Grade 13

# Accounting

## Teacher's Guide

(To be Implemented from 2018)


**Department of Commerce**

Faculty of Science & Technology

**National Institute of Education**

**Maharagama, Sri Lanka**

www.nie.lk

Email: info@nie.lk

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**First Edition 2018**



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**Printing :**

## Message from the Hon. Minister of Education

## Message from the Director General

With the primary objective of realizing the National Educational Goals recommended by the National Education Commission, the prevalent content based curriculum was modernized, and the first phase of the new competency based curriculum was introduced to the eight year curriculum cycle of the primary and secondary education in Sri Lanka in the year 2007

The second phase of the curriculum cycle was introduced to the education system in the year 2015 as a result of a curriculum rationalization process based on research findings and various proposals made by stake holders.

Within this rationalization process the concepts of vertical and horizontal integration have been employed in order to build up competencies of students, from foundation level to higher levels, and to avoid repetition of subject content in various subjects respectively and furthermore, to develop a curriculum that is implementable and student friendly.

The new Teachers' Guides have been introduced with the aim of providing the teachers with necessary guidance for planning lessons, engaging students effectively in the learning teaching process, and to make Teachers' Guides will help teachers to be more effective within the classroom. Further, the present Teachers' Guides have given the necessary freedom for the teachers to select quality inputs and activities in order to improve student competencies. Since the Teachers' Guides do not place greater emphasis on the subject content prescribed for the relevant grades, it is very much necessary to use these guides along with the text books compiled by the Educational Publications Department if, Guides are to be made more effective.

The primary objective of this rationalized new curriculum, the new Teachers' Guides, and the new prescribed texts is to transform the student population into a human resource replete with the skills and competencies required for the world of work, through embarking upon a pattern of education which is more student centered and activity based.

I wish to make use of this opportunity to thank and express my appreciation to the members of the Council and the Academic Affairs Board of the NIE, the resource persons who contributed to the compiling of this Teachers' Guide and other parties for their dedication in this matter.

**Dr. (Mrs.) Jayanthi Gunasekara**
Director General
National Institute of Education

# Foreword

## Message from the Director

According to the present policy with regard to the curricula of Sri Lanka the entire curriculum has to be revised once every eight years. A new revision of this nature has become necessary became of the meaningful expectation that a generation of students capable of facing local as well as global challenges taking place, needs to be produced. Further the recent past has witnessed immense economic, political, social and trade related changes on a global scale. As a result the stage has arisen for all curricula to be revised in 2015. The revised G.C.E. (Advanced Level) Grade 13 curriculum has been revised and will come into effect from the year 2018

Taking the situation above in to consideration, I am extremely pleased that Grade 13 Accounting, Teacher's guide has been written and forwarded in such a short time.

I would like to extend my very sincere thanks, especially to the panel of writers, for functioning with such commitment, to the Director General for her instructions and guidance for the fulfillment of this task successfully, to the Deputy Director General and to all those who supported the conclusion of this responsible endeavor.

It is my firm belief that this Teacher's guide on Accounting for Grade 13 will prove of immense support to subject directors, In service advisors and teachers in the provision of learning experiences successfully, to students.

**P. H. Kusumawathie**
Director (Covering)
Departmemt of Commerce

## Curriculum Committee

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| **Guidance and Approval** | : | **Dr. (Mrs.) Jayanthi Gunasekara**<br>Director General<br>National Institute of Education |
| **Guidelines** | : | **Dr. (Mrs.) Jayanthi Gunasekara**<br>Deputy Director General (Acting)<br>Faculty of Science and Technology |
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| **Mr. Athula Ekanayaka** | Teacher, St.Thomas's College, Matale. |
| **Mr. E.M. Navaratna** | Teacher, Central College, Kuliyapitiya. |
| **Mr. U.B. Dharmadasa** | Teacher, Thambuttegama MMV . |
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## Instructions for the use of the Teachers' Guide

This Teachers' Guide has been prepared for Grade 13 based on the syllabus for Accounting proposed to be implemented for G.C.E. (A/L) from 2018.

Model activities have been included here as guidance in the planning of teachers' learning-teaching process so as to ensure the development of the students' competencies.

This Teachers' Guide has been prepared in keeping with the order in which the learning – teaching process should be implemented in the classroom. Learning outcomes have been presented for every competency level in the syllabus. It is expected that the teacher will implement a student centred learning-teaching procedure to ensure that all the students achieve these learning outcomes and the relevant competencies. For this purpose the learning-teaching process has been presented under each competency level in order to provide you with guidance. It is by no means compulsory that you conform to these instructions in that very form itself since, you as creative individuals, have complete freedom to conform to any other student-centered learning-teaching procedure you consider for students.

Similarly, included in this Teachers' Guide are the basic terms and concepts related to the subject area under each competency level. They will serve as guidance to the subject matter you should elicit through the activities in the classroom as well as for the notes you give the students.

**S. K. Prabaharan**
Senior Lecturer
Project Leader - Accounting
Department of Commerce
National Institute of Education

# National Goals

1. The achievement of a functioning sense of National Cohesion, National Integrity, and National Unity.

2. The establishment of a pervasive pattern of Social Justice and active elimination of inequities.

3. The evolution of a Sustainable Pattern of living – A sustainable Life Style.

4. Seeking a livelihood and work opportunities that are, at one and the same time, productive and give avenues of self-fulfilment.

5. Participation in human resource development that will support socio-economic growth of the country.

6. Involvement in nation building activities: learning to care.

7. Cultivation of an element of adaptability to change – learn to learn and adapt, developing competence to guide change.

8. Coping with the complex and the unforeseen; and achieve a sense of security and stability.

9. Securing an honourable place in the international community.

# Basic Competencies

The following competencies promoted through education will help to achieve the above mentioned National Goals.

**(i) Competencies in Communication**

This first set of competencies is made up of four subsets - Literacy, Numeracy, Graphics and information communication skills :

| | | |
|---|---|---|
| Literacy | : | Carefully listening, Speaking clearly, Reading for comprehension, writing clearly and accurately. |
| Numeracy | : | Using numbers to count, calculate, code and to measure, matter, space and time. |
| Graphics | : | Making sense of line and form, expressing and recording essential data, instructions and ideas with line, form, colour, two and three-dimensional configurations, graphic symbols and icons |
| ICT Competencies | : | Knowledge on computers, and the ability to use the information technology skills at learning or work as well as in the private life |

**(ii) Competencies relating to the Personality Development**

- Generic skills such as creativity, divergent thinking, initiative, decision making, problem-solving, critical and analytical thinking, team work, inter-personal relationships, discovering and exploring
- Values such as integrity, tolerance and respect for human dignity.
- Cognition

**(iii) Competencies related to the Environment.**

This is the second set of competencies related to the Social, Biological and Physical Environments.

| | | |
|---|---|---|
| **Social Environment** | : | Awareness, sensitivity and skills linked to being a member of multi cultural plural society, social relationship, personal conduct, general and national heritage, legal conventions, rights, responsibilities, duties and obligations. |
| **Biological Environment** | : | Awareness, sensitivity and skills linked to the living world, man and the ecosystem, trees, forests, seas, water, air and life - plant, animal and human life. |
| **Physical Environment** | : | Awareness, sensitivity and skills related to space, energy, fuels, matter, materials and their links to human living, food, clothing, shelter, health, comfort, respiration, sleep, relaxation, rest, wastes and excretion, media of communication and transport. *Included here are the skills in the use of tools to shape and materials for living and learning.* |

**(iv) Competencies related to Preparation for the world of work**

Employment related skills to maximize their potential and to enhance their capacity to contribute to economic development; to discover their vocational interests and aptitudes; to choose a job that suits their abilities and; to engage in a rewarding and sustainable livelihood

**(v) Competencies related to religion and ethics**

This fourth set of competencies are laden with values and attitudes. It is essential for individuals to assimilate values, so that they may function in a manner consistent with the ethical, moral and religious modes of conduct, rituals and practices in everyday living, selecting the most appropriate.

**(vi) Competencies in Play and Use of Leisure**

Competencies that link up with pleasure, joy, emotions and such human motivations. These find expression in play, sports, athletics and leisure pursuit of many types. These also link up with such values as cooperation, team work, healthy competition in life and work. Included here are such activities that are involved in aesthetics, arts, drama, literature, exploratory research and other creative modes in human living.

**(vii) Competencies related to 'Learning to learn**

These competencies flow directly from the nature of a rapidly changing, complex and interdependent world. Whatever one learns, that learning will need updating and review. This requires that one should be aware of, sensitive and skilful in sustained attention, and be willing to persevere and attend to details that matter in a given situation.

## Objectives of the Subject

- Obtain basic understanding of the theoretical basis of accounting.
- Obtain and apply basic knowledge of accounting techniques.
- Produce guidance on new educational opportunities opened through the subject area of accounting.
- Apply the knowledge acquired through the area of accounting, for various professional needs.
- Acquiring the knowledge for the effective use of resources in a gainful manner that is suitable for sustainable development within the existing social, economic and political environments.
- Acquire the ability of preparation, presentation, and analysis of financial statements of various business organizations.
- Acquire the experiences through the research study in the subject thatcan be used for future research study development.

## CONTENTS

# Learning Outcomes and Model Activities

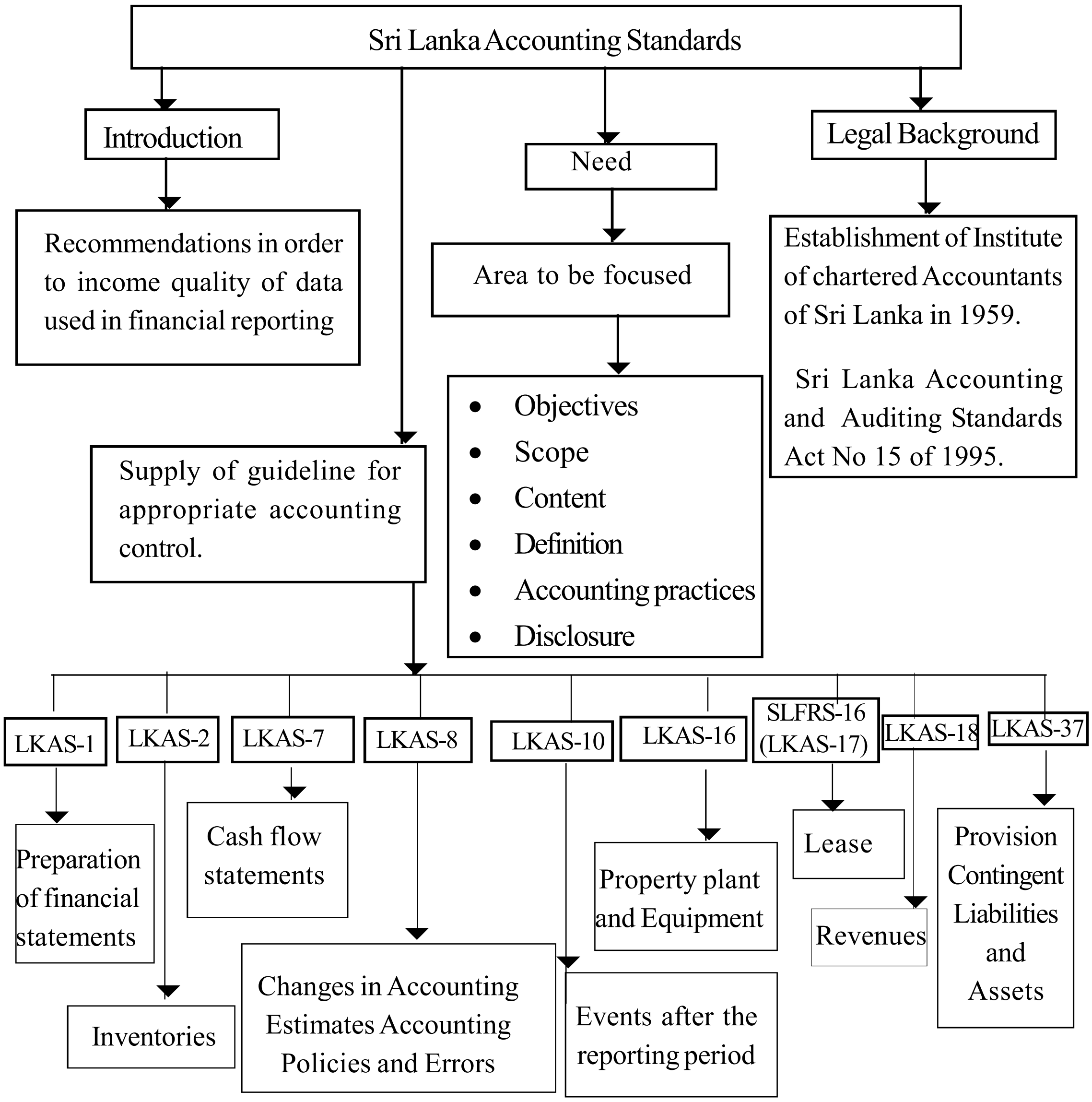
**Competency 11.0 : Uses Sri Lanka Accounting Standards for the preparation and presentation of financial statements**

**Competency Level 11.1 : Analyze legal background of Sri Lanka Accounting Standards**

**Learning outcomes :**

- Explains importance of Accounting and Auditing standards Act for Accounting.
- Name duties related to Sri Lanka Accounting Standards committee.
- Name duties related to Accounting and Auditing Standards Monitoring Board.
- Name duties related to Institute of Charted Accountants of Sri Lanka.

**Basic Terms and Concepts** **Concept Map**



**Teaching Learning Process :**

**Engagement**

- Question the facts from the students why Sri Lanka Accounting Standards were used for the preparation of financial statements and highlight the following facts based on the answers given by students.

- Explains the need of Accounting Standards in order to maintain quality and consistency of Financial Statements.

**Proposed instructions to assist learning :**

- Pay attention on the following topics to be given to each group.
  - Accounting Standards Committee
  - Sri Lanka Accounting Standards Monitoring Board.
  - Institute of Charted Accountants of Sri Lanka.
- Give guidelines in order to disclose details related to each topic after providing reading materials.
- Advise them to introduce Accounting and Auditing Standards Act No. 15 of 1995.
- Advise them to introduce topics given to each group.
- Guide them to write how each topic effects on accounting.
- Distribute questions to each group provided in Annexure 11.1.1
- Prepare them to present their findings in more creative manner.

**Guideline to Subject Matter :**

- Disclose that in preparing and presenting financial statements of specified Business enterprise should follow Sri Lanka Accounting Standards recommended by Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995.

- Incorporation of Sri Lanka Accounting Standards Committee according to Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995.

- The Sri Lanka Accounting Standards Committee has been established as clearly stipulated in the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995.

- The Sri Lanka Accounting and Auditing Standards Monitoring Board has the power to examine whether the Sri Lanka Accounting Standards have been adhered to in preparation of accounting statements of a specified business enterprises, and to take necessary action if the standards have not been adhered to.

- Example For Functions of Institute of Charted Accountants of Sri Lanka.
  - Organizing exams in order to provide related qualification and relevant educational courses.
  - Controlling and supervising of student education and training.
  - Maintaining and controlling of accounting standards and required methods and limitations in maintaining them.
  - Promote resources on Accounting and related subjects.
  - Development maintaining and revising the standards for the clearly specified Business enterprise using legal powers vested by the Sri Lanka Accounting and Auditing Standards Act. No. 15 of 1995.

**Annexure 11.1.1**

- Provide answers for the question given to each group.
  - Group 01.

    Explain in brief the importance of Accounting and Auditing Standards Act.
  - Group 02.

    Explain in brief the role of Sri Lanka Accounting and Auditing Standards Monitoring Board.
  - Group 03

    Explain 4 duties of Institute of Chartered Accountants of Sri Lanka.

**Assessments and Evaluation Criteria :**

- Introduce in brief the accounting standards
- Naming the role of Accounting Standard Committee
- Naming the role of Accounting and Auditing Monitoring Board.
- Naming four functions of Institute of Chartered Accountants of Sri Lanka

**Competency 11.0 : Uses Sri Lanka Accounting Standards for the preparation and presentation of financial statements.**

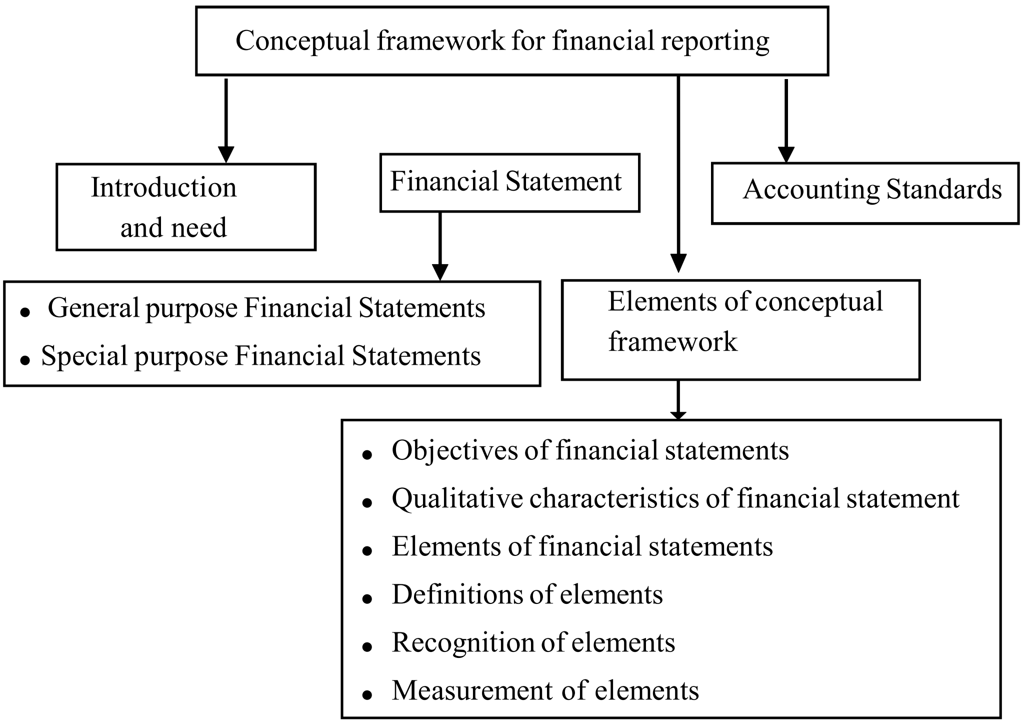
**Competency Level 11.2 : Analyze Conceptual Framework for Financial Reporting.**

**Learning outcomes :**

- Name the types of financial statements.
- Explains conceptual framework for financial reporting.
- Explains the elements of conceptual framework for financial reporting.

**Basic terms and concepts:**

**Concept Map**



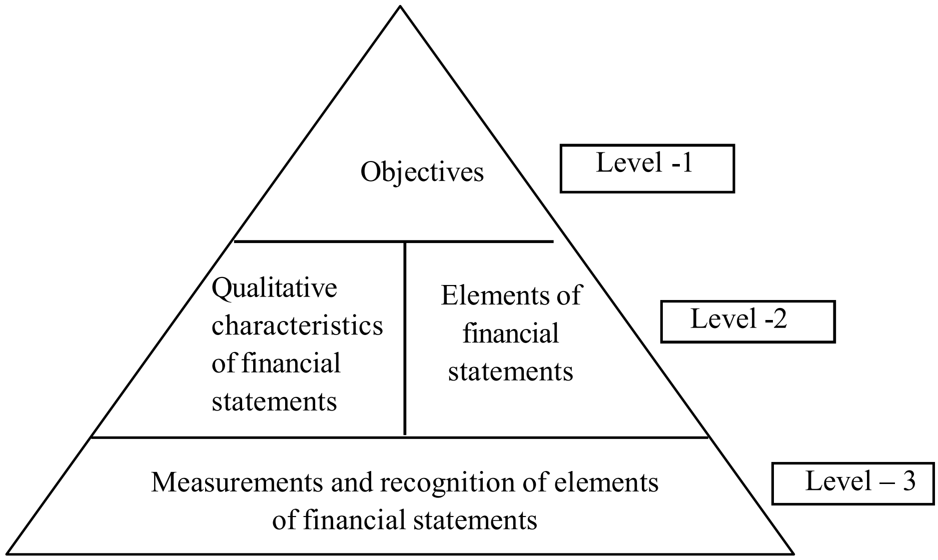

**Proposed instructions to Assist Learning**

- Commence a discussion incorporating the following points.
  - Objectives of Financial Reporting
  - Problems faced by organization if they do not compliance with standard methods.
  - Benefits gained by organizations in complain with the conceptual framework;
  - Financial statements prepared by organization
  - Elements of financial statements
  - Users of financial statements
  - What is meant by Accounting Standards

**Guidelines on subject matter :**

- **Conceptual framework for financial reporting**

  A set of rules which helps to make functions and limitations of financial accounting and financial statements are known as conceptual framework.

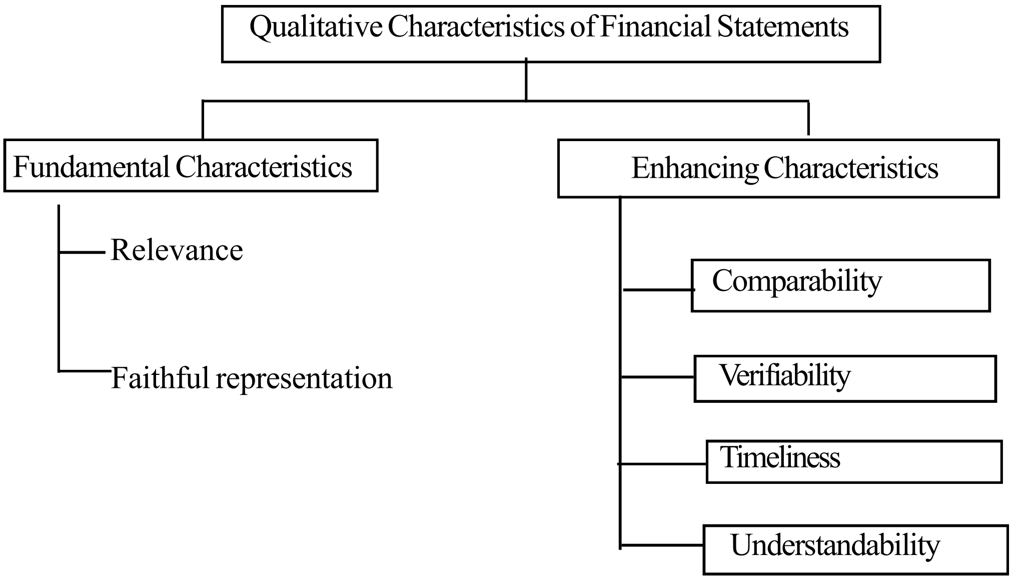



- **Objectives of financial Statements**

  The objectives of general purpose financial statements to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources of the entity.

  General purpose financial statements provide financial performance, financial position and changes in financial position of an entity. Underyling assumption in preparing financial statement is going concern concept.

**Diagram**




- **Relevance**

Relevant financial information is capable of making a difference in the decision made by users. If financial information is to be useful it must consist following sub characteristics.

- Predictive value
- Confirmatory value
- Materiality

- **Faithful representation**

Economic phenomena represented in financial reports should be faithfully presented. To be a perfectly faithful representation a depiction should have the following characteristics.

- Completeness
- Neutral

- **Comparability**

If data of one entity can be compared with similar information about another entities and with similar information about the same entity for another period is known as comparability.

- **Verifiability**

Variability helps assure users that information faithfully represents the economic phenomena it purports to represent.

- **Timeliness**

Timeliness means having information available decision making on time to be capable of influencing their decisions.

- **Understandability**

Presenting information clearly and concisely makes it understandable to the users.

- **Elements and Definitions**

Contents of financial statements represent the elements. Information provided by the elements helps to achieve objectives of financial reporting. There are five elements.

They are,

  - Assets
  - Liabilities
  - Income
  - Expenses
  - Equity

- **Assets**

An asset is a resource controlled by the entity as a result of past transactions / events and form and which brings future economic benefits are expected to flow to the entity.

Following main three characteristics are possessed by an asset according to the above definition.

  - Ability to generate economic benefits
  - Can be controlled by the entity
  - As a result of a past transaction or event

- **Liabilities**

A liability is a present obligation of the entity arising from past transactions / events. The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Following main three characteristics are possessed by liability according to the above definition.

  - It is probable that an out flow of resources embodying economic benefit will result from the settlement of a present obligation.
  - Outflow of future economic benefits.
  - There should be a present obligation
  - As a result of a past transaction or an event.

- **Equity**

  Equity is the residual interest in the assets the entity after deducting all its liabilities.

  The above equity, assets and liabilities are directly related to the measurement of financial position of an entity.

- **Income**

  Income is increased in economic benefits during the accounting period in the form of inflows or increase of assets or decrease of liabilities that result in increase in equity. Other than those relating to contributions from equity participants.

- **Expenses**

  Expenses decrease the economic benefits during the accounting period in the form of outflows of assets or incurrence of liabilities that result in decrease in equity. Other than those relating to distribution to equity participants.

- **Recognition of the Elements**

  Following criterias should be recognized in order to identify elements on accordance with conceptual framework for financial reporting.

  - Elements should be in accordance with the definition
  - Economic benefit embodying should inflow to the organization.
  - Can be measured reliably.

- **Measurements of the elements of Financial Statement**

  Measurement of the process of determining the monetary amounts is the elements of the financial statement. Following methods can be used in measuring elements of financial statements.
  - Historical cost
  - Current cost
  - Realizable value
  - Present value

**Introduction to Accounting Standards**

Various professional Institutes provide rules to be followed by organizations in preparing financial statements are known by Accounting Standards or required rules to be followed in recognizing, measuring and presenting transactions. The Institute of Chartered Accountants of Sri Lanka is the authorized institute in Sri Lanka.

**Assessment & Evaluation Criteria:**

- Explains conceptual framework for financial reporting
- Names and explains elements of conceptual framework for financial reporting.
- Institution to Accounting Standards
- Answer following questions in brief
    1. State the underlying concept in preparing financial statements.
    2. Give three characteristics of assets and liabilities and equity.
    3. State a similarity and difference between liabilities and equity.
    4. Conditions to be satisfied in recognizing elements of financial statements.
    5. State the objectives of General purpose financial statements.
    6. State two techniques used in measuring elements of financial statements.
    7. State two enhancing characteristics and fundamental characteristics of financial information.

**Competency 11.0 : Uses Sri Lanka Accounting Standards for the preparation and presentation of financial statements**

**Competency Level 11.3 : Accounting and discloses changes in Accounting Estimates Policies and errors**

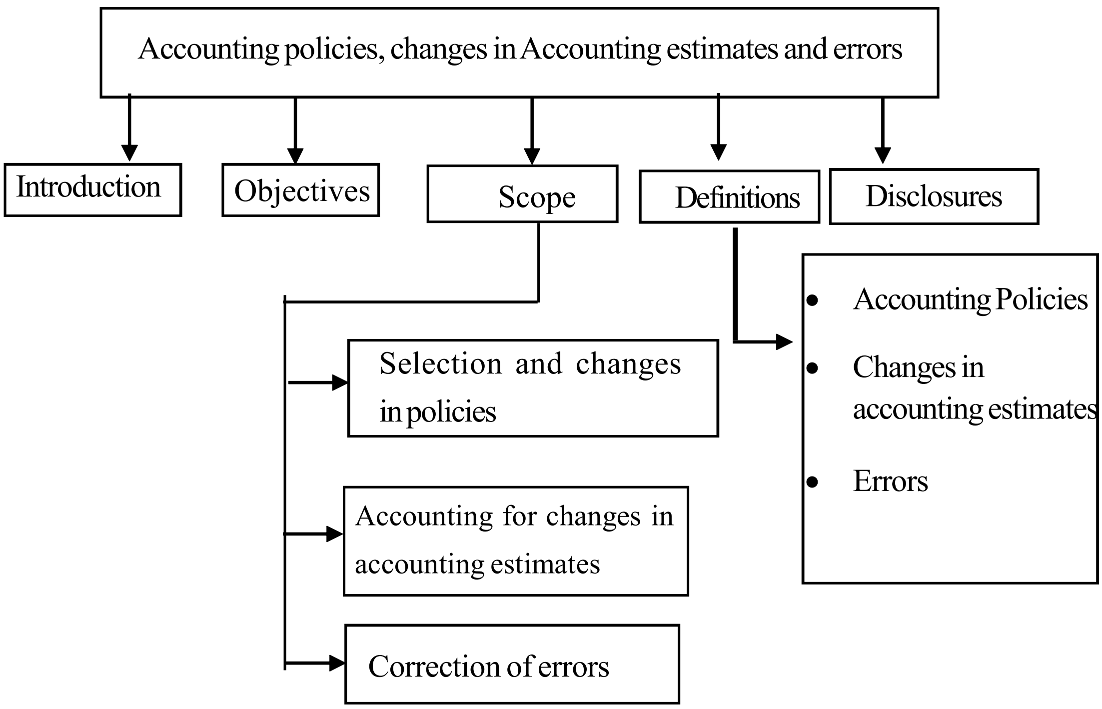
**No of Periods : 05**

**Learning Outcomes :**

- Defines "Accounting policies, changes in Accounting estimates and errors" according to the standard.
- Presents two main points to be considered in selecting Accounting Policies.
- States the situations where Accounting Polices could be changed.
- Explains the way of recording changes in accounting estimates.
- States that it should recognize and correct current year errors before approving the finical statements.
- Disclosure requirements according to the standard.

**Basic terms and concepts**

**Concept Map**



**Learning - teaching Process:**

- Conduct a discussion to highlight the following
  - Accounting policies
  - Changes in accounting estimates
  - Errors
  - Changes in accounting polices
  - Disclosure requirement for changes in accounting estimates

**Guidance on Subject Matter**

- Definitions
  - Accounting Policies
    Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements.
  - Changes in accounting estimates
    It is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset. That results from the assessment of the present status and expected future benefits and obligations associates with assets and liabilities.
  - Errors
    Errors are omissions from and misstatements in the entities periods arising from a failure to user or misuse of reliable information that was available when financial estimates for those periods were authorized for issue.
    Example : Mathematical errors, errors in use of accounting policies, oversight mis - interpretation and frauds.
- **Selecting Accounting Policies :**
  There are two ways of selecting an accounting policy.
  - If an accounting standard is clearly applied to a transaction or an event. The accounting policy should adhere to the standard.
  - If not management shall use to judgment in developing and applying an accounting policy.
- **Changes in Accounting Policies:**
  An entity shall change an accounting policy only if the change
  (a) Is required by a standard
  (b) Required to changes in entity's financial position performance or cash flows to be presented in more reliable and more relevant manner.

**Accounting for changes in accounting estimates.**

- If the change affects only the period in which the change occurred, then adjust the profit or loss of the period.
  Examples : • Impairment loss on trade receivables.
  • Allowance for expected losses on trade receivables.
- If the change affects both the period in which the changes occurred and the future periods. Then adjust the profits / losses of each period affected.
  Examples : Changes in depreciation values due to the changes in useful economic life of property plant and equipment.
- If the change affects assets, liabilities or equity. Then adjust the related period assets, liabilities, equity and their fair values.

**(Important : Accounting for Changes in accounting policies and errors are not discussed for Advanced Level)**

**Examples of disclosures.**

| Changes in Accounting Policies | Changes in Accounting Estimates | Prior period errors |
|---|---|---|
| • Nature of the change accounting policy | Reasons for changing the estimates | Nature of the prior period errors. |
| • The effect on present and future periods | Effect on the financial statements due to the change in the estimate | The correction at the beginning of the earliest period presented. |
| | | A description of how and during which period the error has been occurred. |

**Assessment and Evaluation Criteria:**

- Define accounting policies, changes in accounting estimates and errors according the standard.
- Name two main points to be considered in selecting accounting policies.
- Name two situations where accounting policies could be changed.
- Explain the way of recording changes in accounting estimates.
- State that errors found in preparing financial statements should be corrected before authorizing for issue.
- Disclosure requirements according to the standard.

**Competency level 11.0 : Uses Sri Lanka Accounting Standards in preparing and presenting financial statements.**

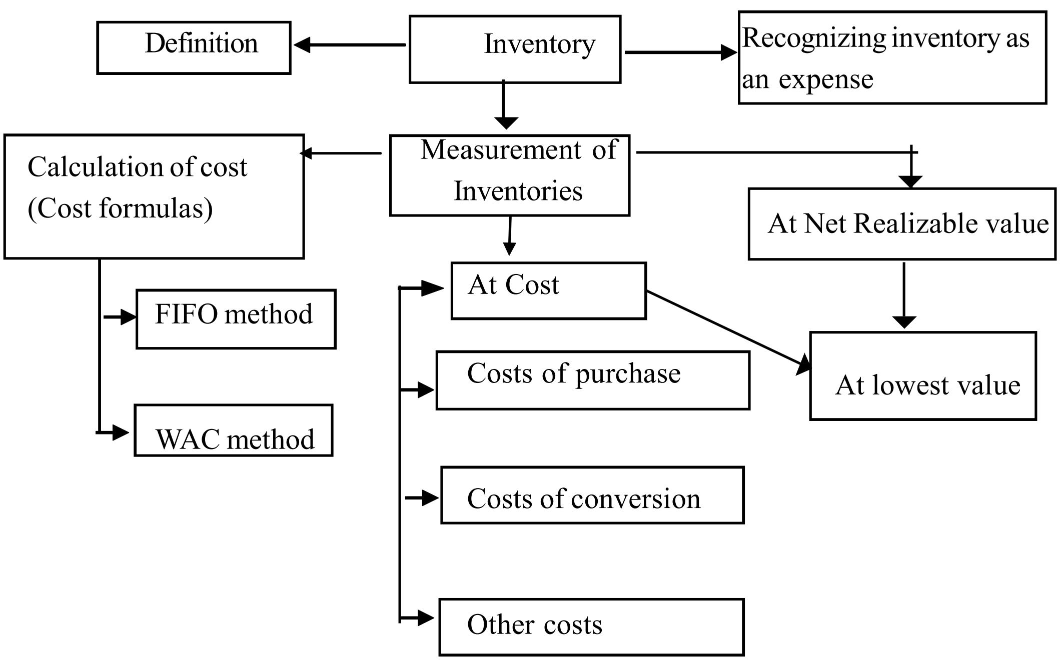
**Competency level 11.4 : Explaining the main concepts relating to inventory and accounting for inventory.**

**No of periods : 05**

**Leaning outcomes :**

- Defines "Inventory" as per Inventory Standard
- Explains the inventory cost
- Explains Net Realizable Value
- Calculates cost of closing stocks based on First In Fist Out method (FIFO) and Weighted Average Cost method (WAC).
- Records the value of inventory which is recognized as an expense in the financial statements.

## Concept Map



**Basic Terms and Concepts**

**Approach :**

- Discuss the following with students
  - Types of inventories
  - Definitions of inventories
- Inquiries from students about few stock items that could be seen in the following business at the year end.
  - At a grocery
  - At a furniture shop

**Proposed instruction for activity plan**

01. Name the closing inventories of each of the following businesses
    - At a grocery
    - At a garment factory
    - At a beauty salon
    - At a building construction business

02. Define following terms as per inventory standard
    - Inventory
    - Costs of inventories
    - Net Realizable Value

03. Fashion Ltd company produces and exports readymade garments. Using the following information selects items that can be included under costs of inventories of this company. (This company is a registered company for VAT)
    - Purchase price of raw materials
    - Carriage inward charges of raw materials
    - Loading and unloading charges
    - Value Added Tax
    - Trade discounts (On purchase price)
    - Salaries of machine operators
    - Costs for fashion designing
    - Salaries of supervisors
    - Interest on bank loans
    - Expenses in preparing export documents

04. Following are the details of inventories of a company as at the year end.

As per LKAS 02, calculate the value of inventories based on lower of cost and net realizable value using item by item method and group method separately. Show the journal entries and extracts of financial statements.

| Group | Types of product | Number of units | Unit cost (Rs.) | Net Realizable value per unit (Rs.) |
|---|---|---|---|---|
| Soap | A | 300 | 50 | 40 |
| | B | 200 | 40 | 45 |
| | C | 100 | 30 | 40 |
| Tooth paste | P | 50 | 80 | 70 |
| | Q | 60 | 50 | 60 |

05. Following are the stocks receipts and issues details of Wansan's business for the year ended 31.03.2016

| Date | Description | Quantity (units) | Unit price (Rs.) |
|---|---|---|---|
| 01.03.2016 | Opening inventory | 100 | 45 |
| 02.03.2016 | Purchases | 300 | 45 |
| 05.03.2016 | Issues | 200 | - |
| 10.03.2016 | Purchases | 800 | 60 |
| 15.04.2016 | Issues | 400 | - |
| 21.03.2016 | Issues | 400 | - |
| 25.03.2016 | Purchases | 600 | 75 |
| 30.03.2016 | Issues | 400 | - |

Calculate the following based on First In First Out method (FIFO) and weighted Average Cost of method?

(i) Inventory value as at 31.03.2016

(ii) Cost of sales for the month of March, 2016.

(iii) Gross profit if all the stocks mentioned above will be sold at Rs. 80

06. Mention the two situations where the inventories could be recognized as expenses.

07. Mention two disclosures regarding inventories in the financial statements?

- Provide each group with learning materials of standards.
- Guide students to answer the questions using those materials.
- State whether their answers are correct when they present answers to the class

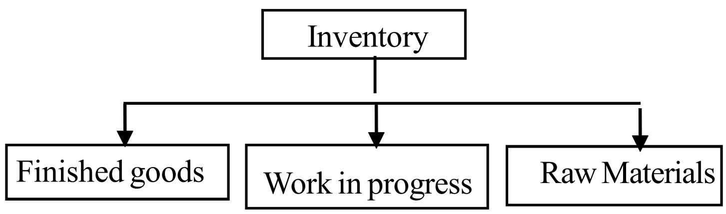
**Guidelines for subject matters :**

- Definitions
  - Inventories are assets :

    (a) held for sale in the ordinary course of business (Finished goods)

    (b) In the process of production for such sale (work in progress)

    (c) In the form of materials or supplies to be consumed in the production process or in the rendering of services (Raw materials)




- Elements of cost of inventories
  - Costs of purchase
  - Costs of conversion
  - Other costs incurred in bringing the inventories to their present location and condition.

- **Net Realizable value**

  Net realizable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make the sale.

  Net realisable value = Estimated selling price – (Estimated costs of completion + Estimated costs necessary to make the sale)

- As per LKAS 02, inventories shall be measured at the lower price between the cost and net realizable value.

- As per LKAS 02, inventories shall be measured at the lower of cost and net realizable value.
- Methods of deciding net realizable value.

  There are the methods of deciding the lower of cost or net realizable value.

  1. Item by item basis
  2. Group method

- **Cost formulas**

  Before calculating cost or net realizable value of inventories, it should be confirmed that the remaining inventory balance is consisted with which purchase / which product.

  Cost formulas provide a basis to decide on which purchases or which products the remaining inventory is represented. There are few methods.

  Following cost formulas are recommended by the standard.

  (i) First in First Out method (FIFO)

  (ii) Weighted Average Cost method (WAC)

**(i) First in First Out method (FIFO)**

The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. But in Practically, it is not needed to sell the items in first out first out basis only.

**Weighted Average Cost method (WAC)**

Under this method, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period.

It is calculated as follows.

$$\text{Weighted Average Price} = \frac{\text{Value of inventory at the issuing date}}{\text{Quantity of inventory at the issuing date}}$$

**Recognition as an expense :**

There are two situations here the inventories are recognized as expense.

(i) When inventories are sold, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognized. It is identified as cost of sales.

(ii) The amount of any written – down of inventories to net realizable value and all losses of inventories shall be recognized as an expense in the period the written down or loss occurs.

**Evaluation and assignment criteria:**

- Defining inventories as per the standard.
- Explaining costs of inventories
- Calculation of inventory cost using FIFO and WAC methods.
- Situations in which stocks are recognized as expense.
- Disclosures regarding inventories in financial statements.

**Competency level 11.0 : Uses Sri Lanka Accounting Standards in preparing and presenting financial statements.**

**Competency level 11.5 : Defining basic concepts and accounting for property plant and equipment.**

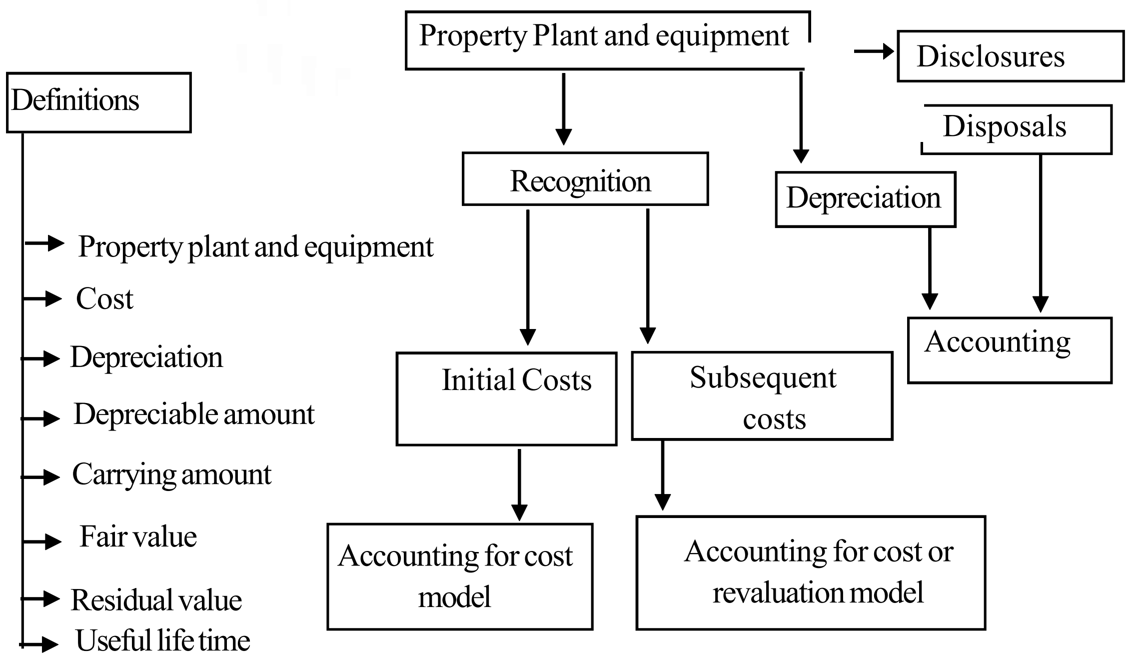
**Number of periods : 05**

**Learning outcomes :**

- Defining property plant and equipment as per Sri Lanka Accounting Standard.
- Defining the following terms as per Sri Lanka Accounting Standard
    - Cost
    - Depreciation
    - Depreciable amount
    - Carrying amount
    - Fair value
    - Residual value
    - Useful life time
- States the need of consideration towards initial costs and subsequent costs when recognizing
- Names elements of costs
- Explains that it should be necessary to measure at cost for the first time and then cost model or revaluation model could be used for measurement of property plant and equipment.
- Accounting at revaluation model
- Name depreciation methods and accounting for depreciation.
- Accounting for disposal of property plant and equipment.
- Make necessary disclosures regarding property plant and equipment

**Basic terms and concepts**

## Concept Map




**Teaching learning process :**

- In order to approach to this competency level, guide students to answer the attachment number 11.5.1.
- Conduct a discussion on types of property plant and equipment used by various businesses.
- Property, plant and equipment are tangible items that : are held for use in the production or supply of goods or services, for rental to others or for administrative purposes and are expected to be used during more than one period.
- Following terms should be defined as per LKAS 16 – Property, plant and equipment
    - Cost
    - Depreciation
    - Carrying amount
    - Fair value
    - Residual value / scrap value
    - Useful life time

## Guidance of subject matter:

- **Cost**

  Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements.

- **Depreciation**

  Depreciable amount is the cost of an asset or other amount substituted for cost, less its residual value.

- **Carrying amount**

  Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairments losses.

**Calculation of impairment losses are not expected here**

- **Fair value**

  Fair value is the amount for which an asset could be exchanged between knowledgable, willing parties in an arm's length transaction.

- **Residual value**

  The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, in the condition expected at the end of its useful life.

- **Useful life**

  Useful life is the period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

- **Recognition**

  The cost an item of property, plant and equipment shall be recognized as an asset if,

  1. It s probable that future economic benefits associated with the item will flow to the entity and,

  2. The cost of the item can be measured reliably.

- An entity evaluates under the recognition principle all its property plant and equipment costs at the time they are incurred those. These costs can be of two types.

  1. Initial costs
  2. Subsequent costs

- **Initial costs**

Costs incurred initially to acquire or construct an item of property, plant and equipment. These costs should be capitalized.

- **Subsequent costs**

  Costs incurred subsequently to add to, replace part of or service it could be identified in two types.

  1. Capital expenditure
  2. Revenue expenditure

- **Capital expenditure**
  Expenditure incurred in an innovation or establishment of a new equipment to increase the useful life time of an asset or capacity of an asset or quality of the products or to decrease expenses related in production could be identified as capital nature expenses.
- **Revenue expenditure**
  The costs incurred in maintaining the assets.
  Examples : Machine repair expenses
  Building painting expenses

  **Property, plant and equipment measurement at recognition.**

  An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost and it includes the following.

  (a) Its purchase price, including import duties and non refundable purchase taxes, shipment charges, insurance changes after deducting trade discounts and rebates.

  (b) Any costs directly attributable to bringing the asset to the expected location and condition.

  Example :

  - Direct costs of construction or acquisition of assets
  - Cost of site preparation
  - Initial delivery and handling costs
  - Installation and assembly costs
  - Net costs of testing whether the asset is functioning properly
  - Professional fees

(c) The estimation of costs of dismantling and removing the assets at the end of the life time.

**Measurement after recognition :**

- An entity shall choose either the cost model or revaluation model for measurement after recognition at cost.
- Property, plant and equipment are measured at revaluation model as follows.
- Methods of recording fair value of the asset. Here the carrying amount has been calculated by deducting accumulated depreciation against cost and compare it with the fair value.
- Revaluation of Property, Plant and Equipment

Revaluation for the first time

**Revaluation surplus**

(1) Accumulated depreciation until revaluation date

Relevant Accumulated depreciation account Dr. xx

Relevant asset account Cr/ xx

(2) Revaluation surplus

Relevant asset a/c Dr. xx

Revaluation surplus a/c Cr. xx

(Profit or Loss & Other Comprehensive income statement.)

**Revaluation deficit**

(1) Accumulated depreciation until revaluation date

Relevant Accumulated for depreciation account Dr. xx

Relevant asset account Cr/ xx

(2) Revaluation deficit

Other expenses Dr. xx

(Profit or Loss & Other Comprehensive income statement.)

Relevent asset account Cr. xx

Revaluation of an item of property, plant and equipment when it was revalued in a previous year.

**Example** : A Profit of Rs. 1 000 000 was received by the first time revaluation of building.

This building is revalued again

Eg. If revalaution deficit is Rs. 800 000

Revaluation Reserves A/c Dr. 800 000
(Profit or Loss & Other Comprehensive income statement)
Building account Cr. 800 000

Eg. If revalaution deficit is Rs. 1 300 000

(Profit or Loss & Other Comprehensive income statement)
Revaluation Reserves account Dr. 1 000 000
Profit or Loss Account Dr. 300 000
(Profit or Loss & Other Comprehensive income statement)
Building account Cr. 1 300 000

Imagine that the deficit is Rs. 500 000 by the first time revaluation of a machine.

This machine is revalued again

Eg. If revalaution surplus is Rs. 400 000

Machine account Dr. 400 000
Profit or loss account Dr. 400 000
(dedicated from other expenses)

Eg. If revaluation surplus is Rs. 700 000

Machine account Dr. 700 000
Profit or loss account (Income statement) Cr. 500 000
Revaluation Reserve Account Cr. 200 000
(Profit or loss and other comprehensive income statement)

- When revaluing assets, accumulated depreciation should be debited to accumulated deprecation account and credited to relevant asset account.
- Calculation of depreciation of property, plant and equipment using straight line method and reducing balance method.
    - Calculation of depreciation as per straight line method.

$$\text{Annual depreciation} = \frac{\text{Cost} - \text{residual value}}{\text{Useful life time}}$$

- Calculation of depreciation as per reducing balance method.

  Annual depreciation = (Cost – Accumulated depreciation) X Rate of depreciation

- Annual depreciation is recorded as follows.

  Deprecation account Dr. xx

  Accumulated depreciation account Cr. xx

- Accounting for disposals of property, plant and equipment

  Double entries relating to disposals of property, plant and equipment are as follows.

  Cost of the disposed asset

  Asset disposal account Dr. xx

  Asset account Cr. xx

- Accumulated depreciation of the disposed asset.

  Accumulated depreciation account Dr. xx

  Asset disposal account Cr. xx

- Sales price of the asset

  Cash account Dr. xx

  Asset disposal account Cr xx

- Exchange value of asset

  Asset account Dr. xx

  Asset disposal account Cr. xx

- Profit arising from disposal

  Asset disposal account Dr. xx

  Profit or loss account (Income statement) Cr. xx

- Loss arising from disposal

  Profit or loss account (Income statement) Dr. xx

  Asset disposal account Cr. xx

- Disclosures relating to property, plant and equipment
  - The measurement bases used for determining the gross carrying amount
  - The depreciation method used
  - The useful lives or the deprecation rates used
  - The gross carrying amount and the accumulated depreciation at the beginning and end of the period.

**Attachment 11.5.1**

01. Mention whether the following assets in the business could be recognized as property. Plant and equipment.
    Business organization

| Type of business | Recognize / not recognize as property, plant and depreciation. |
|---|---|
| 1. A motor vehicle which is for selling at "Isuru Motors" who is a motor vehicle selling company.<br>2. Bus used by "Renuka Transport Services" which provides passenger Transport Services.<br>3. Sewing machines at a garment factory<br>4. The land of the garment factory<br>5. Office building of<br>• Home land building construction company | |

02. Following are the details of a machine which is imported by a manufacturing company. The business is a VAT registered company.

| | (Rs.000') |
|---|---|
| Listed of price of the machine | 1000 (Trade discount 10%) |
| Import duties | 200 |
| Clearing fees | 20 |
| Carriage inwards | 10 |
| Unloading charges | 05 |
| Installation and assembly costs | 35 |
| Engineering and professional fees | 10 |
| Cost of first test round | 08 |
| Cash received from selling samples produced in the test round | 03 |
| VAT (Relevant for purchasing of the machine) | 90 |
| Reinstallation cost in another place | 10 |
| Machine repair expenses | 12 |

Calculate the initial recognition cost of the machine?

03. Mention two conditions needed to recognize property, plant and equipment as asset?

04. As at 01.04.2016, value of machinary at Vimukthi PLS is Rs. 1 200 000. As at that date, balance of the accumulated for depreciation account is Rs. 400 000.

i. According to first time revaluation as at 01.04.2016, value of machineries is Rs. 950 000. Show the relevant journal entries?

ii. If these machineries are revalued for Rs. 750 000 for the first time as at 01.04.2016. Write the relevant journal entries

iii. If these machineries were revalued on 01.04.2015 and a deficit of Rs. 500 000 was received and again revalue on 01.04.2016 for a value of Rs. 950 000. Write the relevant journal entries.

iv. If the revalued amount as at 01.04.2016 is Rs. 750 000 and by the revaluation done as at 01.04.2015 received a surplus of Rs. 50 000.
Write the relevant journal entries.

05. As at 01.04.2015, Ruwan PLC purchased a motor vehicle for a value of Rs. 2 700 000. Useful life time is 5 years (Depreciation rate s 20%) and residual value is Rs. 200 000.

1. Calculate the annual depreciation based on straight line method for the years ending 2015/2016 and 2016/2017
2. Prepare the relevant journal entries and ledger accounts for the two years.
3. As at 01.04.2016, Nethumi PLC purchased a machinery for a value of Rs. 1 500 000 and it is revalued annually at 20% on reducing balance method. Calculate the depreciation for the following years.

Year 2016 2017 2018

**Evaluation**

- Define property, plant and equipment as per LKAS 16.
- Define the following terms as per the standard
    - Cost
    - Depreciable amount
    - Carrying value
    - Residual value
    - Useful life time

**Competency level 11.0 : Uses Sri Lanka Accounting Standards in preparing and presenting financial statements**

**Competency level 11.6 : Discloses and accounting for provisions, contingent liabilities and contingent assets according to Sri Lanka Accounting standard**

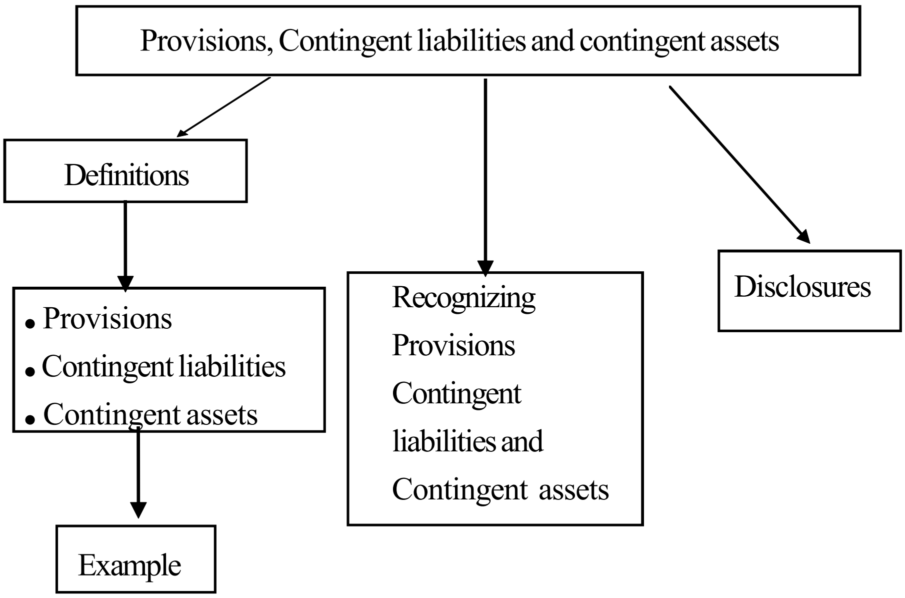
**No of periods : 05**

**Leaning outcomes :**

- Defines provisions, contingent liabilities and contingent assets as per Sri Lanka Accounting Standard
- Compare provisions, contingent liabilities and contingent assets
- Recognition and disclosures according to Sri Lanka Accounting standard.

**Basic terms and concepts**

**Concept Map**




**Teaching – learning Process :**

- Conduct a discussion with student to highlight the followings
- Provisions
- Contingent liabilities
- Contingent assets
- Recognition
- Disclosures

**Guidance and Subject matters :**

Definitions according to the standard

- **Provisions :**

  " Is a liability of uncertain timing or amount"

- **Contingent liability :**

  " A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non occurrence of one or more uncertain future events wholly within the control of the entity.

A present obligation that arise from past events but is not recognized because ,

(i) It is not probable that an outflow of resources embodying economic benefits will require settling the obligation.

(ii) The amount of the obligation cannot be measured with sufficient reliability.

If the above conditions are satisfied it could be recognized as an expense in the Income Statement and should show under current liabilities.

**Contingent Assets**

A possible asset that arises from past events and whose existence will be comfirmed only by the occurence or non occurrence of one or more uncertain future events not wholly within the control of the entity.

**Recognise and differentiate between provision and contingent liabilities**

It should satify following conditins.

(i) Present obligation of a past event

(ii) Outflow of resouces embodying economic benefits will be required to settle the obligation.

(iii) The amount of the obligation can be measured reliably.

If the above conditions are satisfied it could be recognised as an expense in the income statement and should show under current liabilities.

**Contingent liabilities**

Following conditions to be satisfied

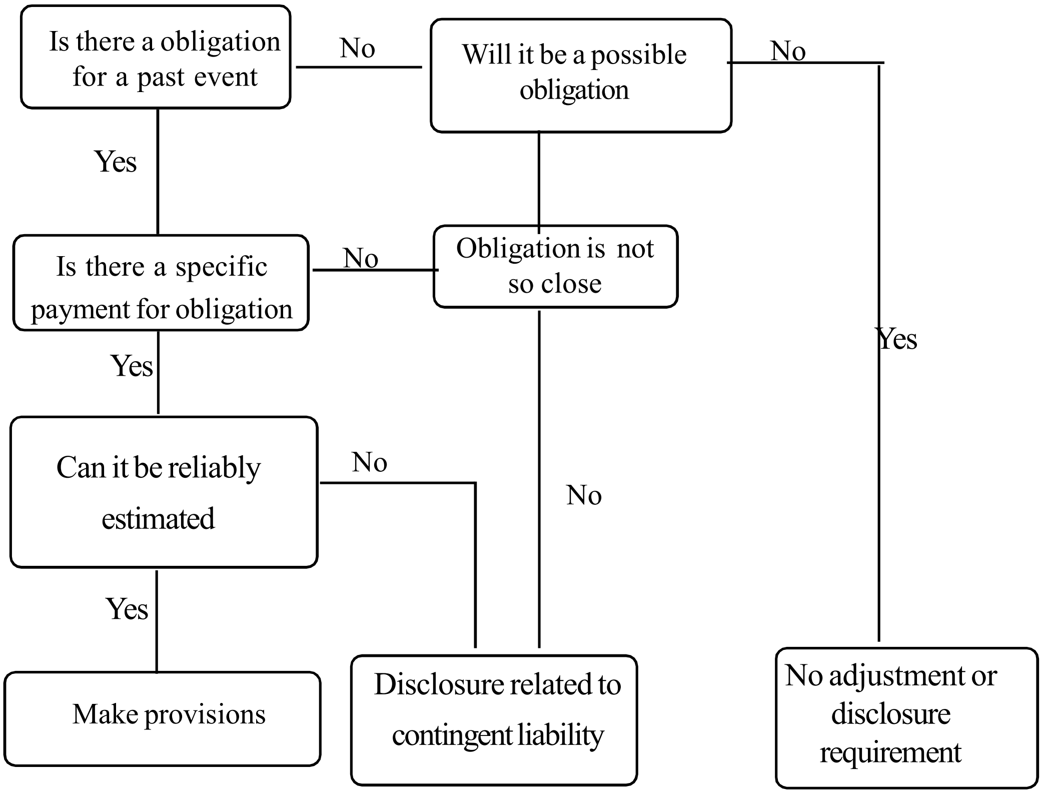
(i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(ii) The amount of the obligation cannot be measured with sufficient reliability.

- Cannot he controlled by the organization
- As a result of a past event / transaction

(iii) Contingent liabilities are not recognized as a liability in financial statement. Only disclosure is required.

- By examining the following diagram provisions and contingent liabilities could be understood.




**Contingent Assets**

Could not be recognized as an asset on the statement of financial position. Disclose only of there is an inflow economic benefit.

- Example for provisions
  - Provisions for warrantee
  - The government or any organization files a case selecting compensation or environmental pollution.
  - An employee files a case seeking compensation as he was terminated from the employment. Amount could be reliably estimated.
- Example for contingent liabilities
  - An employee files a case seeking compensation as he was terminated ith the current year and the amount could not be reliably estimated.
  - Compensation payable due to closure of a section of the business.
- Example for contingent assets
  - The compensation claimed for a land which was taken over by the Road Development Authority.

**Disclosures**

| Provisions | Contingent liabilities | Contingent assets |
|---|---|---|
| 1. Opening and closing balances of provisions.<br><br>2. Additional provisions made within the current period<br><br>3. Provisions provided during the year | 1. A brief description of the nature of the liability<br><br>2. An indication of the uncertainties relating to the amount or timing of any out flow. | 1. A brief description of the nature of the assets<br><br>2. An estimate for the financial effect |

**Assessment and Evaluation Criteria**

- Define the following according to LKAS 37
  - Provisions
  - Contingent Assets
  - Contingent liabilities
- Differentiate between contingent assets and contingent liabilities.
- Disclosure requirement
- Explain in brief each of the following situations to be presented in financial statements. Journal entries if it is a provision.

1. Sales income for the year ended 31/03/2017 was two million. They provide a warrantee period. It is estimated that 2% provision could be provided as warrantee.

2. An employee files a case against the company seeking compensation of 5 000 000 lawyer decided that it not required to be compensation. .

3. Environmental authority files a case against company for a compensation of Rs. 200 000. It is reliably estimated that it should be paid in the future.

4. An organization files a case against a businessman who broke the business agreement. Compensation value is Rs. 400 000' It is not decided that. This compensation is receivable or not.

**Competency level 11.0 : Uses Sri Lanka Accounting Standards in preparing and presenting financial statements**

**Competency level 11.7 : Understands Accounting for Right to use of Lease property.**

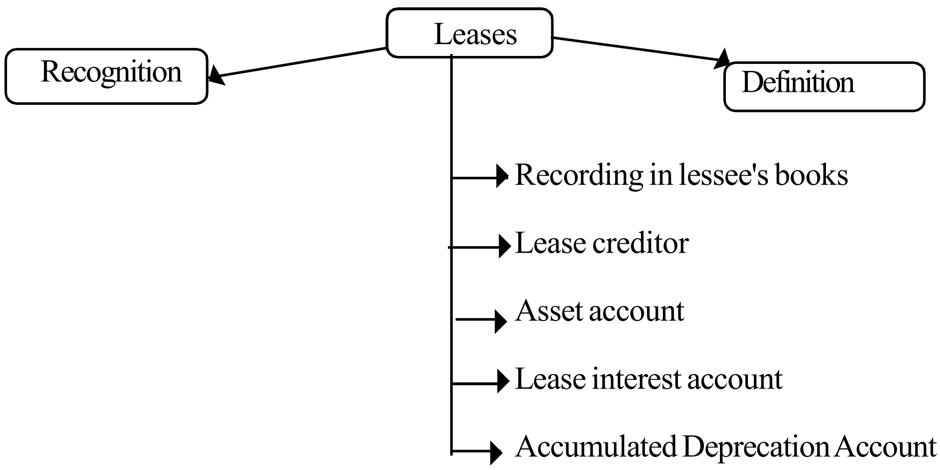
**No of periods : 05**

**Leaning Outcomes :**

- Defines leases according to the Sri Lanka Accounting Standard.
- Records leases in books of purchaser.
- Accounting for interest on lease.
- Presents how to show lease creditors on statement of financial position.

**Basic terms and concepts**

**Concept Map**




**Proposed Instructions to Assist Learning :**

- Conduct a group discussion to highlight the following points.

  Explain this competency level by providing practical examples to the students as an approach.

- Give each student a copy of Annexure 11.7.1, 11.7.2.

**Proposed Instructions for Learning**

- Parties related to lease – Lessee and Lessor
- Assets acquired to lease terms – and, building, machines, motor vehicles, equipments.
- Lease means – A lease is an agreement whereby the lessor conveys to the lessee. The right to use an asset for an agreed period of time in return for a payment or series of payments.
- Risks and rewards of right to use of lease property.

| Risks | Rewards |
| --- | --- |
| • Idle capacity | • Generating of economic benefits |
| • Technical obsolescence | • Increases in asset value |
| • Maintenance and repair | • Capital gain from appreciation in value |

- The accounting for the lease in the books of the lessee.
  - Lower of fair value or present value of right of use of lease property.

    | | | | |
    | --- | --- | --- | --- |
    | Relevant asset account | Dr | xxx | |
    | lease creditor account | | Cr | xxx |

  - Initial deposit value / Down payment

    | | | | |
    | --- | --- | --- | --- |
    | Lease creditor account | Dr | xxx | |
    | Cash account | | Cr | xxx |

  - Interest on lease at the end of the period

    | | | | |
    | --- | --- | --- | --- |
    | Interest on lease account | Dr | xxx | |
    | Lease creditor account | | Cr | xxx |

  - If interest is not given

    Interest at the end of 1st year

    | | |
    | --- | --- |
    | Fair value of the asset (or less amount) | xxx |
    | Initial deposit | (xx) |
    | | xxx |

  (Interest should be calculated based on this value)
- Payment of installment

  | | | | | |
  | --- | --- | --- | --- | --- |
  | Lease creditor account | Dr | xx | | |
  | Cash account | | | Cr | xx |

- Adjustment of depreciation at the year end balance of the asset.

  Calculation of depreciation = If title transferred at the end of the lease period

  $$= \frac{\text{fair value} - \text{Residual value}}{\text{useful economic life}}$$

  If title not transferred at the end of the lease period

  $$= \frac{\text{fair value} - \text{residual value}}{\text{Lease period}}$$

| | |
|---|---|
| Relevant depreciation account | Dr xx |
| Relevant Accumulated depreciation account | Cr xx |

Presenting closing lease creditor value on statement of financial position.

| | |
|---|---|
| Current liabilities – annual installment | xx |
| Next year lease interest | (xx) |
| Current position of lease | xx |
| Non current liabilities | |
| Closing lease creditor value | xxx |
| Current position of lease creditor value | (xx) |
| Lease creditor | xx |

**Discuss only accounting entries related to lease.**
**Interest calculation is not expected by students.**

Give each student a copy of Annexure 11.7.2

Amanda Plc Ltd purchased a machine on 01.04.2017 for finance lease. Following transactions are provided.

| | |
|---|---|
| Fair value of the machine | - Rs. 1 541 992 |
| Initial payment | - Rs. 400 000 |
| Annual instalment at the year end | - Rs. 400 000 |
| Lease period | - 4 years |
| Useful economic life | - 5 years |
| Residual value | - Rs. 41 992 |
| Interest on lease | - 15% |

Title is transferred at the end of the lease period.

Following are the interest for each year.

| Year | Interest on lease |
|---|---|
| 2017/2018 | 171 289 |
| 2018/2019 | 136 994 |
| 2019/2020 | 97 542 |
| 2020/2021 | 52 174 |
| Total interest | 457 999 |

**Required**

1. Relevant journal entries and account for annual deprecation for the year ended 31.03.2018.
2. Relevant ledger account and account for annual depreciation for the year ended 31.03.2018
3. Disclosures requirement in financial statement for the year ended 31.03.2018

**Assessment and evaluation criteria**

- Define leases according to Sri Lanka accounting standard.
- Accounting for leases in lessee's books
- Recording of interest on lease
- Recording of lease creditor as current and non current liability in the statement of financial position.
- On 01.04.2016 Sahan Ltd acquired a motor vehicle on finance leased terms.

  Following details are provided.

| | |
|---|---|
| Fair value of the motor vehicle | - Rs. 2 300 000 |
| Lease period | - 5 years |
| No initial deposit | - Rs. 606 800 |
| (paid at the end of each year) | |
| Annual interest | - 10% |
| Useful life of the motor vehicle | - 5 years |
| Residual value | - Rs. 300 000 |

- Relevant journal entries and ledger accounts of Sahan Ltd for the year ended 31.03.2017 are as follows.

**Sahan Ltd**

**General Journal**

| **Date** | **Details** | **Debit** | **Credit** |
|---|---|---|---|
| 01.04.2016 | Motor vehicle account (Dr) | 2 300 000 | |
| | Lease creditor account | | 2 300 000 |
| | (Purchase of a motor vehicle on lease) | | |
| 31.03.2017 | Interest on lease account (Dr) | 230 000 | |
| | Lease creditor account | | 230 000 |
| | (Recording of interest) | | |
| 31.03.2017 | lease creditor account (Dr) | 606 800 | |
| | Cash account | | 606 800 |
| | (Payment of annual installment) | | |
| 31.03.2017 | Motor vehicle depreciation account | 400 000 | |
| | Accumulated depreciation on | | 400 000 |
| | Motor vehicle account | | |
| | (Recording of annual depreciation) | | |

**Workings :**

31.03.2017 Interest payment $= 2\ 300\ 000 \times \frac{10}{100}$

$= \underline{\underline{Rs.230\ 000}}$

Annual deprecation at 31.03.2017 $= \frac{2\ 300\ 000 - 300\ 000}{5}$

$= \underline{\underline{Rs.400\ 000}}$

## Lease Creditor's account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| 01.04.2016 | Cash (Initial Capital) | xxx | 01.04.2016 | Motor vehecle A/c | 2300 000 |
| 31.03.2017 | Cash (Annual Installment) | 606 800 | 31.03.2017 | Interest Accont | 230 000 |
| 31.03.2017 | Balance c/d | 1923 200 | | | |
| | | 2530 000 | | | 2530 000 |
| | | | 01.04.2017 | Balance B/f | 1923 200 |

## Motor Vehicle account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| 01.04.2016 | Lease Creditor account | 2300 000 | 31.03.2017 | Balance C/d | 2300 000 |
| | | 2300 000 | | | 2300 000 |
| 31.03.2017 | Balance B/f | 2300 000 | | | |

## Lease Interest account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| 31.03.2017 | Lease creditor account | 23000 | 31.03.2017 | Profit of loss account ( Income statement) (finance expenses) | 230 000 |
| | | 230 000 | | | 230 000 |

## Depreciaton on motor vehicle account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| 31.03.2017 | Accumulated depreciation | 400 000 | 31.03.2017 | Profit of loss account (Income statement distribution expenses) | 400 000 |
| | | 400 000 | | | 400 000 |

## Accumulated depreciaton on motor vehicle account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| 31.03.2017 | Balance c/d | 400 000 | 31.03.2017 | Depreciation account | 400 000 |
| | | 400 000 | | | 400 000 |
| | | | 01.04.2017 | Balance B/f | 400 000 |

**Sahan Ltd**

Extract of statement of financial position as at 31.03.2017

Statement of comprehensive income

| | |
|---|---|
| | Rs. |
| **Distribution expenses** | |
| Motor vehicle depreciation | 400 000 |
| | |
| **Finance expenses** | |
| Interest on lease | 230 000 |
| | |
| **Statement of financial position** | |
| **Non current liabilities** | 1508 720 |
| Lease creditor 414 480 | |
| (192320 - 414 480) | |
| Current liabilities | |
| Lease creditor | 414 480 |
| (Installment – Next year interest) | |

**Workings**

Next year interest (31.03.2018) $= 1\ 923\ 200 \times \frac{10}{100} = 192\ 320$

**Notes :**

Following items were considered when calculating profit before tax.

| | |
|---|---|
| Lease interest | Rs. 230 000 |
| Motor vehicle Depreciation | Rs. 400 000 |

**Students are not expected to calculate lease interests for advanced level**

**Competency level 11.0 : Uses Sri Lanka Accounting Standards in preparing and presenting financial statements**

**Competency level 11.8 : Disclosure and Accounting for events after reporting period**

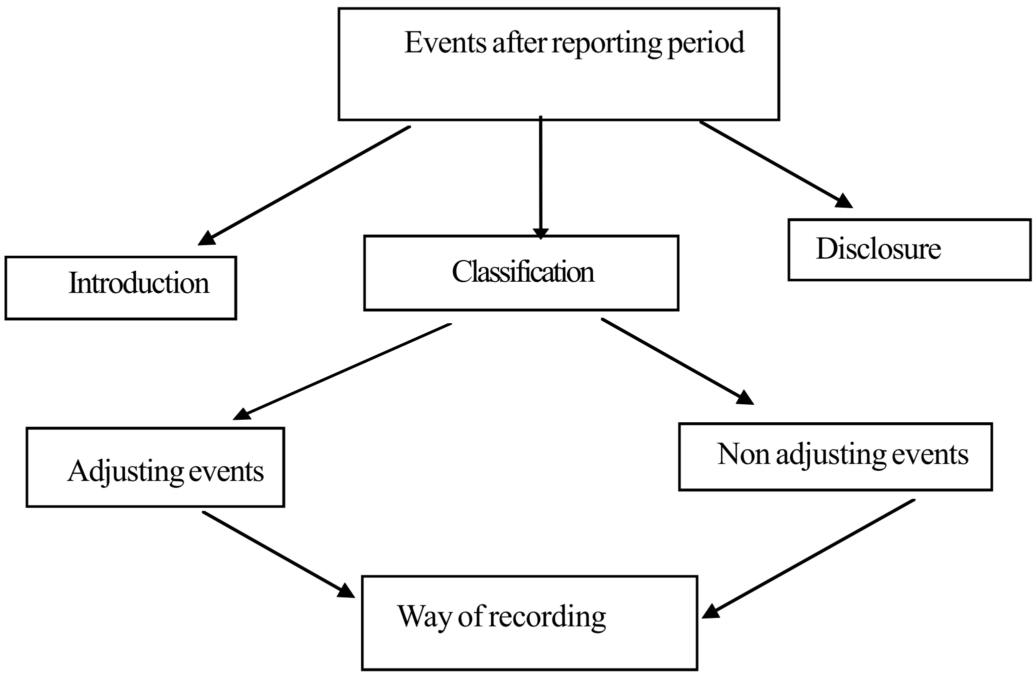
**No of periods : 05**

**Leaning outcomes :**

- Defines events after reporting period according to the standard
- Classifies adjusting and non adjusting events according to the standard
- Discloses according to the standard

**Basic terms and concepts**

**Concept Map**




**Activity :**

- Presents following flash card to the students.

| |
|---|
| 01. Presentation of Financial statements of Hansali PLC Ltd for the year ended 31.03.2016 |
| 02. Directors authorized financial statement on 10.08.2016. Financial statements were presented to share holders on 30.04.2016 |
| 03. Financial Statements were presented on 2016.09.30 to share holders |

- Explain events after reporting period by allowing students to examine details in flash cards.
    - What is the accounting period?
    - What is the time after reporting period?
    - What are the events after reporting period?

- Divide students into two groups provide them a list of transactions in Annexure 11.8.1 after explaining events after reporting period.

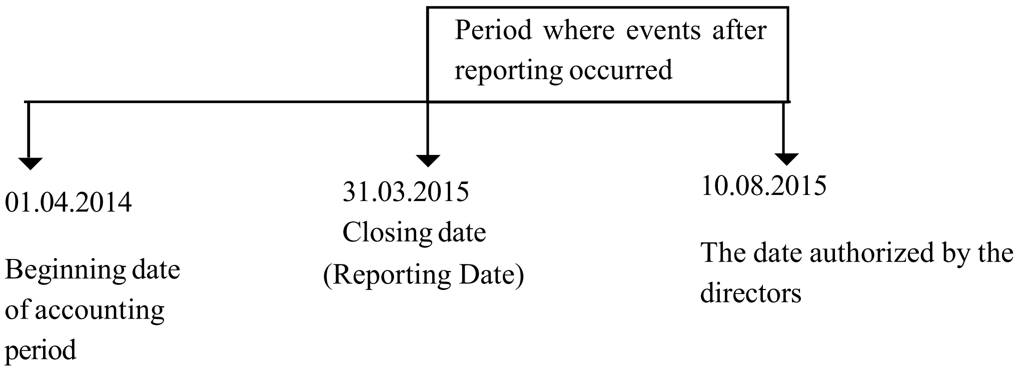
**Activity**

- Provide following topics to two students groups
    1. Adjusting events
    2. Non adjusting events
- Direct each groups to list of transactions related to each topic.
- Direct them to present each of the above information in financial statements.
- Provide the groups to creativity present their findings to the whole class.
- Summarize the subject matter after their findings.

**Guidance on subject matter :**

**Events after reporting period**

"Are those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorized for issue."



Classification of events after reporting period Adjusting events

Adjusting events

Evidence provides that existed at the Reporting sheet date.

Adjusting events

**Example**

- A debtor who existed at 31.03.2015 was bankrupted before authorization (10.08.2015) should be adjusted as at 31.03.2015.

- Judgement given for a pending court case after the reporting period.

- Selling of stock less than cost value after the reporting period which were held at the end of the period.

- Actual value of an asset purchased during the accounting period was decided after the reporting period.

Non adjusting events

Events that are indicative of conditions that arose after the Reporting date

Non adjusting events

**Example**

- Part of stocks as at 10.05.2015 were destroyed by fire. This event does not affect the stocks as at 31.03.2015. But the material should be disclosed for the year ended 31.03.2015. This should be adjusted during the next accounting period.

- Proposed dividend for ordinary share holder after the reporting period.

- Reduction in market value of investments after the reporting period.

- A part of a building taken over by the government after reporting period.

Dissimilarities between adjusting and non adjusting events.

| Adjusting events | Non adjusting events |
|---|---|
| 1. Provides at the end of the reporting period | 1. Presents a situation existed after the reporting period |
| 2. These would affect profit or loss and statement of comprehensive income and statement of financial position. | 2. Do not affect on profit or loss and comprehensive income statement and statement of financial position. |
| 3. Adjusting in financial statements. | 3. Non adjusting in financial statement. |
| 4. Disclosure and adjusting needed. | 4. Disclose by way of a note |

**Disclosure requirements**

- Date of authorization for issue
- The person who authorizes
- Discloses the situation as at the end of the period
- Nature of non adjusting events
- Elements in financial effect
- If it is not a financial estimate

**Annexure 11.8.1**

**List of Transaction**

Accounting period : 01.04.2016 – 31.03.2017
Date of Authorization : 15.08.2017

1. On 10.05.2017 it is proposed to pay 10% dividends for ordinary share holders of Subodha PLC Company
2. Value of Investment on 31.03.2017 was Rs. 450 000. Directors decided that market value of investment on 15.08.2017 was Rs. 350 000.
3. Court decided to pay a compensation of Rs. 150 000 on 25.04.2017 to employee who has filed a case against the company.

4. Death of a debtor worth Rs. 50 000 informed on 20.04.2017 who was existed at 31.03.2017.
5. Closing stock value as at 31.03.1017 amounted to be Rs. 600 000. Which inclued the stocks Rs. 100 000 was sold on 10.04.2017 for Rs. 75 000.
6. On 10.07.2017 a part of a building destroyed by fire and estimated loss is Rs. 500 000.
7. On 10.07.2017 an insurance company agrees to pay a insurance claim of Rs, 200 000 which were damaged at the end of the accounting year.
8. The government has taken a land which belongs to the company on 12.07.2017 estimated value is Rs. 1500 0000.

**Assessment and Evaluation Criteria:**

1. Defines following
   - Reporting period
   - After the reporting period
   - Events after the reporting period
2. Classification of events after the reporting period
3. Classifies adjusting and non adjusting events.
4. Provide examples for adjusting and non adjusting events
5. Select the adjusting events and make necessary adjustment
   (i) An insurance company agrees to pay Rs. 10 000 for an insurance claim requested during the accounting period.
   (ii) Proposed dividends for ordinary share holders were Rs. 5 000
6. Accounting year of Perera Ltd ends on 11.03.2017. On 30.05.2017 directors authorized their financial statements. Following events were reported after 31.03.2017.
   1. Goods costing Rs. 350 000 as at 31.03.2017 has an net realizable value of Rs. 290 000 on the same day. This stock was sold on 25.04.2017 for Rs. 250 000.
   2. Somapala an employee filed a case against the company. On 15.04.2017. The court decided to pay Rs. 100 000 as compensation.
   3. A building costing Rs. 500 000 was destroyed by fire on 30.04.2017 loss is estimated as Rs. 150 000
   4. Government has takenover a land valued Rs. 1 500 000 on 07.05.2017

**Required :**

1. Classify adjusting and non adjusting events.
2. Disclosure requirement and the way of adjusting in financial statements.

State whether true / false

(i) Reporting period is the time period between starting and ending date. (........)

(ii) Proposed dividends for ordinary share holders should only be disclosed. (........)

(iii) Goods costing Rs. 100 000 at the end has been sold for Rs. 80 000 before authorization of financial statements. It increases the profit. (........)

.

**Competency 11.0 : Uses Sri Lanka accounting Standards in preparing and Presenting of Financial Statements**

**Competency Level 11.9 : Keeps accounts and discloses Revenues**

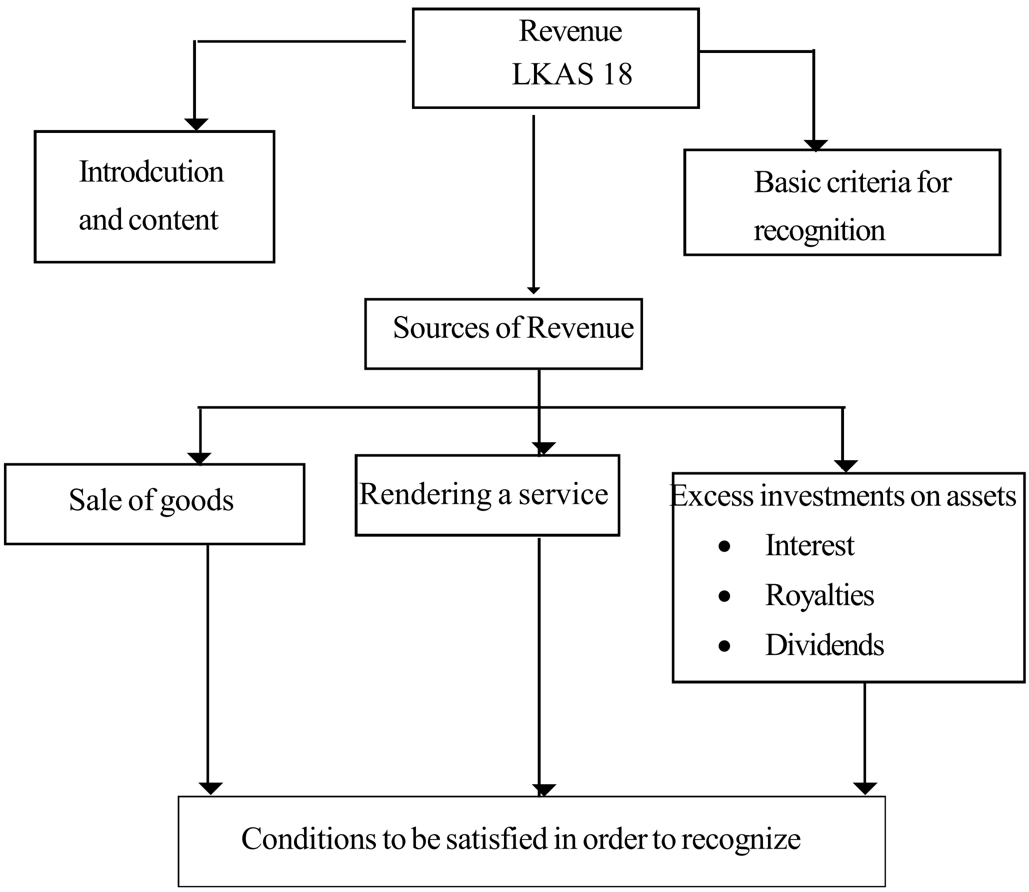
Number of Periods : 02

Learning outcomes :

- Creates revenue according to the standard
- Recognize variety of revenues

**Basic Terms and Concepts**

**Concept Map**



- Lead a discussion with students to highlight following.
  - Importance of recognizing "Revenue"
  - Items to be included in "Revenue"
  - Criteria of recognizing "Revenue"
  - Provide a definition for 'Revenue"
- Revenue arises in ordinary course of activities of an organization. Income can be divided into two.
  - Revenue
  - Profit
- The objective of this standard is to prescribe the accounting treatment of revenue arising from certain types of transactions and events. According to LKAS 18
- It should satisfy the following in order to recognize revenue.

There are two conditions to be satisfied

1. It is probable the economic benefits associated with the transaction will flow to the entity.
2. The amount of the revenue can be measured reliably.

**Examples :**

- If Rs. 46 000 cash collected by selling goods with an inclusive of 15% VAT can be divided into two.
  1. Sales value of Rs. 40 000 exclusive of VAT. Profits earned from that sale is an economic benefit to the organization.
  2. Value added amount of Rs. 6 000 collected on behalf of the government is not gained any benefit of the organization.

- Any revenue arising from the use by others of entity assets yielding or any source of investment is interest income. It could be recognized as an income and should account only is the economic benefit flows into the business and could be measured reliably. Any transaction could be measured reliably and economic benefit associated with the transaction will flow to the entity is known by "Revenue"
  This standard applies to revenue from
  1. The sale of goods
  2. Rendering of service
  3. The use by others of entity assets gives rise to revenue in the form of
     - Interest
     - Royalty
     - Dividends

**Sale of Goods**

- Goods produced by the entity for the purpose of sale and goods purchased for sale could be considered as revenue of an organization.

  Revenue from the sale of goods shall be recognized when all the following conditions have been satisfied.

  (i) The entity has transferred to the buyer the significant risks and rewards of ownership.

  (ii) The entity retains neither continuing management involvement to the degree usually associated with ownership nor effective control over the goods sold.

  (iii) Value could be measured reliably

  (iv) It is probable that the economic benefits associated with the transaction will flow to the entity.

**Rendering of Services.**

- When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognized by reference to the stage of completion of the transaction at the end of the reporting period.

- The outcomes of a transaction can be estimated reliably when all the following conditions are satisfied.

  (a) The amount of revenue can be measured reliably.

  (b) It is probable that the economic benefits associated with the transaction will flow to the entity.

  (c) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

**Example :**

- Consultation period of two years given for a project and it will be paid at the end of the service period. Total consultation expense is Rs. 800 000 and at the end of the first year 40% s payable.

  The first year 40% payable.

  At the end of the first year service income is $800\ 000 \times \frac{40}{100} = Rs.320\ 000$

**Interest Income**

- Interest income is a source of revenue by providing excess resources to other parties.

  Interest income relevant for the period to be recognized in respect to the time under accrual basis. Interest income to be recorded if the amount can be measured reliably and, created an inflow of economic benefits.

**Example :**

- On 01.04.2018 an amount of Rs. 500 000 deposited in a fixed investment at an interest rate of 10%. Accounting year ends in on 31.12.2018. Company does not receive any interest income during the period. But it can be calculated as follows.

$$500\ 000 \times \frac{10}{100} \times \frac{9}{12} = \text{Rs. } 37\ 500$$

  Interest income for the period is Rs. 37 500. It should be recorded under current asset since they could not be collected for the period.

**Royalties**

- Royalty income should be calculated according to accrual basis It could be recognized as an income only if
  - It is probable that the economic benefits associated with the transaction will flow to the entity.
  - The amount of the revenue can be measured reliably.

**Example :**

An owner of a graphite mine has given authority to extract graphic to another party.
For each tonne of graphite a payments of Rs. 5 000 should be given.
10 tonnes were extracted during the first year and Rs. 40 000 paid each year.
Therefore

Royalty income according to the royalty agreement is Rs. 50 000 calculated based on accrual.
Receivable amount of 10 000 should be shown under current asset.

**Dividends**

- The amount of dividends payable to each share holder depends on the ability of owner of the share holder.
  Also it could be measured reliably.

**Example**

- Purchased 40 000 shares at a price of Rs. 20 each. It is decided to pay a three rupees dividends to their share holders and obtained approval from the board of directors.
- Dividend income for the period is Rs. 40 000 shared X 3 each = Rs. 120 000

Revenue can be define as follows.

Revenue is the gross inflow of economic benefits during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity other than increases relating to contributions from quality participants.

**Assessment and Evaluation**

1. Name the items included in revenue.

2. Conditions to be satisfied to recognize revenue.

3. State the relevant revenue with the amount if it could be recognized as revenue, the related conditions to be satisfied it is not recognized as revenue.

   (a) Senani Ltd sold yogurt to Manaodya Ltd. In order to settle the payment. Manodya gave157000 costing two fans and balance amount of Rs. 18 600 paid by way of a cheque.

   (b) Sold a 69 000 goods inclusive 0f 15% VAT and received Rs. 20 000 as an advance for the next year.

   (c) A fixed deposit was opened on 01.01.2108 at an interest rate of 10%. Their accounting year ends on 31.03.2018.

   (d) According to the rent agreement it is agreed to pay a Rs. 4 000 for every one cube of brick removed. During the first year they received 150 cubes of bricks. They paid Rs. 450 000 the rent institute.

   (e) Purchased 20 000 shared at a price of Rs. 40 each and for the first year 8% of dividend were agreed to pay.

**Competency 12.0 : Prepares Financial Statements for a Limited Company**

**Competency Level 12.1: Analyze legal background relating to Limited Liability Company**

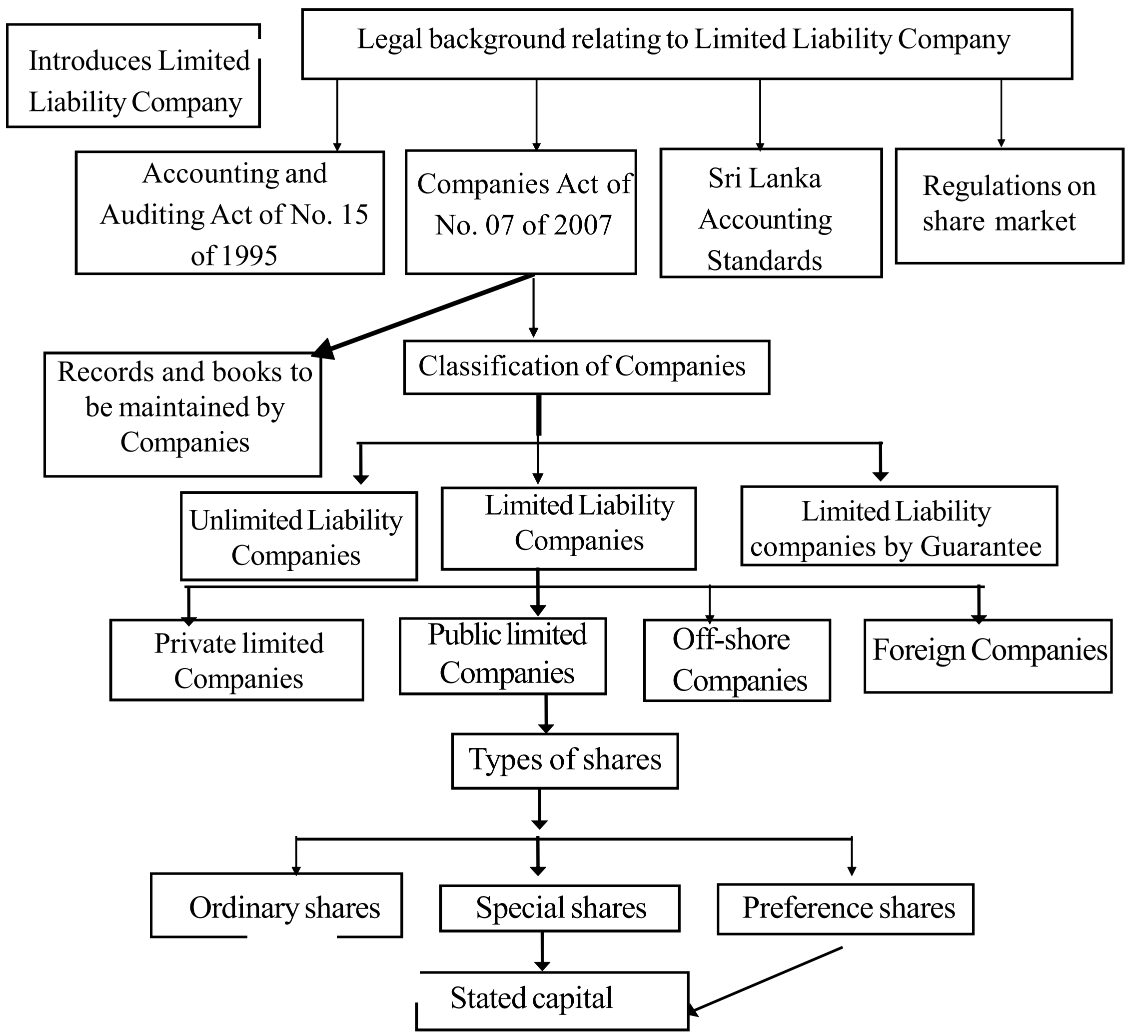
**No. of Periods : 06**

**Learning Outcomes :**

- Defines " Limited Liability Companies".
- Classifies companies according to the companies Act of No 7 of 2007
- Explains about the existence of legal background relating to accounting for companies.
- State the records to be maintained by companies
- Explains types of shares that can be issued by a company and the term stated capital.

**Basic Terms and concepts :**

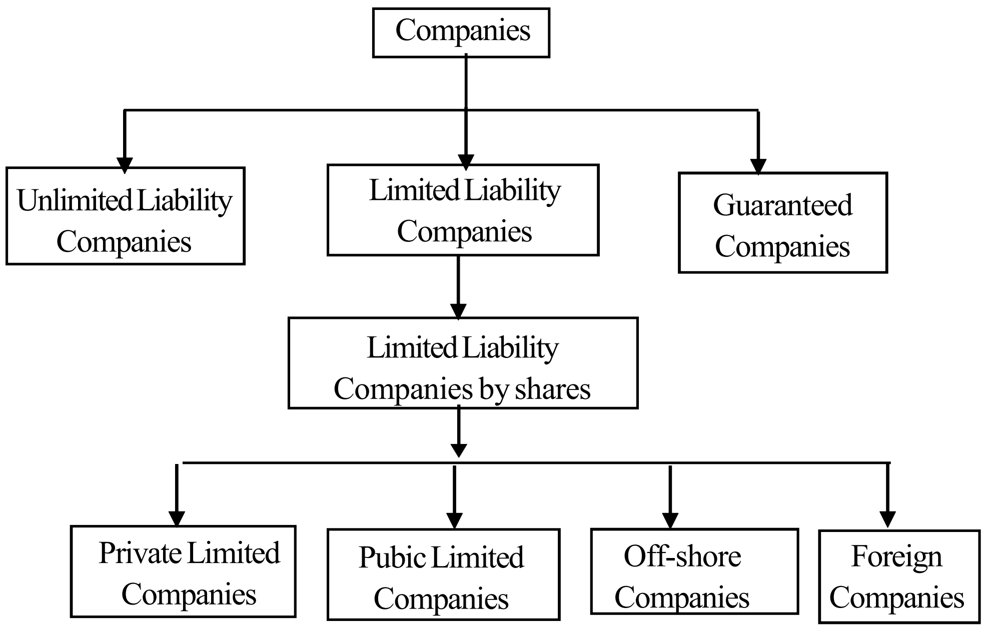
**Concept Map**



**Learning – Teaching Process**

**Engagement :**

- Distribute a copy of Annexure 12.1.1
- Conducting brainstorming inquiring about students opinions relating to limited liability companies as business organization.
- Lead the discussion emphasizing the following facts
    - Introduction about Limited Liability Companies
    - Legal background relating to Incorporated Companies
    - Introduction of records and books to be maintained by a Limited liability companies.
    - Introduction about types of shares of a Limited Liability Company and raising of stated capital.
    - Classification of companies according to the Companies Act is as follows.



**Books and record that are maintained by Limited Liability Companies**

(i) Records on cash receipts to the company and ways of spending using the collection.

(ii) Records about assets and liabilities

(iii) Records on trading of goods such as credit purchases and sales with details of customers and suppliers.

(iv) Records on closing stock.

(v) Service reports if it is related to provide services.

**Types of shares of Limited Liability Company.**

According to the section 49 of companies Act, "share in a company shall be movable property." Types of shares that can be issued by Limited Liability Companies are, as follows.

1. Ordinary shares / Equity shares
2. Preference shares
3. Special shares

**Regarding preference shares, only theoritical aspect should be taught at G.C.E Advanced Level**

**Stated Capital**

Companies issue its shares to general public in order to raise funds for company. The capital raised through such share issues is the stated capital.

According to the section 58 of companies Act, stated capital in relation to a company means the total of all amounts received by the company or due and payable to the company in respect of the issue of shares and in respect of calls on shares."

Issue of shares in a company to be launched in accordance with the section 51 of Companies act and provisions in articles of association.

**Consideration for issue of shares**

As per the section 52 of companies Act, the Board of directors decides the consideration for which the shares will be issued.

**The consideration for a share issued may take in any, form including**

- cash
- Promissory notes
- Future services
- Assets and properties
- other securities

**Annexure 121.1**

- Distribute a copy of Annexure 12.1.1 among students.

01. Categorize the names of business firms available in your town in the table given below.

| Sole Proprietorship Business | Business with a few number of owners | Business with several number of owners |
|---|---|---|
| 1.<br>2.<br>3.<br>4. | 1.<br>2.<br>3.<br>4. | 1.<br>2.<br>3.<br>4. |

02. State three differences between Public Limited Liability Companies and Private Limited Companies

| Public Limited Companies | Private Limited Companies |
|---|---|
| 1.<br>2.<br>3. | 1.<br>2.<br>3. |

03. Write down three books and records to be maintained by a Limited Liability Company.

..........................................................................................................................................
..........................................................................................................................................
..........................................................................................................................................

04. State three types of shares that can be issued to general public to raise funds by a Public Limited Liability Company.

..........................................................................................................................................
..........................................................................................................................................

05. Differentiate two types of shares given below using the available criteria.

..........................................................................................................................................
..........................................................................................................................................

| Criteria | Ordinary shares | Preference shares |
|---|---|---|
| 1. Ownerships of company | | |
| 2. Right for dividends | | |
| 3. Right for voting | | |
| 4. Right for administration | | |

**Assessment and Evaluation Criteria :**

1. Classify the forms of business.
2. State the differences between public limited and private limited companies.
3. Name the books and records to be maintained by a public limited company.
4. State the types of shares which can be issued by a public limited company and briefly explain the differences.

**Competency 12.0 : Prepares Financial Statements for a Limited Company.**

**Competency Level 12.2 : Accounting records for issuing shares by collecting consideration at once.**

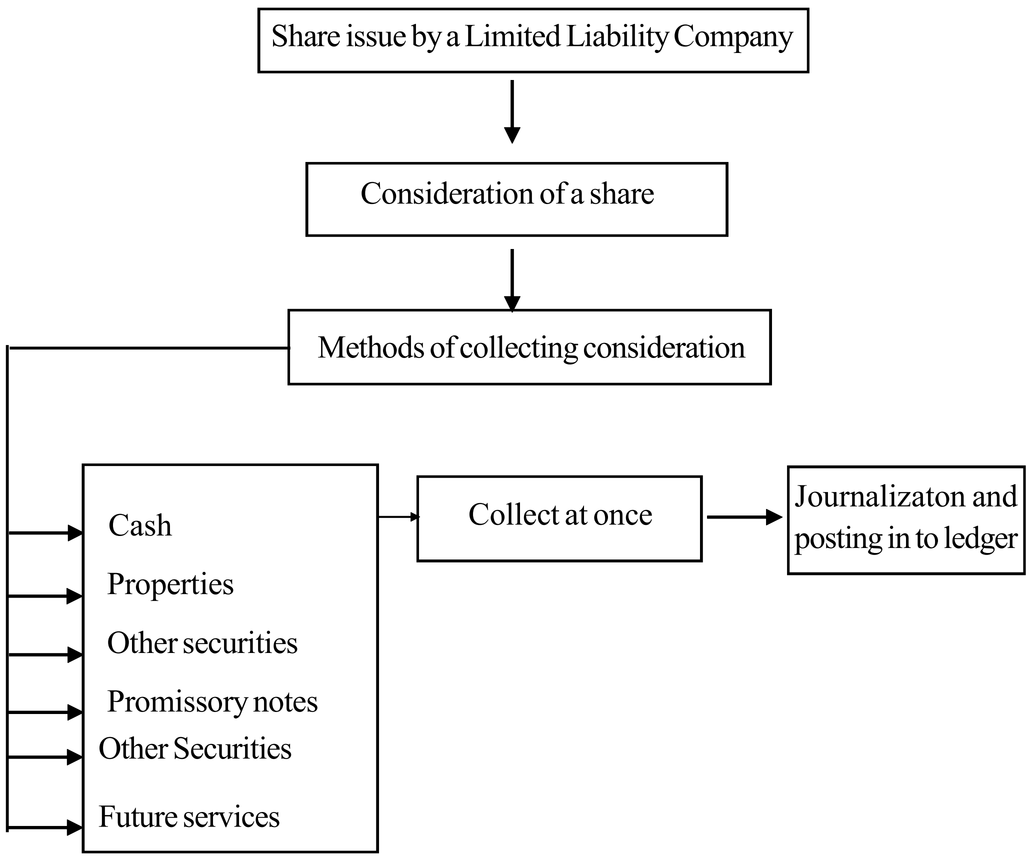
**No. of Periods : 08**

**Learning outcomes** :

- Explains "consideration of a share"
- States the methods of collecting consideration of a share.
- Prepares accounts of when collecting the consideration by cash at once.

**Basic Terms and Concepts :**

**Concept Map**



**Learning – Teaching Process :**

**Engagement :**

- Distribute annexure 12.2.1, 12.2,2, 12.2.3 and 12.3.4
- Lead a discussion with students recalling the memory and the practical situation of share market using following questions.
  - What is meant by a share?
  - What is meant by a consideration of a share?
  - How to deicide the consideration of a share and how to get approval for it.
  - How to collect the consideration of a share.

**Guidance to Clarify Subject Matter.**

Share issue and collect consideration.

Issue of share can be taken place in two occasions such as

(i) Initial Public Offer

(ii) Secondary Public offer

Consideration per share can be collected at once or as installments (collection as installments is not under G.C.E (Advanced level Syllabus)

**Journal entries relating to collection of cash at once.**

(i) Cash account Dr. xxx

Share issue account Cr. xxx

(Receipt of money with applications)

2) Share issue account Dr

Stated capital Account Cr

(Allotment of shares)

- Cash to be returned back when a company received applications for shares exceeding the number of shares to be issued. Allotment of shares can be done by using a selected ratio using different loses. This is referred as pro - rata allocation method.
- Excess collection to be refunded to applicant under this method, there,

Share issue Account Dr.

Cash Account Cr.

- Distribute the annexure 12.2.1 among students.

**Annexure 12.2.1**

Complete following table using the knowledge you acquired relating to consideration per share.

| Brief definition on consideration of share | Parties who decides the consideration of a share | Things that are accepted for a consideration of a share | Way of collecting consideration of a share |
|---|---|---|---|
| | | | |

**Annexure 12.2.2**

- Distribute Annexure 12.2.2 among students.
  - On 01.01.2018 Amanda PLC issued 100 000 share to general public at a consideration of Rs. 40 closing date for application collection was 31.01.2018. 120 000 Shares were applied by applicants on 31.01.2018

    On 05.02.2018 excess money was refunded to applicant and remaining were capitalized.
  - Record the above situation in ledger accounts.

**Amanda PLC**

Cash Account

| | |
|---|---|
| | |

Share issue Account

| | |
|---|---|
| | |

Stated capital – Ordinary shares Account

| | |
|---|---|
| | |

**Annexure 12.2.3**

- Distribute annexure 12.2.3 among students.

Arunalu PLC issued 100 000 shares at a consideration of Rs. 50 on 01.01.2018 to general public closing date for application collection was 31.01.2018 and 250 000 shares were requested on applications.

**Required :**

Answer the following questions referring to above incidents.

(a) (i) Amount collected with applications,

(i) Amount rejected

(ii) Amount of capitalizations /amount of allocated shares?

(b) Write down journal entries if all the money was collected to cash account.

(i) ................................................ Dr

................................................ Cr

( )

(ii) ................................................ Dr

................................................ Cr

( )

(iii) ................................................ Dr

................................................ Cr

( )

- Distribute annexure 12.2.4 among students.

**Annexure 12.2.4**

Locahna PLC issued shares at a consideration of Rs. 60 on 01.01.2018 and collected al considerations at once.

| Share holders / Description | Existing share holders | Employees | Local Investors & other individuals | Foreigners | Total |
|---|---|---|---|---|---|
| Number of Shares applied for | 50 000 | 200 000 | 300 000 | 50 000 | ----- |
| Number of shares allocated | ----- | ----- | 100 000 | ---- | ----- |
| Rate of allocation | 1 : 1 | 2 : 1 | ................ | 5 : 1 | ........ |

**Required :**

(i) Journal entry for cash collection with applications.
..................................................................... Dr
..................................................................... Cr

(ii) Journal entry for cash returned / refund
..................................................................... Dr
..................................................................... Cr

(iii) Journal entry for capitalizaton
..................................................................... Dr
..................................................................... Cr

(iv) Dinidu an employee received 5000 shares. How much he paid with application.
.....................................................................

(v) A local investors received 3000 shares. How much is returned to him?
.....................................................................

**Criteria for Assessment and Evaluation**

- Describing of consideration of a share
- Stating the ways of collecting consideration per share.
- Journal entry records for collection of consideration at once.
- Postings in ledger for cash collection of consideration at once.

**Competency 12.0 : Prepares Financial Statements for a Limited Company.**

**Competency Level 12.3 : Accounting for Reserve Capitalization and right issue.**

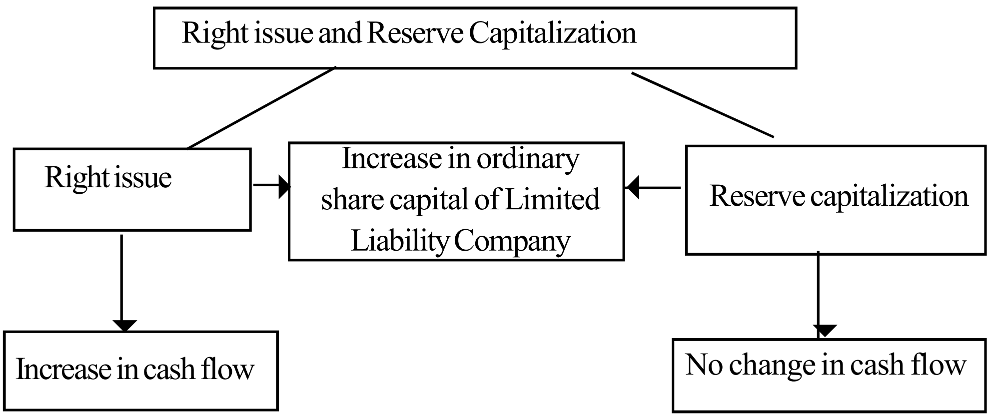
**No. of Periods : 04**

**Learning outcomes** :

- Explains the right issue
- Explains reserve capitalization
- State the differences between right issue and reserve capitalization
- Records right issue and reserve capitalization in accounts

**Basic Terms and Concepts :**

**Concept Map**




**Guidance on Subject Matters :**

**Engagement :**

- Lead a discussion with students relating to their ideas related to issue of shares by limited liability company.
- Brief introduction about right issue.
- Aims of exercising a right issue
- Reserves available in Limited Liability Company
- Brief description on revaluation reserves, General reserves and retained earnings.
- Aims of capitalization of reserves.

**Right Issue Means;**

- Issuing shares to existing ordinary share holders of a Limited Liability Company based on a ratio by getting money.

**Reserve Capitalization means.**

- Issuing shares to existing ordinary share holders of a limited Liability Company based on a ratio using available reserves not by collecting money from them.

**Journal Entry for Right Issue**

Cash Account Dr

Stated capital - Ordinary shares Account Cr

(Right issue of ordinary shares at ……………..ratio)

**Journal entry for Reserve Capitalization**

Relevant Reserve Account Dr

Stated capital – Ordinary shares Account Cr

(Capitalization of Reserves at …………… ratio)

**Distribute Annexure 12.3.1 among students.**

**Annexure 12.3.1**

Complete following table referring to the discussion made.

(i) Differenciate between right issue and reserve capitalization

| Criteria | Right Issue | Reserve capitalization |
|---|---|---|
| Cash flow | | |
| Total equity | | |
| Use of reserves | | |
| Number of shareholders | | |

(2) Similarities between right issue and reserve capitalization

| |
|---|
| 1. |
| 2. |

**Distribute Annexure 12.3.2 among students.**

**Annexure 12.3.2**

Atugalpura PLC
Statement of Financial Position as at 01.01.2017
(Extracts)

| | | Rs' 000 |
|---|---|---|
| Stated Capital | | |
| Ordinary Shares (100 000) | | 4 000 |
| Reserves | | |
| Revaluation Reserves | 1 000 | |
| General Reserves | 500 | |
| Retained Earnings | 2 000 | 3 500 |

Board of directors made following decisions.

1. Capitalization of reserves by issuing ordinary shares for existing ordinary share holders at 4 : 1 ratio for a consideration of Rs. 40 /-
2. Right issue for a consideration of Rs. 50 for the ordinary shares available before the reserve capitalization at a ratio of 5 : 1

**Required :**

(i) Journal entries to record above transactions.

(ii) General ledger accounts relating to above transactions.

(iii) Extracts of statement of financial position after recording above transactions.

**Instructions :**

Existing consideration per share $= \frac{4000\ 000}{100\ 000}$

$= \text{Rs. } 40$

Amount of reserve capitalization $= \frac{100\ 000}{4} \times 40 = Rs.1000\ 000$

Amount of Right Issue $= \frac{100\ 000}{5} \times 50 = Rs.1000\ 000$

Distribute Annexure 12.3.3 among students.

**Annexure 12.3.3**

**Thilakshana PLC**
**Statement of financial position as at 01.01.2018**
**(Extracts)**

| | (Rs.' 000) |
|---|---|
| Stated capital | |
| Ordinary share capital at Rs. 50/- | 5 000 |
| Reserves | |
| Retained earnings | 3 000 |

Above equity details are appeared from the following decisions made by board of directors.

- Right issue of ordinary shares at a ratio of 4 : 1 for a consideration of Rs. 50/-
- Reserve capitalization after the right issue considering all available shares at a ratio 5 : 1 at a consideration at Rs. 50/-

**Required :**

1. Journal entries to record above transactions
2. General ledger accounts to record above transactions

**Assessment & Evaluation**

- Differenciating right issue and reserve capitalization
- Stating similarities between right issue and reserve capitalization
- Preparing a Journal Entries for right issue and reserve capitalization using an example.
- Preparing accounts relating to right issue and reserve capitalization
- Preparing statement of financial position after the right issue and reserve capitalization

**Competency 12.0 : Prepares Financial Statements for a Limited Company**

**Competency Level 12.4.1 : Preparing of financial statement of Limited Liability Company by applying Sri Lanka Accounting Standards**

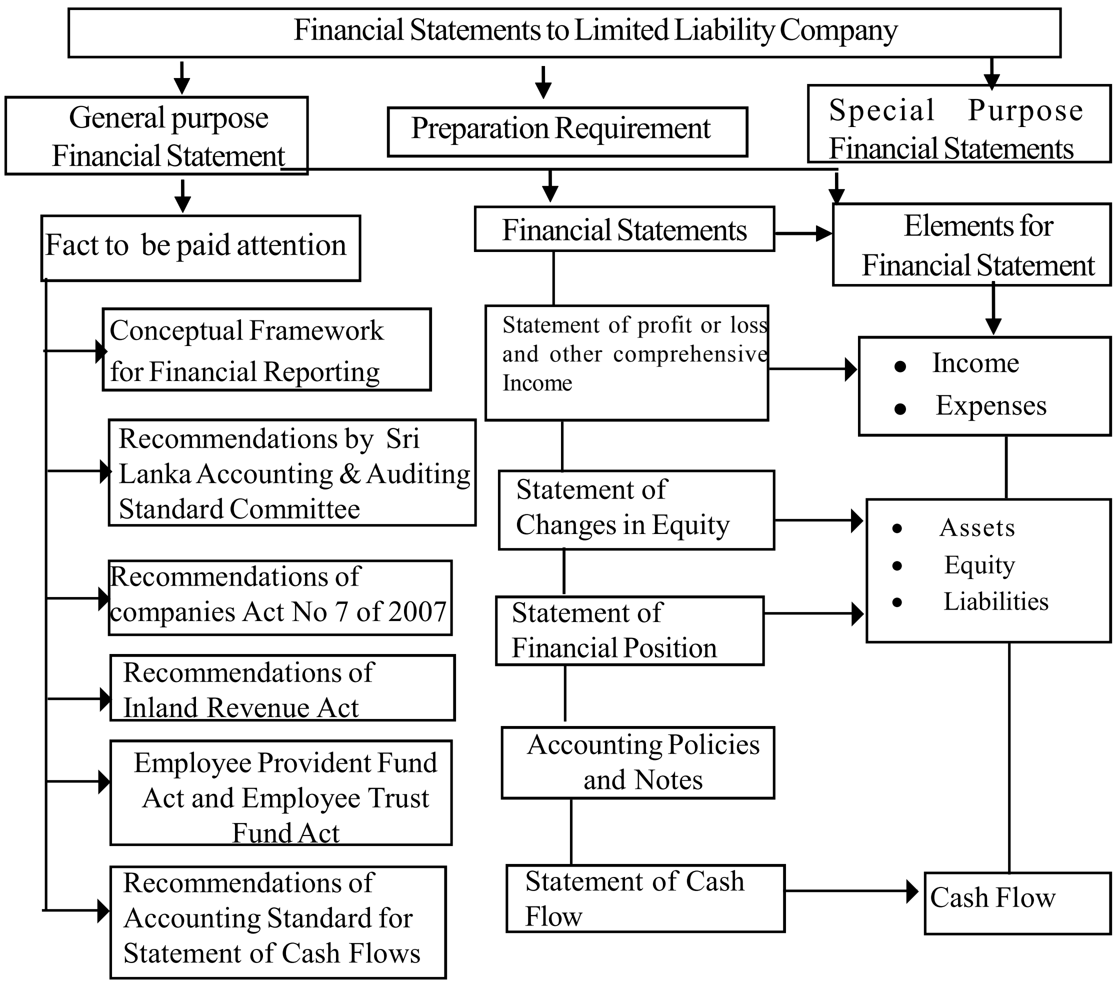
**No. of Periods : 60**

**Learning outcomes** :

- Prepares statement of profit or loss and other comprehensive income according to the recommendations under the Accounting Standard for Presentation of financial statements.
- Prepares statement of financial position
- Prepares statement of changes in Equity
- Prepares Notes to the accounts

**Basic Terms and Concepts :**

**Concept map**



**Learning Teaching Process :**

- Financial Statements of a Limited Liability Company are prepared on two requirements bases as

  1. Special purpose
  2. General purpose

- Financial Statements which included all information for management requirements are called as special purpose financial Statements. These are also referred as descriptive Financial Statements.

- Financial Statements prepared to provide accounting information for the common of external parties are general purpose financial statements.

- When preparing general purpose financial statements, it is required to consider about,

  - Recommendations, formats and guidelines mentioned in Sri Lanka Accounting Standard No. 01
  - Recommendations in conceptual framework for financial reporting
  - Requirements in Companies Act No 07 of 2007
  - Guidelines from Sri Lanka Accounting and Auditing Standards Committee.

- Following are the **items / Components** of financial Statements,

  1. Statements of profit or loss and after comprehensive income
  2. Statement of financial position
  3. Statement of changes in equity
  4. Statement of cash flows
  5. Accounting policies and notes

- Recommended format and guidelines in Sri Lanka Accounting Standard 01 to be applied when preparing financial statements.

**....................................PLC**

**Statement of Profit or Loss and other comprehensive Income**

**for the year ended ………….** (Rs.000)

| | Notes | Rs. | Rs. |
|---|---|---|---|
| Sales | | | xxx |
| Cost of Sales | | | (xxx) |
| Gross profit | | | xxx |
| Other Income | 01 | | xxx |
| | | | xxx |
| Distribution Cost | | xx | |
| Administration cost | | xx | |
| Other Expenses | | xx | |
| Finance cost | | xx | (xxx) |
| Profit Before Tax | 02 | | xxx |
| Income Tax Expenses | 03 | | (xxx) |
| Profit /Loss for the period | | | xxx |
| **Other Comprehensive Income** | | | |
| Change in revaluation reserve of | | | |
| Property Plant & Equipment | | | xxx/(xx) |
| Total Comprehensive Income | | | xxx |

**----------------------------------------PLC**

**Statement of Changes in Equity**

**for the year ended ………….**

(Rs.000)

| Description | Ordinary Shares | Revaluation Reserve | General Reserve | Retained Earnings | Total |
|---|---|---|---|---|---|
| Balance B/F | xx | xx | xx | xx | xx |
| Share Issue | xx | -- | -- | -- | xx |
| Total Comprehensive Income | -- | xx | -- | xx | xx |
| Right Issue | xx | -- | -- | -- | xx |
| Reserve Capitalization | xx | -- | (xx) | (xx) | -- |
| Transfer to General reserves | -- | -- | xx | (xx) | -- |
| Interm Dividends paid | | | | | |
| - Ordinary Shares | -- | -- | -- | (xx) | (xx) |
| Closing Balance | xxx | xx | xx | xx | xxx |

**.................................................... PLC**

**Statement of Financial Position as at .............**

(Rs.000)

| | Notes | Rs. | Rs. |
|---|---|---|---|
| **Non-current assets** | | | |
| Property, plant and equipment | 04 | | xxx |
| Right to use of lease property | 05 | | xxx |
| Investment (Long term) | | | xxx |
| | | | xxx |
| **Current Assets** | | | |
| Inventory | | xxx | |
| Trade Receivable | 06 | xxx | |
| Other current Assets | | xxx | |
| Cash and cash equivalents | 07 | xxx | xxx |
| Total Assets | | | xxx |
| **Equity & Liability** | | | |
| Stated Capital | | | |
| Ordinary Shares | | | xxx |
| **Reserves** | | | |
| Revaluation reserves | | | xxx |
| General Reserve | | xxx | |
| Retained Earnings | | xxx | xxx |
| | | | xxx |
| **Non Current Liabilities** | | | |
| Bank Loan | | xxx | |
| Lease Creditors (Non - Current) | | xxx | xxx |
| **Current Liabilities** | | | |
| Lease creditors (current) | | xxx | |
| Trade Payables | | xxx | |
| Current portion of Long term debts | | xxx | |
| Short term Provisions | | xxx | |
| Other Current Liabilities | | xxx | |
| Short-term loans / Bank OD | | xxx | |
| Total Equity and Liabilities | | | xxx |

Accounting policies and notes to the accounts disclosed together with financial statements of Limited Liability Company.

Followings to be disclosed using notes.

(i) **Other Income**

| | |
|---|---|
| | Rs |
| Profit on disposal of PPE | xx |
| Dividend Income | xx |
| Interest Income | xx |
| Rent Income | xx |
| Discount Received | xx |
| Commission Income | xx |
| | xx |

(2) Following expenses are considered in calculating Profit before tax

| | |
|---|---|
| | Rs. |
| Depreciation | xx |
| Loss on disposal of PPE | xx |
| Deficit / Loss on revaluation | xx |
| Loan interest | xx |
| Lease Interest | xx |
| Warranty expense | xx |
| Stock written off | xx |
| Employee Compensation | xx |
| Director fee/Allowance /Remittances | xx |
| Audit fees | xx |
| EPF expenses | xx |
| ETF expenses | xx |
| Donations | xx |

(3) Income Tax

| | |
|---|---|
| Income Tax on profit for the year | xxx |
| Under / over Provision (Last Year) | x/(x) |
| | xx |

(4) Property, Plant and Equipment **(Rs.000)**

| | Land | Buildings | Motor vehicles | Machines | Office Equipment | Computers | Total |
|---|---|---|---|---|---|---|---|
| Opening Balance | xxx | xxx | xxx | xxx | xxx | xxx | xxx |
| Purchases | -- | xxx | -- | -- | -- | xxx | xxx |
| Revaluations | xxx | xxx | -- | -- | -- | -- | xxx |
| Disposals | -- | -- | (xx) | -- | -- | -- | (xx) |
| Depreciation Adjustment for Revaluation | -- | (xxx) | -- | -- | -- | -- | (xxx) |
| Closing Balance | xxx | xxx | xxx | xxx | xxx | xxx | xxx |
| Accumulated Depreciation | | | | | | | |
| Opening Balance | -- | xxx | xxx | xxx | xxx | xxx | xxx |
| Depreciation for the year | -- | xxx | xxx | xxx | xxx | xxx | xxx |
| Disposals | -- | (xx) | -- | -- | -- | (xx) | |
| Depreciation Adjustment for revaluation | -- | (xxx) | -- | -- | -- | -- | (xxx) |
| Closing Balance | -- | xxx | xxx | xxx | xxx | xxx | xxx |
| Carrying Amount | xxx | xxx | xxx | xxx | xxx | xxx | xxx |

(5) **Right to use of lease Property**

| | |
|---|---|
| Motor Van | xxx |
| Less Accumulated Depreciation | (xx) |
| | xxx |

(6) **Trade receivables**

| | |
|---|---|
| Trade receivables | xx |
| Allowance for expected losses on trade receivables | (xx) |
| | xxx |

(7) Cash and Cash equivalents

| | Rs. |
|---|---|
| Petty cash Balance | xx |
| Cash | xx |
| Treasury Bills (3 months) | xxx |
| | xxx |

Accounting policies applied in preparing & presentation of finance statements to be closed with the financial statements. Such as,

(i) Cost formula used for inventory valuation (FIFO/WAC)
(ii) Base for asset recognition either cost or revalued amount
(iii) Various agreements assigned by the business

**Instructions for Planning Exercise :**

Students can be assigned to bring financial reports of limited liability companies available in news papers, magazine or internet as a pre requirement for engaging to this competency level. Discuss with students relating to the information available in those reports.

- Discuss the students' ideas by getting information of financial statements separately.
- Explain about the information provided through each type of financial statements.
- Statement of profit or loss & other comprehensive income – financial performance

  Statement of changes in equity and statements of financial position – financial status
- Discuss about the information which are important for interested parties for decision making but not disclosing in the face of financial statements.
- Emphasis the necessity of preparing accounting notes which disclose the important information for interested parties relating to preparation and preparation of financial statements.

- Distribute Annexure 12.4.1.1, 12.4.1.2, 12.4.1.3, 12.4.1.4, and 12.4.1.5 among students.
  - Following annexure to be distribute among students in the order of 124.1.1, 12.4.1.2, 12.4.13, 12,4.1.4 and 12.4.1.5.
  - Facilitate students to engage in activities by following the instructions on them.
  - Give opportunity for students to present the class.

**Annexure 12.4.1.1**

Balance of income and expenses for the financial year of 2017/2018 of Milano PLC given below.

| | (Rs.000) |
|---|---|
| Sales | 40600 |
| Purchases | 25000 |
| Inventory 01/04/2017 | 4000 |
| Carriage inward charges | 1000 |
| Return Inwards | 600 |
| Return Outwards | 500 |
| Profit on disposal of motor vehicle | 100 |
| Rent income | 600 |
| Interest Income | 300 |
| Salaries and wages | 4000 |
| Book keeping expenses | 200 |
| Loan interest | 30 |
| Impairment loss of trade receivables | 170 |
| Stock Donations | 50 |
| Director remmittances | 2600 |
| Audit fee | 160 |
| Sales warantee | 140 |
| Depreciation for Buildings | 80 |
| Depreciation for motoe vehicle | 120 |
| Eco emisson and vehicle license fee | 40 |
| Telephone and Electricity expenses | 200 |
| Advertising expences | 100 |
| Lease interest | 60 |
| EPF Expense | 600 |
| ETF Expense | 120 |
| Other Administration Expense | 1230 |
| Other distribution expense | 150 |
| Other Financial expense | 50 |
| Surplus on Land revalution for first time | 2000 |

**Additional Information**

1. Inventory as at 31/3/2018 was Rs. 3500 000. Net Realizable value of it was estimated as Rs. 3200 000

2. Income Tax is $\frac{1}{5}$ of profit before tax of the accounting year.

**Required :**

1. Prepare statement of profit or loss and other comprehensive Income for the year ended 31/3/2018 of Milano PLC referring the above details.

2. Prepare notes to the account for the year ended 31.03.2018 of Milano PLC

**Annexure 12.4.1.2**

(1) Balance of equity items as at 01.04.2017 of Wariyapola LC given below.

| | Rs.'000 |
|---|---|
| Rs. 50/- ordinary shares (2000 000) | 100 000 |
| Revaluation reserves (Land) | 4 000 |
| General Reserve | 22 500 |
| Retained earnings | 3 500 |

(2) Extract from the statement of profit or loss and other comprehensive income for the year ended 31.03.2018 of Wariyapola PLC.

| | |
|---|---|
| Profit for the period | Rs. 6500 000 |
| Surplus on land revaluation during the year | Rs. 2000 000 |
| Total comprehensive Income | Rs. 8500 000 |

(3) Transactions caused to change the equity during the year ended 31.03/2018 of Wariyapola PLC are as follows.

(i) On 01/04/2017, 5000 ordinary shares were issued and 60 000 applications were collected for that share were proportionately distributed and excess money was returned,

(ii) On 01/07/2017 board of directors decided to capitalized its reserves considering the ordinary shared available at 01/4/2017 before the new share issue by offering 1 share for every 5 ordinary shares held at a consideration of Rs. 50. General reserves are used for that.

(iii) On 01/10/2017. 20 000 ordinary shares were issued for ordinary share holders at 4 : 1 ratio at a consideration of Rs. 50. All shareholders exercised the right.

(iv) On 3103/2018, board of directors decided to transfer Rs. 1000 000 dividend of Rs. 3000 000 for ordinary shares. However for ordinary share holders during the year. Ordinary share holders were paid Rs. 20 000 as dividend during the year.

**Required :**

1. Statement of changes in Equity for the year ended 31/03/2018 of Wariyapola PLC.
2. Notes to the account referring above transactions for the year ended 31/03/2018 of Wariayapola plc
3. Journal entries, ledger accounts to record above transaction.

**Annexure 12.4.1.3**

Balances available as at 31/3/2018 in Rathtota PLC after preparing statement of profit or loss and other comprehensive income ad statement of changes in equity given below.

| | |
|---|---|
| Inventory as at 31/3/2018 | 7 800 |
| Investment in ordinary shares | 6 000 |
| Fixed depoit (3 years) | 2 500 |
| Trade receivables | 6 425 |
| Trade payable | 9 165 |
| 12% Bank Loan | 3 600 |
| Prepaid Insurance (31/03/2018) | 60 |
| Income tax payable 31/3/2018 | 480 |
| Property, plant and equipment (carrying amount) | 19 840 |
| Bank loan payable as at 31/03/2018 | 65 |
| Allowance for Expected losses on trade receivables | 25 |
| Accrued electricity as at 31/3/2018 | 40 |
| Cash and cash equivalents | 8 750 |
| Revaluation reserves | 8 200 |
| Stated capital – Ordinary shares | 16 800 |
| Lease creditors | 5 700 |
| Lease creditor – current portion | 300 |
| General reserve | 2 300 |
| Retained earnings | 4 700 |

- Prepare statement of financial position as at 31/03/2018 of Raththota PLC

**Annexure 12.4.1.4**

Following account balances are extracted from the accounting records prepared by Singithi PLC as at 31/03/2017

Balances of property, plant and equipment and accumulated depreciation as at 01/04/2016

| | Cost | Accumulated Depreciation |
|---|---|---|
| Land and Building (Land Cost Rs. 4000) | 7500 | 850 |
| Distribution vehicles | 10000 | 3200 |
| Machines | 6000 | 2500 |
| Furniture and fittings | 2700 | 700 |
| Computers | 4000 | 1500 |

**Additional Information.**

1. During the year 2016/2017 Land was revalued for Rs. 6000 000
2. A motor vehicle cost Rs. 3000 000 was exchanged on 31/03/2017 with a new motor vehicle of Rs. 5000 000. Rs 2800 000 was paid by cash on exchange. Accumulated depreciation for exchanged vehicle was Rs. 1500 000.
3. Annual deprecation expenses for buildings distribution vehicles, machines, furniture and fittings and computers were Rs. 4000 000, Rs. 800 000, Rs. 500 000, Rs. 300 000 and Rs. 1000 000 respectively.

- Prepare note on property, plant and equipment referring Singiti PLC

**Annexure 12.4.1.5**

Trial Balance as at 31/3/2017 of Ruwanjalee PLC given below.

(Rs. 000)

| Description | Dr | Cr |
|---|---|---|
| Property Plant and Equipment – (cost) | | |
| Land and Buildngs (land - Rs. 17 500) | 22 500 | |
| Motor vehicles | 6 600 | |
| Machines | 8 400 | -- |
| Computer & Equipment | 4 200 | -- |
| Accumulated depreciation for property, plant & equipment as at 01.04.2016 | | |
| Buildings | -- | 1 000 |
| Motor vehicles | -- | 300 |
| Machines | -- | 800 |
| Computers | -- | 400 |
| 10% Fixed Deposit | 4500 | -- |
| Cost of sales and sales | 20 600 | 64 500 |
| Income tax payment | 400 | |
| Adminstrtaion Expenses | 6 520 | -- |
| Distribution expenses | 8 000 | -- |
| Finance Expenses | 1 800 | -- |
| Trade receivables | 2 480 | |
| Trade payable | -- | 1 800 |
| Allowance for Expected losses on trade receivables | -- | 200 |
| Stated capital - ordinary shares (2016.01.01) | -- | 10 000 |
| Revaluation reserves (2016.04.01) | -- | 3000 |
| General Reserve (2016.04.01) | -- | 2 000 |
| Retained Earnings (2016/2017) | -- | 3 000 |
| Interim dividends (2016.04.01) | 400 | -- |
| 15% Bank Loan | -- | 2 000 |
| Lease Creditors | -- | 3 000 |
| Inventories as at 31.03/2017 | 3 600 | -- |
| Cash | 2000 | |
| Total | 92 000 | 92 000 |

Following adjustments to be completed before preparation of financial statements of Rewnajalee PLC for the year ends 31.03.2017

(01) Adjustments related to property plant and equipment (All depreciable assets to be depreciated on straight line method)

(i) Useful life time of building is 40 years. No salvage value is estimated.

(ii) Balance of Revaluation reserves represents the surplus generated through land revaluation before 2 years. This land was revalued for Rs. 20 000 000 during the year and it was not adjusted yet.

(iii) Motor vehicle account balance represent the motor vehicle acquired on finance lease at 01.04.2016 with a fair value if Rs. 3000 000. Down payment was not made when purchasing the motor vehicle. Annual lease installment of Rs. 600 000 to be paid at the end of each year. Installment payment made this year was recorded under finance expenses. Annual interest is 10% of the opening balance, Motor vehicles to be depreciated by 10% per annum.

(iv) Salvage value of machines of the end of useful life time of 10 years was estimated as Rs. 40 000.

(v) Remaining useful life time of computer and equipment were estimated as another 2 years form 01/04/2017.

(02) Inventory items cost Rs. 200 000 including stock of 31.03.2017 were sold for Rs. 150 000 on 10.04.2016

(03) Stock cost Rs. 1000 000 was sent to Padeniya PLC on 31/01/2017 on sale or return basis. They were not sold till 31.03.2017. Invoice value of the stock there were Rs.1500 000. Period of return is not yet over. This stock was not included for closing stock.

(04) Maspotha PLC, a debtor with a due of Rs. 80 000 was declared as bankrupt by the court on 12.04.2017. This balance was already recognized as an expected losse on trade receivables as at 31.03.2017. Rs. 300 000 Allowance to be maintained for an expected losses on trade receivables on remaining debtor balance.

(05) Fixed deposit was started on 01.04.2016 and, the interest received was included in bank statement. No adjustment was done on that.

(06) 6 months interest payment for 15% bank loan was included in finance expenses. Interest for remaining 6 months were not yet paid. Rs. 400 000 out of the bank loan to be paid within 2017/2018.

(07) Ruwanjalee PLC sold goods under warranty certificates. It was estimated that a provision of Rs. 200 000 to be made for sales warranty.

(08) Income tax for the year was ¼ of profit before tax.

(09) Rs. 500 000 was paid for advertising expenses during the year. Rs. 300 000 out of that is applied for next year.

(10) Financial statements were approved by board of directors on 30.06.2017

**Required :**

(i) Statement of profit or loss and other comprehensive income for the year ended 31.03.2017

(ii) Statement of changes in equity for the year ended 31.03.2017

(iii) Statement of financial position as at 31.03.2017

(iv) Notes to the account for the year ended 31.03.2017

**Assessments and Evaluation Criteria:**

- Explaining other comprehensive income
- Stating the content of total comprehensive income
- Recording the transactions affected for equity.
- Preparing financial statements using given facts

**Exercise : ** Trial balance extracted from Saranga PLC as at 31.03.2017 given below

(Rs.'000)

| Discription | Dr | Cr |
|---|---|---|
| Trade receivable / Trade payable | 2 600 | 2 200 |
| Accrued expenses as at 31.03.2017 | -- | 200 |
| Prepaid distribution expenses as at 31.03.2017 | 100 | -- |
| Property, plant and equipment | | |
| (cost and Accumulated depreciation) | | |
| Land | 10 000 | -- |
| Buildings | 4 000 | 1 000 |
| Motor vehicles | 12 000 | 2 000 |
| Machines | 1 400 | 400 |
| Depreciation for property, plant and equipmemt | 1 000 | -- |
| Cost of sales and sales | 12 000 | 26 000 |
| Administration Expenses | 3 300 | -- |
| Distribution cost | 1 800 | -- |
| Finance Expense | 1 200 | -- |
| Other Expense | 800 | -- |
| 10% Bank Loan | -- | 4 000 |
| Lease Creditor (01.04.2016) | -- | 4 560 |
| Allowance for expected losses on trade receivables (31.03.2017) | -- | 800 |
| Income tax payment | 1 300 | -- |
| Stated capital - Ordinary shares (200 000 shares) | -- | 5 000 |
| Income tax payment | 400 | -- |
| Retained earnings (01.04.2016) | -- | 6 090 |
| Revaluation Reserves | -- | 1 500 |
| Salaries and wages | 2 000 | - |
| Cost of inventory as at 31.03.2017 | 1 000 | -- |
| EPF Payable | -- | 150 |
| Repair expense for sales warranty | 100 | -- |
| Cash and cash equivalents | 5 000 | - |
| General reserve | -- | 8 100 |
| | 60 000 | 60 000 |

**Additional Information**

Following facts to be considered in preparing financial statements of Saranga PLC for the \year ended 31/03/2017.

(i) A motor vehicle acquired under a lease on 01/04/2016 by Saranga PLC was correctly recorded. Followings are related to motor vehicles.

Fair value of motor vehicle was Rs. 6000 000. Lease period 4 years. Rs. 1440 000 was paid as down payment. Annual installment of Rs. 1400 000 to be paid at the end of each year. Expected useful life time of the motor vehicle is 5 years. Lease interest included in current and next year lease installments are as follows.

| Year | Interest (Rs'000) |
|---|---|
| 2016/2017 | 456 |
| 2017/2018 | 357 |

(2) Bank loan to be paid by 4 installments. First installment to be paid on 30.09.2017. Loan interest was not paid for whole year.

(3) Property plant and equipment other than lease motor vehicle are used for administration activities. Annual depreciation for property, plant and equipment items given below.

(i) Expected useful lifetime of buildings is 40 years.

(ii) Motor vehicles other than lease motor vehicles to be depreciated by 10% per annum.

(iii) Salvage value of machines at the end of useful time of 10 years was estimated as Rs. 400 000.

(iv) Lease motor vehicle was not depreciated for current year.

(4) Allowance was made as expected losses on trade receivables for a due of Rs. 600 000 from samduni PLC which was a balance under trade receivables. This amount was declared as bankdrupt by the court.

(5) Management of the company decided to start a provision for sales warranty. 2% of sales to be provided for sales warranty. Amount spent to repair warranted items are included in trial balance.

(6) 10% contribution from employees from salary was adjusted and, Rs. 50 000 was paid. 15% of employee contribution for EPF and 3% contribution for ETF were not yet adjusted.

(7) A professional valuer revalued land and buildings on 31.03.2017 as follows.

| | |
|---|---|
| Land | Rs. 2500 000 |
| Buildings | Rs. 12 000 000 |

Revaluation surplus and deficits were recognized in previous revaluations' and valuation reserve consisted with

| | |
|---|---|
| Surplus on building revaluation | - Rs. 300 000 |
| Surplus in land revaluation | - Rs. 1200 000 |
| - | Rs. 1500 000 |

(8) Inventory items cost Rs. 300 000 which include under closing stock is expiring on 10.04.2017 those items were sold for Rs. 320 000 after reducing its prices and Rs. 45 000 was spent for that.

(9) Income tax for the year is ¼ of the profit before tax.

(10) Company made a right issue on 01/10/2016 offering ordinary share at 4 :1 ratio, it was correctly entered in ledger. Consideration per share was Rs. 25. All share holders exercised their right.

(11) Following decisions were taken by board of directors on 31. 03. 2017

(i) Reserve capitalization using retained earnings at a ratio of 5:1

(ii) Transfer Rs. 500 000 to general reserves.

(iii) Pay Rs. 2/- dividend for ordinary share holders (only for shares available & before reserve capitalizations)

**Requied**

(i) Statement of Profit or loss and other comprehensive income for the year ended 31.03.2017

(ii) Statement of charges in equity for the year ended 31.03.2017

(iii) Statement of financial position as at 31.03.2017 Exercise for explaining subject matters.

- **Exercise for explaining subject matters.**

Trial balance extracted from chandi PLC as at 31.03.2017;

(Rs.'000)

| Description | Dr | Cr |
|---|---|---|
| Sales | -- | 80 600 |
| Cost of sales | 52 000 | -- |
| Eectricity, Rates and Insurance | 150 | -- |
| Advertising and sales promotion expense | 400 | -- |
| Carriage outward charges | 100 | -- |
| Director remuneration | 2 000 | -- |
| Salaries and wages | 1 820 | -- |
| Interest payments | 800 | -- |
| Trade receivable | 3 050 | -- |
| Trade payable | | 1 700 |
| Interim dividend | 2000 | -- |
| Property, plant and equipment cost and accumulated depreciation as at 01.04.2016 | | |
| Land and buildings | 30 000 | 2 500 |
| Motor vehilcle | 44 000 | 7 800 |
| Treasury bills (3 months) | 3000 | 700 |
| Cash Balance | 3 270 | -- |
| Petty cash balance | 600 | -- |
| Office equipment | 400 | -- |
| Impairment losses on trade receivables | 100 | -- |
| Allowance for expected losses on trade receivables 01.14.2016 | -- | 200 |
| Audit fee | 400 | -- |
| General reserve | -- | 1 200 |
| Lease crditor | -- | 4 000 |
| Provision for Income tax as at 01.04.2016 | -- | 150 |
| Income tax payment | 380 | -- |
| Stock as at 31.03.2017 at cost | 3 500 | -- |
| Retained earnings as at 01.4.2016 | -- | 3 000 |
| Revaluation reserves | --- | 1 800 |
| Stated capital - Ordinary shares (200 000 shares) | -- | 40 000 |
| Other income | -- | 350 |
| Eco emission and licence fee of motor vehicle | 30 | -- |
| 12% fixed depost | 2 000 | -- |
| 15% Long term Bank Loan | -- | 6 000 |
| | 150 000 | 150 000 |

- Following information to be taken into consideration before preparing financial statements for the year ended 31.03.2017 (All values are expressed in Rs. '000)

01. (i) Cost of buildings were Rs. 10 000. Revaluation reserve balance represent the surplus created thorough the land revaluation on 1.04.2014. A professional valuation institute revalued lands on 1.4.2016 again and recognized a deficit / loss of Rs. 2000. The deficit / loss was not yet recorded.

(ii) It was correctly recorded the purchase of motor vehicle on 1.4.2016 a finance lease. Lease installment that to be paid at each year end is Rs. 1200. It include on interest of Rs. 200. 4 installment to be paid for self interest at lease and useful life time of the motor vehicle is 5 y ears. Installment paid for current year was debited to trade payable account.

(iii) All depreciable assets to be depreciated on straight line method by using rates given below.

| | |
|---|---|
| Buildings | 5% |
| Motor vehicles | 20% |

Salvage value estimation for office equipment at the end of useful life time of 3 years is Rs. 900.

(2) Net realizable value of stock as at 31.03.2017 under grouping method was Rs. 3600. But, net realizable value under item by item method was Rs. 3450.

(3) Board of directors approves financial statements on 02.05.2017. On 10.04.2017 the court informed about the bankruptcy of debtor with above of Rs. 50. This amount should be considered as impairment loss. Allowance for expected loss of trade receivable should increase by Rs. 100.

(4) Accrued expenses as at 31.03.2017 - Electricity 50

- Audit fee 100

Prepared expenses as at 31.03.207 - Insurance 50

- Advertising & sales promotion 100

(5) Payable amount of income tax for previous year was settled with in current year 1/10 of profit before tax was assessed as income tax for current year.

(6) An ex-employee field a case against the company requesting a compensation of Rs. 600. Company lawyers have informed that it have to be paid a compensation of Rs. 500.

(7) Fixed deposit was stated on 01.10.2016 and bank informed interest for the period ended 31.03.2017 was added to the fixed deposit. But it was not yet adjusted.

(8) Interest payment balance represents the loan interest paid within the year. Loan was obtained prior to 01.04.2016 .

(9) A computer purchase on 01.10.2016 of Rs. 2000 was wrongly recorded as purchases. Useful life time of computers is 4 years. Computers to be listed as office equipment.

(10) Board of directors made following decisions 0n 31.03.2017.
- Reserve capitalization using retained earnings at a ratio of 20 : 1.
- Transfer Rs. 500 to general reserves.
- Rs. 1 to be paid as dividend for ordinary shareholders.

**Requied**

(i) Statement of Profit or loss and other comprehensive income for the year ended 31.03.2017

(ii) Statement of charges in equity for the year ended 31.03.2017

(iii) Statement of financial position as at 31.03.201Exercise for explaining subject matters.

Chandi PLC
Statement of profit or loss and other comprehensive income
for the year ended 31.03.2017

| | Notes | Rs.'000 | Rs.000 |
|---|---|---|---|
| Sales | -- | | 80 000 |
| Cost of sales | | | (50 000) |
| Gross profit | | | 30 000 |
| Other income | 01 | -- | 470 |
| | | | 30 470 |
| Distribution cost | | 9 280 | |
| Adminstration Expenses | | 5 920 | |
| Other expenses | | 850 | |
| Finance Expenses | | 1 100 | (17 150) |
| Profit Before Tax | 02 | | 13 320 |
| Income tax expense | 03 | | (1 332) |
| Profit for the year | | | 11 988 |
| **Other comprehensive Income** | | | |
| Revaluation deficit | | | (1 800) |
| Total comprehensive income | | | 10 188 |

Chandi PLC

**Statement of changes in Equity**

**for the year ended 31.03.2017** **(Rs.'000)**

| Description | Stated capital ordinary shares | Revaluation Reserves | General Reserve | Retained Earnings | Total |
|---|---|---|---|---|---|
| Balance B.F as at 1'4.2014 | 40 000 | 1 800 | 1200 | 3 000 | 46 000 |
| Reserve capialization | 2 000 | -- | -- | (2000) | -- |
| Total comprehensive Income | -- | (1 800) | -- | 11 988 | 10 188 |
| Transfer to general reserve | -- | -- | 500 | (500) | -- |
| Dividend payment | -- | -- | -- | (2 000) | (2 000 |
| Balance as at 31.3.2017 | 42 000 | | 1 700 | 10 488 | 54 188 |

Chandi PLC

**Statement of Finacial Position**

**for the year ended 31.03.2017**

| | Notes | Rs. 000 | Rs. 000 |
|---|---|---|---|
| **Assets** | | | |
| **Non-current Assets** | | | |
| Property, plant & Equipment | 04 | | 52 050 |
| Right to use of lease property | 05 | | 3200 |
| 12% fixed deposit | | | 2 120 |
| | | | 57 370 |
| **Current Asset** | | | |
| Inventory | | 3 450 | |
| Trade receivable (3000-300) | | 2 700 | |
| Prepaid expenses | | 150 | |
| Cash and cash equivalents | 06 | 4 270 | 10 570 |
| **Total Assets** | | | 67 940 |
| **Equity & liabilities** | | | |
| Stated capital - Ordinary shares | | | 42 000 |
| General reserves | | 1 700 | |
| Retained earnings | | 10 488 | 12 188 |
| | | | 54 188 |
| **Non-current liabilities** | | | |
| Lease crditors | | 2 000 | |
| 15% Bank Loan | | 6 000 | 8 000 |
| **Current Liabilities** | | | |
| Lease creditor (Current portion) | | 1 000 | |
| Trade and other payables | | 2 900 | |
| Accrued expenses | | 250 | |
| Provision for compensation of Employees | | 500 | |
| Income tax payable | | 1 102 | 5752 |
| Total Equity and liabilities | | | 67 940 |

Notes to the financial statements (Rs.'000)

01. **Other Income**

| | |
|---|---|
| Interest for deposits | 120 |
| Other Income | 350 |
| | 470 |

02. Following items were considered in calculating Profit Before Tax

| | (Rs.'000) |
|---|---|
| Deficit on land revaluation | 200 |
| Loss on disposal of motor vehicle | 100 |
| Stock written off | 50 |
| Depreciation of PPE | 9 250 |
| Depreciation for lease property | 800 |
| Employee compensation | 500 |
| Director remuneration | 2 000 |
| Bank Loan Interest | 900 |
| Audit fee | 500 |
| Lease Interest | 200 |

03. **Income Tax**

Tax on Profit of the period 1332 $\left(13\ 320 \times \frac{10}{100}\right)$

04. **Property Plant and Equipment**

| Cost | Land | Buildings | Motor Vehicles | Office Equipment | Total |
|---|---|---|---|---|---|
| Balances as at 1.4.2016 | 20 000 | 10 000 | 40 000 | 3 000 | 73 000 |
| Purchases | -- | – | – | 2 000 | 2 000 |
| Revaluation | (2 000) | – | – | – | (2 000) |
| Disposal | -- | - | (1 000) | – | (1 000) |
| Balance 31.3.2017 | 18 000 | 10 000 | 39 000 | 5 000 | 72 000 |
| Accumulated depreciation | | | | | |
| Balances at 1.4.2016 | -- | 2 500 | 7 800 | 700 | 11 000 |
| Depreciation expenses | -- | 5 00 | 7800 | 950 | 9250 |
| Disposal | -- | -- | (300) | | (300) |
| Balance 31.3.2017 | -- | (3 000) | 15300 | (1 650) | 19950 |
| Company Amount | 18 000 | 7 000 | 23700 | 3 350 | 52050 |

Note 5 : **Right of use of Lease Property**

| | |
|---|---|
| Motor Vehicle | 4000 |
| less : Accunulated | |
| Depreciation | (800) |
| | 3200 |

Note 6: **Cash and cash equivalent**

| | |
|---|---|
| Treasury Bills | 400 |
| Petty cash balance | 600 |
| Cash balance | 3270 |
| | 4270 |

**Note 7:** Board of directors proposed to pay a final dividend of Rs. 200 for ordinary shareholders.

## Workings

**Distribution cost**

| | |
|---|---|
| Motor vehicle depreciation | 8 600 |
| Under allowance expected losses on trade receivables | 250 |
| Adveristing and promotion | 300 |
| Carriage outward charges | 100 |
| Eco emission and licence fee | 30 |
| | 9280 |

**Administration Expenses**

| | |
|---|---|
| Depreciation for Building | 500 |
| Depreciation for Machines | 950 |
| Electricity, Rates & Insurence | 200 |
| Director remuneration | 2 000 |
| Salaries an Wages | 1 820 |
| Audit fee | 500 |
| | 5920 |

**Finance Expenses**

| | (Rs.) |
|---|---|
| Loan Interest | 900 |
| Lease Interest | 200 |
| | 1100 |

**Other Expenses**

| | (Rs.) |
|---|---|
| Deficit/loss on land revaluation | 200 |
| Loss on disposal of motor vehicle | 100 |
| Stock Written Off | 50 |
| Employee compensation | 500 |
| | 850 |

Motor vehicle disposal A/C

| | | | (Rs.) |
|---|---|---|---|
| M V | 1000 | M V Acc. Dep. | 300 |
| | | Purchases | 600 |
| | | P/L | 100 |
| | 1000 | | 1000 |

Lease Creditor A/C

(Rs.'000)

| | | | |
|---|---|---|---|
| Trade payables | 1 200 | Balance B/f | 4 000 |
| | | Laase Interest | 200 |
| B/c/d | 3 000 | | |
| | 4 200 | | 4 200 |
| | | Balance B/f | 3 000 |

| | | |
|---|---|---|
| Current Liabilities | 1 200 - 200 | = 1 000 |
| Non-current Liabilities | 3 000 - 1 000 | = 2 000 |

Fixed deposit interest $= 2\ 000 \times \frac{12}{100} \times \frac{1}{2}$ $= 120$

Loan interest $= 6\ 000 \times \frac{15}{100}$ $= 900$

Interest Paid (800)

Accrued Loan interest 100

**Accumulated depreciation for Disposed Motor Vehicle**

01.10. 2014 - 01.04.2016 $= 1\frac{1}{2}$ years

$$= \left(1\ 000 \times \frac{10}{100} \times 1.5\right) = 300$$

**Depreciation for the year**

Motor vehicle $= \left(\frac{4\ 000}{5}\right)$ $= 800$

Other vehicle $= \left(39\ 000 \times \frac{20}{100}\right)$ $= 7\ 800$

8 600

Buildings $= \left(1\ 000 \times \frac{5}{100}\right)$ $= 500$

Office Equipment $= \left(\frac{3\ 000 - 900}{3}\right)$ $= 700$

Computer $= \left(\frac{2\ 000}{4} \times \frac{1}{2}\right)$ $= 250$

$= 950$

Debtors' Control / Trade receivable a/c

(Rs.'000)

| | | | |
|---|---|---|---|
| Balance B/F | 3 050 | Impairment losses on trade receivables | 50 |
| | | Balance C/d | 3 000 |
| | 3 050 | | 3 050 |
| Balance B/f | 3 000 | | |

Impairment losses on trade receivable a/c

(Rs.'000)

| | | | |
|---|---|---|---|
| Balace B/F | 100 | Profit or loss a/c | 250 |
| Debtors' control a/c | 50 | | |
| Allawance for expected loss on trade receivable | 100 | | |
| Blance c/d | 250 | | 250 |

Allowance for expected losses on trade receivables

(Rs.'000)

| | | | |
|---|---|---|---|
| | | Balance B/f | 200 |
| B/c/d | 300 | Impairment loss on trade receivable | 100 |
| | 300 | | 300 |
| | | Balance B/f | 300 |

Income Tax a/c

(Rs.'000)

| | | | |
|---|---|---|---|
| Cash | 380 | Balace B/F | 150 |
| | | Profit or loss a/c | 1 332 |
| Blance c/d | 1 102 | | |
| | 1 482 | | 1 482 |
| | | Balance B/f | 1 102 |

**Competency 12.0 : Prepares Financial Statements for a Limited Company**

**Competency Level 12.4.2 : Prepare Statement of Cash flows of a limited liability company accordance with the Sri Lanka Accounting Standard**

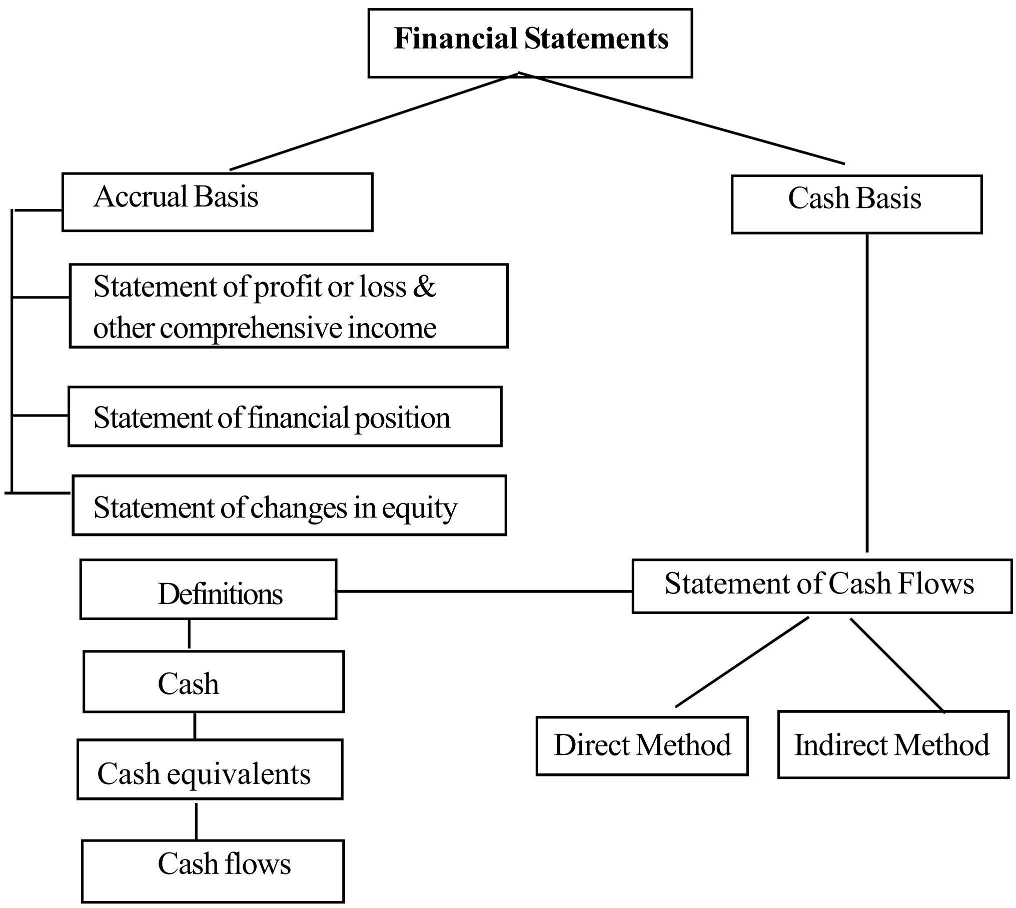
**No. of Periods : 7 12**

**Learning Outcomes :**

- Explains statement of Cash flows as per the applied accounting standard.
- Explains operating Activities
- Explains investing activities
- Explains financing activities
- Prepares statement of cash flows by applying accounting standard

**Basic Terms and concepts :**

**Concept Map**



**Proposed instruments for Learning – teaching process**

Proper and clear explanation is required relating to the subject content and related subject matters of this competency level of the syllabus.

**Introduction / Objectives**

- Provision of information about the changes in cash and cash equivalents of an entity for a concerned period by means of a statement of cash flows which classifies cash flows during the period generated form or used in operating, investing and financing activities..
- Statement of cash flow presents the sources of cash generated and sources of cash used by a business with in a period concerned.
- **Important facts about the definitions given in accounting standard.**
- **Cash**

  Cash compresses cash in hand and demand deposits.

  Ex. Cash balance, Petty cash balance.
- **Cash equivalents**

  Short term, highly liquid investments that are readily convertible to known amounts of cash which are subjected to a significant risk of changes in value.

  Example : 3 months Treasury bills
- **Cash Flows**

  Receipts are known as cash inflows and payments are known as cash outflows
- **Operating Activities**

  Cash flows from the principal revenue producing activities of the entity and other activities that are not investing or financing activities.

  Examples :
  - Receipts from selling goods or services
  - payments to suppliers for providing goods or services
  - Payment of salaries and others for employees.
  - Receipts from insurance compensation and payments for insurance premium.
  - Any other cash flow which can not be identified as investing or financing activities

**Investing Activities :**

Investing activities means expenditures have been made for resources intended to generate future income and cash flows. It includeds acquisition and disposal of long term assets for future business developments.

Example :

- Cash payments to acquire, construct or capitalization development cost relating to property, plant and equipment, intangibles and other long term assets.
- Cash receipts from sale of property, plant and equipment, intangibles and other long term assets.
- Cash payments to acquire equity or debt instruments of other entities, investments in joint ventures and cash receipts from sale of those investments.
- Cash advances and loans made to other parties and cash receipts from the repayments.
- Interest received, dividend received, rent received.

**Financing Activities:**

Financing activities means the cash flows which make changes in composition of equity capital and debt capital of a business. They are connected with the ways of capital raising of a business.

Example:

- Proceeds from issuing shares or other equity instruments.
- Payments to owners to acquire or redeem shares.
- Proceeds from issuing debentures and long term loans or repayment of amount borrowed.
- Payment of lease installments. (Except interest)
- Payment of dividends for share holders (Distribution among owners).

**Reporting of cash flows**

Two methods are available to report cash flows for concerned period as

1. Direct method
2. Indirect method

- Both methods can be applied to calculate cash flows from operating activities. Cash flows from investing and financing activities can be calculated only by using direct method. Reporting method of statement of cash flow is decided depending on the method applied for operating cash flows.

  All gross cash receipts and gross cash payments are disclosed through the direct method.; where by profit or loss is adjusted for the effect of transactions of non-cash nature, changes in working capital to calculate operating cash flows under indirect method.

  Cash flows relating to income and expenses which are used to calculate net profit are considered when reporting operating cash flows under direct method.

- Under indirect method, the net cash flow from operating activities is determined by removing the effect of non-cash items form profit before tax. Further items that to be categorized under other activities and changes in working capital to be adjusted.
- This calculation can be explained further using following table.

| **Direct Method** | **Indirect Method** |
|---|---|
| • Record the cash receipts and cash payments for operating activities.<br>Example<br>• Cash purchases / Cash sales<br>• Creditor payments/ debtor receipts.<br>• Commission received / Interest and other receipts<br>• Cash payments for operating expenses<br>• Tax payments<br>• Interest payment | Following to be adjusted by taking the profit / loss before tax for the period as the base.<br>• Non – monetary transactions / items)<br>Example :<br>• Depreciation, Loss on disposal of PPE interest expenses to be added back<br>• Income which is to be considered under other activities to be deducted.<br>Example : Interest income<br>Dividend income<br>• Adjustment for working capital changes including Accruals and Pre payments.<br>• Tax payment<br>• Interest payment |

**Format**

**Direct Method**

**......................Business**

**Statement of cash flows for the year ended ..............................**

(Rs.)

| | | |
|---|---|---|
| **Operating Activities** | | |
| Cash sales | xxx | |
| Debtor receipts | xxx | |
| Cash purchase | (xx) | |
| Payments to suppliers | (xx) | |
| Cash payment for administration expenses | (xx) | |
| Cash payment for distribution expenses | (xxx) | |
| Cash payment for other operating expenses | (xx) | |
| Cash generated from / used in operating activities | xx | |
| Interest paid | (xx) | |
| Tax paid | (xx) | |
| Net cash flows generated from / used in operating Activities | | xx |
| **Investing Activities** | | |
| Received cash from disposal of property, plant and Equipment | xxx | |
| Received cash from selling other Non-current Assets | xx | |
| Loan provided to employees | (xx) | |
| Dividend received | xx | |
| Interest received | xx | |
| Rent received | xx | |
| Purchase of property, plant and equipment | (xx) | |
| purchase of other non-current assets | (xx) | |
| Net cash flows generated from/used in investing activities | | xx |
| **Financing Activities** | | |
| Share issue | xx | |
| Loan obtaining | xx | |
| Other Long term loan obtaining | xx | |
| Dividend paid | (xx) | |
| Distribution among share holders | (xx) | |
| Repayment of loan | (xx) | |
| Loan installment paid | (xx) | |
| Lease installment paid (Except interest) | (xx) | |
| Net cash flow generated from / used in financial activities | | xxx |
| Net increase / decrease in cash and cash equivalents | | xxx |
| Opening cash and cash equivalents | | xxx |
| Closing cash and cash equivalents | | xxx |

**Operating cash flow (Generated from / used in) Using Indirect Method**

**…………………Business**
**Statement of cash flows for the year ended ……………………**

(Rs.'000)

| | | |
|---|---|---|
| **Operating Activities** | | |
| Profit Before Tax | xx | |
| **Adjustments** | | |
| Depreciation of property plant and equipment | xxx | |
| Loss on disposal of property plant and equipment | xxx | |
| Profit on disposal of property plant and equipment | (xxx) | |
| Interest expense | xx | |
| Interest income, rent income, Dividend income | (xxx) | |
| Operating profit before working capital changes. | xx | |
| Changes in inventories(Difference between opening and closing balance) | | |
| Changes in Trade receivables (Difference between opening and closing balance) | x/(x) | |
| Changes in prepaid expenses (Difference between opening and closing balance) | x/(x) | |
| Changes in Trade payables (Difference between opening and closing balance) | x/(x) | |
| Changes in accrued expenses (Difference between opening and closing balance) | x/(x) | |
| Cash generated from / used in operating activities | x | |
| Interest paid | (x) | |
| Tax paid | (x) | |
| Net cash flow generated from / used in operating activities | | xx |

**Distribute annexure 12.4.2.1 among student.**

Recognize the following items referring LKAS 7. State whether the items are cash and cash equivalent in the space provided.

| | |
|---|---|
| Petty cash balance | ............................................. |
| Cash balance (favourable) | .............................................. |
| Investment (2 years) | .............................................. |
| Treasury Bills (3 months) | ............................................... |
| Fixed Deposit (1 year) | ............................................... |

2. Put a (√) in the suitable column to categorize following items according to the cash flow categorization in LKAS – 7 using direct method.

| Items | Operating | Investing | Financing |
|---|---|---|---|
| Cash and cheque received from trade debtors | | | |
| Salaries and wages paid for employees. | | | |
| Income tax payment | | | |
| Dividend payment | | | |
| Rent received for business place | | | |
| Lease installment payment (except interest) | | | |
| Capitalization of reserves | | | |
| Purchase of machine for business use | | | |
| Cheque payments for trade creditors | | | |
| Proceeds from selling used office equipment | | | |
| Loan interest paid | | | |
| Cash collection from right issue | | | |
| Obtaining a bank loan | | | |
| Payment of audit fee | | | |
| Receipt of fixed deposit interest | | | |
| Repayment of Bank loan | | | |
| Purchase of property, plant and equipment | | | |
| Electricity and insurance payment | | | |
| Purchase of Long-term investments | | | |
| Cash sales | | | |
| Cash purchases | | | |

**Distribute annexure 12.4.2.2 among students.**

Following cash control account was prepared by Newway PLC for the year ended 31.03.2017

**Newway PLC**
**Cash Control a/c for the year ended 31/03/2017**

(Rs.'000)

| | | | |
|---|---|---|---|
| Balance B/F a 01.04.2016 | 1500 | Cash purchases | 2 000 |
| Cash sales | 4 000 | Creditor payments | 3 500 |
| Debtor receipt | 7500 | Expenses | |
| | | Adminstration expenses paid | 2 000 |
| Income | | Distribution expense paid | 1 200 |
| Dividend for invetsment | 400 | Loan interest paid | 1 000 |
| Rent Income | 200 | Other payments | |
| Other receipts | | Income tax paid | 2 000 |
| Disposing a land | 5 500 | Purchase of motor vehicle | 4 500 |
| Ordinary Share Issue | 3 000 | Purchase of furniture & office equipment | 1 500 |
| Bank loan obtained | 2 000 | | |
| Collection from right issue | 1 000 | Lease repayment | 1 000 |
| | | Loan installment and payment | 2 800 |
| | | Dividend paid | 2 400 |
| | | Balance C/d 31.3.2017 | 1200 |
| | 25 100 | | 25 100 |
| 01.04.2017 Balance B/F | 1200 | | |

**Note :** Lease interest of Rs. 500 was included in paid lease installment

**Required :**

Prepare statement of cash flow for the year ended 31.3.2017 of Newway PLC by applying direct approach according to LKAS - 7

**Distribute Annexure 12.4.2.3 among students.**

(1) Calculate profit before tax using the fact extracted from Dinidu PLC

| | |
|---|---|
| Retained earnings Balance as at 01.04.2016 | 4 000 |
| Transactions occured during 31.03.2017 | |
| Dividend payment for ordinary share holdres | 500 |
| Proposed dividend for ordinary share holdres | 400 |
| Collection from right issue | 2 000 |
| Capitalization of reserves | 1 000 |
| Transfers to general reserves | 1 500 |
| Income tax payments | 1 200 |
| Income tax expense for the year | 1 600 |
| Retained earnings as at 31.3.2017 | 5 400 |

(2) State the correct adjustment relating to items given below when calculating operating cash flows using indirect method according to LKAS-07.

| Item | Adjustment to be done | | |
|---|---|---|---|
| | add | Less | Not to be adjusted |
| Deprecation of PPE | | | |
| Dividend income | | | |
| Proceeds from disposal of motor vehicle used for administration activities | | | |
| Interest expense | | | |
| Receipts from debtors | | | |
| Income tax paid | | | |
| Income tax expense | | | |
| Interest paid | | | |

((3) Current assets and current liabilities available in Sankapala PLC as at 31.03.2017 given below. State the way of recording the effect as add (+) or less (-) when calculating operating cash flow using indirect method.

| Item | 31.03.2016 | 31.03.2017 | Adjustment |
|---|---|---|---|
| Closing stocks | 2 000 | 3 000 | |
| Prepaid expenses | 500 | 300 | |
| Treade debtors | 3 500 | 3 000 | |
| Trade creditors | 1 200 | 1 700 | |
| Accrued operating expenses | 700 | 300 | |

**Distribute Annexure 12.4.2.4 among students.**

(1) Mudalindu PLC started its operations on 01.04.2016. Financial statements of first year given below.

**Mudalindu PLC**
**Statement of Profit or loss**
**for the year ended 31.03.2017**

| | | (Rs.'000) |
|---|---|---|
| Sales | | 9 500 |
| Cost of sales | | (4 500) |
| Gross profit | | 5 000 |
| Other Income | | 500 |
| | | 5500 |
| Dsitribution expenses | 1 400 | |
| Administration expenses | 1 600 | |
| Finance expenses | 400 | (3 400) |
| Profit Before Tax | | 2 100 |
| Income Tax | | (600) |
| Profit for the period | | 1 500 |

**Mudalindu PLC**

**Statement of Finance Position**

**as at 31.03.2017**

| | (Rs.000) |
|---|---|
| Property plant and equipment | 7 000 |
| Investments (Shanthi PLC) | 2 000 |
| Inventories | 1 500 |
| Trade and other receivables | 4 000 |
| Bank balance | 1 000 |
| Total Assets | 15 500 |
| Equity and Liabilities | |
| Stated capital - ordinary shares (@Rs.90-100 shares) | 9 000 |
| Retained earnings | 1 000 |
| 10% Bank loan (2016.04.01) | 3 000 |
| Trade and other payables | 2250 |
| Accured Interest | 150 |
| Tax Payables | 100 |
| Total Equity and Liabilities | 15 500 |

**Other Informtion :**

(i) Mudalindu PLC engages purchase and sales on credit terms. Trade & other receivable balance represent trade debtors and trade & other payable balance represent trade creditors.

(ii) Rs. 100 000 out of finance expenses in statement of profit or loss was bank charges, remaining were interest for bank loan.

(iii) Composition of property plant and equipment given are below.

| Asset | Cost | Accumulated Depreciation | Carrying Amount |
|---|---|---|---|
| Machines | 2 400 | 400 | 2 000 |
| Motor vehicles | 3 000 | 600 | 2 400 |
| Land | 2 600 | - | 2 600 |
| | 8 000 | 1 000 | 7 000 |

All property plant and equipment items were purchased on cash.

(iv) Other income consist of dividend collected for investments.

(v) Dividends were not paid by the company with in the year.

**Required :**

1. Statement of cash flows (as per LKAS 7)
   - Prepare statement of cash flows using direct method to calculate the cash flows from operating activities.
   - Prepare statement of cash flows using indirect method to calculate cash flows from operating activities.
2. State two items which cannot be considered as cash flow.

**Guidance for clarifying subject matters.**

**Sanath PLC**

**Statement of profit or loss for the year ended 31.03.2017**

**(Rs.'000)**

| | Note | Amount | Amount |
|---|---|---|---|
| Sales | | | 20 000 |
| Cost of sales | | | (8 000) |
| Gross profit | | | 12 000 |
| Other income | | | 400 |
| | | | 12 400 |
| Distribution cost | | 2 300 | |
| Administration expenses | | 2 700 | |
| Finance expenses | | 1 000 | |
| Other expenses | | 400 | (6 400) |
| Profit Before Tax | | | 6 000 |
| Income Tax | | | (1 500) |
| Profit for the year | | | 4 500 |
| **Other comprehensive income** | | | |
| Surplus on land Revaluation | | | 2 500 |
| Total Comprehensive Income | | | 7 000 |

**Sanath PLC**

**Statement of changes in Equity for the year ended 31.03.2017**

**(Rs.'000)**

| Description | Ordinary shares | Revalution Reserves | General Reserve | Retained earnings | Total |
|---|---|---|---|---|---|
| Balance at 01.04.2016 | 8 000 | 1 500 | 2 000 | 4 200 | 15 700 |
| Share issue | 1 000 | - | - | - | 1 000 |
| Right issue | 2 000 | - | - | - | 2 000 |
| Reserve capitalization | 2 000 | - | - | (2 000) | - |
| Total comprehensive Income | - | 2 500 | - | 4 500 | 7 000 |
| Dividend paid | - | - | - | (1 000) | (1 000) |
| Tranfer to General reserves | - | - | 500 | (500) | - |
| Balance at 31.03.2017 | 13 000 | 4 000 | 2 500 | 5 200 | 24 700 |

**Sanath PLC**

**Statement of Financial Position as at 31.03.2017 and 31.03.2016**

**(Rs.'000)**

| Asset | Note | Amount 2017.03.31 | Amount 2016.03.31 |
|---|---|---|---|
| **Non current asset** | | | |
| Property, plant and equipment | | 18 000 | 15 300 |
| Investment | | 2 000 | 1 000 |
| **Current assets** | | | |
| Closing Inventory | | 2 200 | 1 000 |
| Trade Reveivables | | 2 500 | 1 500 |
| Treasury bills (03 months) | | 500 | - |
| Cash | | 1 700 | 200 |
| Total Assets | | 26 900 | 19 000 |
| **Equity & Liabilities** | | | |
| Stated capital | | | |
| Ordinary shares | | 13 000 | 8 000 |
| Reserves | | | |
| Revaluation reserves | | 4 000 | 1 500 |
| General reserves | | 2 500 | 2 000 |
| Retained earnings | | 5 200 | 4 200 |
| **Non-current liabilities** | | | |
| Bank loan | | 1 700 | 2 600 |
| **Current liabilities** | | | |
| Trade Payables | | 500 | 700 |
| Total Equity and Liabilities | | 26 900 | 19 000 |

**Additional Information :**

1. Interest for bank loan was included under finance expenses.
2. All purchases and sales were on credit term.
3. During the year, equipment cost, Rs, 1000 000 was sold with a profit of Rs. 400 000.
4. Stock as at 31.03.2017 at cost was Rs. 2600 000. Net reliable value of it was estimated as Rs. 2200 000. Stock written of Rs. 400 000 was included under other expenses.

**Sanath PLC**
**Property, Plant and Equipment**

**(Rs.'000)**

| Description | Land | Buildings | Motor vehicles | Equipments | Total |
|---|---|---|---|---|---|
| Balance at 01.04.2016 | 4 500 | 5 800 | 1 200 | 5 700 | 17 200 |
| Additions | - | - | 2 000 | - | 2 000 |
| Disposal | - | - | | (1 000) | (1 000) |
| Revaluations | 2 500 | - | - | - | 2 500 |
| Balance as at 31.03.2017 | 7 000 | 5 800 | 3 200 | 4 700 | 20 700 |
| Accumulated Depreciation | | | | | |
| Balance as at 01.04.2016 | - | 800 | 300 | 800 | 1 900 |
| Deprecation expense | - | 400 | 500 | 300 | 1 200 |
| Disposal | - | - | - | (400) | (400) |
| Balance as at 31.03.2017 | - | (1 200) | (800) | (700) | (2 700) |
| Carrying Amount | 7 000 | 4 600 | 2 400 | 4 000 | 18 000 |

**Required :**

Prepare

1. Statement of cash flows using direct method as per LKAS 07
2. Operating cash flows using indirect method as per LKAS 07

   By referring the financial statements of Sanath PLC

**(1)**

**Sanath PLC**
**Statement of Cashflows**
**for the year ended 31.03.2017**

(Rs.'000)

| | | |
|---|---|---|
| Operating Activities | | |
| Debtor receipts | 19 000 | |
| Creditor payments | (9 800) | |
| Expense payment | (3 800) | |
| Cash flow generated from operating activities | 5 400 | |
| Interest paid | (1 000) | |
| Tax paid | (1 500) | |
| Net cash flows generated from operating Activities | | 2 900 |
| Investing Activities | | |
| Disposal of equipment | 1 000 | |
| Purchase of Motor vehicle | (2 000) | |
| Purchase of investment | (1 000) | |
| Net cash flows used in investing activities | | (2 000) |
| Financing Activities | | |
| Issue of shares | 1000 | |
| Right Issue | 2 000 | |
| Payment of bank loan | (900) | |
| Dividend paid | (1000) | |
| Net cash flows generated from fiancail activities | | 1100 |
| Net increase in cash and cash equivalents | | 2000 |
| Cash and cash equivalents as at 01/04/2016 | | 200 |
| Cash and cash equivalents as at 31.03.2017 | | 2200 |

**Workings**

Debtor Control Account / Trade Receivable (Rs.000)

| | | | |
|---|---|---|---|
| B/F | 1 500 | Cash | 19 000 |
| Sales | 20 000 | B/C/d | 2 500 |
| | 21 500 | | 21 500 |
| B/F | 2 500 | | |

Creditor Control Account / Trade payables (Rs.000)

| | | | |
|---|---|---|---|
| Cash | 9 800 | B/F | 700 |
| | | Purchases | 9 600 |
| C/d | 500 | | |
| | 10 300 | | 10 300 |
| | | B/F | 500 |

Disposal of Equipment Account (Rs.000)

| | | | |
|---|---|---|---|
| Equipment | 1 000 | Acc. Dep. Equipment | 400 |
| P/L | 400 | | |
| | | Cash | 1 000 |
| | 1 400 | | 1 400 |

Purchase Calculation

| | (Rs.000) |
|---|---|
| Opeining Stock | 1 000 |
| + Pruchases | 9 600 |
| Stock to be sold | 10 600 |
| Closing stock | (2 600) |
| | 8 000 |

Distribution Expenses (Rs.000)

| | | | |
|---|---|---|---|
| Dep. MV | 500 | P/L Account | 2 300 |
| Cash | $\boxed{1\ 800}$ | | |
| | 2 300 | | 2 300 |

Administration Expenses (Rs.000)

| | | | |
|---|---|---|---|
| Dep. Building | 400 | P/L | 2 700 |
| Dep. Equipment | 300 | | |
| Cash | 2 000 | | |
| | 2 700 | | 2 700 |

**Sanath PLC**
**Statement of Cashflows**
**for the year ended 31.03.2017** **(Rs.'000)**

| | | |
|---|---|---|
| **Operating Activities** | | |
| Profit before tax | 6 000 | |
| **Adjustments** | | |
| Depreciation | 1 200 | |
| Profit on disposal of equipment | (400) | |
| Interest expense | 1 000 | |
| Operating profit before working capital changes | 7 800 | |
| Increase in inventory | (1 200) | |
| Increase in trade receivables | (1 000) | |
| Decrease in trade payable | (200) | |
| Cash generated from operating activities | 5 400 | |
| Interest paid | (1 000) | |
| Tax paid | (1 500) | |
| Net cahs flows generated from operating Activities | | 2 900 |
| **Investing Activities** | | |
| Disposal of equipment | 1 000 | |
| Purchase of Motor vehicle | (2 000) | |
| Purchase of investments | (1 000) | |
| Net cash flows used in investing activities | | (2 000) |
| **Financing Activities** | | |
| Issue of shares | 1000 | |
| Right Issue | 2 000 | |
| Payment of bank loan | (900) | |
| Dividend paid | (1 000) | |
| Net cash flows generated from fiancail activities | | 1 100 |
| Net increase in cash and cash equivalents | | 2 000 |
| Cash and cash equivalents as at 01/04/2016 | | 200 |
| Cash and cash equivalents as at 31.03.2017 | | 2 200 |

**Competency 13.0 :** **Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.1 : Emphasis the requirement and importance of interpreting financial statements**

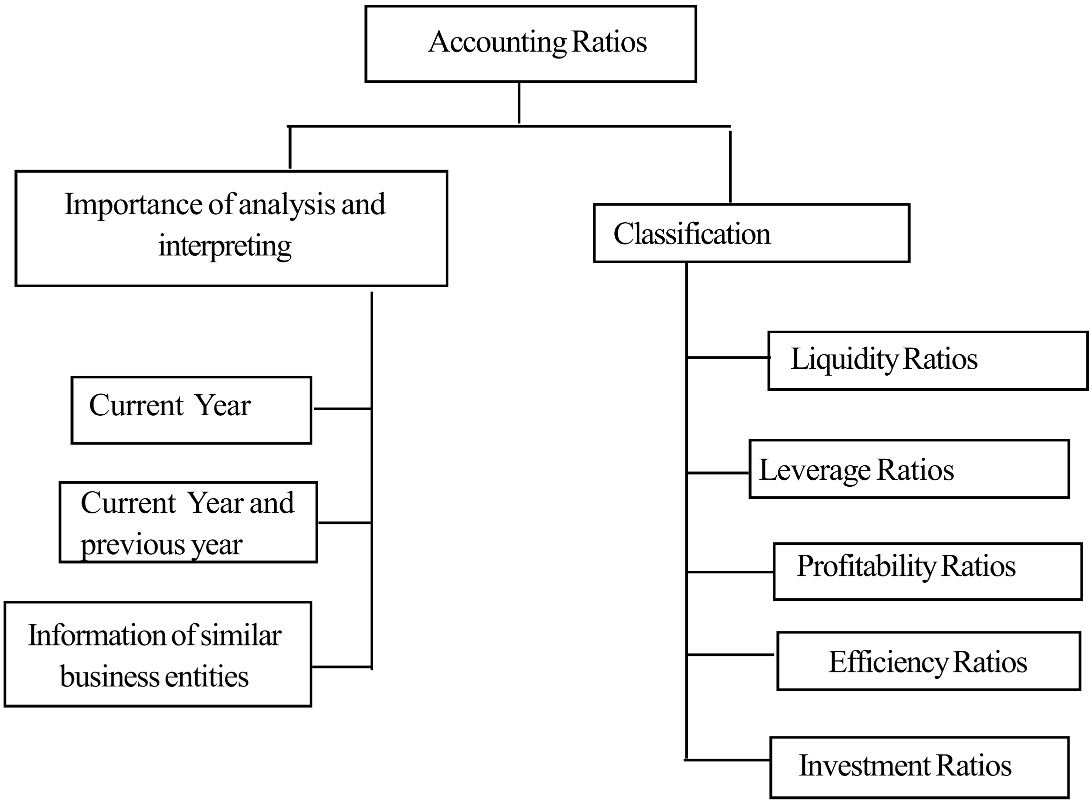
**No. of Periods :** **10**

**Learning Outcomes :**

- Explains the meaning of analyzing and interpreting financial statements.
- Presents the requirements of analyzing and interpreting financial statements.
- Explains the ability of using various ratios as a technique to analyze and interpret financial statements.

**Basic terms and concepts**

**Concept Map**



- Real status of business cannot be understood just by referring the information available in the financial statements. Information can be presented in more meaningful manner by using accounting ratios. This process is simply defined as "analyzing and interpreting financial statements."

- Following requirements can be attained by analyzing and interpreting financial statements.
    - Can recognize the status of a business analytically than the available information in financial statements.
    - Estimation of future financial status, profitability and liquidity.
    - Can assess present status of the business.
    - Can compare current year data with previous years or with other similar business entities.
    - Guide to make suitable decisions.

- Accounting ratios are classified as follows for the need of decision making.
    - Liquidity ratios
    - Leverage ratios
    - Profitability ratios
    - Efficiency ratios
    - Investment ratios

**Assessments and Evaluation Criteria :**

- Notify the importance of accounting ratios for decisions making
- Classify accounting ratios as requirements
- Notify the areas subject to compare using accounting ratios

**Competency 13.0 :** **Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.2 : Calculates and Interprets liquidity ratios**

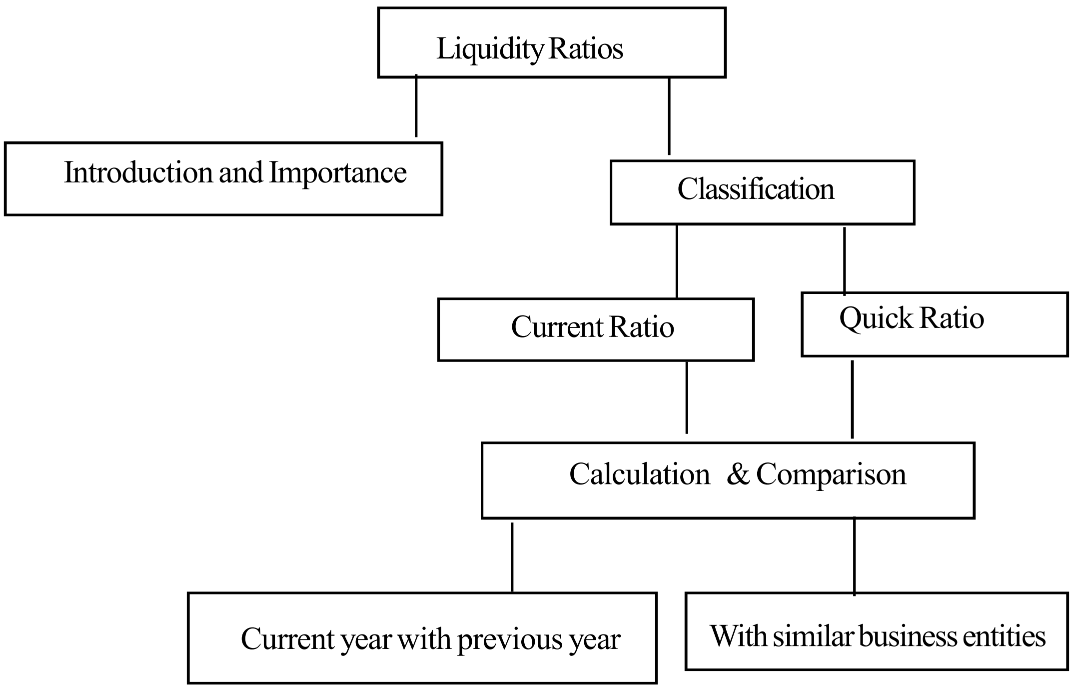
**No. of Periods :** **06**

**Learning Outcomes :**

- Explains "Liquidity ratios."
- Names and describes types of the liquidity
- Calculates current ratio
- Calculates quick ratio
- Makes decisions comparing ratios..

**Basic terms and concepts**

**Concept Map**



## Instructions for Activities :

Present following instructions to student.

**Extract of financial statement.**

| 31.03.2016 (Rs.'000) | | 31.03.2015 (Rs.'000) |
|---|---|---|
| 450 | Inventory | 500 |
| 300 | Trade receivables | 200 |
| 150 | Cash and cash equivalents | 300 |
| 250 | Trade payables | 350 |
| 50 | Accured Expenses | 50 |

- Get the answers for following questions referring above information?
- Ask them to calculate current assets, and current liabilities for each year.
- Let them obtain current ratio by comparing current assets and current liabilities for each year.
- Notify them the ratio between current assets after removing inventories with current liabilities as quick ratio.
- current ratio used to measure the short term liquidity.
- It shows the ability of repaying current liabilities. Standard ratio for current ratio is 2 : 1 (current assets : current liabilities). Current ratio can be calculated as

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

- Quick ratio is obtained by comparing the amount remained after deducting inventory and prepaid expenses from current assets with current liabilities.
- Liquidity ratios are important to assess the short term solvency.
- Liquidity ratios can be used to make decisions relating to short term financing of a business by comparing them with previous year or similar business entity.

**Assessments and Evaluation Criteria :**

- Notify the importance of calculating liquidity ratios.
- Following details are relating to Hansini's business and a competitive business of it, Shinsa's business as at 31.03.2018

| | Hansini (Rs.'000) | Ahinsa (Rs.'000) |
|---|---|---|
| Inventories | 6 000 | 7 000 |
| Trade reveivables | 4 000 | 6 000 |
| Prepaid expenses | 2 000 | 3 000 |
| Trade Payables | 8 000 | 9 600 |
| Accrued expenses | 4 000 | 2 400 |
| Cash and cash equivalants | 6 000 | 8 000 |

1. Calculating following ratios from each business
   - current ratio
   - quick ratio
2. Which business is more efficient considering liquidity. Explain with reasons.

**Competency 13.0 :** **Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.3 : Calculating and interprets Leverage Ratios**

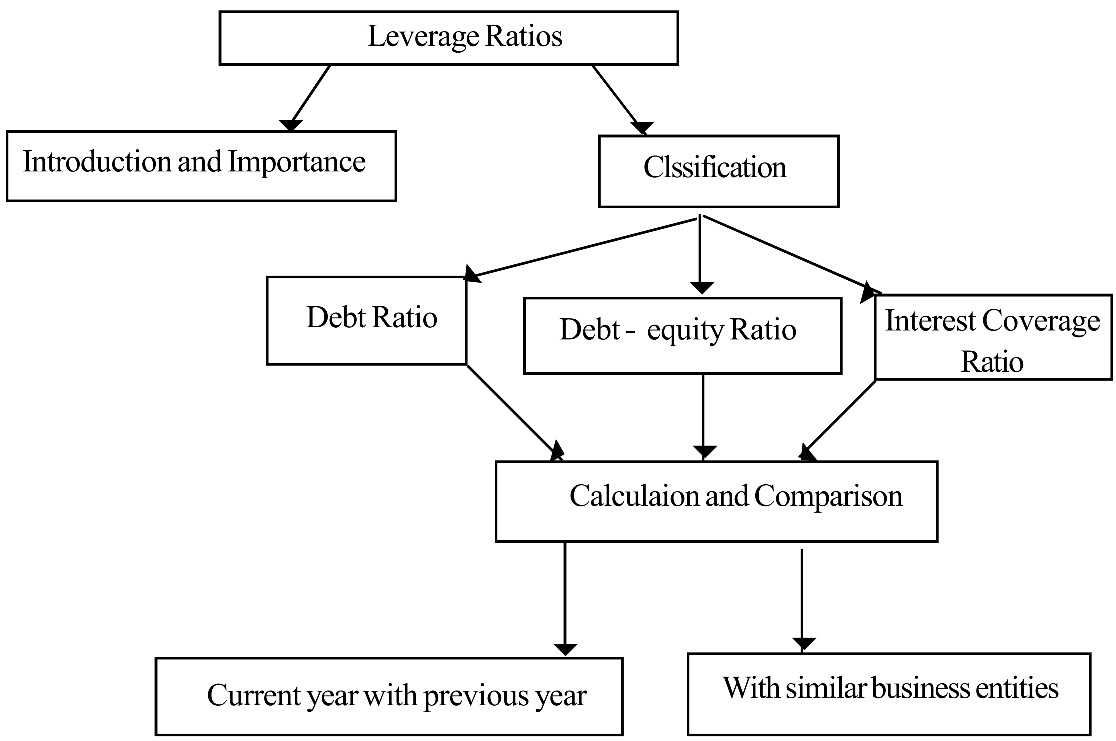
**No. of Periods : 06**

**Learning Outcomes :**

- Explains "Leverage ratios."
- Calculates Debt Ratio
- Calculates Debt-Equity Ratio
- Calculates interest coverage ratio
- Make decisions comparing ratio.

**Basic terms and concepts**

**Concept Map**



**Instructions for Activities :**

- Present following information to students.

**Extracts of statement of financial position**

| 2016.03.31 (Rs.'000) | | 2017.03.31 (Rs.'000) |
|---|---|---|
| 8 000 | Stated capital (Rs. 20) | 12 000 |
| 2 000 | Reserves | 3 000 |
| 5 000 | 12% Bank Loan | 4 000 |
| 6 000 | Current liabilities | 9 000 |

Profit before tax of each year was 10% from equity.

Obtain answers for following questions refering above information.

- Calculate equity capital for each year
- Calculate Total capital for each year
- Calculate the presentation of debt capital from total capital for each year
- Present the debt capital as a ratio of equity capital
  (Debt capital : equity capital)
- Calculate the value by adding profit before tax and interest expense for each year.
- Present the answer obtained by dividing value obtained by adding profit before tax and interest from interest expense as number of times.
- Long term financial stability of a business is measured by using the leverage ratios
- Long term solvency can be studied by comparing equity capital and debt capital
- It is necessary to evaluate the ability of paying interest for long term loans.

Ratios to be studied under Leverage ratios.

- Debt ratio
- Debt – equity ratio
- Interest coverage ratio

**Debt ratio**

Debt ratio is used to measure the percentage of debt capital from total capital. Long term loans with fixed interest rate are considered under debt capital.

$$\boxed{\text{Debt ratio} = \frac{\text{Debt capital}}{\text{Total capital}} \ \mathbf{x\ 100}}$$

Debt capital = Long term loans with fixed interest rate

Total capital = Ordinary share capital + Reserves + Long term loans

- **Debt – Equity Ratio**

Relationship between debt capital and equity capital is presented as Debt-equity ratio. If debt capital is greater than equity capital it is recognized as **high leverage** where, debt capital is lower than equity capital, it is refered as **low – leverage.**

Debt capital : Equity capital or

$$\text{Debt-equity ratio} = \frac{\text{Debt capital}}{\text{Equity capital}} \textbf{ or } \frac{\text{Debt capital}}{\text{Equity capital}} \textbf{ x 100}$$

Equity capital = Ordinary share capital + reserves

**Interest Coverage Ratio**

This ratio is considered whether business earned enough profit to cover the interest for long term loans. High value for interest coverage ratio is exhibited the safety of loan provided.

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before tax } + \text{interest}}{\text{Interest}}$$

**Assessments and Evaluation Criteria :**

- Explains the objectives of calculating leverage ratio.
- Following extracts of statement of financial position is of Rohin's business

| | **03.31.2016** | **03.31.2017** |
|---|---|---|
| | (Rs.'000) | (Rs.'000) |
| Stated Capital Ordinary Shares ar Rs. 25/- | 20 000 | 24 000 |
| General Reserves | 4 000 | 6 000 |
| Revaluation Reserves for PPE | 5 000 | 9 000 |
| Retained Earnings | 11 000 | 6 000 |
| 12% Bank Loan | 20 000 | 20 000 |
| 10% Mortgage loan (4 years) | 5 000 | 2 000 |
| Current liabilities | 12 000 | 15 000 |

Profit before tax is 10% from equity

Calculate the following ratios

- Debt equity ratio
- Debt ratio
- Interest Coverage ratio

- Present your opening on long term financial stability of this business.

**Competency 13.0 : Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.4 : Calculating interprets Profitability Ratios**

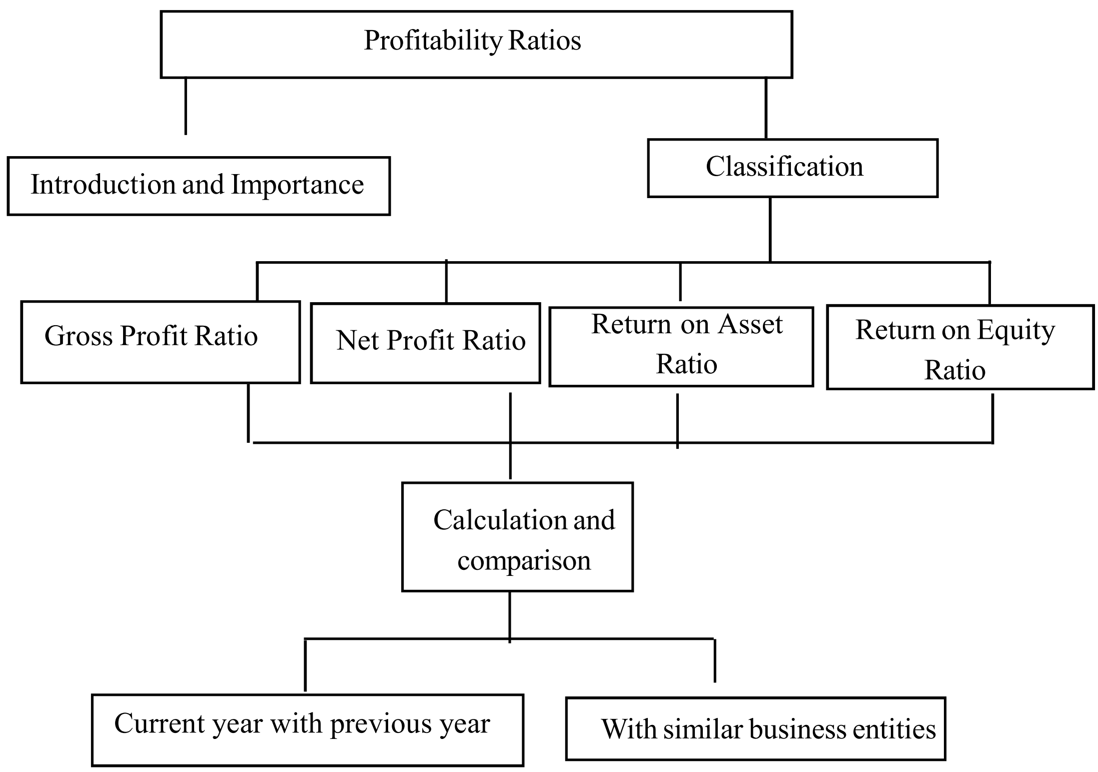
**No. of Periods : 06**

**Learning Outcomes :**

- Explains profitability ratios
- Names and explains types of profitability ratios
- Calculates Gross profit ratio
- Calculates Net profit ratio
- Calculates Return on Assets ratio
- Calculates Return on Equity ratio
- Makes decisions by comparing ratios

**Basic terms and concepts**

**Concept Map**



**Instruction for Activities**

Distribute following financial statements among students.

**Randika PLC**
**Statement of Profit or Loss**

| 2017.03. 31 (Rs.'000) | | 2017.03. 31 (Rs.'000) |
|---|---|---|
| 10 000 | Sales | 8 000 |
| (6 000) | Cost of Sales | (5 600) |
| 4 000 | Gross Profit | 2 400 |
| (1 500) | Operating Expenses | (1 000) |
| 2 500 | Profit before tax | 1 400 |
| (750) | Income Tax | (420) |
| 1 750 | Profit for the Period | 980 |

**Randika PLC**
**Statement of Financial Postiion**

| 2017.03. 31 (Rs.'000) | | 2017.03. 31 (Rs.'000) |
|---|---|---|
| 15 000 | Non-current Assets | 12 000 |
| 10 000 | Current Assets | 8 000 |
| 12 000 | Ordinary Share Capital | 10 000 |
| 3 000 | Reserves | 4 000 |
| 2 000 | 10% Long term Loans | 2 000 |

- Get the answers for following questions for the year 2016
  - Gross profit as a percentage of sales
  - Profit for the year as a percentage of sales
  - Profit for the year as a percentage of Total assets
  - Profit for the year as a percentage of Equity
  - Notify that the percentage between Gross profit and sales is the Gross profit ratio and percentage of profit for the year from sales is Net profit ratio.
  - Percentage of profit for the year from equity is referred as return on equity.

- **Profit after deducting income tax is referred as profit for the period.**
- Calculate ratio for year 2017 as they calculated for the year 2016.
- Better year can be selected by comparing ratio for two years.
- Profitability ratios are calculated as follows.

$$\text{Gross Profit Ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

$$\text{Net Profit Ratio} = \frac{\text{Profit before tax /Profit for the year}}{\text{Sales}} \times 100$$

$$\text{Return on total assets} = \frac{\text{Profit for the year + Interest}}{\text{Total Assets}} \times 100$$

$$\text{Return on Equity} = \frac{\text{Profit for the year}}{\text{Equity capital}} \times 100$$

**When questioning the students to calculate Net profit ratio, the paper setter should mention clearly that whether to use profit before tax or profit for the year.**

**Criteria for Assessment and Evaluation :**

- Briefly explains the advantages of calculating profitability ratios
- Financial year of Capital PLC was ended as at 31.03.217. Annual sales were Rs. 500 000. Gross profit was 40% of sales. Operating expenses except interest were Rs. 65 000 and interest expenses were Rs. 15 000. Income tax for the year was Rs. 30 000.
- Total Assets were Rs. 60 000 and Equity were 75% of assets.
- Calculate the following ratios.
    - Net Profit Ratio (before tax)
    - Return on total assets ratio
    - Return on equity ratio
    - Propose the actions to be taken in order to reach gross profit ratio up to 30%

**Competency 13.0 : Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.5 : Calculates and interprets efficiency ratios**

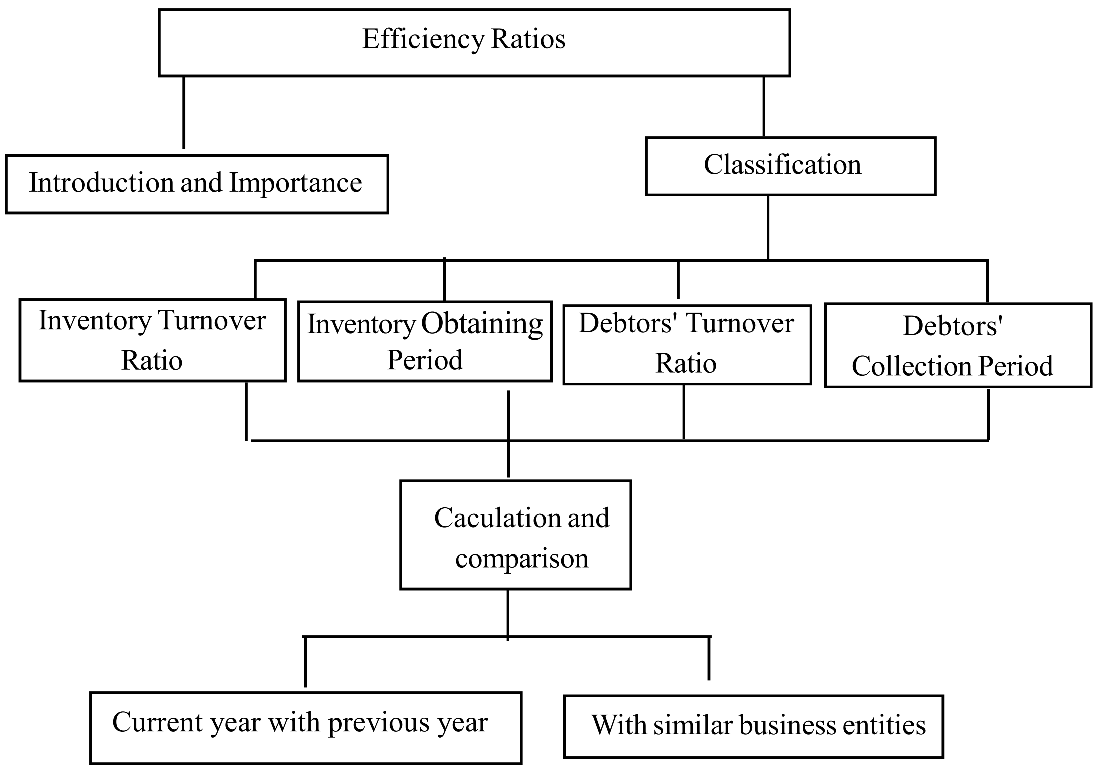
**No. of Periods : 06**

**Learning Outcomes :**

- Explains efficiency ratios
- Names and explains types of efficiency ratios
- Calculates inventory turnover ratio
- Calculates inventory obtaining period
- Calculates debtors' turnover ratio
- Calculates debtors' collection period
- Makes decisions by comparing ratios

**Basic terms and concepts**

**Concept Map**



**Instructions for Activities**

- Present following details to students
- Following information were obtained from financial statements of Kalpani PLC, in which financial year was ended at 31.03.2018

| | Rs.'000 |
|---|---|
| Credit sales | 90 000 |
| Credit purchases | 60 000 |
| Inventory as at 01.04.2017 | 8 000 |
| Trade debtors as at 01.04.2017 | 16 000 |
| Inventory as at 31.03.2018 | 12 000 |
| Trade debtors as at 31.03.2018 | 14 000 |
| Operating expenses | 9 000 |

Obtain the answers for questions below referring above details

- Calculate cost of sales
- Calculate average inventories
- Obtain the answer by dividing cost of sales from average inventories, and present it as number of times.
- Obtain the answer by dividing average inventories from cost of sales and multiply it by 365 days.
- Calculate average trade debtors.
- Obtain the answer by dividing credit sales from average trade debtors and present it as number of times.
- Obtain the answer by dividing average trade debtors from credit sales and then multiply it by 365 days; express the answer in number of days.

1. Stock turnover ratio $= \dfrac{\text{Cost of sales}}{\text{Average stock}}$

2. Stock obtaining period $= \dfrac{\text{Average stock}}{\text{Cost of sales}} \times 365$ or $\dfrac{\text{365 Days}}{\text{stock turnover ratio}}$

3. Debtors' turnover ratio $= \dfrac{\text{Credit sales}}{\text{Average debtors}}$

4. Debtors' collection period $= \dfrac{\text{Average debtors}}{\text{Credit sales}} \times 365$

Periods can be calculated in weeks or months also

**Assessments and Evaluation Criteria :**

- State the benefits of efficiency ratios
- Ratios calculated by Hasini PLC for 2 years are given below.

| | 2017 | 2018 |
|---|---|---|
| Inventory Turn Over Ratio (No. of times) | 18 | 15 |
| Inventory holding period (days) | 20 | 24 |
| Debtors' Turn over Ratio (No of times) | 10 | 12 |
| Debtors' collection period (days) | 36 | 30 |

Answer for followings referring above

- Year in which sales were more efficient.
- Year in which debtor collection was more efficient.
- Year in which the operations were more efficient

**Competency 13.0 : Presents information required for management to decision making by analyzing and interpreting financial statements using ratios.**

**Competency level 13.6: Calculates and interprets investors' ratios**

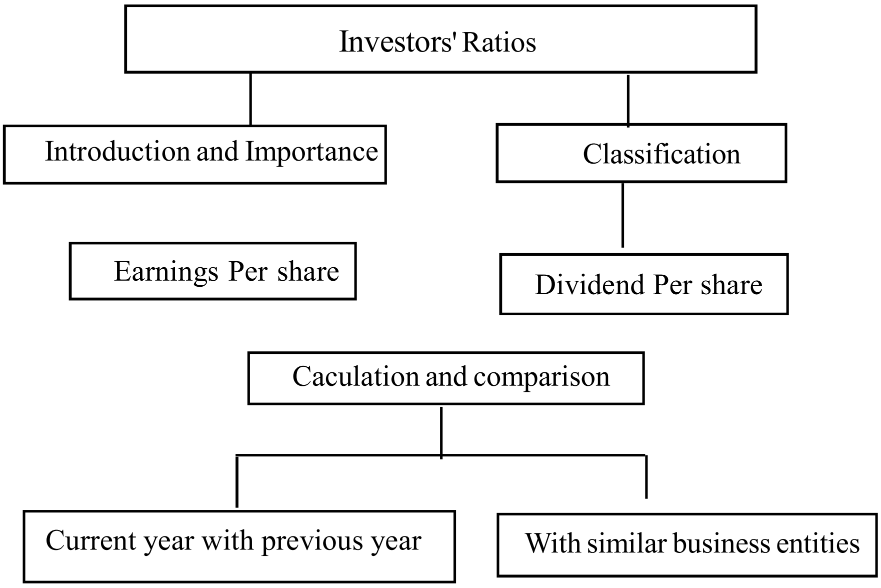
**No. of Periods : 06**

**Learning Outcomes :**

- Explains investors' ratios
- Names and explains types of investors' ratios
- Calculates earnings per share.
- Calculates dividend per share.
- Makes decisions by comparing ratios

**Basic terms and concepts**

**Concept Map**




**Instructions for Activities**

Extracts of statement of changes in equity for the year ended 31.03.2018 at Dewmini PLC given below.

| | Ordinary Share Capital | General Reserves | (Rs.'000) Retained Earnings |
|---|---|---|---|
| Balance as at 01.04.2017 | 10 000 | 2 000 | 1 000 |
| Profit for the year | - | - | 4 000 |
| General reserve | - | 500 | (500) |
| Dividend paid | - | - | (1 000) |
| Balance as at 31.03.2018 | 10 000 | 2 500 | 3 500 |

- Consideration of an ordinary share as at 31.03.2018 was Rs. 20/-
  - Inquire about the possibility of distributing profits for ordinary share holders for the year 2018
  - Inquire about the amount paid as interim dividends for the year.
  - Inquire about the number of shares issued by the company.
  - Notify that earnings per share is calculated by dividing profit for the year from the number of ordinary shares.
  - Notify that dividend per share is calculated by dividing dividends for the ordinary share holders from the number of ordinary shares.
  - Investor's ratios can be calculated as follows.

$$\text{Earnings per share} = \frac{\text{Profit for the year}}{\text{Number of Ordinary Shares}}$$

$$\text{Dividend per share} = \frac{\text{Dividends for ordinary shares for the year}}{\text{Number of Ordinary Shares}}$$

**Criteria for Assessment and Evaluation:**

- State the uses of investors' ratios for an entrepreneur
- Way of calculating earnings per share
- Way of calculating dividend per share
- Following details were obtained from similar type of companies.

| | A Ltd | B Ltd |
|---|---|---|
| Earning per share (Rs.) | 24.75 | 18.25 |
| Dividend per share (Rs.) | 10.50 | 10.50 |

- State the most suitable company for investment.

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting.**

**Competency level 14.1 : Make use of Management Accounting for Decision Making.**

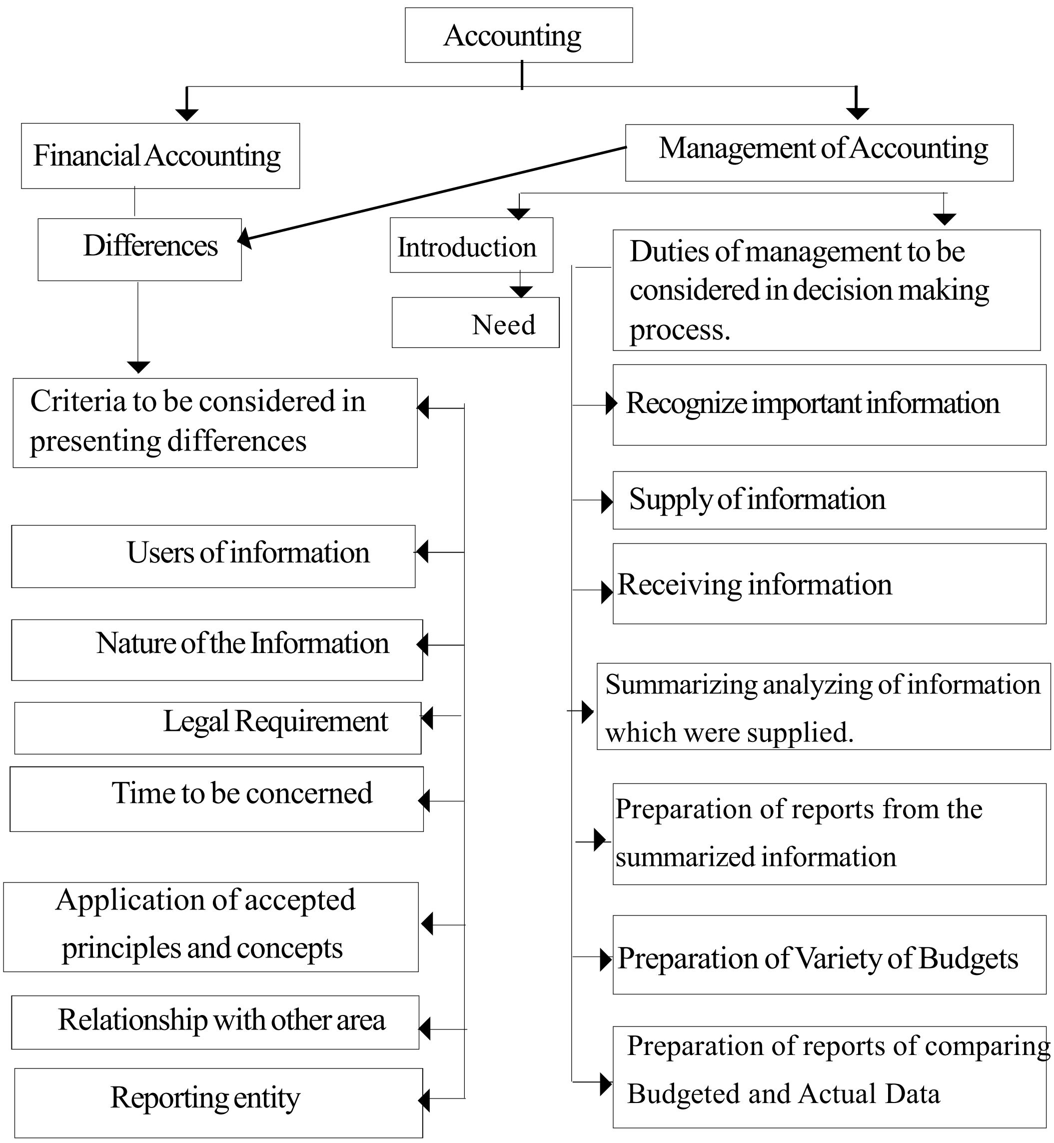
**No. of Periods : 06**

**Learning Outcomes :**

- Explains management accounting.
- Names duties of management to be considered in making management decision making.
- Tabulate the differences between management accounting and financial accounting.

**Basic terms and concepts**

**Concept Map**



**Proposed instructions for Teaching – learning process**

- Explains subject matter and content of the subject related to this competency level.
- Accounting can be divided into two types. They are,
  1. Financial Accounting
  2. Management Accounting
- Cost accounting is discussed as a sub section of Management Accounting.
- Management Accounting means provision of relevant information what will assist management to make decisions by collecting and arranging relevant data.
- Association of Chartered Certified Accountants defines management as follows.
- "Providing management accounting techniques to help you support business to plan, control and monitor performance."
- Management accounting means providing financial and non financial information for all the managerial levels.
- Need of management accounting can be summarized as follows.
  - provide information for management decisions.
  - Identify differences and make necessary corrections by comparing estimated situations and actual situations.
  - Provide appropriate solutions in order to solve problems arises in operational activities.
  - Preparation of reports and evaluation of efficiency of different sections of the business.
  - provide past and future situations in order to make future plans.

Management duties to be considered in making management decisions.

- Provide financial accounting and cost accounting information to managers
- Classifying an analyzing of information collected.
- Arrange financial, cost data and data collected from other areas according to the requirement of the managers.
- Preparation of reports from the summarized data.
- Preparation of budgets for management activities.
- Preparation of reports by comparing Budgeted and Actual Circumstances.
- Different bases, criteria identifying dissimilarities between management and financial accounting.

| Basis / Criteria | Management Accounting | Financial Accounting |
|---|---|---|
| • Parties who use information | Managers/internal parties | Both external and internal parties |
| • Nature of information | Monitory and non monitory information which helps management to make decisions. | Information which can be measured in monitory terms |
| • Legal Requirement. | No legal requirement | Legal requirements should be satisfied. |
| • Time to be considered | Present and future information | Past activities |
| • The reporting period. | No specified time period for report. Reports prepared based on different departments or needs of the management. | Reports prepared for an accounting period. |
| • Application of accepted principles and concepts | Based on management requirement. | Should prepare accounting to Sri Lanka Accounting Standards. |
| • Reporting entity | The whole organization is not considered at once. Each area of department considered separately. | Reports prepared as one entity. |
| • Relationship between other areas | Information provided to economics financial and information statistics beyond accounting | Limited only for accounting field. |

**Assessment and Evaluation criteria :**

(i) What are the main types of accounting?

(ii) Explain the meaning of management accounting

(iii) What are the management duties to be considered in making decisions?

(iv) Differentiate management and financial accounting based in criteria.

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**

**Competency level 14.2 : Anasyles basic concepts of Management Accounting**

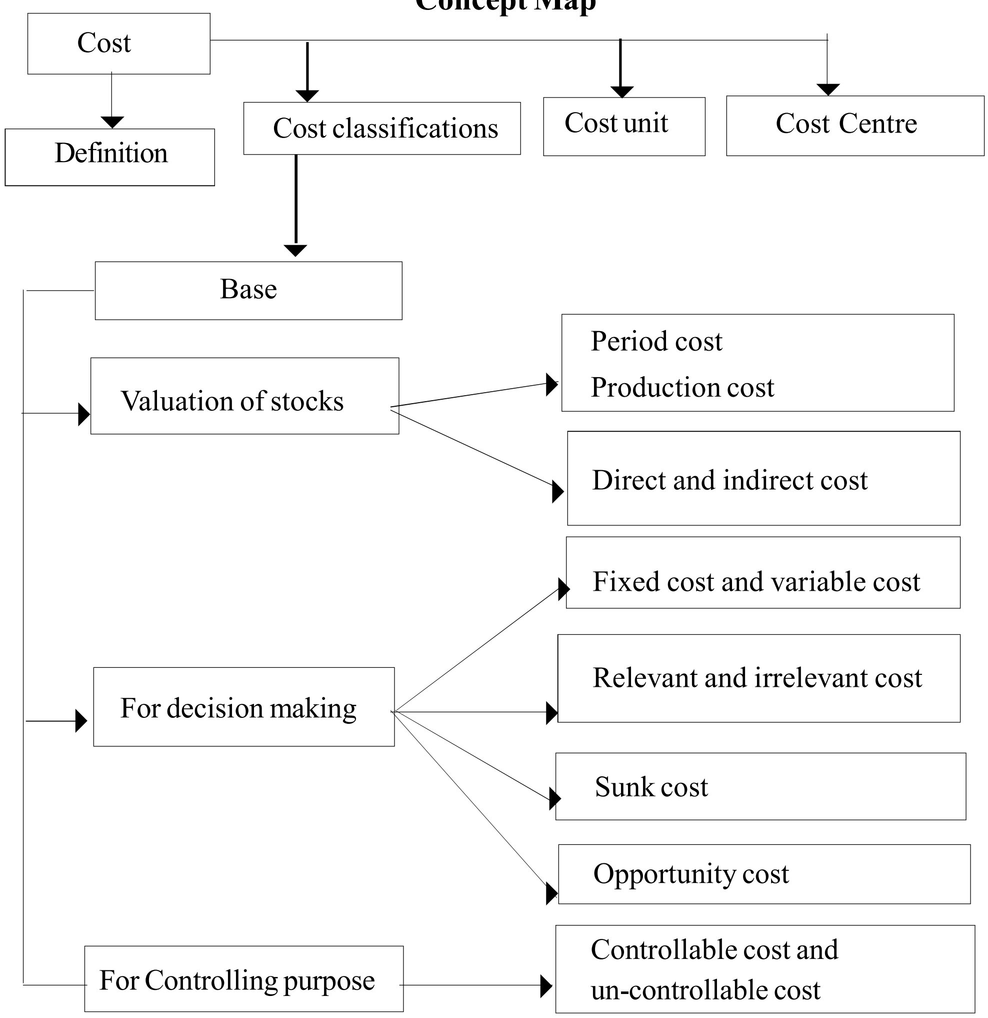
**No. of Periods : 14**

**Learning Outcomes :**

- Explains cost, cost unit and cost centre.
- Classifies cost based on different objectives of management
- Explains and names classification of costs for valuation of stocks.
- Classifies costs for decision making
- Classifies costs for controlling purpose

**Basic terms and concepts**

**Concept Map**



**Proposed instructions for Teaching-learning Process**

- Explains subject matter and subject content of related to this competency level.
  - Sahan Abeynayake who runs a business near express way with three departments of consumer selling, sweets outlet and stores. Following expenses estimated to be incurred for 1 Kg of rice.

| | (Rs.) |
|---|---|
| Rice (1kg) | 80.00 |
| Three vegetables 250g each | 120.00 |
| Fish | 100.00 |
| Spices | 30.00 |
| Coconut | 50.00 |
| Gas / Fire wood | 30.00 |
| Other expenses | 40.00 |

- He decided to prepare 6 packets of lunch from 1 kg of rice and also he makes his own decisions.
- Inquire student ideas highlighting following :
- Manager requires related cost in order to make decisions of the business.
- There are different departments in an organization and it is required to collect costs of each department.
- Makes decisions like, calculation of cost per unit from total cost, calculation of selling price, valuation of stocks.

**Cost concepts**

- **Cost**

  Value of economic resources sacrificed in order to purchase or to provide service.

- **Cost Unit**

  A quantitative measurement used to calculate cost of a product or service.

- **Cost Centres**

  It is a place, activity, equipment or a person in relation to a cost unit to identify and management of cost.

**Classification of cost**

It can be classified according to the need of management.

- Cost classification for stock valuation

  Cost accounting provides information in order to value inventories.

  Cost can be classify as follows.

  - Product cost
  - Period Cost

- Period cost means total cost incurred to produce goods or services. A cost which can be identifiable with a product, changes with the volume of production are known as direct cost (prime cost), cost incurred in common, do not change with the volume of production. Known by the name of indirect production cost (Production overheads)

- Cost which are debited to profit and loss account (Income statement) against income of a particular period known by the name of period cost.

**Cost classification for decision making**

- Behaviour of a cost should be identified in order to prepare budgets, profit planning, preparation and operating of plans for financial control. Cost can be classified as follows.

  - Variables and fixed cost
  - Relevant and irrelevant cost
  - Sunk cost
  - Opportunity cost

- Any cost that changes directly in proportion to the volume of production, activity level or sales volume known by the name variable costs, variable cost per unit is a fixed value. Whereas total variable cost varies with the level of production or sales volume.

- Any costs which do not changes with the activity level or volume of sales known by the name fixed costs, Total fixed costs do not change but unit fixed cost changes with the activity level or volume of sales.

- If any cost directly relevant to a decision is known by the name relevant costs, and other cost which are not discussed under relevant costs are known by the name irrelevant costs.

- Irrelevant costs is already incurred as a result of a past decision made by the management known by the sunk cost.

- Next best return forgone when selecting best alternative from several alternatives known by the name opportunity costs.

- Cost classification for controlling purpose.

  Classification of cost based on responsibilities of managers to minimize or to control the cost. And thereby cost can be clarify as follows.

  - Controllable costs
  - Un- Controllable costs

  Any cost behaves within the responsibility of manager of an organization is known by controllable cost. Whereas any costs which do not behaves with the responsibility of manager of an organization is known by uncontrollable costs.

**Assessment and Evaluation Criteria:**

1. What is the cost unit used in following cost centres :
   - A bakery
   - A hospital
   - An electricity supply organization
   - A cinema
2. Piyal started a furniture shop on 01.01.2018 by withdrawing Rs. 400 000 from a 12% fixed deposit. He registered his business by the name "Dewa Shakhty" by incurring registered fee of Rs. 2500.

   For furniture they incurred.

   - Purchase of machinery for Rs. 80 000
   - Obtain a building for a monthly rent of Rs. 8 000
   - Payment of Rs. 3 000 per finished table allocated for each carpenter.
   - Purchased 400sq.ft of timber at a price of Rs. 400 per sq.ft and for each table it is required 18sq.ft of timber.
   - Rs. 18 000 incurred for factory insurance and electricity
   - Incurred Rs. 4 000 for sand papers and polish
   - Should include equipment depreciation of Rs. 3000 (for 3 months)
   - Included other factory expenses of Rs. 19 000.
   - During the quarter ended 31.03.2018. They manufactured 20 tables out of which 15 were sold.

Based on the above information, answer the following questions.

(i) Calculate period cost and product cost

(ii) What is the value of remaining stock as at 31.03/2018 (Raw material and finished stock)

(iii) Calculate variable and fixed costs separately.

3. Explain following in brief by giving examples

(i) Irrelevant cost

(ii) Sunk cost

(iii) Opportunity cost

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**

**Competency level 14.3 : Uses Process of Material Control**

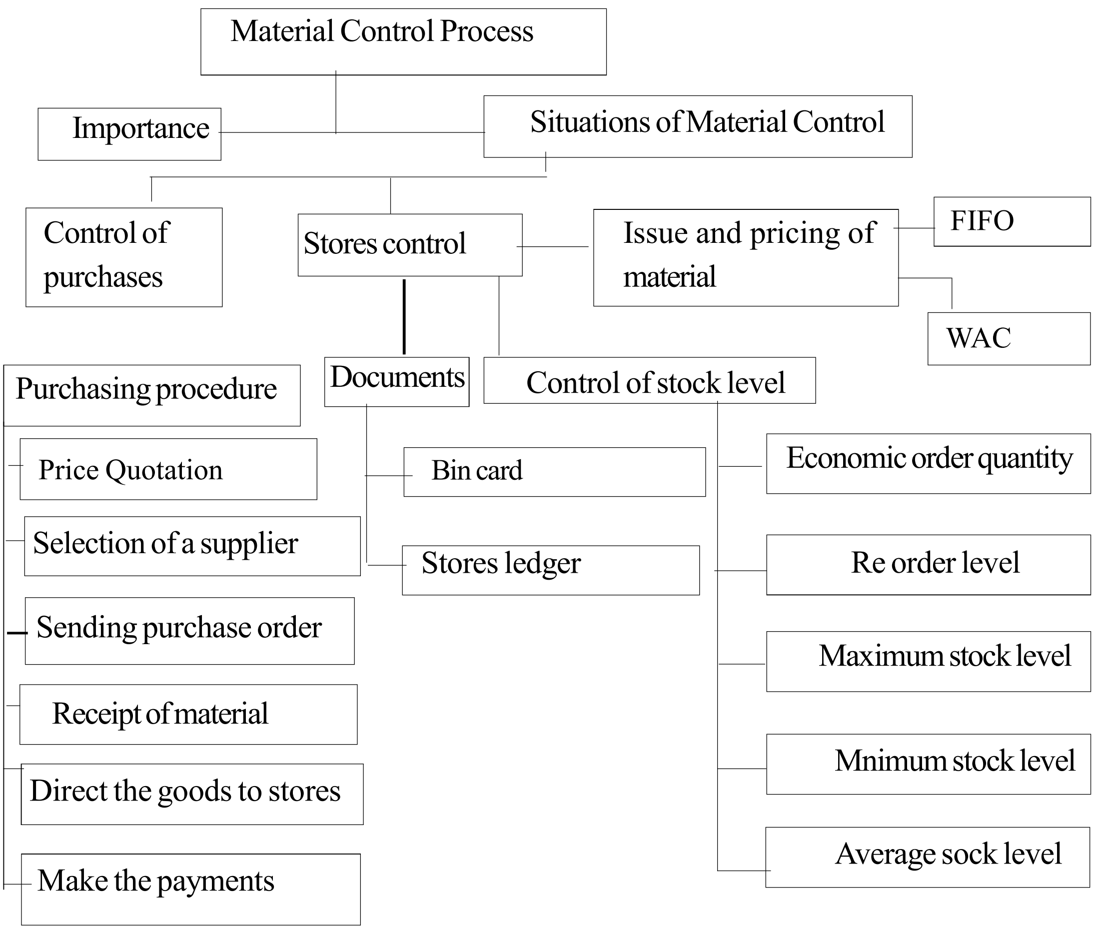
**No. of Periods : 10**

**Learning Outcomes :**

- Explain importance of material control
- Names situations of material control
- Presents purchasing procedure
- Presents techniques of material control
- Calculates Economic order quantity
- Names documents related to material control
- Calculate re order level
- Calculate maximum stock level
- Calculate minimum stock level
- Calculate average stock level
- Apply FIFO method and WAC for pricing and issue of stocks.

**Basic terms and Concepts**

**Concept Map**



**Teaching learning process**

Explain subject matters and content of the subject related to this competency level.

Discuss with students importance of controlling daily consumable goods like rice, sugar, milk, tea, which were purchased in bulk for a once a month, store then appropriately in bins and also store in small containers for daily requirement.

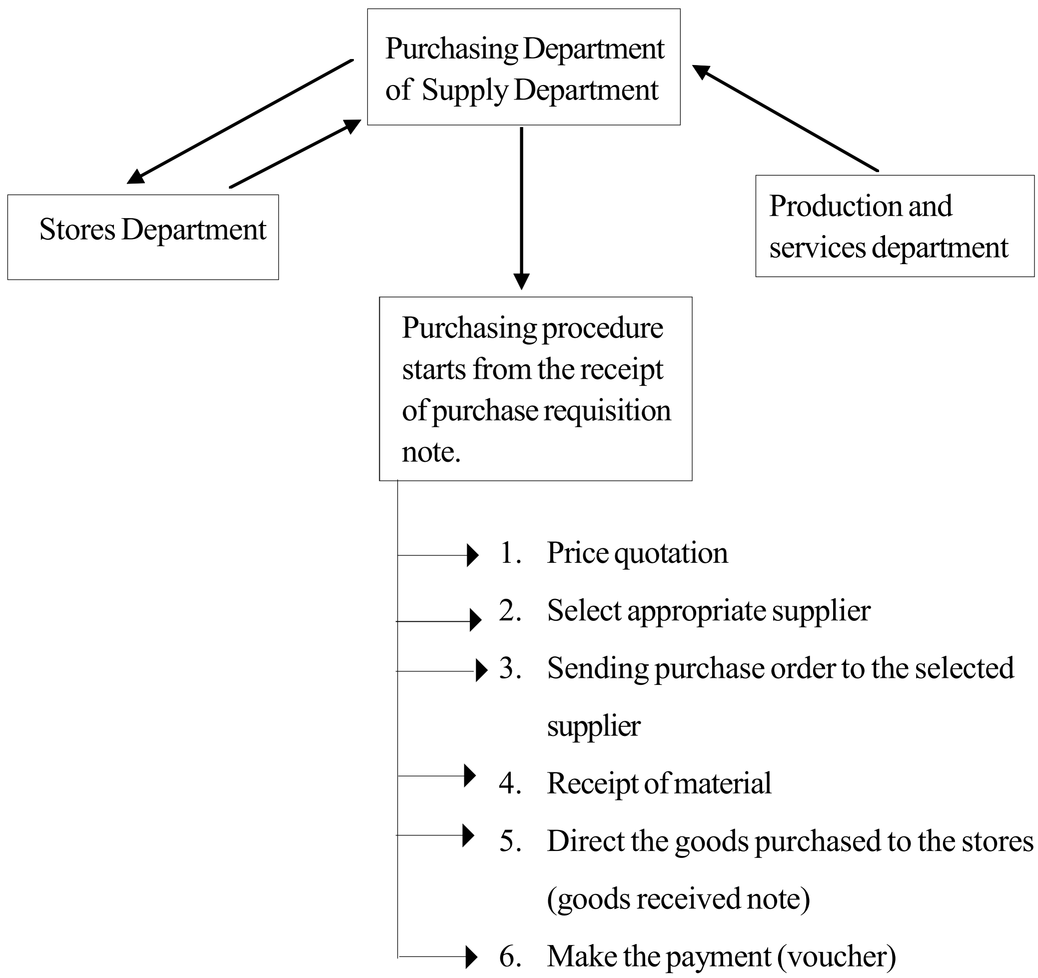
Discuss the way of stock control techniques.

- Inquire students ideas of stock control techniques.
- Controlling of material purchases
- Controlling of store of materials
- Controlling of issue of stocks

Direct and indirect materials used and produced on or supplying if service is known by materials, importance of controlling rich cots are as follows.

- Working capital will not unnecessarily tied up with stocks.
- Minimize cost of purchase and cost of maintaining stocks.
- Carry out production activities without only obstruction
- Minimizing of stock wastage
- Can avoid urgent purchases
- Report stock detail to the management

It is required to maintain stock control according to a procedure. Following diagram shows purchasing procedure, and documents used.




1. Production or service department requests raw materials from stores by issuing material requisition note.
2. Inquire whether the stores have enough materials.
3. Following answers are provided by the stores to supply department.
   - Note enough material in store.
     Direct purchase requisition note to supply department indicating required quantity.
   - Enough materials are available in store. No need of purchase.
   - Recording of materials received. Store them accordingly, pricing of material, issues from stores are maintained by the stores. Also maintain different techniques for stock control.

- Source documents used in material control.
  - Bin card
  - Stores ledger
- Bin card includes details of receipt and issues of material and balance stock for a day.
- Stores ledger is a statement which shows receipt of material and issues of material and balance stock **with values.** LKAS 02 recommends methods to be used in pricing of material issues.
  1. First In First Out (FIFO)
  2. Weight Average Cost (WAC)
- According to FIFO method materials in the stores are issued by using price of the firstly purchased materials after finishing first quantity batch prices of next purchased batch showed be used (Discuss under competency level 11.4).
- Weight Average cost method uses the prices calculate by dividing total value of material from quantity of material issues (Discuss under competency level 11.4).
- Economic order quantity means the quantity to be purchased at a time to minimize total cost from ordering and holding expenses.
- Assumptions used in EOQ model.
  1. Annual demand is known and fixed
  2. Ordering cost is known and fixed
  3. Holding cost is fixed
  4. quantity ordered is received at once
  5. Price per unit is fixed
  6. Minimum stock level is at the zero level

  Economic order quantity can be calculated as follows.

$$EOQ = \sqrt{\frac{2DCo}{ch}}$$

EOQ means Economic Order Quantity

D – Annual consumption / Demand

Co – Cost of ordering

Ch – Annual holding cost per unit

- Following stock levels are used in stock control.
  1. Re-order level
  2. Minimum stock level
  3. Maximum stock level
  4. Average stock level
- Re-order level means the level at which material should be purchased.

| |
|---|
| Re –order level = maximum consumption X maximum lead time. |

Maximum waiting time is known as maximum lead time and maximum usage is known as maximum consumption.

- Maximum stock level means the minimum stock level to be maintained in order to carry out production without any interruption.

| |
|---|
| Minimum stock level = Re order level – (Average consumption **x** average lead time) |

- Maximum stock level is the stock level to be maintained at any given time which should not exceed. Excess stock is not good for the organization.

- Average quantity of material storage is known as average stock level. There are two usage of calculating average stock level.

| |
|---|
| Maximum stock level = Recorder level - (Minimum consumpsion **x** Minimum lead time) + Reorder Quantity |

Average stock level = Minimum stock level + $\frac{\text{Economic order Quantity}}{\mathbf{2}}$

Or

Average stock level = $\frac{\text{Minimum stock level + Maximum stock level}}{2}$

**Assessment and Evaluation :**

1. State the purpose, department who issues or receive for each of the following source documents.

| Source document | Issued by | Received by | Purpose |
|---|---|---|---|
| • Stores requisition note<br>• Goods requisition note<br>• Quotations<br>• Purchase order<br>• Delivery note<br>• Goods received note | | | |

2. Recommended methods used in issuing prices of materials.
   (i) ..................................................................
   (ii) ..................................................................

3. Following details are related to material
   - Monthly stock consumption 500 units
   - Price per unit Rs. 80
   - Cost per order Rs. 60
   - Holding cost is 10% of material cost per unit.

   1. Calculate Economic order quantity
   2. Number of orders per year

| | |
|---|---|
| Maximum consumption | – 300 units per day |
| Average consumption | – 200 units per day |
| Re order period | – average of 20 days, minimum 10 days |
| Re order quantity | – 3 000 units |

Calculate

1. Re order level
2. Maximum stock level
3. Minimum stock level
4. Average stock level

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**

**Competency level 14.4 : Records the labour cost**

**No. of Periods : 05**

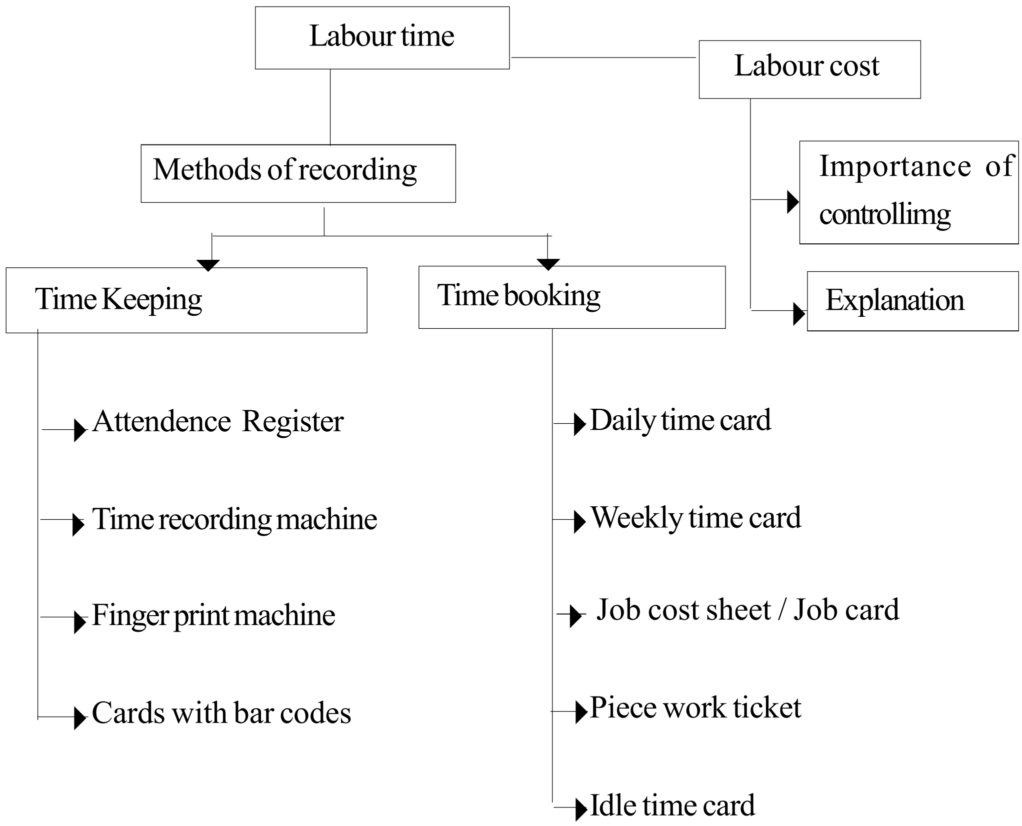
**Learning Outcomes :**

- Explains labour cost
- Presents importance of labour cost control
- Keeps records of Labour cost

**Basic trems and concepts :**

:

**Concept Map**



**Proposed Instruction for Teaching Learning Process**

Explains subject matter and Subject content related to this competency level.

Explains directly or indirectly incurred to pay wages of workers who sacrifice their labour to produce goods or service is meant by labour cost. It includes the following.

- Basic salary
- Overtime payment
- Other extra allowances
- Medical or other special allowances
- Employee Provident Fund contribution
- Employee Trust Fund

- Importance of labour cost control :
  - More attention is needed for labour cost than other resources reason being labour is a human resources,
  - A control of labour cost is important because large proportion of cost unit comprises of labour cost.
  - Can minimize cost time per unit by increasing production capacity through an improvement of labour productivity.
  - Recording of labour time can be two types
    - Time keeping
    - Time booking
- Methods of time keeping

  Attended time is the time duration between arrival and departure time of workers in an organization. There are several methods;

  **Examples** - Attendance register
  - Time recording machine
  - Finger print machine
  - Cards with bar codes

**Methods of time booking**

Records time spent by workers in different jobs or process for determining labour cost is time booking. These are variety of records depending on the nature of the organization. Following are some of the methods of time booking.

- Time cards
  - Daily time card
  - Weekly time card
- Job ticket
- Job cost sheet / Job card
- Piece work ticket
- Idle time card

- **Time card**

A sheet completed by each worker by including the time spent of each job.

A sheet/card which is used to recored the time spent on each job during the day is known as daily time card. A sheet/card records weekly time details known as weekly time card.

- **Job Ticket**

A card which contains duties, instructions to be give and required time for each job of worker is called job ticket.

- **Job cost sheet / Job card**

This is a document which will be completed by several workers who perform a particular job and transfer to the either works after finishing each worker's Job.

- **Piece work ticket**

This is a document which is be used to record the time taken by each worker to produce goods in a situation where their wages are based on output level.

- **Idle Time Card**

This is the time if any worker not engaged in any other work due to machine break downs; lack of raw materials or electricity power cuts. Idle time is also taken for the calculation of ways.

**Assessment and evaluation criteria :**

Following informations are relevant for the calculation of wages of Nisha book shop".

- Maximum working number of days for a month are 20 days. 8 hours per day. Starts from 8.00 am to 4.00 pm.
- 1.5 times per hourly rate is paid for any worker who works on Saturday and Sundays.

- Cost of living per month for a worker is Rs. 2000.
- EPF contributions
  - Employee contribution towards EPF is 10% on basic salary.
  - Employer contribution towards EPF is 15% on basic salary.

| Employee | Monthly Basic salary | No of working days | Weekend work (hour) |
|---|---|---|---|
| Kubudu | 16 000 | 20 | - |
| Sumudu | 19 200 | 20 | 10 |
| Pubudu | 20 000 | 18 | 15 |

- Calculate labour cost according to following headings.
- Basic salary
- Overtime payments
- Cost of living benefit
- EPF contribution
- Total Labour cost

(i) State the source documents used in recording labour time

(iii) What are the benefits of labour cost control.

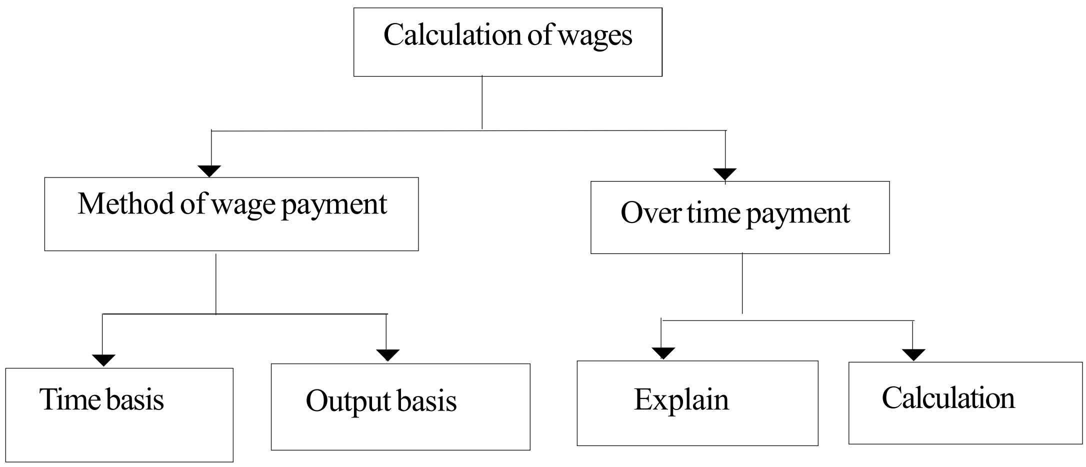
**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**
**Competency level 14.5 : Calculate labour cost based on time and output**
**No. of Periods : 05**

**Learning Outcomes :**

- Names methods of Salary payment
- Explains time and output basis
- Explains overtime payments
- Calculates overtime payments

**Basic terms and concepts** :

**Concept Map**




**Proposed Instructions and Teaching Leaning Process :**

Explain subject matter and content of the subject related to this competency level.

- There are two basis for labour cost calculation
    - Time basis
    - Output basis
- If workers are paid according to the time for which they work is known as time basis wage payment.
- It can be calculated as follows.

| |
|---|
| No of hours worked X Rate per hour = Wage |

If workers are paid according to the quantity of work dome is known as output basis wage payment. This is also known as "Piece rate" payment.

It can be calculated as follows.

| No of units produded X rate per unit = Wage |
|---|

Comparison between time basis and output basis

| Time basis | Output basis |
|---|---|
| • Wages paid based on time worked by an employee.<br>• Appropriate where output cannot be measured in quantitative terms<br>• Workers are not motivated<br>• Favourable for the apprentices.<br>• Extra supervision needed | • Wages paid based on output level.<br>• Can be used in a situation where work can be measured.<br>• Workers are motivated.<br>• Unfavourable for the apprentices.<br>• Extra supervision not needed. |

- Payment made for the extra hours worked in known as overtime payment. **Overtime wage rate is higher than the normal wage.** It can be calculated as follows.

| Overtime hours x overtime rate per hour = overtime payment |
|---|

**Assessment and Evaluation Criteria :**

(a) Number of units produced by three employees during a day are as follows. Rate per unit of output is Rs. 20.

| Employee | Units produced |
|---|---|
| Sunny | 60 |
| Winne | 55 |
| Jonie | 65 |

(b) Numbers of hours worked during the first week are as follows.

| | Monday | Tuesday | Wednesday | Thursday | Friday | Saturday | Sunday |
|---|---|---|---|---|---|---|---|
| Amal | 8 | 8 | 8 | 8 | 8 | 5 | 4 |
| lakmal | 8 | 8 | 8 | 8 | 10 | 6 | 4 |
| Kalpani | 8 | 8 | 8 | 8 | 10 | - | 5 |
| Gotham | 10 | 6 | 7 | 8 | 8 | 5 | 3 |

- They should work eight hours during week days except Saturday and Sunday.Normal hour rate is Rs. 80.
- Overtime payments are as follows.
- 1.5 times per hour during weekday rate of wage
- Two times week day rate of wage for Saturday and Sunday.

**Calculate following**

(i) Total salary of each worker for a week

(ii) Overtime payment of each workers for a week

(iii) Total cost of labour

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**

**Competency level 14.6 : Prepare pay sheet**

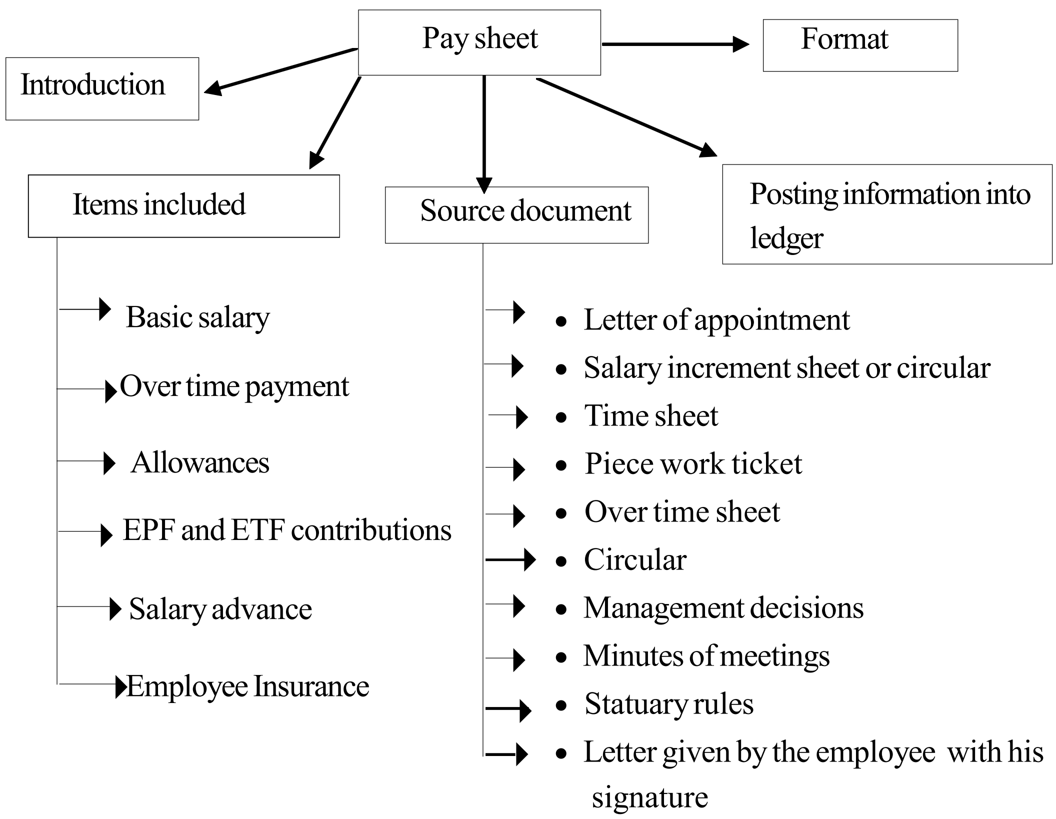
**No. of Periods : 20**

**Learning Outcomes :**

- Lists source documents appropriate for the preparation of salary pay sheet.
- States items included in a pay sheet.
    - Basic salary
    - Allowances
    - Gross Salary
    - Deductions
    - Net Salary
- Presents format of a pay sheet
- Prepares pay sheet
- Posts information in pay sheet to ledger

**Basic Terms and Concepts :**

**Concept Map**



**Proposed Instructions for learning – teaching process :**

Explain subject matter and content of subject related to this competency level.

- Pay sheet is a statement which includes total salaries. Deductions, Gross salary and EPF an ETF contribution of each employee for a particular period.

| Item | Source |
|---|---|
| 1. Basic salary / Total salary | • Letter of appointment<br>• Salary increment sheet/circular<br>• Time card<br>• Piece work ticket |
| 2. Overtime | • Overtime payment sheet, Overtime payment ticket. |
| 3. Allowances | • Circulars<br>• Management decisions<br>• Minutes of meetings |
| 4. EPF contributions<br>ETF contributions | • Statuary rules<br>• EPF Act. ETF Act |
| 5. Salary Advance<br>6. Employee insurance installment | • Letter given by the employee with his signature |

**Format of a pay sheet**

**…………………….Ltd**

**Paysheet for the month ................ year ............**

| | | | **Earnings** | | | | **Deductions** | | | | | **Contribution** | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Serial number | Employee number | Name | Basic salary | Allowances | Overtime payments | Gross salary | EPF contribution | Salary Advance | Employee loan | Total Deduction | Net salary | ETF contribution | ETF contribution | Signature of Employee |

- Following journal entries are related to the data included in pay sheet by using salary and wages control account.

1. Total Gross Salary

| | | | |
|---|---|---|---|
| Salaries and wages account | Dr | xxx | |
| Salaries and wages control account | | | xxx |

2. Total deductions from the salary

| | | | |
|---|---|---|---|
| Salaries and wages control account | Dr | xxx | |
| Relevant deduction account | | | xxx |

3. EPF contribution of employer

| | | | |
|---|---|---|---|
| EPF expense account | Dr | xxx | |
| EPF payable account | | | xxx |

4. ETF contribution

| | | | |
|---|---|---|---|
| ETF expense account | Dr | xxx | |
| EPF payable account | | | xxx |

5. Payment of net salary

| | | | |
|---|---|---|---|
| Salaries and wages account | Dr | xxx | |
| Cash account | | | xxx |

7. Net salary not paid in cash

| | | | |
|---|---|---|---|
| Salaries and wages control account | Dr | xxx | |
| Salaries and wages payable account | | | xxx |

At the end of the period balance in salaries wages account. Employee Provident Fund expense account. Employee trust fund expense account are transfered to the profit and loss (Income statement) account.

**Assessment and Evaluation criteria :**

Following salary details are related to Naotunna (PLC) Ltd for the month of march 2018.

- Standard number of labour hours per month 160
- Rate per hour is Rs. 200
- Overtime payment is 150% form the total salary
- EPF contribution from basic salary
  - Employee 10%
  - Employer 15%
- ETF contribution is 3% from basic salary.

**Required :**

(i) Pay sheet for the month of March 2018

(ii) General journal entries

(iii) Ledger accounts

**Competency 14.0 : Evaluation of Basic Concepts of Management Accounting**

**Competency level 14.6 : Absorbs Overhead Cost to a Product**

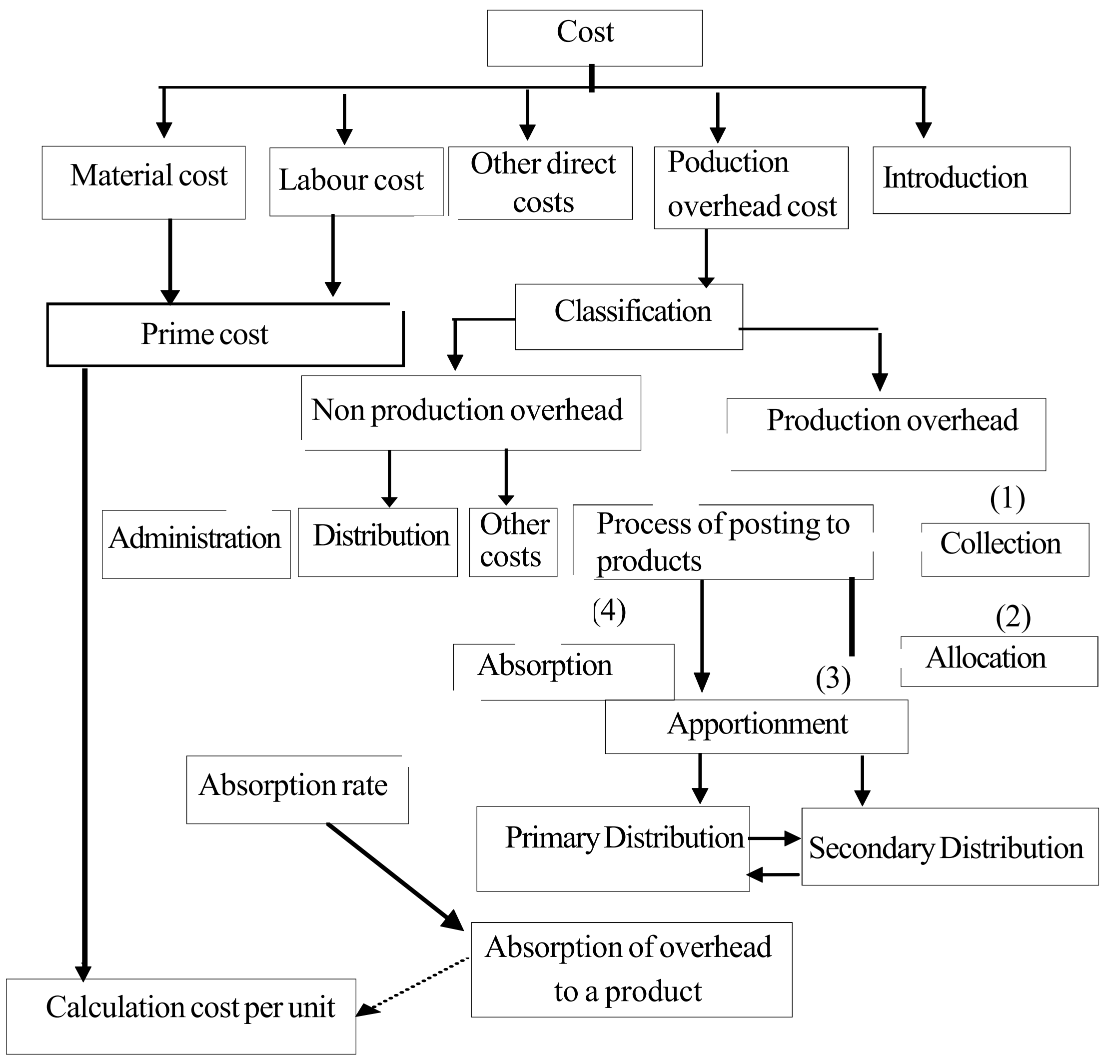
**No. of Periods : 30**

**Learning Outcomes :**

- Explains production overheads.
- Classifies production over head cost as manufacturing and non manufacturing.
- Explains and lists process of allocation of production over heads.
- Prepares production over head analysis sheet.
- Absorbs production over head to a unit of product.

**Basic Terms and concepts**

**Concept Map**



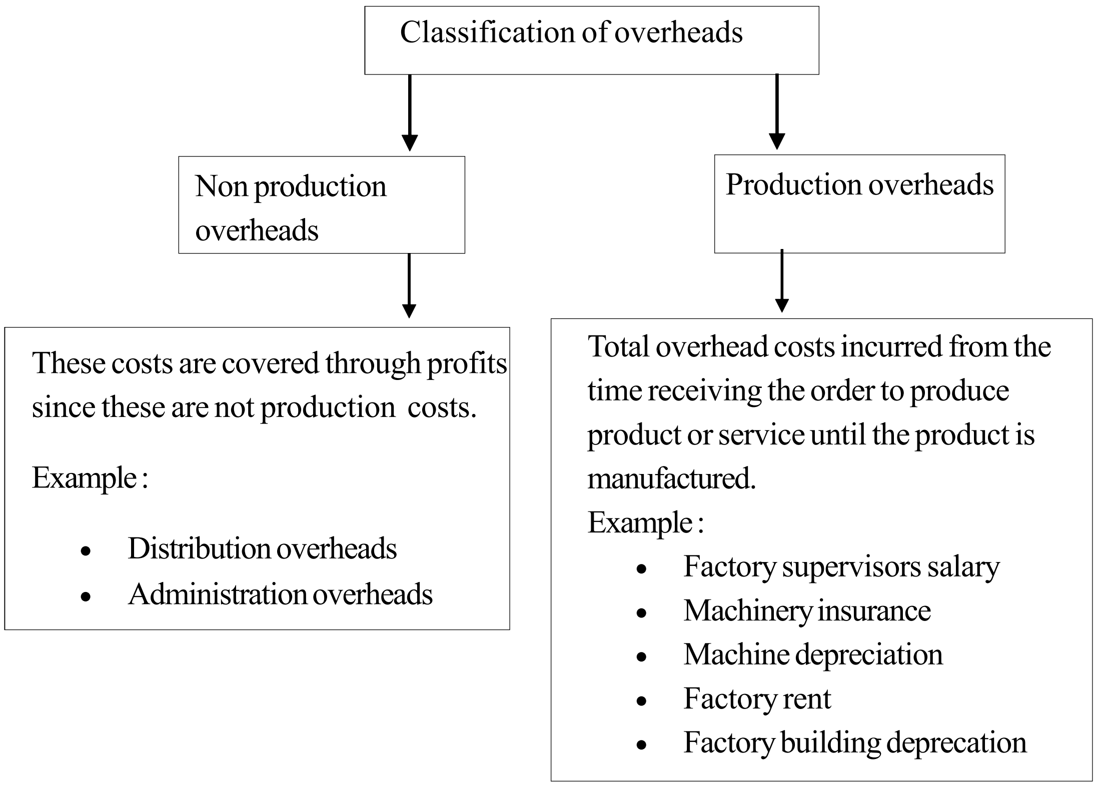
**Subject matter :**

**Production overhead  Cost**

Total common expenses incurred for large quantity of production which cannot be identified with a single product can be turned as overhead cost is known as production overhead cost or in other words total of indirect materials, labour and other expenses.

**Example** : Glue, polish, varnish, security Guard salary, supervisor's salary, rent, rates, electricity

These costs cannot be identified for a cost unit. Therefore, it can be identified for a production.




**Process of distribution overheads**

Distribution overhead costs among cost centres which can't be identified easily for each cost centres. This is known as distribution of overheads and following are the relevant steps.

1. Collection of overhead costs
2. Allocation of overhead costs
3. Apportionment of overhead costs
4. Absorption of overhead costs

**Collection of overhead costs**

Cost could be recognized by the following source documents relevant for each expenses.

Example :

| Overhead cost item | Source document |
|---|---|
| • Indirect wages | • Salary pay sheet |
| • Electricity expenses | • Electricity bill / voucher |
| • Depreciation used for production | • General journal voucher |

**Allocation of overhead costs**

- Distribute overhead costs among cost centres which can be identified easily for each cost centre.

  **Example :**
  - Receipt of electricity bill for each cost centre
  - Preparation of salary pay sheet for each cost centre

**Appointment of overhead head costs**

Distribute overhead costs among cost centres which cannot be identified directly for each cost centre by using reasonable base.

Primary Distribution

- Distribute overhead costs which cannot be directly or easily identified with a particular cost center over the production and service departments known as primary distribution.

Secondary Distribution

- Redistribution of overhead costs of service cost centres to the production department by using reasonable base.

**Examples for bases of Apportionment**

| **Cost item** | **Base of portionment** |
|---|---|
| Eectricity<br>Rent<br>Rates<br>Repair of building<br>Lighting | Floor area / square feet |
| Water bills<br>Electricity bills<br>Telephone expenses | Units consumed |
| Medical expenses<br>Restaurant Keeping expenses<br>Indirect wages<br>Expenses of welfare<br>Employee insurance<br>Supervision expenses | Number of employees |
| Machine depreciation<br>Machine insurance | Value of machinery / carrying value |
| Expenses of service department | Number of stores requisitions / consumption rate |
| Maintenance expenses | Number of hours spent for maintenance |
| Expenses of air conditoning | Volume |

**Absorption of overhead costs**

Charging or absorbing total over head cost pertaining to production department to a cost unit can be termed as absorption of overheads.

Overhead absorption rates can be calculated by dividing budgeted overhead cost from a number of units or using an appropriate base.

**Example :**

| Overhead Absorption Rate | Method of Calcualton |
|---|---|
| 1. Output Basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated number of units product}}$ |
| 2. Direct material cost basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated direct material cost}} \times 100$ |
| 3. Direct labour cost basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated direct labour cost}} \times 100$ |
| 4. Prime cost basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated prime cost}} \times 100$ |
| 5. Direct labour hour basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated direct labour hours.}}$ |
| 6. Machine hour basis | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated machine hours}}$ |

Preparation of overhead analysis sheet. Example is as follows.

(i) There are two production departments and a service department in a garment factory. Expenses of producing 1000 garments are as follows.

| Item | Cutting section | Sewing section | Stores |
|---|---|---|---|
| Machine (Rs.) | 700 000 | 1 400 000 | - |
| Building (Rs.) | 400 000 | 200 000 | 1 000 000 |
| Area (sq ft) | 10 000 | 50 000 | 10 000 |
| No of workers | 1 000 | 2 000 | 500 |
| No of stores Requisitons notes | 50 | 30 | - |
| Indirect Materials (Rs.) | 20 000 | 40 000 | - |
| Indirect wages (Rs.) | 50 000 | 100 000 | - |

| | (Rs.) |
|---|---|
| Building rent | 70 000 |
| Electricity | 14 000 |
| Employee insurance | 8 400 |
| Machine insurance | 3 000 |
| Machine depreciation | 30 000 |

Prepare production overhead analysis sheet.

| Cost item | Basis of apportionment | Total value | Production Department | | (Rs.) |
|---|---|---|---|---|---|
| | | | Cutting | Sewing | Stores |
| Indirect machine | Direct /Allocation | 60 000 | 20 000 | 40 000 | - |
| Indirect wages | Direct /Allocation | 150 000 | 50 000 | 100 000 | - |
| Building rent | Area (1:5:1) | 70 000 | 10 000 | 50 000 | 10 000 |
| Electricity | Area (1:5:1) | 14 000 | 2 000 | 10 000 | 2 000 |
| Machine insurance | Value of machine (1:2) | 3 000 | 1 000 | 2 000 | - |
| Employee insurance | No. of Workers (2:4:1) | 8 400 | 2 400 | 4 800 | 1 200 |
| Machine depreciation | Value of machine (1:2) | 30 000 | 10 000 | 20 000 | - |
| Total overhead cost | Cost | 335 400 | 95 400 | 226 800 | 13 200 |
| Service department overhead cost | Stores requistions (5:3) | --- | 8 250 | 4 950 | (13 200) |
| Total overhead cost | | 335 400 | 103 650 | 231 750 | - |

(2) Following estimated costs are related to Cooray furniture shop for the next year.

| Item | Production department | | Service department |
|---|---|---|---|
| | A | B | S |
| Direct wages (Rs.) | 360 000 | 120 000 | 20 000 |
| Indirect materials (Rs.) | 30 000 | 20 000 | 10 000 |
| Direct materials (Rs.) | 480 000 | 180 000 | 30 000 |

| Other production overhead costs | (Rs.) |
|---|---|
| Machine Depreciation | 400 000 |
| Employee expenses | 200 000 |
| Rent | 300 000 |

| | A | B | C |
|---|---|---|---|
| Cost of machine (Rs.) | 125 000 | 70 000 | 5 000 |
| Area (sq.ft.) | 3 000 | 1 500 | 500 |
| No of employees | 60 | 30 | 10 |
| Direct labour hours | 3 700 | 3 350 | - |

Service department cost should be distributed among production department by using 1 : 1 basis.

**Required :**

1. Overhead analysis sheet
2. Secondary distribution
3. Calculate overhead absorption rates for A and B departments by using direct labour hours.

**Answer :**

(Rs.'000)

| (01) Item | Basis if apportionment | Production Dept. | | Service (Rs) |
|---|---|---|---|---|
| | | A (Rs.) | B (Rs.) | S (Rs.) |
| Indirect wages | Direct /Allocation | 360 | 120 | 20 |
| Indirect expenses | Direct /Allocation | 30 | 20 | 10 |
| Indirect material | Direct /Allocation | 480 | 180 | 30 |
| Machine depreciation | cost of machine 25:14:1 | 250 | 140 | 10 |
| Employee expenses | Number of employees 6:3:1 | 120 | 60 | 20 |
| Rent | square feet (6 : 3 : 1) | 180 | 90 | 30 |
| | | 1 420 | 610 | 120 |
| 02. Cost of service department | 1 : 1 | 60 | 60 | (120) |
| Total ovehead | | 1 480 | 670 | - |

(03) Overhead absorption rates

| Department A | Department **B** |
|---|---|
| $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated direct labour cost}}$ | $\dfrac{\text{Total estimated overhead costs}}{\text{Estimated direct labour cost}}$ |
| $\dfrac{1480000}{3700}$ = Rs. 400 | $\dfrac{670000}{3350}$ = Rs. 200 |

03. Cooray furniture shop received an order to produce 1 000 chairs. Estimated costs are as follows.

| | |
|---|---|
| Direct material cost per chair | Rs. 700 |
| Direct labour cost per chair | Rs. 1 000 |
| Direct other expenses | Rs. 100 |

Overhead costs are absorbed based on direct labour cost.

A – 08 Direct labour hours

A – 06 Direct labour hours

(i) Calculate cost per chair

| | (Rs.) |
|---|---|
| Direct material cost | 700 |
| Direct labour cost | 1 000 |
| Direct other costs | 100 |
| Prime cost | 1 800 |
| **Overhead cost :** | |
| Dep. A Rs. 400 x 08 | 3 200 |
| Dep. B Rs. 200 x 06 | 1 200 |
| Production cost per chair | 6 200 |

**Instructions to assist learning**

- Present students expenses listed in Annexure 14.7.1
- Instruct them to classify according to the following.
  - Production overhead costs
  - Administration overhead costs
  - Distribution overhead cost
  - Selling overhead costs

- Ask them to suggest the type of cost related in calculating production cost of a unit
- Discuss with the student how to apply above cost in order to calculate unit cost.
- Presents the students clearly process of distributing over head cost. Basis of apportionment.
- Give each student a copy of annexure 14.7.2 related to Naween's business. (3/6 groups)
- Allow them to distribute following by using over head analysis sheet.
    - Primary distribution
    - Secondary distribution
- Provide following overhead absorption rates to each group
    - Direct material cost basis
    - Direct labour cost basis
    - Machine hour basis
    - Direct labour hour basis
    - Prime cost basis
    - Production unit basis
- Direct them to calculate overhead cost absorption rate of each department.
- Direct them to search overhead of a flower pot in order to calculate overhead absorption rate to give each group.
- Direct material cost of a flower pot Rs. 1 100
- Direct labour cost Rs. 650
- Provide exercise to students in order to calculate cost related to different situations.

**Annexure 14.7.1**

**List of expenses of overhead costs.**

- Sales representatives salary
- Packing expenses
- Sales commission
- Audit fees
- Office expenses
- Administration salaries and wages
- Machine maintenance expenses
- Factory rent
- Factory supervisors salary
- Motor vehicle insurance
- Advertising expenses

- Factory electricity
- Factory insurance
- Office rent
- Indirect material
- Distribution vehicle maintenance cost
- Production department maintenance cost
- Office equipment depreciation
- Factory rates

**Annexure 14.7.2**

- Following expenses are related to production cost of 1000 plastic flower vases.

| | (Rs.) |
|---|---|
| Building rent | 4200 |
| Indirect wages | 44 000 |
| Machine maintenance | 4400 |
| Machine operation power | 21 000 |
| Factory workers expenses | 8800 |

**Other Information**

| Item | Procution Department | | Stores |
|---|---|---|---|
| | Assesment | Finishing | |
| Number of employees | 05 | 05 | 01 |
| Cost of machine (Rs.) | 700 000 | 400 000 | - |
| Machine hours | 2 000 | 1 500 | - |
| Direct labour hours | 2 500 | 2 250 | - |
| Direct Material cost | 500 000 | 600 000 | - |
| Area (sq.mt) | 10 | 10 | 01 |
| Direct labour cost (Rs.) | 250 000 | 400 000 | - |
| Material requisition notes | 10 | 05 | - |

**Assessment and Evaluation Criteria**

(i) State whether the following statement is true / false

- Total overhead cost means the addition of indirect material, indirect labour and indirect other expenses which cannot be directly identifiable for a cost unit or product.

(2) Clssify the following overhead cost as production or non production.

- Advertising, factory rent, machine depreciation, Electricity, factory insurance, sales commission, fuel, factory wages, office salaries

(3) Selection of correct sequence of distribution of general overhead cost.

1. Collection of cost, allocation, apportionment
2. Collection of cost, allocation, apportionment and absorption.
3. Source document, apportionment and absorption
4. Collection of cost, allocation, apportionment and absorbs to cost unit
5. Collection of cost, primary distribution, secondary distribution and absorption.

(4) Explain in brief

1. Primary distribution of overheads
2. Secondary distribution of overheads

(5) Prepare a overhead analysis sheet, according to accrual basis (all values are in Rupees)

| | | | |
|---|---|---|---|
| Machine depreciation | 40 000 | | |
| Indirect materials division | | A - 50 000 | B - 40 000 |
| Indirect wages division | | B - 100 000 | B - 60 000 |
| Insurance | 10 000 | | |
| Factory rent | 20 000 | | |
| Supervisory Salary | 30 000 | | |
| Electricity | 5 000 | | |

| Basis of Apportionment | A | B | Service |
|---|---|---|---|
| Machine cost (Rs,) | 200 000 | 100 000 | 50 000 |
| Area (sq.mt) | 300 | 100 | 100 |
| No. of employees | 50 | 40 | 10 |
| Electricity consumed (units) | 30 | 20 | 10 |
| Value of insurance policy | 300 000 | 100 000 | 100 000 |

Service department overhead costs are equally distributed among production departments.
Service department overhead costs are equally distributed among production departments.

(6) Following cost are related to one unit of torch.

| | |
|---|---|
| Direct material | Rs. 900 |
| Direct labour | Rs. 400 |

(Rs.'000)

| | Finishing | Assemble | Stores |
|---|---|---|---|
| Total overhead cost | 875 500 | 414 500 | 210 000 |
| Material requisition notes | 700 | 500 | - |
| Expected machine hours | 25 000 | 30 000 | - |
| Expected labour hours | 10 000 | 20 000 | - |

- Overhead costs of finishing and assembly departments are absorbed according to machine hours and labour hours respectively
- Calculate unit cost of a torch

**Competency 15.0 : Supports the management decision making through cost behaviour and cost, volume, profit analysis.**

**Competency level 15.1 : Analyses the behaviour of cost**

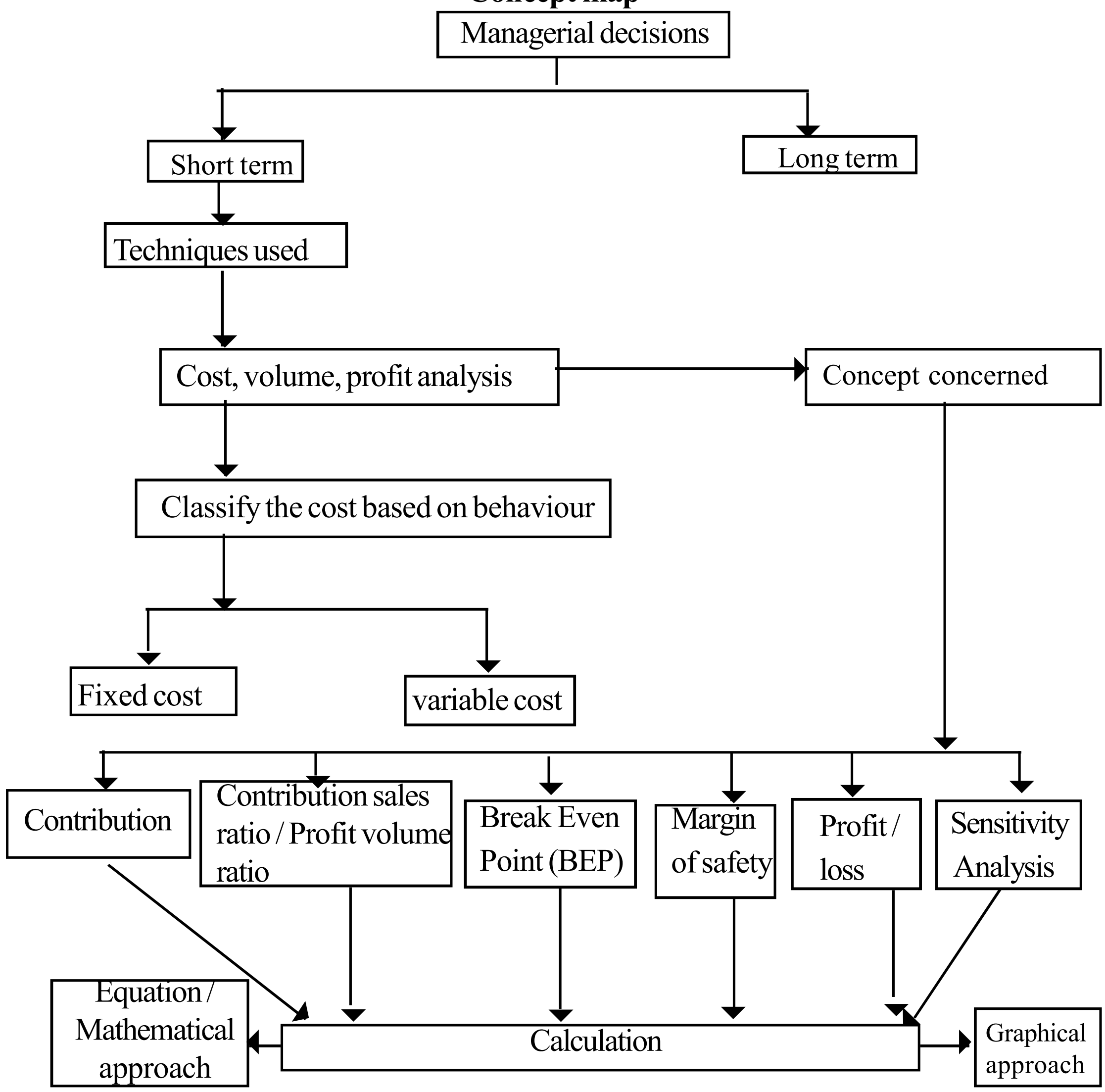
**No. of Periods : 02**

**Learning Outcomes :**

- Classifies the cost based on behaviour
- Explains the variable cost
- Explains the fixed cost
- Reviews the behaviour of cost through a graph

**Basic terms and concepts**

**Concept map**



**Teaching-Learning process**

Give the following details to the students

In order to celebrate the commerce day of the college, the school main hall will be used and the maximum capacity of the main hall is 500 seats. Treasurer estimates the following expenses for this event.

- Stationery for one student - Rs. 15.00
- Refreshment for one student - Rs. 50.00
- For lighting - Rs. 30 000.00
- For sound systems - Rs. 20 000.00

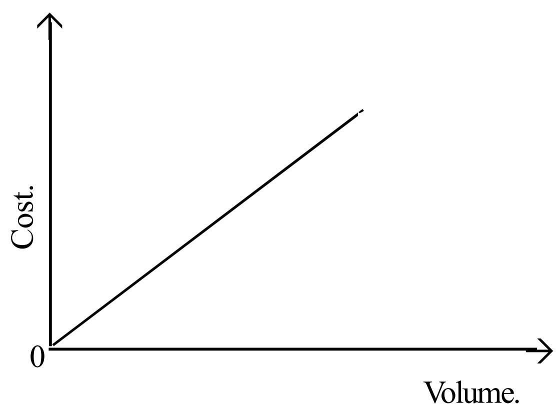
Find out the following information from the above details.

- Identify the costs which are changed with number of students.
- Identify the costs which are not been changed with number of students.
- Explain that the cost which are changed with number of participants is identified as variable cost and the cost which are not changed with number of participants is identified as fixed cost.
- In cost, volume profit analysis, cost is classified only into two categories such as fixed cost and variable cost.
- Show that cost / Income behaves as a straight line with volume.

**Variable cost**

The cost which tends to vary in proportion with volume of output is identified as variable cost. This is named as variable cost.

Eg:
- Commission on sales
- Direct materials
- Direct labour

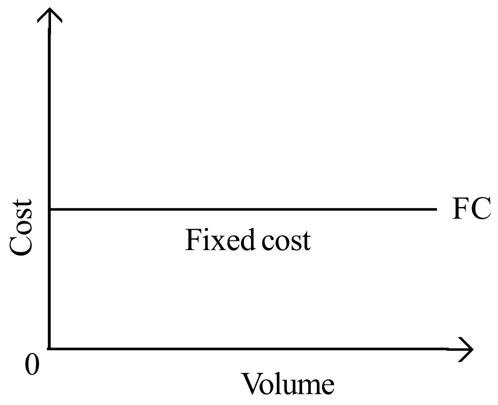


**Fixed cost**

The cost which tends to be unaffected by variation of output is identified as fixed cost.

Example : • Rent expense

- Insurance




- For short term decision making purposes, cost classified as fixed and variable.

**Assessment and Evaluation Criteria**

- Compare between fixed and variable cost
- Categorize the following cost items as fixed and variable.
  - Annual rent – Rs, 120 000
  - Raw material cost of 10 000 units – Rs. 200 000
  - Sales commission per unit – Rs. 10
  - Salaries of office staff – Rs. 60 000
  - Fuel expense for bus – Rs. 20 000

Create separately

- Total variable cost curve and
- Total fixed cost curve

  When volume of output changes from 2000 units to 10 000 units.

**Competency 15.0 :** **Supports the managerial decision making by analysing the cost behaviour and cost volume profit analysis.**

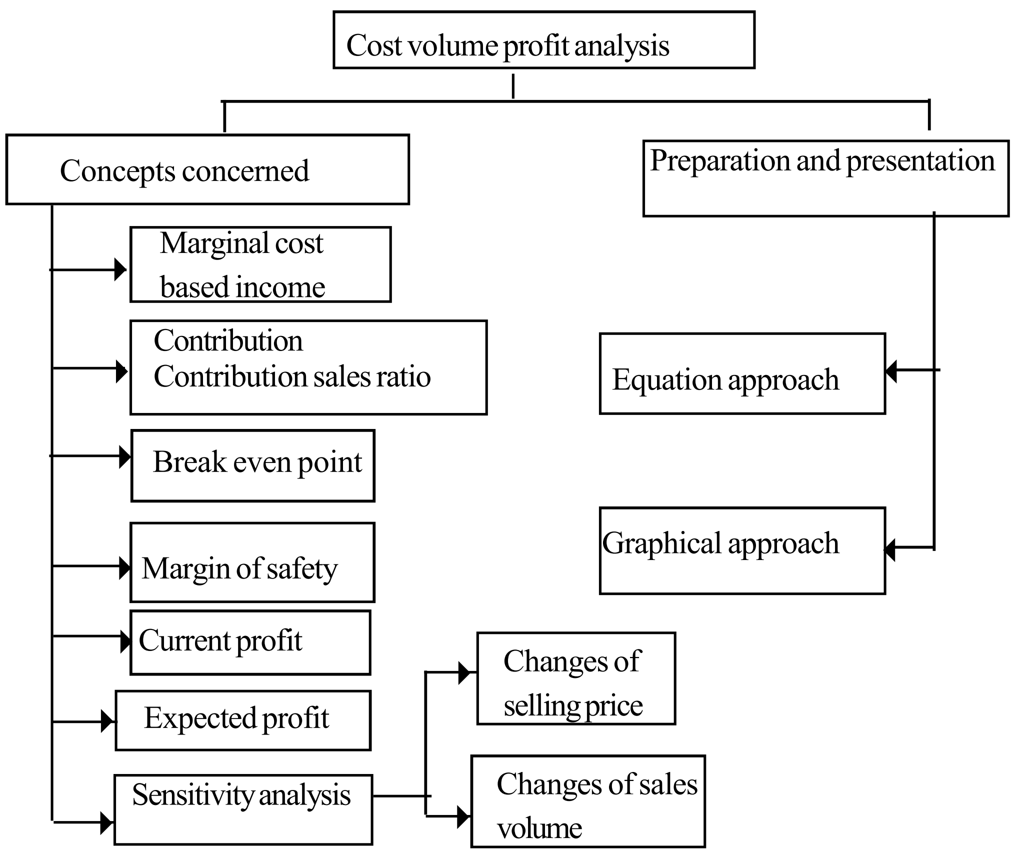
**Competency level 15.2 :** **Supports the decision making using cost volume profit analysis.**

**No. of Periods : 18**

**Learning Outcomes :**

- Calculates contribution per unit
- Calculates total contribution
- Makes decisions by calculating contribution sales ratio
- Calculates Break Even Point in units and in value
- Calculates margin of safety
- Presents cost volume profit analysis in equation form and graphical form.
- Decision making based on cost volume profit analysis
- Show the sensitive items in relation to changes of sales price and sales volume

**Concept Map**



**Guildeline for subject matters :**

- Marginal costing means the technique in which variable costs are charged to cost units and fixed costs of the period are written off against the total contribution.
  - Variable costs are production cost.
  - Fixed costs are period cost.
- Marginal cost based income statement
- Income statement is prepared by considering only one product or service and calculate the total profit.

Marginal cost based income statement is as follows.

| | |
|---|---|
| Income | x |
| Less | |
| Variable cost | (x) |
| Contribution | x |
| Less | |
| Fixed cost | (x) |
| Profit | x |

- Difference between the income and variable cost is identified as contribution. This could be calculated as unit contribution and total contribution.

| **Unit contribution** | | **Total contribution** | |
|---|---|---|---|
| Unit selling price | x | Total income | xx |
| Unit variable cost | (x) | Total variable cost | (xx) |
| Contribution | x | Total contribution | xx |

- Contribution sales ratio reflects the value of contribution in sales price. This is named as profit volume ratio and sales contribution ratio.

$$\text{Contribution sales ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100$$

**Example :**

- Current sales units are 10 000 of a product which has a sales price of Rs. 200. When producing 2000 units, total cost is Rs. 400 000. At 3 000 units, total cost is Rs. 550 000

- Quantity (units) Total cost (Rs,)

| Quantity (units) | Total cost (Rs,) |
|---|---|
| 2 000 | 400 000 |
| 3 000 | 550 000 |

$$\text{Unit variable cost} = \frac{\text{Change of total cost}}{\text{Change of quantity}}$$

$$= \frac{150{,}000}{1{,}000} = \underline{\underline{150}}$$

- Unit contribution = Unit selling price - unit varaible cost

  = (200 - 150)

  $= \underline{\underline{50}}$

- $$\text{Contribution sales ratio} = \frac{\text{Unit contribution}}{\text{Unit selling price}} \text{ x } 100$$

  $$= \frac{50}{200} \times 100$$

  $$= \underline{\underline{25\%}}$$

- Break even points means the level in which a company survives in the market without making any profit or loss.
- Break even units can be calculated by dividing fixed cost from contribution.
- Break even point can be presented as a value and as in units.
- The gap between the present capacity and Break even point is margin of safety and it is the sales which exceeds break even point.
- The margin of safety can be calculated by dividing profit by contribution sales ratio
- Profit is calculated by deducting fixed cost by total contribution
- Total contribution could be obtained by adding profit to fixed cost.

**Example :**

- Present capacity / sales units = 5 000
  Selling price per unit = Rs. 200
  Contribution sales ratio = 40%
  Fixed cost = Rs. 240 000

- Calculate contribution per unit?
- Break even point in value and in units?
- Calculate profit?

Contribution $= 200 \times \frac{40}{100} = \underline{\underline{80}}$

- Break even point (units) $= \frac{\text{Fixed cost}}{\text{Unit contribution}}$

$$= \frac{240\ 000}{80}$$

$$= \underline{\underline{3\ 000\ \ units}}$$

- Break even point (Rs.) = (3 000 x 200/-)
  = Rs.600 000
  or

$$= \frac{240\ 000}{40} \times 100$$

$$= Rs.600\ 000/-$$

- Margins of safety (units) = Present capacity units - Break even units
  = 5 000 - 3 000
  = 2 000 units

- Margins of safety (Rs.) = Margin of safety (units) x Unit selling price
  = 2 000 x 200
  = Rs. 400 000

- Profit calculation $= \text{Total contribution - Fixed cost}$

$$= 400\ 000 - 240\ 000$$
$$= 160\ 000$$

- Total contribution $= \dfrac{\text{Profit}}{\text{Contribution sales ratio}}$

$$= \frac{160\ 000}{40} \times 100$$
$$= \underline{\underline{Rs.400\ 000}}$$

- Margin of Safety (Rs.) x contribution sales ratio

$$\text{Profit} = \left(400\ 000 \times \frac{40}{100}\right)$$
$$= \underline{\underline{Rs.160\ 000}}$$

- Number of units to be produced to achieve an expected profit can be calculated using the following equation.
- Number of units to be produced $= \dfrac{\text{Fixed cost} + \text{Expected profit}}{\text{Unit contribution}}$
- According to above examples, if the company expects a profit of Rs. 200 000, calculate the number of units to be produced?

$$= \frac{240\ 000 + 200\ 000}{80}$$
$$= \frac{440\ 000}{80}$$
$$= \underline{\underline{5\ 500}} \quad \text{Units}$$

**Sensitivity Analysis**

- Analysis the changes of different variables which affect over the profit in sensitivity analysis.
- **Only the changes of sales value and sales price are considered here.**
- The difference of a single variable is considered into account and therefore the other pretend to be constant.

- Sensitivity analysis could be further explained in following table

| | Total Contribution | Break even Point | Margin of Safety | Price |
|---|---|---|---|---|
| Selling price deduction | Decreases | Increases | Decreases | Decreases |
| Selling price increased | Increases | Decreases | Increases | Increases |
| Sales volume deduction | Decreases | no change | Decreases | Decreases |
| Sales volume increment | Increases | no change | Increases | Increases |

**Assumption used in cost volume profit analysis**

- Cost is classified only as fixed and variable
- Fixed cost is not changed in the short term
- Total revenue and total cost curves are straight lines
- The firm produces only one product
- Technology, production methods and efficiency are not changed.

- Example

  "Nadeera PLC" producers and sells only one product. Following details are given in relation to that product.

  | | |
  |---|---|
  | Production capacity (units) | 8 000 |
  | Current profit | Rs. 180 000.00 |
  | Contribution sales ratio | 40% |
  | Fixed cost | 300 000.00 |

Calculate the following

- Margin of safety (Rs.)
- Total contribution
- Break Even point (Rs.)
- Contribution per unit
- Break even point (units)
- Selling price per unit
- Variable cost

**Proposed Answer :**

2. Value of Margin of safety $= \dfrac{\text{Profit}}{\text{Profit value ratio}}$

$$= \frac{180\ 000}{40} \times 100$$

$$= \underline{\underline{Rs. 450\ 000}}$$

3. Total contirbution = Profit + Fixed cost

= 180 000 + 300 000

= $\underline{\underline{\text{Rs. } 480\ 000/-}}$

4. Break even point (value) $= \dfrac{\text{Fixed cost}}{\text{Profit volume ratio}}$

$$= \frac{300\ 000}{40\%}$$

$$\underline{\underline{= 750\ 000}}$$

5. Contribution per units (Rs.) $= \dfrac{\text{Total contribution}}{\text{Number of units}}$

$$= \frac{480\ 000}{8\ 000} \times 100$$

$$= Rs.\underline{\underline{60}}$$

6. Break even point units $= \dfrac{\text{Fixed cost}}{\text{Contrbution per unit}}$

$$= \frac{300\ 000}{60}$$

$$= \underline{\underline{5000 \quad units}}$$

7. Selling price per unit $= \dfrac{\text{Break even sales}}{\text{Number of units}}$

$$= \frac{750\ 000}{5\ 000}$$

$$= \underline{\underline{Rs.150}}$$

8. Variable cost per unit $=$ Selling price per unit - contribution per unit

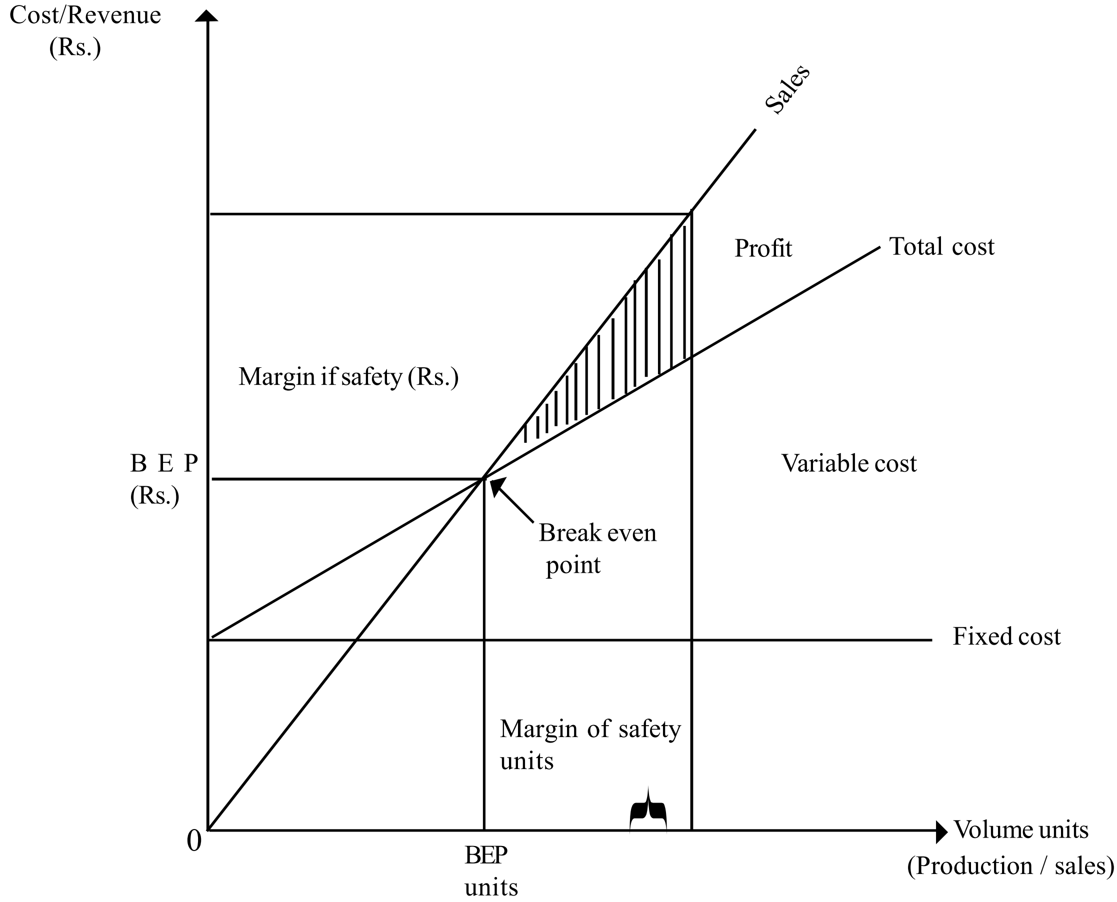
$=$ Rs. 150 - Rs. 60

$=$ $\underline{\underline{\text{Rs. 90}}}$

- Cost volume profit analysis could be presented through equation form as above as well as graphical form.
- In the graphical approach, vertical axes represents cost and revenue and the horizontal axes represents volume.
- Cost volume profit analysis could be illustrated using following graphs.
  - Traditional break even point graph
  - Contribution break even point graph
  - profit volume chart

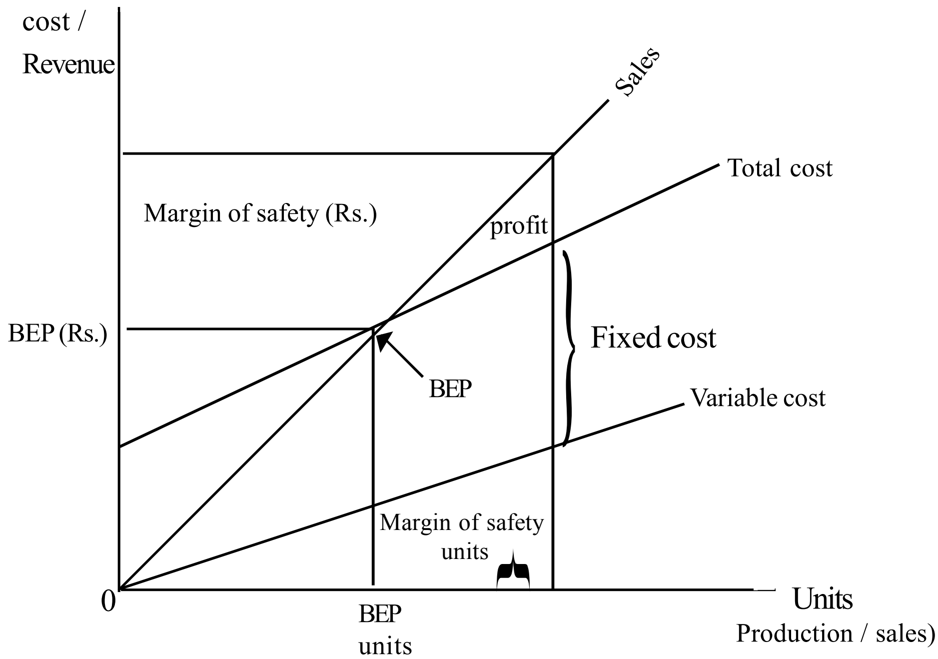
**Traditional Break Even point graph**

Total revenue line, total cost line and fixed cost line are necessary in the graph.




**Contribution Break Even point graph**

Only the revenue line, variable cost line and total cost line are essential in the graph.

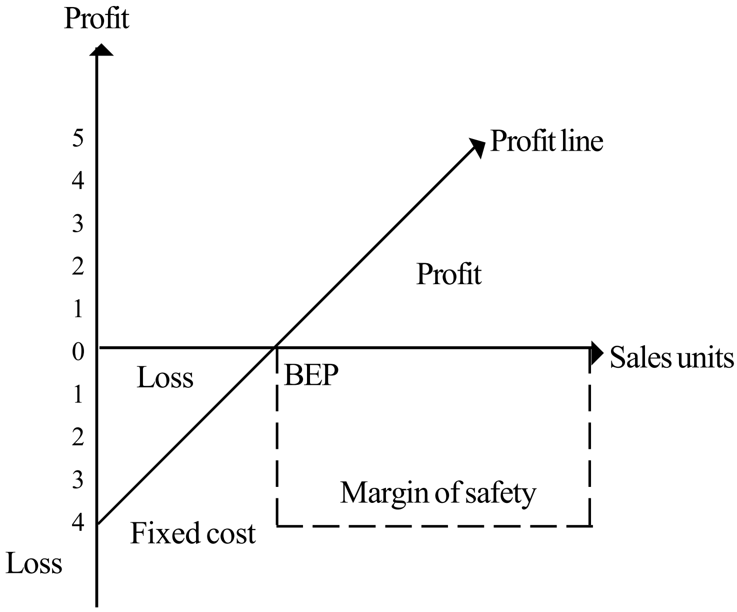


**Profit volume chart**

Profit volume chart is drawn to show the profit at each sales level.

The graph represents Break even point in units and fixed costs.

In the vertical axes, fixed cost and profit & loss are represented.




- Following are the direct material costs of a bottle of mixed fruits prepared by "Anoja" manufacturing company.

| | (Rs.) |
|---|---|
| Pineapple | 150.00 |
| Apple | 100.00 |
| Grapes | 200.00 |
| Sugar | 150,00 |

- Direct labour cost per bottle is Rs. 200.
- Following expenses are needed to be incurred in the production and distribution process.

| | |
|---|---|
| Production overhead cost | 180 000 |
| Administration overhead cost | 120 000 |
| Distribution overhead cost | 100 000 |

- It is estimated to price 4000 bottles. Selling price of a bottle is Rs. 1000.
- Calculate the following using above information
    - Total variable cost
    - Total fixed cost
    - Total cost
    - Cost per unit
    - Contribution per unit
    - Total profit
    - Break even number of bottles
    - Number of bottles at margin of safety
    - Value of margin of safety

- The management of this company was received in order of 200 bottles for an event organized by a youth club. If this order is supplied, an additional overhead cost of Rs. 20 000 is needed to be incurred. A bottle is demanded for Rs. 600. Mention whether this order is acceptes or not with reasons.
- It is expected to increase the production and sales by 20% in the following month. Although the variable cost remains unchanged, fixed cost will increase by Rs. 5 000. If the company expects a profit of Rs. 630 000, mention the price at which a bottle should be sold?

**Evaluation and assignment criteria:**

- Calculation of break even point.
- calculate contribution sales ratio
- Create traditional break even point chart
- At the production level of 1000 units, loss of a company is Rs. 30 000. At the production level of 4000 units, profit is Rs. 30 000, calculate the profit volume ratio?
- Break even point of a company is 12000 units.
  Fixed cost is Rs. 150 000.
  Create profit volume chart.

**Competency 16.0 : Supports the capital investment decision making**

**Competency 16.1 : Plans the process of long term decision making**

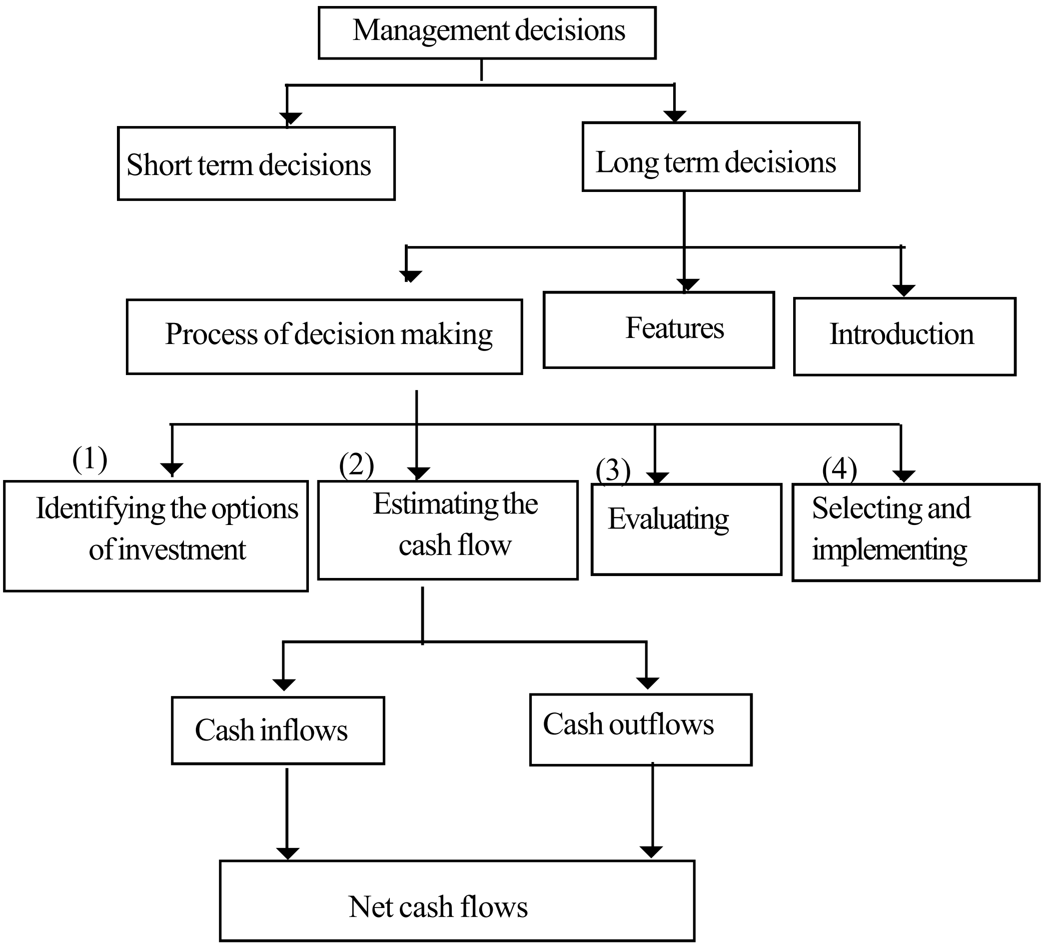
**Number of Periods : 04**

**Learning outcomes :**

- Defines long term decisions
- Process of long term decisions making
- Identifying cash flow estimations relates to long term decisions and calculates net cash flow

**Main terms and concepts :**

**Concept Map**



**Guidance for subject matter :**

- Present 16.1.1. attachment for students to approach for this competency level.
- categorize the decisions as short term and long term
- Give each group a long term decision after recognizing the long term decisions.
- Guide students to present examples of cash inflows and cash outflows if each of the decisions are implemented.

A table like below can be used for that

| Decision | Cash flows | |
|---|---|---|
| | Cash inflows (Rs.) | Cash outflows (Rs.) |
| | | |

- Guide students to categorize the cash flows under following situations.
    1. Initial investment cash flows
    2. Operating cash flows
    3. Terminal cash flows
- Calculate net cash flows received by each group
- Give the opportunity to present the answers of each group
- Revise on subject matters after their presentations
- Defining long term decisions
- Categorize the long term decisions
- Mentioning the steps of long term decision making process.
- Estimating the cash flows by implementing long term decisions.
- Calculating net cash flows.

**Subject Matters**

Decision of a business can be considered as follows :

**Management Decisions**

**Short term decisions**

**Example**

- Increasing the sales price
- Changing the stock level
- Changing the credit period of the debtors
- Increasing the quantity of sales
- Implementing a sales promotion campaign

**Long term decisions**

- Construction of a factory
- purchase of property, plant and equipment
- construction of a highway
- construction of a car park
- makes reform in the curriculum of schools or professional institutes
- Establishment of a new tele communication system
- Establishment of a new computer system

## 01). Long Term Decisions

- The decision of a company in long term agreement is called investment decision. Company expects economical results within subsequent years through such a decision.

  By constructing a factory.
  - Can engage in manufacturing
  - Uses for long term
  - Earns income by selling products

## 02) Characteristics of long term decisions

- Expected scale of investment is large (huge investment)
- Risk due to long term
- Decisions are unchangeable /unalterable (a wrong decision couldn't be able change)
- Funds are necessary throughout the long term

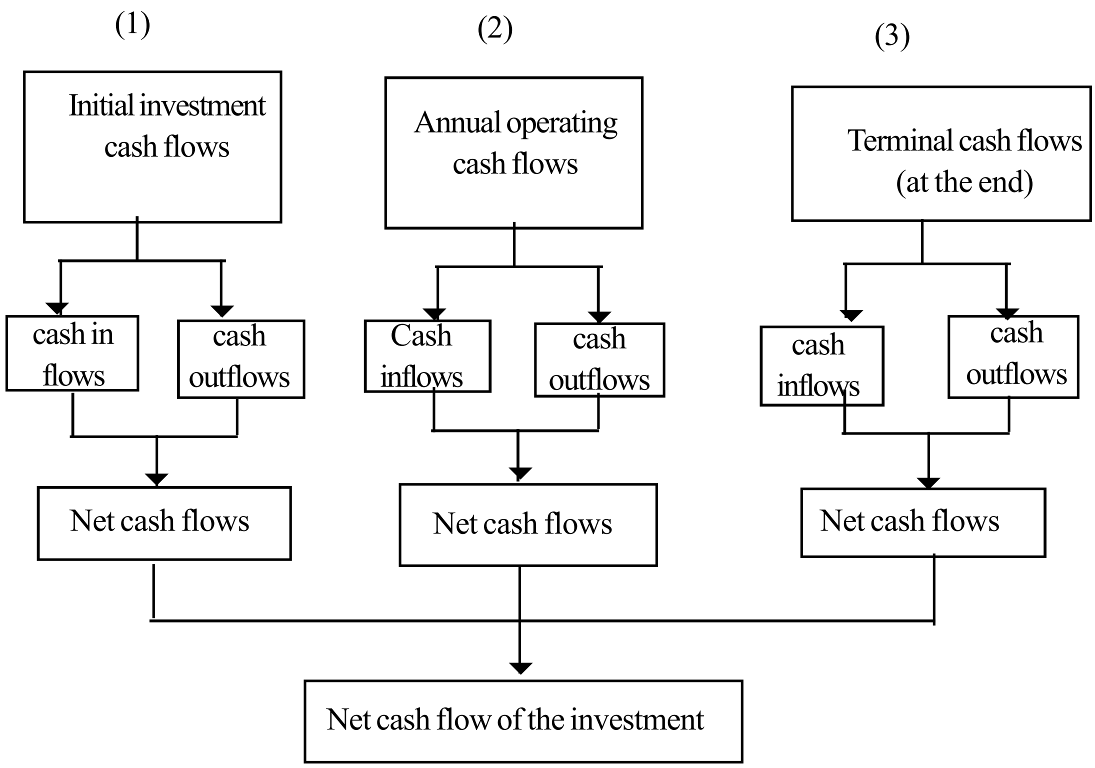
**Long term decision making process**

- A high consideration should be given on the decision since it affects a long term. Therefore the following steps should be followed in making long term decisions.

  1. Identifying the alternatives of investment
  2. Establishing the cash flows of alternatives
  3. Evaluating the alternatives
  4. Selecting and implementing the suitable project

- Estimation of cash flows and evaluation of investments are considered as the most important steps to be made.

- Important sectors with cash flows estimation



Important factors when considering cash flows.

1. Consider after tax cash flows
2. Only the increamental cash flows are considered. It means, not the existing cash flows, the cash flows which are increased due to investment considered here.
3. Includes all the cash flows happened due to indirect effects to the investment.
4. Sunk cost (The cost which already incurred) is not considered as a cash flow.
5. Interest is not included in cash flows
6. Depreciation and non cash expenses are not considered as cash flows.

**Initial investment cash flows**

| | | | |
|---|---|---|---|
| | | | (Rs.) |
| • | Investment (new asset) purchasing price | | xxx |
| • | Transportation and installation costs | | xx |
| • | Initial working capital requirements | | xxx |
| | | | xxx |
| • | (-) cash received from selling the existing asset | xx | |
| • | Tax payable when selling the existing asset | (x) | (xx) |
| • | Initial net cash flow | | xxx |

**Example 01**

| | |
|---|---|
| | (Rs.) |
| Cost of existing machine | 250 000 |
| Purchasing price of new machine | 500 000 |
| Installment cost of the new machine | 50 000 |
| Expected sales price of existing machine | 100 000 |
| Payable tax on the selling price of the existing machine | 20 000 |
| New working capital requirements | 75 000 |

**Requirements :**

1. Calculate the cash inflows and cash outflows of initial investment
2. Calculate the net cash flow of initial investment

**Solution**

1.

| Cash inflows | (Rs.) | Cash outflows | (Rs.) |
|---|---|---|---|
| | | Cost of new machine | 500 000 |
| Sales price of old machine | 100 000 | Cost of establishment | 50 000 |
| (-) Tax Payable | (20 000) | New working capital requirement | 75 000 |
| | 80 000 | | 625 000 |

2. New cash flow of initial investment = cash out flows - Rs. 545 000
(Rs. 625 000 – Rs. 80 000)

**Annual operating cash flows**

There are the cash inflows and cash outflows during the useful life time of the investment by using it in the production process.

**Examples :**

- Cash sales
- Cash receipt from debtors
- Cash purchases
- Cash payments to creditors
- Cash payments for operations
- Fixed assets maintenance expenses except deprecation
- Taxation

**Other payments related to operations**

The difference between cash inflows and cash outflows are identified as operating net cash flow.

**Example 02**

Following are the cash flows of an asset of its useful lifetime of 5 years.

(1) Increments of sales income

| Year | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| (Rs.) | 500 000 | 500 000 | 600 000 | 700 000 | 800 000 |

(2) Estimation of annual purchasing expenses

| | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| (Rs.) | 180 000 | 180 000 | 190 000 | 200 000 | 240 000 |

(3) During the first year, electricity expenses increased by 3000 and in the subsequent years increased by Rs. 1 000 each period.

(4) During the first year, operating expenses increased by Rs. 4 000 and in the subsequent years by Rs. 1 000 each period.

(5) Annual deprecation Rs. 5 000

(6) It is expected to incur a repair expense of Rs. 15 000 in the third year.

(7) 10% tax payable on profit.

Calculate annual net cash flow of operations.

**Solution :** First, profit before tax should be calculated.

| Cash flow item \ Years | 01 | 02 | 03 | 04 | 05 |
|---|---|---|---|---|---|
| Sales Income Statement | 500 | 550 | 600 | 700 | 800 |
| Total Income | 500 | 550 | 600 | 700 | 800 |
| Purchase (Rs.) | (180) | (180) | (190) | (200) | (240) |
| Electricity Expenses (Rs.) | (3) | (4) | (5) | (6) | (7) |
| Operating Expenses (Rs.) | (4) | (5) | (6) | (7) | (8) |
| Depreciation | (5) | (5) | (5) | (5) | (5) |
| Repair Expenses | - | - | (15) | - | - |
| Total Expenses (Rs.) | (192) | (194) | (226) | (218) | (260) |
| Profti before Tax | 308 | 356 | 379 | 482 | 540 |
| Tax (10%) | (30.8) | (35.6) | (37.9) | (48.2) | (54) |
| Profit for the period | 277.2 | 320.4 | 341.1 | 433.8 | 486 |
| (+) Depreciation | 5 | 5 | 5 | 5 | 5 |
| Net cash flow of operations | 282.2 | 325.4 | 346.1 | 438.8 | 591 |

**Terminal cash flows**

Cash inflows and cash outflows at the end of the investment is identified as terminal cash flows.

**Example :**
- Residual value of the investment
- Recovery of working capital

| Profit | Cash outflows |
|---|---|
| 1. Total income and total expenses are considered | Cash inflows and cash outflows are considered |
| 2. Accrual basis is used | Cash basis is used |
| 3. Calculates net profit / loss | Calculate net cash flow |
| 4. Items which are not inflows and outflows are included. | Non cash items are removed<br>**Example :** Bad debts, depreciation, discount allowed. |
| 5. capital nature items are not included. | Capital nature items are included |

**Evaluation and assignment criteria :**

- Defining long term decisions
- Categorize long term decisions
- Steps of long term decisions making process
- Estimating the cash flows derived by implementing long term decisions.
- Calculating net cash flows.
- Give examples for cash flows
- Give with examples on how to calculate cash flows when net profit is given.
- Name the situations in which cash flows occur in a business
- What are the factors to be considered in calculating cash flows?
- Given below are the details of a machine which a company expects to purchase.
  - Purchasing price Rs. 750 000
  - Installation cost Rs. 50 000

- Initial working capital requirement Rs. 50 000
  This could be recovered at the end of the period
- It is estimated that the existing machine could be sold for Rs. 20 000

- Information regarding the machine are as follows.
- First year is Rs. 150 000 and it will be increased by 10% each year. Increasing of expenses in the first year is Rs. 50 000, In the second and third years it is increased by 10% each and fourth and fifth years it is decreased by 10%
- Annual machine depreciation Rs. 140 000
- Taxation on profit 40%
- Useful life time of the asset is 5 years and residual value is Rs. 50 000

**Requirements :**

1. Calculate the value of initial investment?
2. Calculate annual operating net cash flow?
3. Calculate terminal cash flow?
4. Show the table of calculating cash flows in 5 years.

**Competency 16.0** : **Support the capital investment decision making**

**Competency 16.2** : **Supports to make investment decisions by using different capital evaluation methods.**

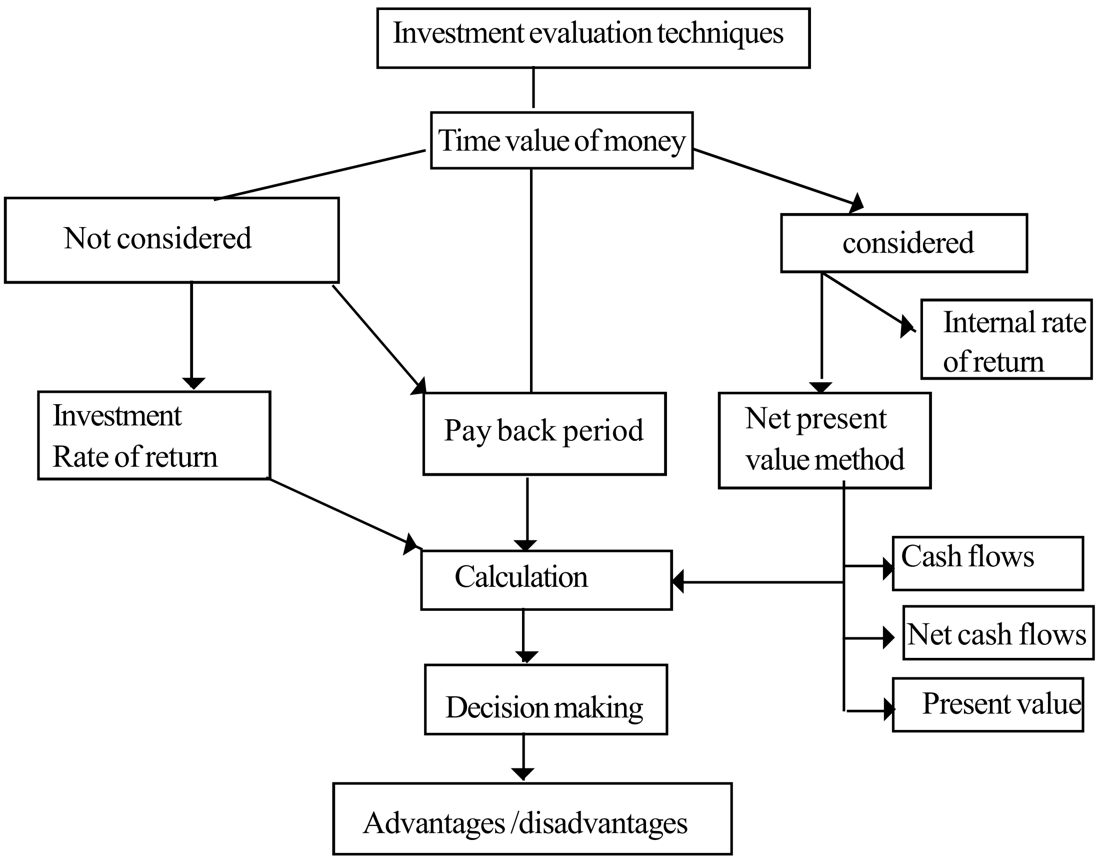
**Number of Periods** : **16**

**Learning outcomes** :

- Names the various capital evaluation techniques.
- Makes decisions on Accounting rates of Return.
- Makes decisions on Pay back period.
- Defines relevant and irrelevant costs.
- Defines time value of money.
- Explains net present value method.
- Makes decisions on net present value.
- Mention the advantages and disadvantages of capital evaluation techniques.

**Main terms and concepts :**

**Concept Map**



- **Subject matters :**

  Before selecting investments those should be evaluated using various techniques. The evaluation techniques are categorized using time value of money.

**Time value of money**

The value of money which is received today is higher than the value of money which will be received in the future is identified as time value of money. The time value changes due to interest or investment costs.

- There are two techniques which do not consider the time value of money
  1. Investment rate of return method.
  2. Pay back period method

**Investment rate of return method (Accounting rate of return)**

This method means the rate of return for the investment.

When calculating this method, cash flows and time value of money are not considered.

only the profit for the period (profit after tax) has been considered.

$$\text{Accounting Rate of Return} = \frac{\text{Average net profit after tax}}{\text{Average investment}} \times 100$$

$$\text{Average net profit after tax} = \frac{\text{Total of the profit after tax during the life time of investment}}{\text{Number of years.}}$$

$$\text{Average investment} = \frac{\text{Value of initial investment} + \text{value of investment of the end}}{2}$$

**Example :**

- Initial investment is Rs. 200 000. It is estimated that at the end of the three periods the value of the investment will be Rs. 80 000.

- Profit for the three periods.

| | | Rs. |
|---|---|---|
| 1 | - | 100 000 |
| 2 | - | 120 000 |
| 3 | - | 80 000 |

Calculate investment rate of return = Rs.'000

Average net profit after tax $= \frac{100+120+80}{3}$

$= \frac{300}{3}$

$= \underline{\underline{100}}$

Average Investment $= \frac{200\ 000+80\ 000}{2}$

$= \frac{280\ 000}{2}$

$= \underline{\underline{140\ 000}}$

$$\text{Investment rate of return} = \frac{\text{Average net profit after tax}}{\text{Average investment}} \times 100$$

$= \frac{100\ 000}{140\ 000} \times 100$

$= \underline{\underline{71.4\%}}$

If the value of this investment at the end is 0.

$$\text{Investment rate of return} = \frac{100\ 000}{\frac{200\ 000+0}{2}} \times 100$$

$= \frac{100\ 000}{100\ 000} \times 100$

$= \underline{\underline{100\%}}$

How to make decisions based on investment rate of return?

- If there is a pre determined accounting rate of return, the investments which have a higher rate of return that value should be selected. (should invest money)
- If there are two or more investment opportunities, investments which have high returns should be selected.

**Advantages and disadvantages of Accounting Rate of Return**

**Advantages**

1. It is easy and simple in calculating
2. Can be implemented with low cost.
3. No need of calculating the cash flows since this is based on profits)
4. Easy to select investments which gives high returns.

**Disadvantages**

1. Time value of money not taken into account.
2. Cash flows are not considered.
3. Errors in calculating the profit are directing after since this method is based on profit.

**Calculation of accounting rate of return only on avarage investment basis is expected to discuss with A/L students.**

2. **Pay back period method.**

- The period which takes to payback the cash of cost which is affiliated with the project is identified as pay back period.
- Pay back period is calculated based on annual net cash flows of the investment.
- This method does not consider the time value of money.

There are two ways in receiving annual cash flows.

1. Receiving equal cash flows every year.
2. Receiving changing cash flows every year.

How to calculate the pay back period.

1. If future net cash flows are equal every period.

$$\text{Pay back period} = \frac{\text{Initial investment}}{\text{Annual net cash flow}}$$

Calculation of pay back period during an abnormal privilege of net cash flows.

$$\text{Pay back period} = \frac{\text{Net cash flow of the next period}}{\text{12 month}}$$

**Example :**

1. A company expects to invest on an investment which has a value of Rs. 250 000 and expected annual cash flows are Rs. 50 000 every year. Calculate the pay back period

$$\text{Pay back period} = \frac{\text{Initial investment}}{\text{Annual net cash flows}}$$

$$= \frac{250\ 000}{50\ 000}$$

$$= \underline{\underline{5 \text{ Years}}}$$

2. A company expects to purchase two machines. The net cash flows related to these two machines are as follows. Purchasing price of both the machines is Rs. 50 000.

| Years | Net cash flows (Rs.) | |
|---|---|---|
| | Machinery A (Rs.) | Machinery A (Rs.) |
| 1 | 80 000 | 80 000 |
| 2 | 80 000 | 70 000 |
| 3 | 70 000 | 90 000 |
| 4 | 90 000 | 50 000 |
| 5 | 60 000 | 40 000 |

Deicide on which machine to be purchased by calculating pay back period.

**Solutions :**

| Years | Net cash flows Machine A (Rs.) | Accumulated net cash flows Machine A (Rs.) | Net cash flows machine B (Rs.) | Accumulated net cash flows Machines B (Rs.) |
|---|---|---|---|---|
| 0 | | (300 000) | | (300 000) |
| 1 | 80 000 | (220 000) | 80 000 | (220 000) |
| 2 | 80 000 | (140 000) | 70 000 | (150 000) |
| 3 | 70 000 | (70 000) | 90 00 | (60 000) |
| 4 | 90 00 | 20 000 | 50 000 | (10 000) |
| 5 | 60 00 | 80 000 | 40 000 | 30 000 |

:

Machine A

$$3 \text{ years} + \frac{70\ 000}{90\ 000} \times 12$$

$$3 \text{ years} + \frac{28}{3} \text{ Months}$$

Pay back period = $\underline{\underline{\text{3 years and 9 months}}}$

Machine B

$$4 \text{ years} + \frac{10\ 000}{40\ 000} \times 12$$

$$4 \text{ years} + 3 \text{ Months}$$

= $\underline{\underline{\text{4 years and 3 months}}}$

"A" Machinery is suitable to be purchased due to less pay back period.

- **Decision under pay back period**

  Should select the investment which has a less pay back period.

- **Advantages and disadvantages of pay back period**

| Advantages | Disadvantages |
|---|---|
| 1. consideration of cash flows<br>2. invested amount could be received quality<br>3. Implementation cost is less<br>4. Easy to calculate<br>5. Awareness is low | 1. Not considering the time value of money<br>2. Not considering all cash flows<br>3. Cash flows gained after the pay back period is avoided from the account. |

- **Net Present Value Method (NPV)**

This could be identified as the best method for evaluating investments.

There are few steps to be followed to calculate Net present value such as,

1. Calculate cash flows
2. Calculate net cash flows
3. Find out present value
4. Find out Net present value

**Present value**

This is identified as today's value of future cash flows.

From time value of money we have understood that the present value of future cash flows are called present value which is calculated by discounting and it means the process of decreasing the value. Discounting value table will help you.

**Example :**

| Year | 10% discounting factor | Net cash flows |
|---|---|---|
| 0 | 1.000 | (50 000) |
| 1 | 0.909 | 40 000 |
| 2 | 0.826 | 30 000 |
| 3 | 0.751 | 30 000 |

- Year "0" means the present moment. Therefore, present value also is Rs. 50 000.
- At the end of the first year cash flow is Rs. 40 000 and its present value is 0.909 x 40 000 = Rs. 36 360.
- At the end of the second year cash flow is Rs. 30 000 and its present value is 0.826 x 30 000 = Rs. 24 780.
- At the end of the third year cash flow is Rs. 30 000 and its present value is 0.751 x 30 000 = Rs. 22 530.
- By adding the period values, Net present value is calculated.

**Decision based on Net Present value**

If the Net Present Value is positive it is suitable to accept the project (Invest in the project).

- If there is only one investment it has a positive NPV, it is advisable to accept the project.
- If there are few more investments it is advisable to accept the project which has the highest NPV.

**Advantages and disadvantages of Net present value.**

**Advantages :**

1. This method considers all the cash flows.
2. Can select the time value discounting factors.

**Disadvantages :**

1. Need to calculate cash flows
2. It is difficult to select the correct discounting factor.

How to make decisions by calculating present value and Net Present Value.

(i) Calculate the present values of following cash flows based on 10% discounting factors.

| Year | Net cash flow (Rs.) |
|---|---|
| 1 | 10 000 |
| 2 | 25000 |
| 3 | 15000 |
| 4 | 10000 |

10% discounting factor

| Year | 0 | 01 | 02 | 03 | 04 |
|---|---|---|---|---|---|
| Discounting factor | 1.000 | 0.909 | 0.826 | 0.751 | 0.683 |

**Solution** :

| Years | 10% Discounting factor | Net cash flows (Rs.) | Present value (Rs.) |
|---|---|---|---|
| 01 | 0.909 | 10 000 | 9 090 |
| 02 | 0.826 | 25 000 | 20 650 |
| 03 | 0.751 | 15 000 | 11 265 |
| 04 | 0.683 | 10 000 | 6 830 |
| | | **Total present value** | **+ 47 835** |

(ii) In the above example, if it is expect to purchase a machinery for a value of Rs. 60 000. write the decision by calculating Net Present Value?

**Solution**

| Years | 10% Discounting factor | Net cash flows (Rs.) | Present value (Rs.) | |
|---|---|---|---|---|
| 00 | (60 000) | 1,000 | (60 000) | (60 000) |
| 01 | 10 000 | 0.909 | 9 090 | |
| 02 | 25 000 | 0.826 | 20 650 | |
| 03 | 5 000 | 0.751 | 11 265 | |
| 04 | 10 000 | 0.683 | 6 830 | 47 835 |
| **Total present value** | | | | **-12 165** |

It is not suitable to purchase the machinery since Net Present value is negative.

Net Present value is defined as the difference between totals of present values and present value of initial investment.

Net Present value = Total present values of net cash flows - Present value of initial investment

**Relevant cost and Irrelevant cost**

Relevant costs are the costs which are changed from option to option. When comparing investments.

In order to words, these cost are not stable with options.

**Example**

- Labour costs and electricity expenses are changed from option to option. These are called relevant costs.

  Rent, insurance premiums are not changed from option to option. These are called irrelevant cost.

  Costs which have been already incurred are called as **sunk cost.**

**Guidance on activity plan :**

- Present the following question to students. Do you need Rs. 5 000 now? or next week? Explain the students that it is better to get Rs. 5 000 now and the reasons, write the answer they provide on the board.
- Conduct a discussion with students to highlight following factors.
- It is most suitable to reserve an amount today than in future
- By investing that an amount could generate an interest.
- The value of cash received today is higher than received that amount in a future date and it could be identified as the time value of money. value of Rs. 5 000 received today is higher, than the value of Rs. 5 000 which will be received in the future.
- **The main reason for this time value of money interest or cost of capital.**
- Present value of future cash flows should be found by discounting it from a discounting factor.

  A company expects to purchase two machinaries and the details are as follows.

**Cash flows**

| Description | Machine X | Machine Y | 10% Discounting factor |
|---|---|---|---|
| New purchasing price | 300 000 | 300 000 | 1.000 |
| First year | 90 000 | 80 000 | 0.909 |
| Second year | 100 000 | 90 000 | 0.826 |
| Third year | 150 000 | 100 000 | 0.751 |
| Fourth year | 150 000 | 90 000 | 0.683 |

- Guide students to calculate present value of initial investment.
- Guide them to calculate present values of years 1, 2, 3 and 4
- Advise them to deduct present value of initial investment by presenting values of future cash flows.
- The difference is Net present value
- Advice them to make the purchasing decision based on net present value.
- Discuss the reasons for that decision.
- Calculate NPV of the other group and confirm whether their answers are correct.
- After confirming, present the subject matters to the class.
- Discuss with students few more examples.

**Evaluation and Assignment criteria:**

- Name investment evaluation techniques
- Calculate accounting rate of return
- Make the decisions on payback period
- Explain time value of money
- Make the decisions on present value and net present value
- Mention the advantages and disadvantages of investment evaluation techniques
- Make the decisions based on various evaluation techniques.

**Exercises:**

**01.** Pay back periods of two expected investments are given below.

Investment 1 – 4 years and 3 month

Investment 2 – 4 years and 1 month

Mention the investment to be accepted and write the reasons.

**02.** There are two options for a business to invest their money. Details are as follows.

| | First investment (Rs.) | Second investment (Rs.) |
|---|---|---|
| Investment cost | 500 000 | 500 000 |
| Profit year1 | 90 000 | 80 000 |
| year 2 | 100 000 | 100 000 |
| year 3 | 150 000 | 150 000 |
| year 4 | 120 000 | 170 000 |

The values of each investment at the end are Rs.100 000 and Rs. 200 000 respectively.

**Requirements**

1. Calculate accounting rate of return of each investment?
2. Mention with reasons the investment to be selected.

**03.** Given below are the net cash flows of a firm which expects to purchase two machines with values of Rs. 300 000 each.

Net cash flow (Rs.)

| Year | Machine X | Machine Y |
|---|---|---|
| 1 | 60 000 | 100 000 |
| 2 | 80 000 | 175 000 |
| 3 | 100 000 | 100 000 |
| 4 | 150 000 | 80 000 |

1. Calculate pay back period of each machine.
2. Mention the machine to be purchased with reasons.

**04.** (i) Discount the net cash flows of above x and y machines using 10% discounting factor and calculate net present value?

(ii) Mention the machine to be purchased on Net Present Value basis.

10% discounting factors

| Years 0 | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| 1.000 | 0.909 | 0.826 | 0.751 | 0.683 |

**05.** "Saroma garment factory" expects to purchase a new machine in future and is it costs Rs. 150 000. Expected future cash inflows and outflows of this machine as follows.

| Years | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| Cash inflows | 160 000 | 180 000 | 150 000 | 160 000 |
| Cash outflows | 100 000 | 110 000 | 100 000 | 90 000 |

12% discounting factor

| 0 | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| 1.000 | 0.893 | 0.797 | 0.712 | 0.636 |

**Requirements :**

1. Calculate the pay back period.
2. Calculate the Net present value
3. Purchasing decision based on Net Present value
4. Mention the maximum price which the company wishes to pay for the machine.

**06.** Write **true or false** for following statements.

1. Time value means the value of cash received in future are lower than the value of cash received today (…………..)
2. Initial investment of a project is rs 500 000. Cash flow of the first year is Rs. 30 000. Discount factor is 10%. Net present value of this investment is a negative value.

**07.** Details regarding two machines which could be used in a specific task have been given below.

| | Machine 1 | Machine 2 |
|---|---|---|
| Iitial investment | 600 000 | 600 000 |
| Annual rent | 100 000 | 100 000 |
| Profit in the first year | 250 000 | 400 000 |
| Profit in the second year | 560 000 | 600 000 |
| Profit in the third year | 600 000 | 800 000 |

**Requirements :**

1. Calculate annual cash flows.