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Introduction to Accounting

AAT Level I

FAC - Financial Accounting

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JMC JAYASEKERA MANAGEMENT CENTRE (PVT) LTD Estd. 1972

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Financial Accounting [FAC]

Level I	**Section A – 40 Marks (OTQs)** 10 – 20 Objective Test Questions (OTQs) (1,2,3 or 4 marks)
	Section B – 40 Marks 4 compulsory questions each worth 10 marks. Short scenario may be given
	Section C – 20 Marks One compulsory question with 20 marks. Mid -sized scenario may be given

Note 01
All the question papers are of three-hours duration and additional reading time of 15 minutes is given for Level II and Level III question papers. The structure of the Business Communication paper is similar to that of Level II question papers

Note 02
Students can apply for courses of Level I and courses of Level II together and Level III can be applied only after the completion of Level I and Level II courses.

Note 03
students can apply for the Business Communication course after the completion of Level I courses.

Note 04
Pass mark per course is 50.

LEVEL - I

101 Financial Accounting (FAC)	Unit	Key Topics	Weightage %	Notional Hours
This course is an introductory course in accounting that intends to provide students with necessary fundamental knowledge in accounting concepts, principles and practices in order to train them to prepare basic financial statements of an organization which will be useful to proceed to higher level accounting courses in Levels II and III.	01	Introduction to Accounting	5	11
	02	Accounting Equation, Double Entry System and Accounting Concepts	25	56
	03	Prime Entry Books, Control Accounts and Trial Balance	27	62
	04	Preparation of Financial Statements	30	68
	05	Bank Reconciliation Statements	8	17
	06	Computerized Environment and Importance of being Ethical	5	11
	Total		**100**	**225**

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UNIT 01 - INTRODUCTION TO ACCOUNTING

1. IMPORTANT TERMS

- **BUSINESS**

  Business is an economic activity, which is related with continuous and regular production and distribution of goods and services for satisfying human wants.

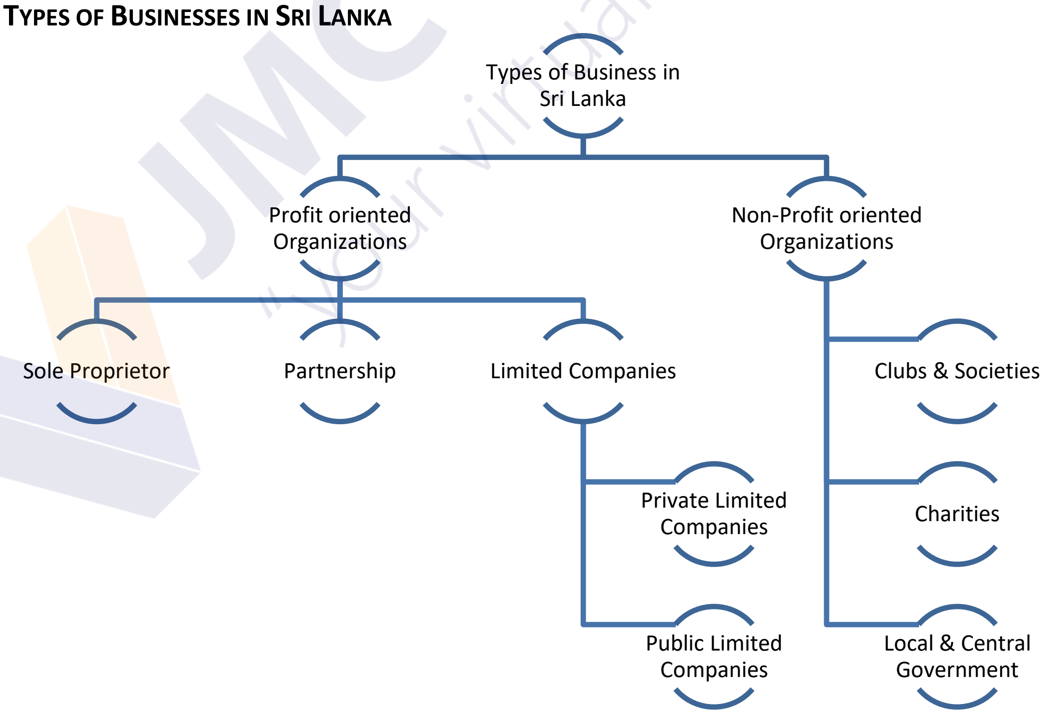
- **BUSINESS ENTITY**

  An organization created by one or more natural persons to carry on a trade or business. It is established as a separate existence for the purposes of Accounts and taxes. Corporations, limited liability companies, and sole proprietorships are types of common business entities.

- **CHARACTERISTICS OF BUSINESS**

  1. Exchange of goods and services
  2. Deals in numerous transactions
  3. Profit is the main Objective
  4. Business skills for economic success
  5. Risks and Uncertainties
  6. Buyer and Seller
  7. Connected with production
  8. Marketing and Distribution of goods
  9. Satisfying human needs and wants
  10. Social obligations

- **TYPES OF BUSINESSES IN SRI LANKA**



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PROFIT – MAKING ORGANIZATIONS

Some organizations are formed with the intent of making profits from their activities in order to provide income to their owners:

(a) Sole trader (sole proprietor)

These are organizations which are owned by one person. They tend to be small because the constrained by the financial resources of their owner & the extent to which they may borrow from friends, family & banks.

(b) Partnerships

These are organizations owned by two or more persons working in common with a view to making a profit. The greater number of owners compared to a sole trader increases the availability of finance and this is often the reason for forming such a structure

(c) Limited companies

These are organizations having a large number of owners. They are a separate legal entity from their owners' means that the company may both sue and be sued under English law. Accounting of these organizations must meet certain minimum obligations imposed by legislation via the Companies Acts.

Two types of limited companies can be identified:

(i) Private limited companies (ii) Public limited companies.

This distinction can be important when considering the accounting requirements. A common feature of private limited companies is that their owners are actively involved in running the business. In this way they are similar to sole traders and partnerships. This is rarely true of public companies.

NON-PROFIT - MAKING ORGANIZATIONS

Other organizations are formed with the intention of providing services, without intending to make profits in the long term.

(d) Clubs and societies:

These organizations exist to provide facilities and entertainments for their members. They are often sports and / or social clubs and most of their income is derived from the members who benefit from the club's facilities.

(e) Charities:

These exist to provide services to particular groups, for example people with special needs and to protect the environment. Although they are regarded as non-profit making, they too often carry out trading activities, such as running shops.

(f) Local and central Government:

Government departments are financed by members of society (including) limited companies). Their finances are used to provide the infrastructure in which we live; and to re-distribute wealth to other members of society.

- **TRANSACTIONS AND EVENTS**
  - **EVENTS:** Anything that happens.
    - Monetary Events – Events related with Money. (Daily shopping, Marriage ceremony)
    - Non-Monetary Events – Events not related with Money. (Winning a game)
  - **TRANSACTION:** A business event which can be measured in terms of money and which must be recorded in the books of accounts. (Sales, Purchases)
    - Features
      - I. Two parties
      - II. Measurable in monetary terms
      - III. Transfer of resources or services

- **BUYING AND SELLING**

Supplier Customer

- **DISCOUNTS**

  Deduction from a value
  1. Trade Discounts – At the time of selling
  2. Cash Discounts – At the time of cash payment
     - Discount Allowed
     - Discount Received

- **TIME PERIOD**

  The time period that a business should report the financial results of its activities over a standard time period, which is usually monthly, quarterly, or annually.

  Tax year : 1st January – 31st December
  Calendar year : 1st April – 31st March

- **ASSETS**

  A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
  - Non-Current Assets - Land, Building, Motor vehicles, Machineries, Furniture and fittings, Equipment, Investments, Fixed Deposit, Treasury Bonds, Goodwill
  - Current Assets - Inventories, Debtors, Treasury Bills, Income Receivables, Prepaid Expenses, Bills Receivable, Bank Balance, Cash in Hand

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- **LIABILITY**
  A present obligation of the entity arising from past events the settlement of which is expected in an outflow of the entities resources.
  - Non-Current Liabilities - Bank Loan, Mortgage Loan, Debentures
  - Current Liabilities - Creditors, Income Received in Advance, Expenses Payable, Bills Payable, Bank Overdraft

- **EQUITY (CAPITAL / NET ASSETS)**
  The proportion of Assets owned by the owners of a business.

  The amount which is derived after deducting the liabilities payable to outside parties from total assets.
  - Equity = Total Assets – Total Liabilities
  - Equity = Capital Invested + Profits – Drawings

- **INCOME**
  Increase in economic benefits during the accounting period in the form of inflows of assets or decrease of liabilities that result in increase in equity.
  - Sales Income – Cash Sales, Credit Sales
  - Other Income – Rent Income, Dividend Income, Investment Income, Commission Income, Interest Income, Discount Received, Profits from disposal of Assets

- **EXPENSE**
  Decrease in economic benefits during the accounting period in the form of outflows of assets or increase of liabilities that result in decrease in equity.
  - Cost of Sales
  - Administration Expenses – Rent, Insurance, Electricity, Rates, Salaries & Wages, Telephone, Stationery, Fixed Assets Depreciation, Professional Fee
  - Selling & Distribution Expenses – Selling Commission, Advertising, Vehicle Expenses, Bad Debts, Discount Allowed, Doubtful Debts, Carriage Outwards, Sales Employee Salary
  - Finance Expenses – Bank Charges, Cheque Book Charges, Bank Loan Interest, Bank Overdraft Interest
  - Other Expenses – Loss on Stock Damages, Donations, Loss on Disposal of Assets

- **NET INCOME / PROFIT**
  The total revenue in an accounting period minus all expenses during the same period. Net income is the excess of revenues over expenses.
  - Net Income = Total Income – Total Expenses
  - Net Income = Closing Net Assets – Opening Net Assets + Drawings – Additional Capital

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- **INFORMATION**
  Information is everything which adds knowledge. Information enhances the knowledge.

1. **Quantitative information**
   Information which could be presented or said in numbers
   Eg: Number of employees are 30
   There are 5 Lorries in the business
   - **Financial information**
     Information which can be presented in monetary terms i.e. in rupees and cents
     Eg: The annual profit is Rs 120,000/-
     The total assets are Rs 50,000/-
   - **Non- financial information**
     Information which cannot be presented in monetary terms
     Eg: The owner is 60 years old.
     The experience of the manager is 10 years
2. **Non quantitative information**
   Information which could not be presented in numbers
   Eg: The manager is a skillful person
   The cashier is very trustworthy

2. HISTORY OF ACCOUNTING

- Language of Business which was first emerged in 1494 with the contribution made by Luca Pacioli's book called ''Summa Summa de Arithmatica, Geomatria, Proportioni et proportionalita (Everything about Arithmetic, Geometry and Proportion).
- Luca Pacioili - Father of Accounting who Introduced Journals & Ledgers, Debit & Credit etc. Born in 1445 at Borgo San Sepulcro in Tuscany.

3. AIMS AND OBJECTIVES OF FINANCIAL ACCOUNTING

- Ensure the maintenance of sound accounting system to provide financial information for various financial decisions and to control the use of resources.
- Provide reliable, accurate and meaningful reports of a business's financial performance to outside parties.
- GENERAL OBJECTIVES
  - Keep systematic records
  - Ascertain the results of the operation
  - Ascertain the financial position of the business
  - Portray the liquidity position
  - Protect business properties
  - Facilitate rationale decision making
  - Satisfying the requirements of law

4. DEFINITION OF FINANCIAL ACCOUNTING

- The function which provides financial information to various parties to take economic decisions of a business by collecting, recording, classifying, summarizing & interpreting the financial transactions occurred in an accounting entity.

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5. Bookkeeping

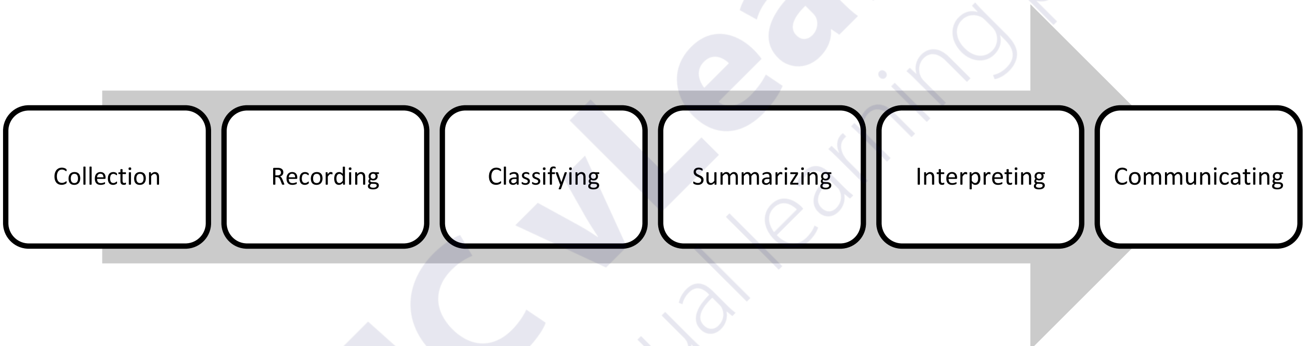
- Bookkeeping is the recording of financial transactions.
- Transactions include sales, purchases, income, receipts and payments by an individual or organization.
- Bookkeeping is usually performed by a bookkeeper.

- **Difference between Bookkeeping and Accounting**

  Both are different sections of finance department, bookkeeping involves the keeping of systematical record of company's financial activity, whereas accounting is the next section, which analyzes these records to prepare different reports and proposals. Bookkeeping in the procedure, which helps the management to manage day-to-day financial activity of company, whereas Accounting justifies these financial actions and find their reasons.

6. Accounting Process

- These are the activities which happen in an accounting entity daily, to provide financial information.



Collection	Collection in money terms of information relating to transactions that have resulted from business operations.
Recording and Classifying	Recording and classifying data into a permanent and logical form. This is usually referred to as **"Book-keeping".**
Summarizing	Summarizing data to produce statements and reports that will be useful to the various users of accounting information - both external and internal.
Interpreting and Communicating	Interpreting and communicating the performance of the business to the management and its owners.
Forecasting and Planning	Forecasting and planning for future operation of the business by providing management with evaluations of the viability of proposed operations. The key forecasting and planning tool is the **"Budget".**

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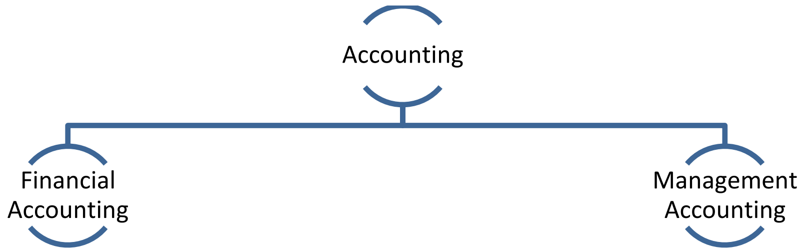
7. Types of Accounting



• Recording of events (transactions)	• Planning of events (transactions)
• Used primarily by those outside of a company or organization.	• Used primarily by those within a company or organization
• Financial reports are usually created for a set period of time, such as a fiscal year or period.	• Reports can be generated for any period of time such as daily, weekly or monthly.
• Financial reports are historically factual and have predictive value to those who wish to make financial decisions or investments in a company.	• Reports are considered to be "future looking" and have forecasting value to those within the company.

8. Accounting Environment (PESTEL)

1. Political
2. Economic
3. Social / Cultural
4. Technological & Professional
5. Environmental
6. Legal

9. Users of Financial Statements / Stakeholders

The users of financial statements are people and institutions use financial statements for a large variety of business purposes and their ability to understand and analyse financial statements helps them to success in the business world. The various users of financial statements are classified and detailed as follows:

- **Internal stakeholders**

1. **Employees -** Employees are stakeholders who are engaged, for various time periods, to help an enterprise achieve its objectives. Financial statements help employees make decisions about their long-term commitment to the enterprise. A growing, profitable and financially strong enterprise is more likely to attract and keep high-value employees. Financial statements also help employees when negotiating collective bargaining agreements with management.

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2. **Managers and owner/operators** - Managers are stakeholders who are employed by the board of directors and who are charged with the responsibility managing the enterprise's resources in order to achieve the objectives outlined in the strategic plans of the enterprise. An analysis of the financial statements helps managers make informed decisions about the economic achievements of the enterprise and so adjust strategies and tactics to exploit identified opportunities and mitigate potential threats.
3. **Boards of directors -** The board of directors are the stakeholders who set the strategic direction and objectives for the enterprise and who engage managers to achieve them. Financial statements allow the board of directors to review the performance of the management in relation to the achievement of the objectives.

- **External stakeholders**

4. **Investors -** Investors are stakeholders that buy shares in a company. Shares entitle the investor to a proportional share of the company's equity and profits. Shares in public companies are traded on stock exchanges and provide investors with dividends. Investors use financial statements to assess the financial strength of a company which impacts on their investment decisions. Existing equity investors use financial statements to monitor their investments and to evaluate the performance of management. Prospective equity investors use financial statements to decide whether to invest in the company. Investment decisions are supported by investment analysts who use financial statements with their buy/sell/hold recommendations. Rating agencies like Moody's use financial statements to assign credit ratings to companies which also help investors with their investment decisions. Other investors that may use financial statements in their decision making include potential joint venture partners and either franchisers or franchisees.
5. **Lenders -** Lenders are stakeholders who supply funds to the enterprise on short and/or long-term basis. Lenders are typically financial institutions that provide short term overdrafts, invoice financing for debtors, term loans for expansion plans, leasing finance for equipment purchases or mortgages for property purchases. Financial Institutions use financial statements to decide whether to grant a company with fresh working capital or extend debt securities (such as a long-term bank loan or debentures) to finance expansion and other significant expenditures.
6. **Suppliers and customers -** Suppliers are stakeholders who provide products and services to the company on credit terms that allows the company to pay for the goods and services later. Suppliers use financial statements to assess the creditworthiness of the business. Customers are stakeholders that suppliers, to evaluate the financial strength and staying power of the company as a dependable resource for their business.
7. **Government departments and agencies -** Government departments and agencies are stakeholders that regulate the way companies conduct their business including the payment of taxes and other duties owed. They use financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.

8. **Competitors -** Competitors are stakeholders who compete for customers in the same market as the enterprise. Competitors use financial statements to benchmark their own financial results to identify variances to target for improvement or exploit as an opportunity. Potential competitors may use financial statements to assess how profitable it may be to enter an industry.

9. **Media -** The media are stakeholders who use the information supplied by enterprises to publish in their mass communication outlets. The media use financial statements to analyse and provide a commentary on the performance and position of an enterprise that they think would be of interest to their readership.

10. **Labor unions -** Labor unions are stakeholders who represent the best interest of the employees of an enterprise. They use financial statements to gauge how much of a pay increase an enterprise can afford in an upcoming wages negotiation.

11. **Supporters and opponents -** Other external stakeholders include people who may support or oppose the actions and activities of an enterprise. They include politicians, lobbyists, issue groups, consumer advocates, environmentalists, think tanks and foundations. They use the financial statements to provide objective evidence for their position

10. FINANCIAL STATEMENTS

- **ELEMENTS OF FINANCIAL STATEMENTS**
  - Assets
  - Liabilities
  - Equity
  - Income
  - Expenses

- **COMPONENTS OF FINANCIAL STATEMENTS**
  - Statement of Comprehensive Income
  - Statement of Financial Position
  - Statement of Changes in Equity
  - Statement of Cash Flow
  - Notes to the Financial Statements

- **QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS**
  - Relevant : Enable its recipient to make effective decisions (Predictive Value, Confirmatory Value)
  - Faithful Representation: Accurate and precise (Complete, Neutral and Free from errors)
  - Materiality : Omitting material will affect the decisions
  - Comparable : Can be easily compared
  - Understandable: Can be easily understood
  - Timeliness : Communicated within the time frame
  - Verifiable : Can be verify

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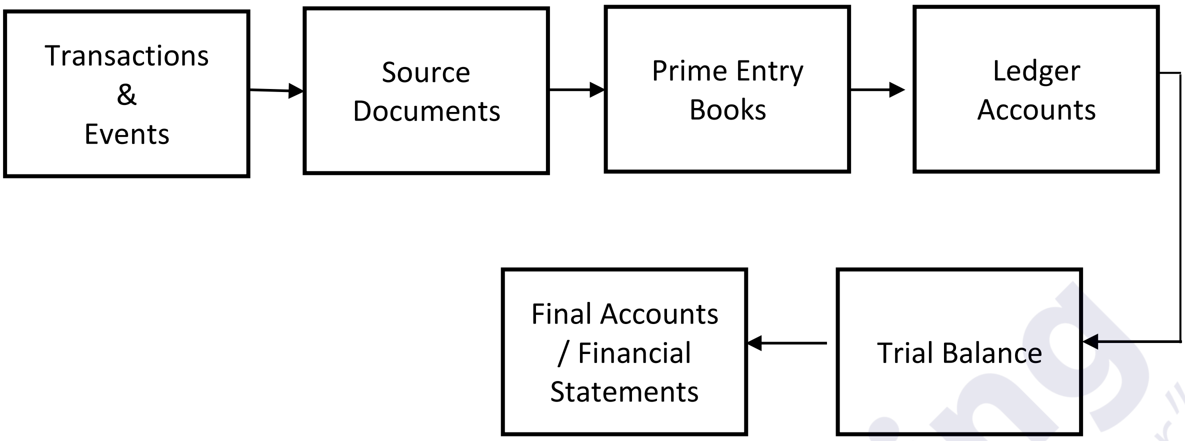
11. Accounting Process



Assignment 01

1. Which information about a business entity would be of most interest to its trade creditors?

   (1) Annual dividends
   (2) Profit for the year
   (3) Ability to pay debts as they fall due
   (4) Ability to reorganize the business entity
   (5) Revaluation surplus

2. What is the correct sequential order in which the following activities occur in the accounting process?

   A - Preparing closing entries
   B - Posting transactions to the ledger
   C - Recording transaction in the journals
   D - Preparing financial statements

   (1) C,A,B,D
   (2) D,C,A,B
   (3) B,A,D,C
   (4) C,B,A,D
   (5) C,B,D,A

3. Which of the statement/s given below is/are true with regard to management accounting?

   A - It is a part of an organisation's management information system
   B - It is used by managers to plan and control an organisations operation
   C - It provides information to external parties for decision making

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(1) A only
(2) B only
(3) C only
(4) A and B only
(5) All A, B and C

(6) State the difference between management accounting and financial accounting in respect of following aspects.

Aspect	Management Accounting	Financial Accounting
Users of information		
Frequency of reporting		

4. State whether each of the following reports can be considered as an output of the accounting process.

Reports	Yes/No
Financial statements	
Statement of cost analysis	
Statement of cash flow analysis	
Report showing product-wise profitability	

5. Which of the following statements is true in relation to management accounting?
(1) Management accounting reports are prepared based on legal requirements
(2) Management accounting reports are often used by shareholders
(3) It is not used for internal decision-making purposes
(4) Its scope is wider than that of cost accounting
(5) Its purpose is to provide information to external parties of the organisation

6. The primary objectives of accounting is to
(1) Record all transactions in the books of accounts
(2) Record, categorise and summarise financial transactions
(3) Provide information to users for decision making
(4) Provide financial results of an organisation through financial statements
(5) Provide detailed analysis of costs to managers

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7. Which of the following set of information includes **only** the information generated through the management accounting system?
   (1) Budgets, Daily material consumption records, Bank reconciliation statement
   (2) Published financial statements, Daily productivity reports, Daily labour utilization records
   (3) Budgets, Project appraisal reports, Bank reconciliation statement
   (4) Budgets, Daily productivity reports, project appraisal reports
   (5) Published financial statements, Sales estimates, Break-even sales information

8. The aim of preparing financial statements to publish is
   (1) To help Colombo Stock Exchange and security commission to fulfil regulatory requirements.
   (2) To provide useful information to users of financial statements to help the present and future shareholders to take investments decisions.
   (3) To record financial position and profitability in order to present and future shareholders to take investment decisions.
   (4) To fulfil the financial responsibilities of directors and to stop corruption and frauds.
   (5) To reveal the accounting errors and frauds and presenting on idea about financial statements.

9. What are the main objectives of the accounting?
   (1) Providing information for investors to take decisions
   (2) Revealing the uses taken by the management from the resource they use
   (3) Giving information whether the entry is in a good financial position
   (4) Giving information to the users to forecast the future cash flow
   (5) Giving information to stakeholders to take decisions

10. The main purpose of cost accounting is to
   (1) Maximise profit
   (2) Help in inventory valuation
   (3) Provide information to management for decision-making
   (4) Aid in the fixation of selling price
   (5) None of above

11. The purpose of financial accounting is to provide information for
   (1) Assessing the profitability and financial position of the firm
   (2) Fixing price
   (3) Locating factors leading to wastages and losses
   (4) Cost control
   (5) Information for management to take decisions

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12. Which of the following statements are correct regarding management accounting?
    (1) Management accounting is a legal requirement
    (2) Management accounting info is always used by shareholders
    (3) Management accounting information is not used in internal decision making
    (4) The contents of management accounting is broader than the concept of cost accounting
    (5) The main objective of preparing management accounting info is to provide info to the external parties

13. Among the items in the financial statements, what effects on profitability
    (1) Assets and Liabilities
    (2) Liabilities and Capital
    (3) Income and Assets
    (4) Income and Expenditure
    (5) Expenses and Assets

14. The final output of financial accounting is/are
    (1) Assets, Liabilities, Income, Expenditure and Equity
    (2) Trial balance
    (3) Income statement, balance sheet, cash flow statement
    (4) Subsidiary set of books
    (5) Note to the accounts

15. Out of the following, accounting input include
    (1) Income statement and balance sheet
    (2) Transactions and events
    (3) Ledgers, journals and cash book
    (4) Prime entry books
    (5) (2) and (3) of the above

16. Which one of the following statements relating to the framework's concept of understandability is true?
    (1) Users of financial statements should have studied accounting standards before reading financial statements
    (2) Information about complex matters should not be included in the financial statements even though they are relevant
    (3) In preparing financial statements it should be assumed that users do not possess knowledge of current accounting practices
    (4) Preparers of financial statements should make every possible attempt to communicate information in the most effective manner
    (5) None of the above

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17. A complete set of Financial Statements for Tilwin Company, at 31st December 2019, would include each of the following, EXCEPT:
    (1) Balance sheet as of 31st December 2009
    (2) Income statement for the year ended 31st December 2009
    (3) Statement of projected cash flows for 2000
    (4) Notes containing additional information that is useful in interpreting the Financial Statements
    (5) Statement of changes in Equity for the year ended 31st December 2009

18. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. Which of the elements are directly related to the measurement of financial position.
    (1) Assets, liabilities and equity
    (2) Income and expenses
    (3) Income, expenses, assets, liabilities
    (4) Assets, expenses, drawings
    (5) None of the above

19. Of the following, select the correct statement:
    (1) Management Accounting provides information only to the external stakeholders.
    (2) The main objective of Financial Accounting is to prevent frauds and errors.
    (3) Transactions are the accounting output of the accounting process.
    (4) Relevance is a fundamental qualitative characteristic of financial information.

20. Which one of the following statements is true with respect to the general purpose of financial statements?
    (1) They provide general information for use by all external users
    (2) They include any report that the management generally requires for decision making purposes
    (3) They are generally acceptable to external users but the information is not reliable for specific tasks
    (4) They are intended to serve the diverse needs of a variety of user groups who are unable to obtain their own accounting information
    (5) They provide forecasted information for use by all external users

21. The following statements are available for your consideration.
    (i) The income statement shows the financial performance of a business at a given date.
    (ii) Cash flow statement explains the cash and cash equivalent generated and how it is distributed within a given period
    (iii) (iii)The balance sheet always indicates that a business is a going concern

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(iv) Disclosure of accounting policies used in preparing the financial statements will enhance the comparability and understandability of financial statements

(1) All are correct
(2) Only (ii) and (iv) are correct
(3) Only (i), (ii) and (iv) are correct
(4) Only (ii), (iii) and (iv) are correct
(5) All are incorrect

22. An asset may be defined as:

(1) A resource which may be used to derive income in the future
(2) An obligation to transfer economic benefits as a result of past transactions or events
(3) A person or entity to whom money is owed by the business
(4) The amount of money invested in the business by the shareholders

23. In business finance, the generally accepted corporate objective is:

a) Maximisation of shareholders' wealth
b) Maximisation of capital employed
c) Maximisation of profit
d) Maximisation of market share

24. Fixed assets can be best defined as:

a) Assets acquired by the organisation with the intention of using them to earn income for a long period of time
b) Items of machinery which are not moveable
c) Goods purchases by the company for resale
d) Cash or other assets which will be converted into cash in a short period of time.

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