

## Preparing Financial Statements (INT)

### AIM

To develop knowledge and understanding of the techniques used to prepare financial statements, including necessary underlying records, and the interpretation of financial statements for incorporated enterprises, partnerships and sole traders.

### OBJECTIVES

On completion of this paper candidates should be able to:

- describe the role and function of external financial reports and identify their users
- explain the accounting concepts and conventions used in preparing financial statements
- record and summarise accounting data
- maintain records relating to non-current asset acquisition and disposal
- prepare basic financial statements for sole traders, partnerships, incorporated enterprises and simple groups
- appraise financial performance and the position of an organisation through the calculation and review of basic ratios
- demonstrate the skills expected in Part 1.

### POSITION OF THE PAPER IN THE OVERALL SYLLABUS

No prior knowledge is required before commencing study for Paper 1.1.

The basic financial accounting in Paper 1.1 is developed in Paper 2.5 Financial Reporting and Paper 3.6 Advanced Corporate Reporting. Knowledge from

3.6 Advanced Corporate Reporting

2.5 Financial Reporting

1.1 Preparing Financial Statements

3.1 Audit and Assurance Services

2.6 Audit and Internal Review

Paper 1.1 provides the background to Paper 2.6 Audit and Internal Review.

### SYLLABUS CONTENT

Note: The extent to which accounting standards are examinable is indicated half-yearly in *student accountant* - in February for the June examination and in September for the December examination.

#### 1 General framework

- (a) Types of business entity – incorporated entities, partnerships and sole traders.
- (b) Forms of capital and capital structures in incorporated entities.
- (c) The roles of the International Accounting Standards Board (IASB), the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC).
- (d) Application of International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) to the preparation and presentation of

financial statements.

- (e) The IASB's Framework for the Preparation and Presentation of Financial Statements (paragraphs 1 to 46 only).

#### 2 Accounting concepts and principles

- (a) Basic accounting concepts and principles as stated in the IASB's Framework for the Preparation and Presentation of Financial Statements and relevant International Accounting Standards
- (b) Other accounting concepts
  - (i) historical cost
  - (ii) money measurement
  - (iii) entity
  - (iv) dual aspect

#### 3 Double-entry bookkeeping and accounting systems

- (a) Double-entry bookkeeping and accounting systems

## Preparing Financial Statements (INT) – continued

- (i) form and content of accounting records (manual and computerised)
  - (ii) books of original entry, including journals
  - (iii) accounts receivable and accounts payable ledgers
  - (iv) cash book
  - (v) general ledger
  - (vi) trial balance
  - (vii) accruals, prepayments and adjustments
  - (viii) asset registers
  - (ix) petty cash.
- (b) Confirming and correcting mechanisms
- (i) control accounts
  - (ii) bank reconciliations
  - (iii) suspense accounts and the correction of errors.
- (c) General principles of the operation of a sales tax.
- (d) Computerised accounting systems.

#### 4 Accounting treatments

- (a) Non-current assets, tangible and intangible
  - (i) distinction between capital and revenue expenditure
  - (ii) accounting for acquisitions and disposals
  - (iii) depreciation – definition, reasons for and methods, including straight line, reducing balance and sum of digits
  - (iv) research and development
  - (v) elementary treatment of goodwill.
- (b) Current assets
  - (i) inventory

- (ii) accounts receivable, including accounting for irrecoverable debts and allowances for receivables
- (iii) cash.
- (c) Current liabilities and accruals.
- (d) Shareholders' equity.
- (e) Events after the balance sheet date.
- (f) Contingencies.

#### 5 Financial statements

- (a) Objectives of financial statements.
- (b) Users and their information needs.
- (c) Key features of financial statements
  - (i) balance sheet
  - (ii) income statement
  - (iii) cash flow statement
  - (iv) notes to the financial statements (examined to a limited extent – see d (iii) below).
- (d) Preparation of financial statements for:
  - (i) sole traders, including incomplete records techniques
  - (ii) partnerships
  - (iii) limited liability companies, including income statements and balance sheets for internal purposes and for external purposes and preparation of basic cash flow statements for limited liability companies (excluding group cash flow statements), all in accordance with International Accounting Standards. The following notes to the financial statements will be examinable:
    - Statement of changes in equity

- Non-current assets
- Events after the balance sheet date
- Contingent liabilities and contingent assets
- Research and development expenditure
- (iv) groups of companies – preparation of a basic consolidated balance sheet for a company with one subsidiary.

#### 6 Interpretation

- (a) Ratio analysis of accounting information and basic interpretation.

#### EXCLUDED TOPICS

The syllabus content outlines the areas for assessment. No questions will be asked on: clubs and societies, or goodwill arising on change of personnel in partnerships.

#### KEY AREAS OF THE SYLLABUS

The objective of Paper 1.1, Preparing Financial Statements, is to ensure that candidates have the necessary basic accounting knowledge and skill to progress to the more advanced work of Paper 2.5 Financial Reporting. The two main skills required are:

- The ability to prepare basic financial statements and the underlying accounting records on which they are based.
- An understanding of the principles on which accounting is based.

## Preparing Financial Statements (INT) – continued

The key topic areas are as follows:

- preparation of financial statements for limited liability companies for internal purposes or for publication
- preparation of financial statements for partnerships and sole traders (including incomplete records)
- basic group accounts – consolidated balance sheet for a company with one subsidiary
- basic bookkeeping and accounting procedures
- accounting conventions and concepts
- interpretation of financial statements
- cash flow statements
- accounting standards (as listed in the exam notes)

### APPROACH TO EXAMINING THE SYLLABUS

The paper based examination is a three hour paper constructed in two sections. Both sections will draw from all parts of the syllabus and will contain both computational and non-computational elements.

	Number of Marks
Section A: 25 compulsory multiple choice questions (2 marks each)	50
Section B: 5 compulsory questions (8 – 12 marks each)	50
	<hr/> 100

Paper 1.1 can also be taken as a three hour computer based examination.

### ADDITIONAL INFORMATION

Candidates need to be aware that questions involving knowledge of new examinable regulations will not be set until at least six months after the last day of the month in which the regulation was issued.

The Study Guide provides more detailed guidance on the syllabus. Examinable documents are listed in the 'Exam Notes' section of the *student accountant*, in February for the June examination and in September for the December examination.

### RELEVANT TEXTS

There are a number of sources from which you can obtain a series of materials written for the ACCA examinations. These are listed below:

### ACCA's approved publishers:

#### BPP Professional Education

Contact number: +44(0)20 8740 2222

Website: [www.bpp.com](http://www.bpp.com)

#### Kaplan Publishing Foulks Lynch

Contact number: +44(0)118 989 0629

Website: [www.kaplanfoulkslynch.com](http://www.kaplanfoulkslynch.com)

Additional reading:

Accountancy Tuition Centre (ATC)

International

Contact number: +44(0)141 880 6469

Website: [www.atc-global.com](http://www.atc-global.com)

International Financial Publishing (IFP)

Contact number: +44(0)148 322 5746

Website: [www.ifpbooks.com](http://www.ifpbooks.com)

These publications are based on international terminologies and accounting standards.

Candidates may also find the following texts useful. However, these publications are based on UK terminology and accounting standards.

Texts covering the whole syllabus:

F Wood and A Sangster **Business**

**Accounting 1** (10th Edition) Pitman ISBN

0273681494(excluding chapters 21,

36, 37, 38, 40, 42, 43, 44, 45, 46, 48)

plus chapters 3, 8, 10, 11, 12, 13, 14,

16, 17, 18, 27, 28, and 29 of **Business**

**Accounting 2** (10th Edition) Pitman ISBN

0273681494

Wider reading is also desirable, especially regular study of relevant articles in ACCA's monthly magazine *student accountant*.

## Preparing Financial Statements (INT) – continued

### STUDY SESSIONS

#### 1 Introduction to Accounting

- (a) Define accounting – recording, analysing and summarising transaction data.
- (b) Explain types of business entity
  - (i) sole trader
  - (ii) partnership
  - (iii) limited liability company.
- (c) Explain users of financial statements and their information needs.
- (d) Explain the main elements of financial statements:
  - (i) balance sheet
  - (ii) income statement.
- (e) Explain the purpose of each of the main statements.
- (f) Explain the nature, principles and scope of accounting.
- (g) Explain the regulatory system:
  - International Accounting Standards Board (IASB), the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC).
- (h) Explain the difference between capital and revenue items.

#### 2 Basic balance sheet and income statement

- (a) Explain how the balance sheet equation and business entity

- convention underlie the balance sheet.
- (b) Define assets and liabilities.
- (c) Explain how and why assets and liabilities are disclosed in the balance sheet.
- (d) Draft a simple balance sheet in vertical format.
- (e) Explain the matching convention and how it applies to revenue and expenses.
- (f) Explain how and why revenue and expenses are disclosed in the income statement.
- (g) Illustrate how the balance sheet and income statement are interrelated.
- (h) Draft a simple income statement in vertical format.
- (i) Explain the significance of gross profit and gross profit as a percentage of sales.

#### 3 & 4 Bookkeeping Principles

- (a) Identify the main data sources and records in an accounting system.
- (b) Explain the functions of each data source and record.
- (c) Explain the concept of double entry and the duality concept.
- (d) Outline the form of accounting records in a typical manual system.
- (e) Outline the form of accounting records in a typical computerised system.
- (f) Explain debit and credit.
- (g) Distinguish between asset, liability, revenue and expense accounts.
- (h) Explain the meaning of the balance on each type of account.

- (i) Illustrate how to balance a ledger account.
- (j) Record cash transactions in ledger accounts.
- (k) Record credit sale and purchase transactions in ledger accounts.
- (l) Explain the division of the ledger into sections.
- (m) Record credit sale and purchase transactions using day books.
- (n) Explain sales and purchases returns and demonstrate their recording.
- (o) Explain the general principles of the operation of a sales tax and prepare the consequent accounting entries.
- (p) Explain the need for a record of petty cash transactions.
- (q) Illustrate the typical format of the petty cash book.
- (r) Explain the importance of using the imprest system to control petty cash.
- (s) Extract the ledger balances into a trial balance.
- (t) Prepare a simple income statement and balance sheet from a trial balance.
- (u) Explain and illustrate the process of closing the ledger accounts in the accounting records when the financial statements have been completed.

## Preparing Financial Statements (INT) – continued

### 5 The journal; ledger control accounts; bank reconciliations

- (a) Explain the uses of the journal.
- (b) Illustrate the use of the journal and the posting of journal entries into ledger accounts.
- (c) Explain the types of error which may occur in bookkeeping systems, identifying those which can and those which cannot be detected by preparing a trial balance.
- (d) Illustrate the use of the journal in correcting errors, including the use of a suspense account.
- (e) Prepare statements correcting profit for errors discovered.
- (f) Explain the nature and purpose of control accounts for the accounts receivable and accounts payable ledgers.
- (g) Explain how control accounts relate to the double entry system.
- (h) Construct and agree a ledger control account from given information.
- (i) Explain and prepare bank reconciliation statements including the need for entries in the cash book when reconciling.

### 6 Computerised accounting systems

- (a) Compare manual and computerised accounting systems.
- (b) Identify the advantages and disadvantages of computerised systems.
- (c) Describe the main elements of a computerised accounting system.

- (d) Describe typical data processing work.
- (e) Explain the use of integrated accounting packages.
- (f) Explain the nature and use of micro-computers.
- (g) Explain other business uses of computers.
- (h) Explain the nature and purpose of spreadsheets.
- (i) Explain the nature and purpose of database systems.

### 7 The financial statements of a sole trader 1: inventory, accruals and prepayments

- (a) Revise the format of the income statement and balance sheet from Sessions 1 and 2.
- (b) Explain the need for adjustments for inventory in preparing financial statements.
- (c) Illustrate income statements with opening and closing inventory.
- (d) Explain and demonstrate how opening and closing inventory are recorded in the inventory account.
- (e) Discuss alternative methods of valuing inventory.
- (f) Explain IASB requirements for inventories.
- (g) Explain the use of continuous and period end inventory records.
- (h) Explain the need for adjustments for accruals and prepayments in preparing financial statements.
- (i) Illustrate the process of adjusting for accruals and prepayments in preparing

financial statements.

- (j) Prepare financial statements for a sole trader including adjustments for inventory, accruals and prepayments.
- (k) Explain and demonstrate how to calculate the value of closing inventory from given movements in inventory levels, using FIFO (first in first out) and AVCO (average cost).

### 8 The financial statements of a sole trader 2: depreciation, irrecoverable debts and allowances for receivables

- (a) Revise the difference between non-current assets and current assets.
- (b) Define and explain the purpose of depreciation.
- (c) Explain the advantages and disadvantages of the straight line, reducing balance and sum of the digits methods of depreciation and make necessary calculations.
- (d) Explain the relevance of consistency and subjectivity in accounting for depreciation.
- (e) Explain and illustrate how depreciation is presented in the income statement and balance sheet.
- (f) Explain and illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts.
- (g) Explain the inevitability of irrecoverable debts in most businesses.
- (h) Illustrate the bookkeeping entries to

## Preparing Financial Statements (INT) – continued

write off an irrecoverable debt and the effect on the income statement and balance sheet.

- (i) Illustrate the bookkeeping entries to record irrecoverable debts recovered.
- (j) Explain the difference between writing off an irrecoverable debt and making an allowance for receivables.
- (k) Explain and illustrate the bookkeeping entries to create and adjust an allowance for receivables.
- (l) Illustrate how to include movements in the allowance for receivables in the income statement and how the closing balance of the allowance may appear in the balance sheet.
- (m) Prepare a set of financial statements for a sole trader from a trial balance, after allowing for accruals and prepayments, depreciation, irrecoverable debts and allowances for receivables.

### 9 & 10 Incomplete records

- (a) Explain techniques used in incomplete record situations:
  - (i) Calculation of opening capital
  - (ii) Use of ledger accounts to calculate missing figures
  - (iii) Use of cash and/or bank summaries
  - (iv) Use of given gross profit percentage to calculate missing figures.
- (b) Explain and illustrate the calculation of

profit or loss as the difference between opening and closing net assets.

### 11 Revise all work to date

### 12 & 13 Partnership Accounts

- (a) Define the circumstances creating a partnership.
- (b) Explain the advantages and disadvantages of operating as a partnership, compared with operating as a sole trader or limited liability company.
- (c) Explain the typical contents of a partnership agreement, including profit-sharing terms.
- (d) Explain the accounting differences between partnerships and sole traders:
  - (i) Capital accounts
  - (ii) Current accounts
  - (iii) Division of profits.
- (e) Explain and illustrate how to record partners' shares of profits / losses and their drawings in the accounting records and financial statements.
- (f) Explain and illustrate how to account for guaranteed minimum profit share.
- (g) Explain and illustrate how to account for interest on drawings.
- (h) Draft the income statement, including division of profit, and balance sheet of a partnership from a given trial balance.

Note: Goodwill arising on the admission and retirement of partners, amalgamation and dissolution are not examinable. However, questions on partnership income statements may include the effect of the admission of new partners and the retirement of partners on the profit-sharing arrangements.

### 14 Accounting concepts and conventions; the IASB's 'Framework for the Preparation and Presentation of Financial Statements' (the Framework) and the IASB standard on the presentation of financial statements

- (a) Explain the need for an agreed conceptual framework for financial accounting.
- (b) Explain the importance of the following accounting conventions (not mentioned in the Framework):
  - (i) Business entity
  - (ii) Money measurement
  - (iii) Duality
  - (iv) Historical cost
  - (v) Realisation
  - (vi) Time interval.
- (c) Revise the users of financial statements from Session 1.
- (d) Explain the qualitative characteristics of financial statements as described in paras. 24 to 46 of the Framework (Revision from Session 1).
- (e) Explain the IASB requirements relating to accounting policies.

## Preparing Financial Statements (INT) – continued

- (f) Explain the advantages and disadvantages of historical cost accounting (HCA) in times of changing prices.
- (g) Explain in principle the main alternatives to HCA:
  - (i) Current purchasing power accounting (CPP)
  - (ii) Current cost accounting (CCA)Note: computational questions on CPP and CCA will not be set.
- (h) Explain the IASB requirements governing revenue recognition

### 15 Accounting for limited liability companies 1 – basics

Note: The inclusion of an introductory coverage of company accounts at this point is to enable students to practise the work so far on financial statements using questions on limited liability companies, and also to facilitate understanding of reserves referred to in the next Session.

- (a) Explain the differences between a sole trader and a limited liability company.
- (b) Explain the advantages and disadvantages of operating as a limited liability company rather than as a sole trader.
- (c) Explain the capital structure of a limited liability company including:
  - (i) Authorised share capital
  - (ii) Issued share capital
  - (iii) Called up share capital

- (iv) Paid up share capital
- (v) Ordinary shares
- (vi) Preference shares
- (vii) Loan notes.
- (d) Explain and illustrate the share premium account
- (e) Explain and illustrate the other reserves which may appear in a company balance sheet.
- (f) Explain why the heading retained earnings appears in a company balance sheet.
- (g) Explain and illustrate the recording of dividends
- (h) Explain the impact of income tax on company profits and illustrate the ledger account required to record it.
- (i) Record income tax in the income statement and balance sheet of a company.
- (j) Draft an income statement and balance sheet for a company for internal purposes.

### 16 Recording and presentation of transactions in non-current assets; liabilities and provisions

- (a) Explain and illustrate the ledger entries to record the acquisition and disposal of non-current assets, using separate accounts for non-current asset cost and accumulated depreciation.
- (b) Explain and illustrate the inclusion of profits or losses on disposal in the income statement.

- (c) Explain and record the revaluation of a non-current asset in ledger accounts and in the balance sheet.
- (d) Explain why, after an upward revaluation, depreciation must be based on the revised figure, and for revalued assets sold, the consequent transfer from revaluation reserve to retained earnings as revaluation surplus becomes realised.
- (e) Make the adjustments necessary if changes are made in the estimated useful life and/or residual value of a non-current asset.
- (f) Explain and illustrate how non-current asset balances and movements are disclosed in company financial statements.
- (g) Explain the distinction between current and non-current liabilities.
- (h) Explain the difference between liabilities and provisions.
- (i) Explain the requirements of International Accounting Standards as regards current assets and current liabilities.

### 17 Goodwill, Research and Development

- (a) Define goodwill.
- (b) Explain the factors leading to the creation of non-purchased goodwill.
- (c) Explain the difference between purchased and non-purchased

## Preparing Financial Statements (INT) – continued

goodwill.

- (d) Explain why non-purchased goodwill is not normally recognised in financial statements.
- (e) Explain how purchased goodwill arises and is reflected in financial statements.
- (f) Adjust the value of purchased goodwill to reflect impairment.
- (g) Define “research” and “development”.
- (h) Classify expenditure as research or development.
- (i) Calculate amounts to be capitalised as development expenditure from given information.
- (j) Disclose research and development expenditure in the financial statements.

### 18 Events after the Balance Sheet Date and Contingencies

- (a) Define an event after the balance sheet date.
- (b) Distinguish between adjusting and non-adjusting events and explain the methods of including them in financial statements.
- (c) Classify events as adjusting or non-adjusting.
- (d) Draft notes to company financial statements including requisite details of events after the balance sheet date.
- (e) Define ‘contingent liability’ and ‘contingent asset’.
- (f) Explain the different ways of accounting for contingent liabilities and contingent assets according to their degree of probability.

- (g) Draft notes to company financial statements including requisite details of contingent liabilities and contingent assets.

### 19, 20 & 21 Accounting for Limited Liability Companies 2 – Advanced

- (a) Revise the work of Session 15 and the preparation of financial statements for limited liability companies for internal purposes including the treatment of income tax and dividends.
- (b) Revise the work of Session 15 on company capital structure, including equity shares, preference shares and loan notes.
- (c) Outline the advantages and disadvantages of raising finance by borrowing rather than by the issue of ordinary or preference shares.
- (d) Define and illustrate gearing (leverage).
- (e) Define a bonus (capitalisation) issue and its advantages and disadvantages.
- (f) Record a bonus (capitalisation) issue in ledger accounts and show the effect in the balance sheet.
- (g) Define a rights issue and its advantages and disadvantages.
- (h) Record a rights issue in ledger accounts and show the effect in the balance sheet.
- (i) Revise the definition of reserves and the different types of reserves.
- (j) Explain the need for regulation of companies in accounting standards.
- (k) Explain the requirements of International

Accounting Standards governing financial statements (excluding group aspects):

- (i) Presentation of Financial Statements
- (ii) Accounting policies, changes in accounting estimates and errors
- (iii) Non-current assets held for sale and discontinued operations (basic definitions and disclosure requirements only)
- (l) Explain and prepare the notes to financial statements required for the syllabus:
  - (i) Statement of changes in equity
  - (ii) Details of non-current assets
  - (iii) Details of events after the balance sheet date
  - (iv) Details of contingent liabilities and contingent assets
  - (v) Details of research and development expenditure.
- (m) Prepare financial statements for publication complying with relevant accounting standards as detailed above.

### 22 Revise all work to date

### 23 Cash flow statements

- (a) Explain the differences between profit and cash flow.
- (b) Explain the need for management to control cash flow.
- (c) Explain the value to users of financial statements of a cash flow statement.
- (d) Explain the IASB requirements for cash flow statements (excluding

## Preparing Financial Statements (INT) – continued

- group aspects).
- (e) Explain the inward and outward flows of cash in a typical company.
  - (f) Calculate the figures needed for the cash flow statement including among others:
    - (i) Cash flows from operating activities (indirect method)
    - (ii) Cash flows from investing activities.
  - (g) Calculate cash flow from operating activities using the direct method.
  - (h) Review of information to be derived by users from the cash flow statement (see also Sessions 26 – 27).
  - (i) Prepare cash flow statements from given balance sheets with or without an income statement.

### 24 & 25 Basic consolidated accounts

- (a) Define a parent company, subsidiary company and group.
- (b) Explain the IASB requirements defining which companies must be consolidated.
- (c) Prepare a consolidated balance sheet for a parent with one wholly-owned subsidiary (no goodwill arising).
- (d) Explain how to calculate the retained earnings balance for the consolidated balance sheet.
- (e) Explain how other reserves (share premium account and revaluation reserve) are dealt with on consolidation.

- (f) Introduce the concept of goodwill on acquisition and illustrate the effect on the consolidated balance sheet.
- (g) Adjust the value of goodwill on acquisition to reflect impairment.
- (h) Explain and illustrate a methodical approach to calculating the necessary figures for the consolidated balance sheet.
- (i) Introduce the concept of minority interests in subsidiaries and illustrate the effect on the consolidated balance sheet.
- (j) Explain and illustrate how the calculation of the minority interest is made.

### 26 & 27 Interpretation of Financial Statements

- (a) Revise users of financial statements and their information needs.
- (b) Explain the advantages and disadvantages of interpretation based on financial statements.
- (c) Explain the factors forming the environment in which the business operates.
- (d) Explain the uses of ratio analysis.
- (e) Explain and calculate the main ratios to be used in interpreting financial statements to appraise:
  - (i) Profitability
  - (ii) Liquidity
  - (iii) Working capital efficiency
  - (iv) Financial risk
  - (v) Performance from an investor's

- point of view.
- (f) Explain the working capital cycle (or cash operating cycle)
  - (g) Explain normal levels of certain ratios.
  - (h) Formulate comments on movements in ratios between one period and another or on differences between ratios for different businesses.
  - (i) Explain the factors which may distort ratios, leading to unreliable conclusions.
  - (j) Prepare and comment on a comprehensive range of ratios for a business.

### 28 Revision