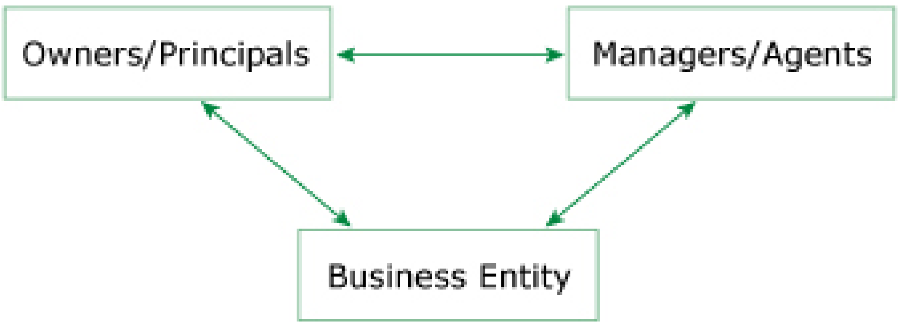

Figure 2 Stewardship

2.2 Accountability

Accountability is connected to the idea of stewardship (though it is a wider concept as it may extend to other **stakeholders** or society in general). Stewards are obliged to give to owners of businesses an account of how they have managed resources. This may be discharged in part by the provision of financial information, such as an income statement and balance sheet. However, the idea of 'accountability' also carries with it the notion of acting responsibly and being able to justify one's actions and, therefore, prepared to suffer the consequences of irresponsible and unjustifiable actions.

2.3 Planning and decision making

Business managers need to have financial information to enable them to make plans for future business activities and operations. For example, if a business plans to sell 120,000 units of a good it manufactures in the next year, it will need to know the quantity and price of raw materials required to make 120,000 units, the number of staff required and the hours each staff member can work and their rate of pay, the type and number of machines required, etc. There will, of course, be other costs associated with production. Such information is typically derived from on-going business activities and experience and reported financial information, combined with knowledge of future price increases for raw materials, wages and other known costs. Planning of this kind can be very difficult in practice if a business is aiming to increase or decrease production of an existing good, and becomes even more difficult in the case of producing any good which the business has not produced before.

2.4 Control

Accounting information can also be used for the purposes of control. Business managers need to monitor activities and operations to see whether they are proceeding according to plan. In the example in Section 2.3 of planning to manufacture and sell 120,000 units of a good, a business may have planned to sell the units evenly over a year, that is, 10,000 units per calendar month. Therefore, the business will need accounting information on a monthly basis to see whether this target is being achieved. If it is not, then the business will need to find out why, and take corrective action if possible. The type of corrective action will depend on the problem that has been identified. Different problems can have the same overall effect. For example, if sales were 'down' in any given month, it might be the case that trade was more seasonal than anticipated and there might be compensating higher sales in other months. It might also have been the case that a sales representative for a particular area had been away on sick leave, which would also result in lower sales. Equally, a production problem could have prevented sufficient goods being manufactured for sale – perhaps being caused by machines breaking down or suppliers' inability to deliver raw materials when needed. It is also possible that sales in a given month might be 'up' on what was forecast – which could also cause problems if it continued in the longer term, as the business may have resources that are inadequate to meet an unanticipated higher demand. Regular provision of accounting information (in this example, for sales and production) is essential for control purposes.

Activity 3

How do you think a shareholder in a company can be assured that the financial statements give a true and fair view of how the directors have been running the company? Take ten minutes or so to type your answer.

Provide your answer...

Feedback

The shareholder would primarily look at the externally audited financial statements for the accounting period ended most recently. You might have been thinking along the lines of the shareholder asking someone to undertake an independent investigation into the financial statements and (by implication) into the directors' management activities. You would have been right, because this is what external auditing involves. An **external auditor** is an independent, external person or firm appointed formally by the shareholders to write a report to them on the externally reported financial results of a company (as shown in its financial statements) and on its management.. There are also **internal auditors**, who might do a similar job, but report to internal committees within a firm.

3 Management and financial accounting

From Section 2, it is clear that accounting information has a number of different purposes, governed by the needs of those using it. This brings us to consider different types of accounting, namely financial accounting and management accounting, as the purposes fulfilled by accounting information generally fall under one or the other heading. It is important to note that this does not mean that any different types of books or records need to be kept. It is just that the information produced from the books and records organises, classifies, summarises and communicates information according to the perspectives and needs of the users, as Table 1 below shows.

Table 1 Differences between financial and management accounting

	Financial accounting	Management accounting
Chief purpose	Production of summarised income statements and balance sheets by managers as a formal report on the stewardship of resources entrusted to them but should also, in the case of public companies, help interested parties (such as investors) make decisions. Depending on the type of the business entity, documents may be publicly available.	Production of detailed and up to date information used by managers to plan activities and control them. This information is not publicly available, but is internal to the entity producing it.
When information is prepared	Annually, at the end of an accounting period, but, depending on the type of business entity, may be every three or six months as well.	Normally prepared on a monthly basis.
Governed by	Legal requirements and often mandatory accounting regulations* and/or conventions which may also dictate a required format (though this depends on the legal form of an entity).	Management needs only – with no legal requirement to produce anything in any format, or anything at all. Information is produced in the format management deems most useful, e.g., by operating unit or product line, to record and monitor sales (by product, region, etc.), costs of production methods or products.

Perspective	Gives information about past performance, and might in practice be outdated by the time summarised documents are produced.	Comparative and up to date. While a given month's results are provided, these are usually accompanied by a total for all months to date and comparative figures for a prior year (as well as for planned activities in the month and period to date).

*In order to facilitate comparison between similar business entities, income statements, balance sheets and other summarised accounting documents are prepared using accepted conventions and standards.

Activity 4

Which of the following statements is untrue?

1. Financial statements are usually produced annually and management accounts are usually produced monthly.
2. Financial statements are more accurate than management accounts.
3. Financial statements may be audited by an external auditor and management accounts are not audited.
4. Financial statements are intended primarily for external users and management accounts for internal purposes.

Take ten minutes or so to type your answer.

Provide your answer...

Feedback

All statements are true, though in the case of Statement 2, it does depend on the extent to which financial or management accounts may contain estimated figures, which are appropriate in certain circumstances, as you will learn later. Remember that all accounting information is produced from the same records – but at different times and for different purposes. It should all be of similar quality. Note that, in respect of Statement 3, while management accounts are not audited, not all financial statements are either, hence the subtle use of the phrase 'may be audited' in respect of financial statements. The requirement for audit is determined by the type of organisation and its size.

4 The main elements of accounting information

Section 1.2 told you that results of all business transactions over a period of time need to be summarised, presented and interpreted in order to assess a business's performance and its financial position at a given date, in the form of an income statement and balance sheet. It was emphasised in Section 3 that the presentation of financial accounting information is governed by a combination of legal requirements and accounting regulations and conventions. Different types of business entities are governed by different requirements. However, one of the rationales underlying the preparation of income statements and balance sheets is to turn raw financial data into useful information, and this is achieved in part by organising, classifying and presenting data in particular ways to make them meaningful. Here we shall look at some conventional ways of doing this.

4.1 Income and expenses

An income statement is a summarised financial statement which shows how well or badly a business is faring. An example of an income statement is shown in Figure 3. This is an income statement for a hypothetical sole trader (here called Mr Schmidt).

Mr Schmidt – Income statement for the year ended 31 March 2010

	£	£
Sales		40,000
Less: Cost of goods sold		
Opening inventory	14,000	
Purchases	22,000	
	36,000	
Less: Closing inventory	(12,000)	
		(24,000)
Gross profit		16,000
Less: Expenses		
Rent	3,000	
Lighting and heating expenses	2,800	
General expenses	800	
		(6,600)
Net profit		9,400

Figure 3 Example of an income statement

As its name suggests, an 'income statement' includes all the income generated by a business in its accounting period. This is usually derived from the sales of its products and services, which are first listed from individual accounts on to the trial balance and then added up together. Income derived from sales may be referred to by a number of different terms, such as **turnover** or **sales** (sometimes **sales turnover**), **sales revenue** or just **revenue**. However, income may be derived from other sources, and the source may be denoted in the terminology used to describe it. If a business derives income from a bank account in the form of bank interest, for example, this too will be included in the income statement. It will be shown separately from income arising from sales and will be called 'bank interest receivable' or something similar. However, perhaps rather unhelpfully for persons learning about accounting for the first time, 'revenue' can also be used as a general term to mean any sort of income, and if so used, could include 'bank interest' as well. There is no hard and fast rule about how the terms 'income' or 'revenue' are used. They are both very common terms, and you will see both used in this course.

In acquiring or making products for sale, or delivering services to customers, however, a business will have laid out some of its own resources (most commonly, money). For example, if a business makes a product, it will need to buy in raw materials, pay wages to employees making the product, and pay for electricity (for example) used in the manufacturing process. Likewise all such items are listed from individual accounts on to the trial balance and then added up together, with like items grouped together. For example, raw materials will be added together, as will energy items, wages, etc. The term **costs** or **expenses** is often used here to denote these types of items. Some accounting textbooks differentiate between these terms, but you will find them used interchangeably without distinction of meaning, and we do not differentiate between them in this course. Often terms used in accounting are also used in every day life with no reference to their financial meanings and this contributes to the overall lack of precision. For example, it is common to speak of someone 'paying the price' for something, such as committing a misdemeanour.

An income statement shows the total costs subtracted/deducted from total income. If there is an excess of total income over total costs, this is referred to as a **profit** (sometimes called a **surplus**, if the entity, like a charity, does not have a profit motive). If total costs exceed total income, then a **loss** or **deficit** (the latter is often used by non-profit-making entities) is said to arise – hence the alternative name for an income statement of 'profit and loss account'. By organising, classifying and presenting income and expenses in this way, the income statement makes them into meaningful information because by calculating a profit or loss it becomes possible to determine how well or poorly a business is performing.

You will see that Mr Schmidt has separated his costs into those that relate to items that he has sold and the rest, and it shows two different kinds of profit. You will learn all about this later in this course, so do not worry if there are things here that you do not understand. Note also that the accounting convention used here puts figures to be deducted in round brackets. This is widely used, especially in the UK, but you should be aware that not every country uses it.

4.2 Assets and liabilities

As the income statement groups together like items of income and deducts like items of costs to show a profit or loss for an accounting period, the balance sheet also groups together like items to show the financial position of an entity at the end of its accounting period. It is rather like a 'snapshot' of the entity at that moment in time. Determining a financial position is something that individual people frequently do as well, and involves sorting out what, as a person, you own and what is of value to you, often in terms of money and things like houses, cars, jewellery, furniture, etc. These types of things are called **assets** and the term means much the same in an accounting context as well. Determining a financial position also involves sorting out what, as a person, you might owe to other people – by way of things like mortgages, loans, credit card bills, unpaid bills for utilities, etc. These are called **liabilities**. If the value of your assets exceeds your liabilities, you could (in theory, at least) sell your assets, realise cash and settle your liabilities.

Assets and liabilities have been carefully defined by the International Accounting Standards Board (IASB). Assets are resources controlled by a business as a result of past events and from which future economic benefits are expected to flow to the business. They might be things the business owns, like machinery.

Businesses try to establish a financial position in a similar way at the end of an accounting period. They may have various assets, such as land and buildings, **plant** and machinery and vehicles, which they use to carry out business, manufacture goods and deliver them, and which they intend to keep for a long time. These are referred to as **non-current assets** or **fixed assets**. ‘Fixed’ here does not necessarily imply that assets are immovably fixed in one place (though many kinds of these assets often are); rather, it implies ‘lasting’. Many non-current assets, such as land and buildings, plant and machinery and vehicles, etc., are also referred to as **tangible assets** in that they have a physical form and can be ‘touched’ (the basic meaning of the word ‘tangible’). It follows that there are also **intangible assets** which are things that cannot be ‘touched’, such as **patents**, **copyrights**, **trademarks**, etc., though their existence may be confirmed by some kind of documentation. Businesses may also have items which they have bought to use in manufacturing, such as raw materials, but have not yet used. These will be used up in the course of manufacturing, and are often referred to as **inventory** or **stock**. They form one of another category of assets known as **current assets**, which either stay with a business entity for only a short time, or change over time. They perform a different role in the business from non-current assets. A business will not have exactly the same type or amount of raw materials in stock at the end of every accounting period, but will keep buying in materials as and when required, as it continues to manufacture and sell goods, so from one accounting period end to another, these items will not be the same. Businesses may also have stocks of finished items, which have not yet been sold, or stocks of items which are only partly finished (**work in progress**).

Other types of current assets are cash and amounts due from customers who have not paid for goods sold to them, referred to as **trade receivables** ('**receivables**' for short and sometimes also referred to as **trade debtors**).

Businesses also have liabilities in a similar way to individuals. They buy from suppliers, and may not pay for goods immediately, so at the end of an accounting period may owe money for such goods, referred to as **trade payables** ('**payables**' for short and also sometimes referred to as **trade creditors**) or for utilities such as gas, electricity or telephone charges. Businesses also borrow money from banks or other lenders to start or continue business. Also, owners of businesses invest their own money in business, most often when business commences. Money, resources or assets put into a business by owners are referred to as **owner’s interest**, **equity** or, commonly, as **capital**, though this latter word can be used to mean other things as well. As money, resources and assets will eventually be repayable to a business’s owners, this may also be regarded as a type of liability. Generally, liability items are classified by reference to when they need to be paid. Those due more than a year after the end of the accounting period are referred to as **non-current liabilities** (or **long-term liabilities**). Those due within a year or less are called **current liabilities**. Amounts due in respect of trade payables will be current liabilities as such amounts are often due within three months or less, whereas loans may not be repayable for several years.

Liabilities are present obligations of a business arising from past events, the settlement of which is expected to result in an outflow from the business of resources embodying economic benefits. They might be sums of money owed to lenders, for example, who have loaned money to a business, and who will need to be repaid in due course.

4.3 The balance sheet

At the end of an accounting period, all assets and liabilities are listed from individual accounts on to the trial balance and then added up together, with like items grouped together. There are two ways of showing assets and liabilities on a balance sheet – using either a **horizontal format** or a **vertical format**. A horizontal format lists all the assets on the left-hand side and all the liabilities on the right. As a result of the manner in which transactions are recorded using double-entry bookkeeping, the total of assets always equals the total of liabilities. This is why a statement of financial position is commonly called a 'balance sheet', that is, both sides (or halves) add up to the same amount. A vertical format often shows capital in the 'bottom' half, and in the 'top' half shows assets with liabilities deducted from them (current liabilities, for example, are deducted from current assets to show net current assets or liabilities). This is often referred to as the **net assets approach**. It is also possible to show all assets in the top half and all liability (or credit) balances in the bottom half (which is now possible under the **international accounting approach**) Any entity could, in theory, produce a balance sheet in either format, as it is just a matter of presentation. The vertical balance sheet (i.e., using the net assets approach) is common in the UK, but different countries have different rules. It would not, for example, be permitted in France, although other countries with specific regulations may require it for certain types of entities. Examples of a horizontal and vertical balance sheet are shown in Figures 4 and 5 below – again for Mr Schmidt, the hypothetical sole trader whose income statement you looked at previously, in Figure 3.

Mr Schmidt – Balance sheet as at 31 March 2010

	£		£
Non-current assets		Capital	
Fixtures and fittings	18,000	Cash introduced	25,000
		Retained earnings	11,000
Current assets		Net profit for the year	9,400
Inventory	12,000		
Trade receivables	5,800	Current liabilities	
Cash at bank and in hand	2,300	Trade payables	8,200
Drawings	15,500		
	53,600		53,600

Figure 4 Example of a horizontal balance sheet

Mr Schmidt – Balance sheet as at 31 March 2010

	£	£
Non-current assets		
Fixtures and fittings		18,000
Current assets		
Inventory	12,000	
Trade receivables	5,800	
Cash at bank and in hand	2,300	
	20,100	
Current liabilities		
Trade payables	(8,200)	
Net current assets		11,900
Net assets		29,900
Capital		
Cash introduced		25,000
Retained earnings		11,000
		36,000
Add: Net profit for the year		9,400
		45,400
Less: Drawings		(15,500)
		29,900

Figure 5 Example of a vertical balance sheet, following the net assets approach

Again, do not worry if there are things here that you do not understand, such as **drawings** or why these are included in the horizontal balance sheet with assets, as these will be explained later (though drawings are simply a withdrawal of capital by the owner(s)). You will see in the above balance sheets that both show the profit of £9,400, as per the income statement in Figure 3, included with the capital elements.

Activity 5

Classify the following list of items as income, a cost/expense, an asset or a liability:

asset

a machine for manufacturing widgets

cost/expense

air conditioning used in a factory

income

sales of 1,000 widgets for cash to Mr Mohammad, a customer

liability

£3,000 borrowed from the bank

asset
a heap of metal on the yard, to be used for manufacturing widgets
liability
£4,000 owed to Pyron Ltd for the metal on the yard
liability
a Toyota Lexus car, used by an employee, but owned by his/her employer, Yen Ltd
liability
£10,000 of personal savings used by someone starting up a business.

Feedback

A machine for manufacturing widgets is a tangible non-current asset – used for carrying out business and likely to be kept for a long time.

Air conditioning used in a factory is a cost/expense – a utility needed to keep machinery and employees at an appropriate temperature while they work. If the actual air conditioning plant itself is implied by the words 'air conditioning' (rather than what the plant actually does) then this would be a tangible non-current asset, likely to be used and kept for a long time.

Sales of 1,000 widgets for cash to Mr Mohammad, is a sale to a customer, generating sales revenue (income).

£3,000 borrowed from the bank is a loan, which will have to be paid back. It is a liability, and whether it is classified as current or long-term will depend on the date of repayment.

A heap of metal on the yard, to be used for manufacturing widgets, is raw material to be used in manufacturing so is inventory. Hence, it is a current asset.

£4,000 owed to Pyron Ltd for the metal on the yard is money owed for material to be used in the business, so it represents a trade payable, and would be a current liability.

A Toyota Lexus car, used by an employee, but owned by his/her employer, Yen Ltd, is a non-current asset. This is because it is used in the business for transporting the employees (it may be what is called a 'pool' car, that is, it is available to a variety of employees). It is important to note that the car is owned by the employee's company, not the employee. Therefore, the car would be one of the company's non-current assets.

£10,000 of personal savings used by someone starting up a business is money introduced to do business – therefore, it is capital which may be regarded as a particular type of liability, in that it will eventually be repayable to the owner.

5 The main financial statements

To summarise from the previous discussions, the financial statements comprise:

The income statement or profit and loss statement, which shows income, less costs/expenses for an accounting period. Where income exceeds expenses, a profit or surplus arises. Where costs/expenses exceed income, a loss or deficit arises.

The balance sheet, which is a ‘snapshot’ of assets and liabilities at a moment in time – the end of the accounting period. The end of the accounting period is also often referred to as the ‘accounting reference date’, ‘balance sheet date’ or ‘closing date’.

To the above, we must also add:

The **cash flow statement**. There is a requirement for certain business entities, namely companies, to provide a cash flow statement to show movements in cash over the period covered by the income statement. This cash flow statement is considered by entities required to provide it as a third financial statement in addition to the income statement and balance sheet. The cash flow statement will be discussed later in this course when you learn about company financial statements, and examples will be given there.

If you look at any income statement and/or balance sheet for an entity, you will find that they are generally accompanied by a set of **notes to the financial statements** which provide further information, explanation or analyses, which are more conveniently shown separately from the main statements.

‘Profit’ and ‘cash’ are not the same thing, although profit commonly becomes cash in time. It is important for a business to generate both – profit to stay in business in the longer term and cash to be able to pay bills and liabilities as they fall due.

Conclusion

This Openlearn course has provided an introduction to some of the basics of accounting. You have learned the basic terminology of bookkeeping and accounting, the general purposes and functions of accounting and the differences between the two sorts of accounting (financial accounting and management accounting). You should also now be able to describe the different elements of financial information, such as income/revenue, costs/expenses, assets and liabilities, as well as identify the main financial statements (income statement, balance sheet and cash flow statement) and their purposes.

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Glossary

bookkeeping

Bookkeeping is the process of recording financial transactions in the books of a business (= accounting records). It is also a term used as an abbreviation for double-entry bookkeeping, a particular form of bookkeeping.

accounting

Accounting is a process which identifies, organises, classifies, records, summarises amd communicates information about economic events, usually, but not exclusively, in monetary terms. Bookkeeping is often considered as being included within accounting, but accounting is a much wider concept than bookkeeping, as accounting may also be regarded as a transformative process as it turns the raw data recorded in the bookkeeping process into useful information.

reporting

Reporting is the communication aspect of accounting. It involves providing information about a business to interested parties, such as owners and managers, and is usually achieved by the production of management information in the form of management accounts or financial statements (income statement, balance sheet and cash flow statement).

account

A section of a book or ledger in which a business entity will record transactions of the same kind, e.g, sales of goods of the same type. In the context of double-entry bookkeeping, an account will often mean a T-account.

double-entry bookkeeping

This is a method of recording a business's transactions/events in a set of T-accounts, such that every transaction/event has a dual aspect and needs to be recorded in at least two T-accounts. It was devised over five hundred years ago, and first written about by an Italian monk called Luca Pacioli. It is now the most commonly used method of bookkeeping.

bookkeeper

A person employed to maintain the books of a business (= accounting records) and keep them up to date.

posting

A term used to mean recording transactions/events in T-accounts.

balance

A balance is the amount of the difference between the debit and credit sides of a T-account. It is inserted on the side with the lower total, and is the figure, which, when included, makes the total of both sides the same. If the insertion occurs on the debit side, it means that total credits have exceeded total debits. Balances on certain asset, liability and capital accounts may be carried forward (or down) to the next accounting period. If, for example, a debit balances arises on such a T-account, it is carried forward to the credit side.

trial balance

A list of the balances extracted from all the individual accounts in an entity's accounting records, showing all debit balances in a left-hand column and all credit balances in a right-hand column. If the underlying double-entry bookkeeping has been done correctly, the totals of both columns should be the same.

balancing off

This is the practice of summing the debit and credit sides of a T-account and inserting a missing figure (a balance) to make both sides equal. It is usually done at the end of an accounting period.

accounting period

An accounting period (sometimes also referred to as a financial period, period of account or accounting reference period) is a period of time for which a business prepares financial results. The accounting period can be any length of time, and the length may be determined by the reason financial results are required, for example, providing management with information (often monthly or quarterly), or producing a set of financial statements. The latter is usually done annually, though this may vary when a business is set up, ceases, or changes its accounting period end date.

period of account

An accounting period (sometimes also referred to as a financial period, period of account or accounting reference period) is a period of time for which a business prepares financial results. The accounting period can be any length of time, and the length may be determined by the reason financial results are required, for example, providing management with information (often monthly or quarterly), or producing a set of financial statements. The latter is usually done annually, though this may vary when a business is set up, ceases, or changes its accounting period end date.

accounting reference date

This is the date at the end of an accounting (reference) period, most usually the date in a year up to which an entity prepares its financial statements. It is also referred to as a closing date. UK business entities may choose any date in the year as the end of their annual accounting period, but this is not always the case elsewhere in the world.

closing date

This is the date at the end of an accounting (reference) period, most usually the date in a year up to which an entity prepares its financial statements. It is also referred to as a closing date. UK business entities may choose any date in the year as the end of their annual accounting period, but this is not always the case elsewhere in the world.

income statement

This is one of the main components of a set of financial statements. It shows the total costs deducted from total income to calculate the profit or loss for an entity over a financial period. It was formerly commonly referred to as a profit and loss statement/account.

profit and loss statement/account

This is one of the main components of a set of financial statements. It shows the total costs deducted from total income to calculate the profit or loss for an entity over a financial period. It was formerly commonly referred to as a profit and loss statement/account.

statement of financial position

A statement of the total assets and liabilities of an entity at a particular date, usually the last day of the entity's accounting period. Total assets will always equal total liabilities, but there are various ways in which information can be presented. Often a balance sheet is regarded as being a 'snapshot' of assets and liabilities at the balance sheet date. International Accounting Standard 1 uses statement of financial position as a term for a balance sheet.

financial statements

A set of statements summarising an entity's financial activities over a given period, usually a year. They generally comprise an income statement (previously called a profit and loss account/statement), a balance sheet and, if required, a cash flow statement, all with supporting notes. Companies must provide additional statements.

set of accounts

A term used to refer to financial statements (themselves often referred to as a set of financial statements), that is, the income statement and balance sheet, and commonly the cash flow statement as well.

International Accounting Standards Board (IASB)

This was set up in 2001 as the successor to the International Accounting Standards Committee. It is an independent, privately funded body which takes responsibility for developing, improving and promoting the use of international accounting standards, with a particular aim to bring about convergence of national standards with international ones.

International Accounting Standards (IASs)

Any of the accounting standards issued by the International Accounting Standards Committee (IASC) between 1973 and 2001, at which date the IASC was superseded by the International Accounting Standards Board (IASB), which adopted all the IASs in issue, but advised that its own standards when issued would be known as International Financial Reporting Standards (IFRSs).

International Financial Reporting Standards (IFRSs)

Any of the accounting standards issued by the International Accounting Standards Board (IASB).

management information system (MIS)

This is a system within a business which provides information needed to manage that business effectively and support the managers' decision making process. A significant characteristic of an MIS is that it analyses other information systems within the business, for example, those applied in operational activities, accounting, etc.

accounting information system (AIS)

This is a system which processes accounting data and turns them into useful information, such as income statements and balance sheets at the end of an accounting period, or the management accounts which are typically produced monthly to help managers monitor and control business activities and make decisions. It is often referred to as an accounting system (for short). The term is also commonly used to refer to the computer software a business may use for accounting and bookkeeping purposes.

accounting system

Information is data processed for a purpose. Once data have been processed into information, that information can be used to aid decision making, which will additionally require the exercise of judgement. Meaningful decisions cannot be taken on the basis of data alone.

agents

An agent (sometimes referred to as a steward) is a person appointed by another person, called a principal, to act on the principal's behalf. Directors of a company act as agents of the shareholders (principals). An accountant may also act as an agent on behalf of shareholders in his/her capacity as auditor, or when acting as a tax adviser to a client in dealing with HM Revenue & Customs.

stakeholders

All those who have an interest in an organisation. They may be users of, or persons with a varying degree of interest in, an entity's financial statements and dependent on or influenced by its financial performance.

external auditor

An independent, external person or firm appointed formally by shareholders to write a report to them on the externally reported financial results of the company in which the shareholders own shares.

internal auditors

An internal auditor is appointed by a entity itself to carry out checks, for example, that internal controls within an organisation are operating satisfactorily or that the entity is complying with legislation, such as that pertaining to health and safety. He/she is often a member of an internal audit department within an entity and will report to an internal committee, rather than being appointed by and reporting to shareholders.

turnover

A term used not only to refer to the actual selling of goods/services to customers, but also to the income or revenue derived therefrom (also referred to as revenue, sales revenue, sales turnover and turnover).

costs

A cost is expenditure on goods and services required to carry out the operations of an entity. Sometimes costs which are not directly involved in generating sales are referred to as expenses or overheads, but these terms are often used interchangeably without distinction of meaning, especially in non-accounting contexts.

profit

In an income statement, when total costs are deducted from total income, if there is an excess of total income over total costs, then this is referred to as a profit (sometimes also called a surplus, especially if the entity concerned does not have a profit making motive, e.g., if it is a charity).

loss

In an income statement, where total costs exceed total income, a loss arises (often referred to as a deficit by non-profit-making entities). A loss can also arise, for example, on the disposal of individual non-current assets, if they are disposed of for less than their net book value (= cost/value less accumulated depreciation to the date of disposal). Such a loss is often referred to as a capital loss.

assets

The International Accounting Standard Board (IASB) defines assets as resources controlled by a business as a result of past events and from which future economic benefits are expected to flow. They might be things a business owns, such as the machinery it uses to manufacture goods or vehicles it uses to deliver goods to customers.

liabilities

The International Accounting Standards Board (IASB) defines liabilities as present obligations of a business arising from past events, the settlement of which is expected to result in an outflow from the business embodying economic benefits. They might be sums of money owed, for example, to lenders who have loaned money to a business or to suppliers of raw materials for manufacturing purchased on credit.

plant

This is the equipment needed to operate a business. It is often used in the phrase 'plant and machinery' as a general term to include all types of apparatus and equipment, but there is no distinct dividing line between what is plant and what is machinery.

non-current assets

Non-current assets are assets for long-term use, generally speaking, for more than one year. Capital expenditures that have been capitalised (i.e. recognised in the balance sheet) appear on the face of the balance sheet as non-current assets.

tangible assets

A type of non-current assets, which have physical form and can be touched (the latter being the basic meaning of tangible), for example, machinery, vehicles, etc.

intangible assets

The word tangible means something that can be touched. In terms of assets, a tangible asset is an asset that has physical form. An intangible asset therefore does not have physical form and cannot be touched, though the existence of many kinds of intangible assets (e.g., copyrights, patents and trademarks) may be evidenced by some form of documentation. This is not the case with goodwill, however, which is probably the most intangible of all assets.

patents

A patent is the grant of an exclusive right (usually to an inventor or an inventor's employer) to exploit an invention.

copyrights

A copyright confers an exclusive legal right to reproduce, or permit others to reproduce, literary, dramatic, artistic or musical works (e.g., recordings).

trademarks

A trademark (a type of intangible asset) is a mark that uniquely identifies a trader's particular goods or services. It can take the form of a mark, symbol, device or word(s), individually or in combination. In the UK, a trader (manufacturer, dealer, importer, retailer or service provider) may register a trademark at the Register of Trade Marks (held at the Patent office), which will allow the trader exclusive use of the trademark, initially for seven years. Provided that the trademark has been properly used, and will continue to be so used, registration is then renewable.

inventory

This is the international accounting terminology to denote trading stock, and may comprise raw materials, work in progress (partly finished items) or finished goods.

current assets

Current assets include cash, liquid assets (also called cash equivalents, which can be converted into cash within a maximum of three months), and assets that are normally converted into cash within the course of business or within one year.

work in progress

This typically refers to inventory items which are partly completed. As manufacturing processes are often continous, not all items will be finished and ready for sale at the end of an accounting period.

trade receivables

Receivables or trade receivables are sums owed by customers to whom a business has sold goods or services. It is the international accounting term now used for trade debtors.

owner’s interest

This is money, resources or assets put into the business by owners, and also referred to as owner's interest or equity. Capital can also mean other things, for example, in economic theory, physical capital (machinery) or financial capital (money).

non-current liabilities

This is the international accounting term now used to refer to long-term liabilities. These are sums owed which are due for payment more than a year after the end of an accounting period.

current liabilities

These are amounts owed by a business to others which are payable within one year or less at the end of an accounting period. There are several different types of items which could be included in current liabilities, but trade payables, accruals and short-term loans are common examples.

horizontal format

A format used to present a balance sheet in which all the assets listed on the left-hand side and all the liabilities (and capital) are listed on the right-hand side.

vertical format

A format used to present a balance sheet in which assets are shown in the top half and capital and liabilities in the bottom half. The net assets approach to a balance sheet is a variant vertical format, whereby current and/or long-term liabilities are deducted from assets to derive a net assets figure equal to the total capital shown in the bottom half.

net assets approach

This is one possible approach to formatting a vertical balance sheet. The top half shows assets less liabilities to derive the figure for net assets, which is then the same as the total capital shown in the bottom half. Opinion varies as to whether non-current (long-term) liabilities should be treated as capital and so not deducted in deriving the figure for net assets, or whether they are part of the liabilities and therefore deductible.

international accounting approach

This refers to the terminology, format, presentation and disclosure to be applied in preparation of specified company financial statements consequent on the adoption of International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB).

drawings

These are resources (usually in the form of cash or goods) taken out of the business by the proprietor of an unincorporated business or partners in a partnership. An example might be when a sole proprietor takes some of his/her inventory for personal use or pays a personal bill through the business bank account.

cash flow statement

This is a statement which shows the inflows and outflows of cash and cash equivalents (investments easily convertible to known amounts of cash, usually within a three month period) over a business's financial period. International Accounting Standard 1 specifies a particular format and headings for company cash flow statements.

notes to the financial statements

Financial statements (income statement, balance sheet and cash flow statement) are usually accompanied by a set of notes to the financial statements, disclosing additional financial information, explanation and analyses, which are more conveniently shown separately from the main statements, or are required to be shown in notes to comply with accounting standards, etc.

Trade payables

Payables or trade payables are sums of money owed to persons or entities who/which have supplied goods or services to a business. It is the international accounting term now used for trade creditors.

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