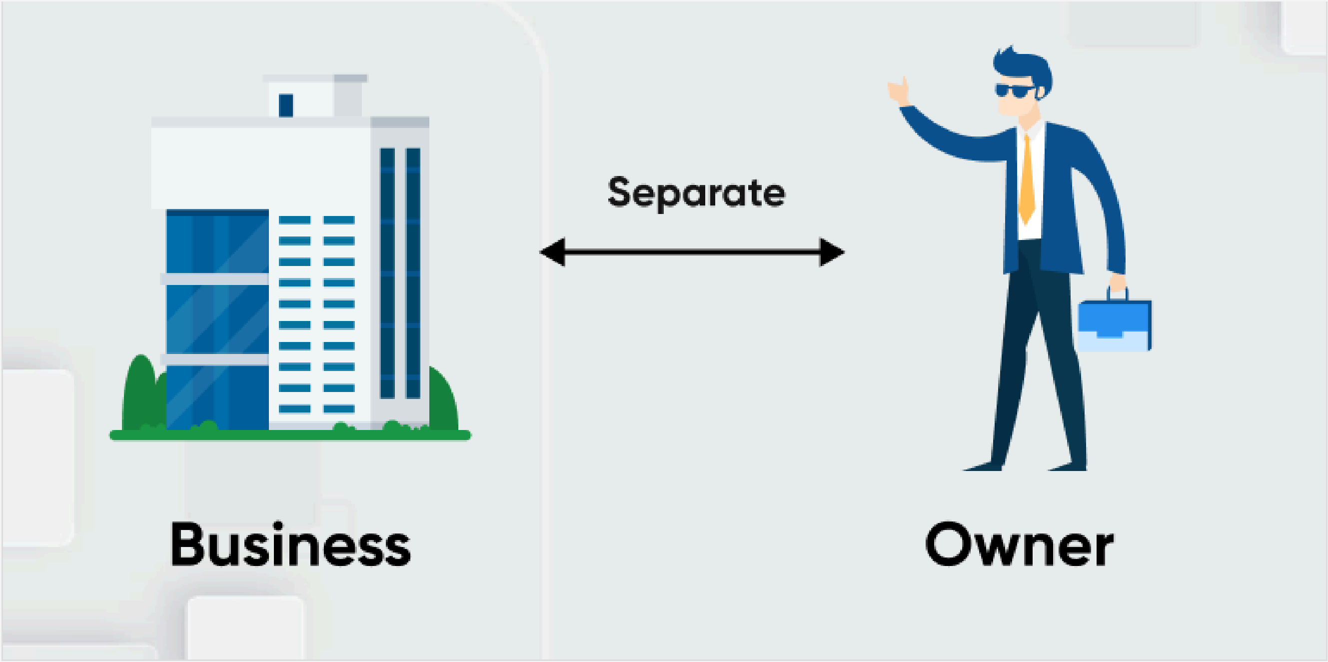
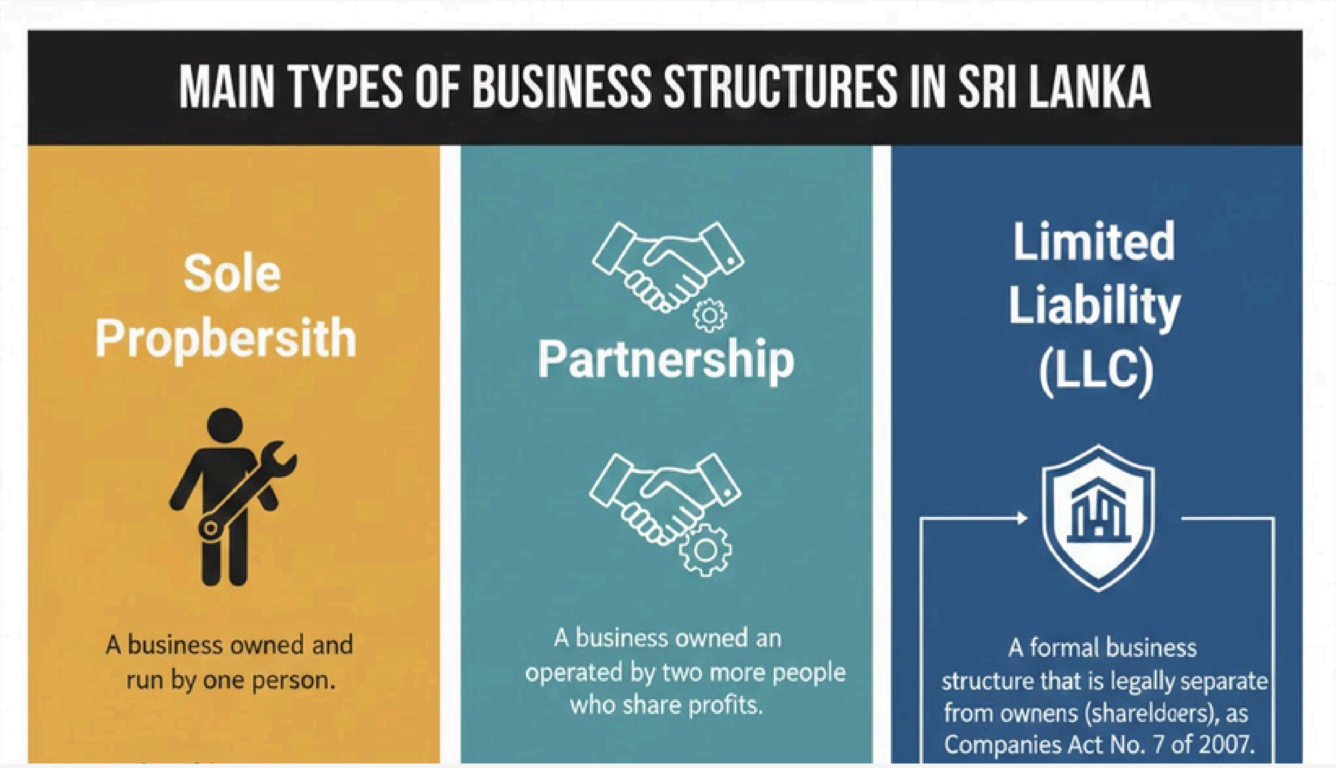
Introduction to Financial Accounting

The Context and Purpose of Financial Statements for External Reporting

1.1 Business Entity Types and Legal Structures





Key Differences Between Business Structures

Feature	Sole Proprietorship	Partnership	Limited Liability Company
Ownership	One owner with full control.	Two or more owners (partners)	Two or more owners (partners)
Liability	Unlimited personal liability.	Unlimited personal liability for partners.	Limited liability for shareholders.
Legal status	Not a separate legal entity.	Not a separate legal entity.	A separate legal entity
Regulations	Fewer rules, private financials.	Less regulated, private financials.	More complex, public reporting required
Decision making	Owner makes all decisions.	Partners must agree on decisions.	A Board of Directors manages the company.

1.2 Financial Reporting Definition and Purpose

Financial Reporting: The process of recording, analysing, summarising, and presenting a company's financial activities. This creates a faithful picture of its performance and financial position

1.3 Users of Financial Statements and Their Information Needs

User category	Specific user groups	Primary role/interest
Primary external users	Existing and Potential Investors, Lenders, Other Creditors (e.g., Suppliers)	Provide capital and assess the risk and return of their investment.
Other external users	Government and Regulatory Agencies, Customers, Employees and their representatives, The Public and Community, Competitors.	Various stakeholders interested in the entity's activities and performance.
Internal users	Management (Directors), Board of Directors	Run the company on behalf of shareholders and oversee its operations.

User Information Needs and Decision-Making Focus

User group	Primary information needs	Key decisions supported
Investors (shareholders)	• Profitability and growth potential • Risk and return on investment	• Profitability and growth potential • Risk and return on investment
Lenders and Creditors	• Ability to repay loans and interest • Cash flow stability	• Assessing creditworthiness for loans • Setting credit terms
Management	• Detailed performance data • Efficiency and resource use	• Strategic planning and budgeting • Controlling operations
Government and Agencies	• Taxable income and compliance	• Calculating tax owed • Ensuring laws are followed
Employees	• Company stability and profitability	• Assessing job security • Negotiating pay and benefits
Customers	• Long-term stability of the business	• Assessing if a supplier is reliable for long-term contracts
Suppliers and Trade creditors	• Ability to pay bills on time	• Deciding whether to offer credit terms
The public and Community	• Contribution to the local economy	• Assessing the company’s social and economic impact
Competitors	• Financial performance and strategy	• Benchmarking their own performance

2.1 Sri Lankan Regulatory System Structure and Purpose

Government of Sri Lanka (Parliament)

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Companies Act No. 07 of 2007 | Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995

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CA Sri Lanka (Standard Setter)) → Business Entity needs to follow LKASs and SLFRs

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SEC (Regulator for Listed Companies) Registrar of Companies (Registry)

<u>Compliance Framework Overview</u>

Business Entity needs to follow LKASs and SLFRs

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External Audit

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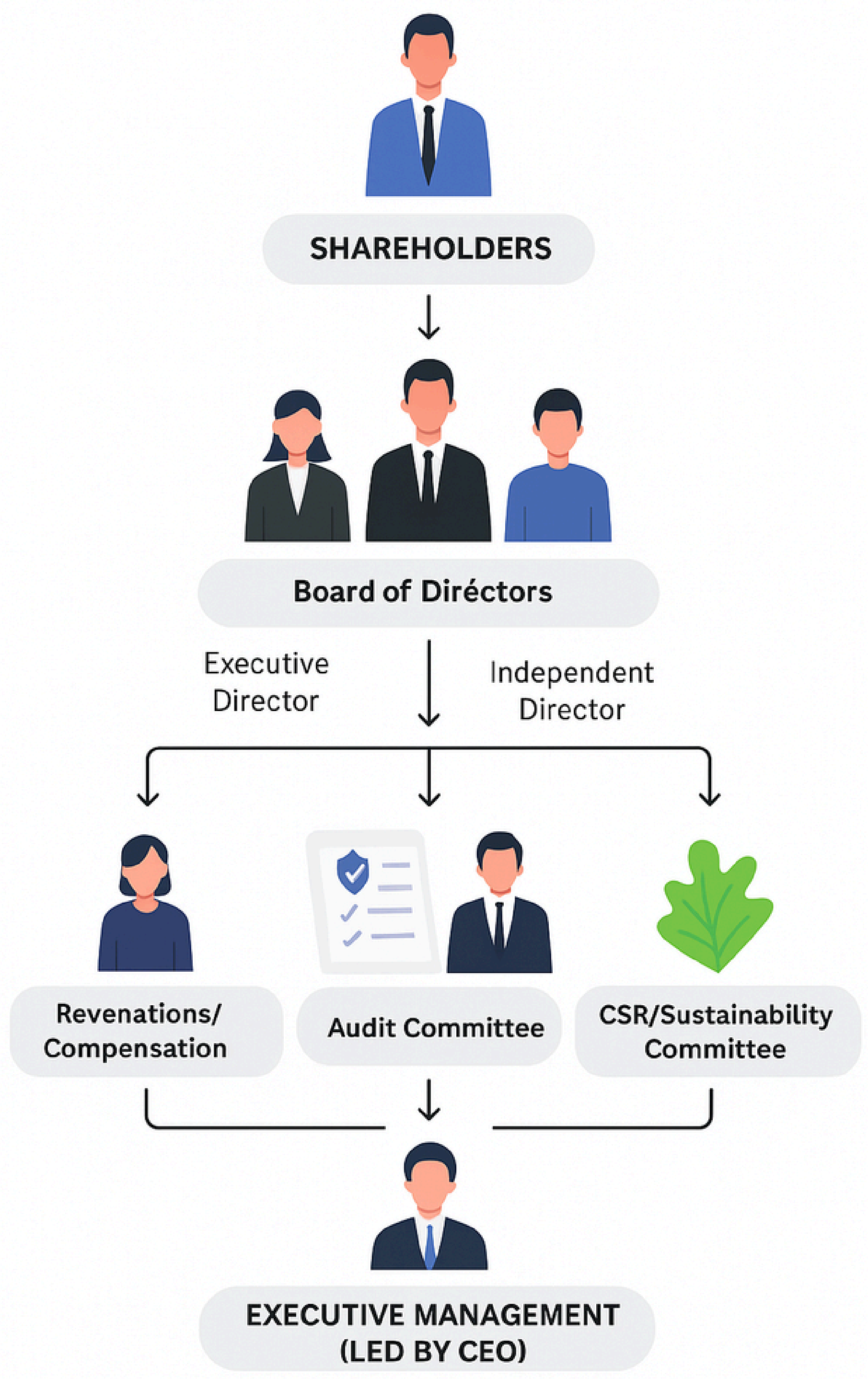
Information available to 'External Stakeholders'

CORPORATE GOVERNANCE STRUCTURE



CORPORATE GOVERNANCE STRUCTURE

SHAREHOLDERS

Owners of the company who provide capital

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BOARD OF DIRECTORS

Composition

Executive Directors

Non-Executive Directors (NEDs)

Independent Directors

The central authority responssible for overseeing management and protecting shareholder interests

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EXECUTIVE MANAGEMENT (LED BY CEO)

Responsible for day-to-day operations and implementing board-approved strategy

Reports regularly to the Board

Key Roles

- Approve strategy, budgets, and policies
- Monitor performance of management
- Ensure compliance with laws, ethics and risk management
- Appoint and evaluate a CEO and senior executives

Committees under the Board

- **Audit Committee**
  oversoes financial reporting, internal controls, and external audit
- **Risk Management Committee**
  Identifies and manages enterprise risks
- **Remuneration/Compensation Committee**
  decides executive pay aligned with performance
- **CSR/Sustainability Committee**

Case Study: Companies Act Compliance Requirements

Description:

You are the Company Secretary at Lotus Construction Ltd. The company has grown significantly and now has 45 shareholders and annual revenue exceeding LKR 2 billion. Under the Companies Act, you need to ensure compliance with statutory requirements including board composition, audit committee establishment, and annual filing obligations. The board currently has 5 directors, all of whom are executive directors. You must advise on necessary governance changes to meet regulatory requirements

Resolution:

Companies Act compliance ensures corporate governance and stakeholder protection. Current structure requires immediate changes:

Regulatory Requirements: Board Composition: Minimum 2 independent directors for companies with >20 shareholders
Audit Committee: Mandatory for companies with revenue >LKR 1 billion
Annual Filings: Audited accounts within 5 months of year-end

Current Non-Compliance: Independent Directors: 0 of 5 (requires minimum 2)
Audit Committee: Not established (mandatory requirement)
Board Size: 5 directors acceptable but needs independence

Compliance Actions:
1. Appoint 2 Independent Directors within 3 months
2. Establish Audit Committee with 3 members(majority independent)
3. Update Articles of Association to reflect governance requirements
4. File Annual Returns within statutory deadlines

2.2 Global Standards Development and Adoption Process

The International Financial Reporting Standards (IFRS) Foundation leads the development of these global standards. Its two main boards are:

- International Accounting Standards Board (IASB): Develops IFRS for financial reporting.
- International Sustainability Standards Board (ISSB): Develops standards for sustainability disclosures.

Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) manages the process if implementing these the following standards in context of Sri Lanka. The following are the standards,

- International Financial Reporting Standards (IFRS)
- International Accounting Standards (IAS)
- IFRS for Small and Medium-sized Entities
- International Sustainability Standards Board (ISSB) Standards

Benefits and Challenges of Adopting International Standards

Benefits	Challenges
Aligns Sri Lanka with global best practice.	Increases complexity for company directors.
Makes our companies easier for foreign investors to understand.	Can be difficult to implement without clear local guidance.
Helps local businesses access global capital.	Requires significant investment in training and development.
Provides a high-quality, robust reporting framework.	Managing local changes and transition periods adds complexity.

2.3 Governance in Financial Statement Preparation

Management runs the business day-to-day. They are responsible for preparing the financial statements according to the accounting standards.

The **Board of Directors** oversees management on behalf of the owners (shareholders). They are ultimately responsible for the integrity of the financial reporting process. In Sri Lanka, these roles are defined by law.

Comparison of Governance and Management Roles in Financial Reporting

Aspect of financial reporting	**Governance role (board of directors/Audit committee)**	**Management Role (Executive team/CFO/Finance department)**
Preparation	Oversight of the overall reporting process; ensure proper internal controls are in place. May set tone at the top regarding ethical reporting and integrity.	Responsible for actual preparation of financial statements in accordance with SLFRS and regulatory requirements. Maintain accounting records and ensure data accuracy.
Oversight	The Audit Committee (under the Board) reviews internal controls, audit findings, and compliance with laws. Ensures independence of external auditors.	Implements and maintains internal controls, prepares reports for board/Audit Committee. Responds to audit findings and addresses risk areas.
Approval	The Board approves the final financial statements before publication, particularly in Annual Reports. Ensures statements reflect a true and fair view.	Prepares and presents financial statements and explanations. Ensures timely submission to the board and regulators.
Accountability	Accountable to shareholders for the integrity of financial reporting. Discloses financial performance in line with regulatory frameworks (SEC, CSE).	Accountable to the Board for accuracy and completeness of financial data. Responds to board queries and justifies financial positions.

Compliance	Ensures the organization complies with SLFRS, SEC/CSE regulations, and corporate governance codes.	Ensures technical compliance during preparation. Keeps up-to-date with changes in standards and laws.
Audit engagement	Appoints external auditors and reviews their independence and effectiveness. Reviews audit reports and management letters	Coordinates audit processes, provides necessary documents, and implements audit recommendations.
Risk Management in Reporting	Reviews risk registers and financial reporting risks. Oversees risk management systems relating to reporting.	Identifies, assesses, and manages risks in financial operations. Reports to the board on financial risk exposures.
Transparency & Disclosure	Ensures financial disclosures are adequate, timely, and clear to stakeholders. Reviews disclosures in Annual Report, especially for listed companies.	Provides necessary disclosures in financial statements (e.g., related party transactions, contingencies, etc.). Maintains accuracy and openness.

Director Responsibilities for Financial Statements

- Ensuring Compliance with Accounting Standards
- Approving Financial Statements
- Maintaining Adequate Internal Controls
- Going Concern Assessment
- Preventing Fraud and Misstatements
- Declaration of Solvency
- Appointment and Oversight of Auditors
- Ensuring Timely Disclosure
- Responsibility for Annual Report

3.1 Fundamental Accounting Principles

Main goal of financial reporting- Is to provide information that is useful to investors, lenders, and other creditors. To achieve this, accounting follows several key principles. These principles ensure that financial statements present a fair presentation

<u>The core accounting principles</u>

Principle/Concept	**Description**	**Why This Matters?**
Business entity	The business is treated as completely separate from its owners.	Ensures financial statements reflect only business activities, not the owners' personal finances.
Going Concern	Assumes the business will continue to operate for the foreseeable future	Allows assets to be valued based on their use in the business, not their immediate sale price.
Accrual Basis	Transactions are recorded when they occur, not when cash is exchanged	Provides a more accurate picture of performance by matching income and expenses to the correct period
Duality	Every transaction has two equal and opposite effects (e.g., Assets = Liabilities + Equity)	This is the basis of the double-entry bookkeeping system and ensures the accounts always balance.
Materiality	Information is material if omitting or misstating it could influence users' decisions.	Allows accountants to focus on what is important and not get lost in tiny details.
Consistency	Allows accountants to focus on what is important and not get lost in tiny details.	Enables users to make meaningful comparisons of a company's performance over time.
Prudence	Exercising caution when making judgements under uncertainty. Assets and income are not overstated; liabilities and expenses are not understated.	Helps to ensure that financial statements do not paint an overly optimistic picture.

Case Study: Accrual vs. Cash Basis Accounting

Description

You are the Finance Manager at Zenith Logistics Lanka. The company provides logistics services with varying payment terms- some clients pay cash on delivery, others have 60-90 day credit terms, and some services span multiple months. The operations manager argues that cash basis accounting would be simpler and more relevant for managing cash flow. However, the auditors insist on accrual accounting. You need to explain the importance of accrual accounting and demonstrate its impact on financial statement accuracy

Resolution

Accrual accounting matches revenues and expenses to the period when they occur, regardless of cash timing:

Accrual vs. Cash Basis Comparison:

- Revenue Recognition: Accrual recognises when service provided; Cash recognises when payment received
- Expense Matching: Accrual matches costs to related revenues; Cash records when paid

Financial Position: Accrual shows receivables/payables; Cash shows only cash position

Practical Example- Zenith Logistics: December Service (LKR 1 million, payment due February):

- Accrual Basis: December revenue LKR 1 million, December receivable LKR 1 million
- Cash Basis: December revenue LKR0, February revenue LKR 1 million

Impact on Decision Making:

- Performance Evaluation: Accrual shows true operational performance by period
- Resource Planning: Accrual reveals actual business activity levels
- Stakeholder Information: Accrual provides complete picture of financial position

Conclusion: Accrual accounting provides more relevant and reliable information for stakeholders, despite increased complexity

3.2 Qualitative Characteristics of Useful Financial Information

- These are the attributes that give financial information its value.

Characteristic type	Characteristic	Description	Why This Matter?
Fundamental	Relevance	Information is relevant if it can make a difference in a user's decision	If information is not relevant, it is useless. It must help users predict future outcomes or confirm past evaluations.
Fundamental	Faithful Representation	Information must be complete, neutral, and free from error. It must reflect the economic substance of events.	Users must be able to trust that the financial statements are a true and fair picture of the business.
Enhancing	Comparability	Users must be able to compare the financial statements of a company over time and with other companies	Helps users identify trends and benchmark performance against competitors
Enhancing	Verifiability	Different knowledgeable observers could reach a consensus that a depiction is a faithful representation.	Assures users that the information is not just one person's opinion but is based on evidence.
Enhancing	Timeliness	Information is available to decision-makers in time to be capable of influencing their decisions.	Old information is less useful. Information must be current to be relevant.
Enhancing	Understandability	Information is presented in a clear and concise way so that users can understand it	Complex information that cannot be understood has no value