

Preparing Financial Statements (GBR)

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

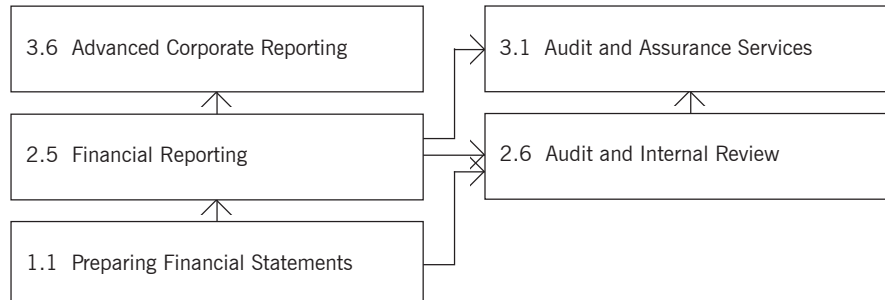
On completion of this paper candidates should be able to:

- describe the role and function of external financial reports and identify their users
- explain the accounting concepts and conventions present in generally accepted accounting principles
- record and summarise accounting data
- maintain records relating to fixed 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



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 – limited companies, partnerships and sole traders.
- (b) Forms of capital and capital structures in limited companies.
- (c) The roles of the Financial Reporting Council (FRC), the Financial Reporting Review Panel (FRRP), Accounting Standards Board (ASB) and the Urgent Issues Task Force (UITF).
- (d) Application of Financial Reporting Standards (FRSs), Statements of Standard Accounting Practice

(SSAPs) and Companies Act requirements to the preparation and presentation of financial statements.
(e) The ASB's Statement of Principles for Financial Reporting (chapters 1, 2 and 3 only).

2 Accounting concepts and principles

- (a) Basic accounting concepts and principles as stated in the ASB's Statement of Principles for Financial Reporting.
- (b) Other accounting concepts
 - (i) historical cost
 - (ii) money measurement
 - (iii) entity
 - (iv) dual aspect
 - (v) time interval.

3 Double-entry bookkeeping and accounting systems

- (a) Double-entry bookkeeping and accounting systems

Preparing Financial Statements (GBR) (Continued)

- (i) form and content of accounting records (manual and computerised)
 - (ii) books of original entry, including journals
 - (iii) sales and purchase 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 value added tax.
- (d) Computerised accounting systems.

4 Accounting treatments

- (a) Fixed 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) stock (excluding long-term contracts)

- (ii) debtors, including accounting for bad and doubtful debts
 - (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) profit and loss account
 - (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 companies, including profit and loss accounts and balance sheets for internal purposes and for external purposes in accordance with Companies Act 1985 formats and preparation of basic cash flow statements for limited liability companies (excluding group cash flow statements). The following additional statements and notes to the financial statements are examinable:
 - The ASB requirements governing reporting financial

- performance including the analysed profit and loss account and the additional statements and notes required by standards.
- Statement of movements in reserves
- Fixed assets
- Exceptional and extraordinary items
- 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

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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.

The key topic areas are as follows:

- preparation of financial statements for limited 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

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 *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:

FTC Foulks Lynch – ACCA's official publisher

Contact number: +44 (0)118 989 0629.
Website: www.financial-training.com/new/foulkslynch

Accountancy Tuition Centre (ATC)

International

Contact number: +44 (0)141 880 6469.
Website: www.ptc-global.com

BPP

Contact number: +44 (0)20 8740 2211.
Website: www.bpp.com

Candidates may also find the following texts useful:

Texts covering the whole syllabus:

F Wood and A Sangster **Business Accounting 1** (9th Edition) Pitman ISBN 0273655523 (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** (9th Edition) Pitman ISBN 0273655574

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

Preparing Financial Statements (GBR) (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 company
- (c) Explain users of financial statements and their information needs.
- (d) Explain the main elements of financial statements:
 - (i) balance sheet
 - (ii) profit and loss account
- (e) Explain the purpose of each of the main statements.
- (f) Explain the nature, principles and scope of accounting.
- (g) Identify the desirable qualities of accounting information and the usefulness of each (See also Session 14).
- (h) Explain the regulatory system:
 - (i) Financial Reporting Council (FRC), Financial Reporting Review Panel (FRRP), Accounting Standards Board (ASB), Urgent Issues Task Force (UITF), Companies legislation.
- (i) Explain the difference between capital and revenue items.

2 Basic balance sheet and profit and loss account

- (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 trading and profit and loss account.
- (g) Illustrate how the balance sheet and trading and profit and loss account are interrelated.
- (h) Draft a simple trading and profit and loss account 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 value added 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 profit and loss account 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.

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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 sales and purchase 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: stock, accruals and prepayments

- (a) Revise the format of the trading and profit and loss account and balance sheet from Sessions 1 and 2.
- (b) Explain the need for adjustments for stock in preparing financial statements
- (c) Illustrate trading accounts with opening and closing stock
- (d) Explain and demonstrate how opening and closing stock are recorded in the stock account
- (e) Discuss alternative methods of valuing stock
- (f) Explain the ASB requirements for stocks
- (g) Explain the use of continuous and period end stock 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 stock, accruals and prepayments
- (k) Explain and demonstrate how to calculate the value of closing stock from given movements in stock levels, using FIFO (first in first out), and AVCO (average cost).

8 The financial statements of a sole trader 2: depreciation and bad and doubtful debts

- (a) Revise the difference between fixed 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 profit and loss account and balance sheet
- (f) Explain and illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts
- (g) Explain the inevitability of bad debts in most businesses
- (h) Illustrate the bookkeeping entries to write off a bad debt and the effect on the profit and loss account and

Preparing Financial Statements (GBR) (Continued)

balance sheet

- (i) Illustrate the bookkeeping entries to record bad debts recovered
- (j) Explain the difference between writing off a bad debt and making a provision for a doubtful debt
- (k) Explain and illustrate the bookkeeping entries to create and adjust a provision for doubtful debts
- (l) Illustrate how to include movements in the provision for doubtful debts in the profit and loss account and how the closing balance of the provision 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 and bad and doubtful debts.

9 & 10 Incomplete records

- (a) Explain techniques used in incomplete record situations:
 - (i) Calculation of opening capital
 - (ii) Use of ledger total 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 profit and loss account, including division of profit, and balance sheet of a partnership from a given trial balance.

Note: Other aspects of partnership (goodwill arising on the admission and retirement of partners, amalgamation and dissolution) are *not* examinable. However,

questions on partnership profit and loss accounts 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 ASB's 'Statement of Principles for Financial Reporting' (the Statement)

- (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 Statement):
 - (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 chapter 3 of the Statement (Revision from Session 1).
- (e) Explain the ASB requirements relating to accounting policies
- (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

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accounting (CPP)

(ii) Current cost accounting (CCA).

Note: computational questions on CPP and CCA will not be set.

15 Accounting for limited companies 1 – basics

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

- (a) Explain the legal and other differences between a sole trader and a limited company
- (b) Explain the advantages and disadvantages of operating as a limited company rather than as a sole trader
- (c) Explain the capital structure of a limited 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) Debentures
- (d) Explain the nature of reserves and the difference between capital and revenue reserves
- (e) Explain and illustrate the share premium account
- (f) Explain and illustrate the other reserves which may appear in a

company balance sheet

- (g) Explain why the heading 'profit and loss account' appears in a company balance sheet
- (h) Explain and illustrate the recording of dividends paid and the treatment of proposed dividends in ledger accounts and the financial statements
- (i) Explain the impact of corporation tax on company profits and illustrate the ledger account required to record it.
- (j) Record corporation tax in the profit and loss account and balance sheet of a company
- (k) Draft a profit and loss account and balance sheet for a company for internal purposes.

16 Recording and presentation of transactions in fixed assets; liabilities and provisions

- (a) Explain and illustrate the ledger entries to record the acquisition and disposal of fixed assets, using separate accounts for fixed asset cost and accumulated depreciation
- (b) Explain and illustrate the inclusion of profits or losses on disposal in the profit and loss account
- (c) Explain and record the revaluation of a fixed 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

profit and loss account reserve 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 fixed asset
- (f) Explain and illustrate how fixed asset balances and movements are disclosed in company financial statements
- (g) Define and give examples of liabilities
- (h) Explain the distinction between current and long-term liabilities
- (i) Explain the difference between liabilities and provisions.

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 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) Explain the need to amortise purchased goodwill
- (g) Define "research" and "development"
- (h) Classify expenditure as research or development
- (i) Calculate amounts to be capitalised

Preparing Financial Statements (GBR) (Continued)

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 Companies 2 – Advanced

- (a) Revise the work of Session 15 and the preparation of financial statements for limited companies for

internal purposes including the treatment of corporation tax and dividends

- (b) Revise the work of Session 15 on company capital structure, including equity shares, preference shares and debentures
- (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 legislation and accounting standards
- (k) Explain the provisions of legislation and accounting standards governing financial statements (excluding group aspects):
 - (i) Companies Act 1985 including the standard formats for company financial statements
 - (ii) The ASB standard on reporting financial performance, including requirements relating to the analysis

of profit, the reporting of realised and unrealised profits and gains and of historical cost profits.

- (l) Explain and prepare the notes to financial statements required for the syllabus:
 - (i) Statement of movements in reserves
 - (ii) Details of fixed assets
 - (iii) Details of events after the balance sheet date
 - (iv) Details of contingent liabilities and contingent assets (see Session 18)
 - (v) Details of research and development expenditure
- (m) Prepare financial statements for publication complying with relevant accounting standards and legislation 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 ASB requirements relating to cash flow statements (excluding 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:

Preparing Financial Statements (GBR) (Continued)

- (i) Cash flows from operating activities (indirect method)
- (ii) Cash flows from investing activities (purchases, sales and depreciation of fixed assets)
- (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 25 – 26)
- (i) Prepare cash flow statements from given balance sheets with or without a profit and loss account.

24 & 25 Basic consolidated accounts

- (a) Define a parent company, subsidiary company and group
- (b) Explain the ASB and Companies Acts 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 profit and loss reserve 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) Explain the need to amortise goodwill and illustrate in the workings
- (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