SHORT NOTES

Unit 01 – Accounting & it's importance

MAIN OBJECTIVES OF ACCOUNTING

Financial - To provide general purpose financial statements to stakeholders for decision making (specially for **existing and potential investors, lenders and other creditors**)

Management - To provide Specific purpose managerial information to managers for decision making

SEQUENTIAL ORDER OF ACCOUNTING

Transactions take place

↓

Source Documents are prepared

↓

Prime entry books are prepared

↓

Posted to Ledger Accounts

↓

Preparation of Trial Balance

↓

Financial Statements

Differences between Financial Accounting and Management Accounting

	Financial	**Management**
Purpose	☞General purpose	☞ specific purpose
Users	☞Internal & External	☞Internal only
Legal requirement	☞compulsory	☞ not compulsory
Reporting frequency	☞ Annually	☞On demand
Nature of information	☞Historical	☞Present and forecasted

☞Legal
☞Technological
☞Technical & Professional
☞ Social & Cultural
☞Political & Economic

} **Environmental factors of Accounting**

Accounting Elements - Assets, Liabilities, Equity — **Main Elements**; Expense, Income, — **Sub Elements**

Components of financial statements

☞Statement of profit or loss - Net profit
☞SOFP – financial position
☞Cash flow statement – Changes in financial position
☞Statement of Changes in equity
☞Accounting notes

Measurement basis of Accounting Element

1) Historical cost
2) Current Cost
    a) Fair Value (the present market value)
    b) value in use and fulfillment value
       (Value in use - The use you gain without selling the asset)
    c) Current cost

Qualitative Characteristics

Fundamental

Relevance - Predictive value
Confirmatory value
Materiality

Faithful representation - Completeness
Neutral
Free from errors

Enhancing/improvable

Timelines
Verifiability
Understandability
Comparability

Main Underlying Assumption

☞Going concern

New trends of accounting

☞Computerized Accounting
☞Human Resource Accounting
☞Environmental Accounting
☞Inflationary Accounting
☞Social Responsibility Accounting

Unit 02 - Accounting equation

A	=	E	+	L

→ **Basic Accounting equation**

E: (+) Add Capital/ Income; (-) Drawings/ Expenses

A	+	E	=	Eq	+	I	+	L

→ **Final Accounting equation**

Profit equation/ Net asset approach

Profit/Loss	=	NA1	-	NAo	+	D	-	AC
Profit/Loss	=	Increase in net assets			+	D	-	AC

Increase in net assets = Increase in Assets – Increase in Liability

Capital = Net Assets

Equity
- **Capital**
  - ☞ only add. capital
- **Retained Earning**
  - ☞Drawings
  - ☞Income
  - ☞Expenses

How to record VAT under accounting equation

Ex-; Credit purchases Rs.230,000 (including 15% VAT)

A	=	E	+	L
+200,000 (stocks) +30,000 (VAT receivable)				+230,000(creditors)

Ex-; Credit sales Rs.230,000 (including 15% VAT) cost of these goods 180,000

A	=	E	+	L
-180,000 (stocks) +230,000 (debtors)		+20,000(profit)		+30,000 (VAT payable)

How to record EPF under accounting equation

A	=	E	+	L
(-) Net salary		(-) employee related total expense		(+) EPF (employer + employee)

Mark up (profit on cost) and Margin (profit on Selling price)

Ex-: Selling price 240,000 **(profit 20% on cost)**

	Cost	+	profit	=	Selling price
Meaning of 20% on cost is	100	+	20	=	120

To find cost = $\frac{240,000}{120}$ x 100 To find profit = $\frac{240,000}{120}$ x 20

Ex-: Cost 160,000 **(profit 20% on selling price)**

	Cost	+	profit	=	Selling price
Meaning of 20% on selling price is	80	+	20	=	100

To find selling price = $\frac{160,000}{80}$ x 100 To find profit = $\frac{160,000}{80}$ x 20

Unit 03 Double entry system

$$\underbrace{A + E}_{\substack{\textbf{Increase Debit} \\ \textbf{Decrease Credit}}} = \underbrace{C + I + L}_{\substack{\textbf{Increase Credit} \\ \textbf{Decrease Debit}}}$$

Type of account

☞Provision for depreciation and provision for doubtful debts - Asset Account
☞Sales return - Income account
☞Purchase return – Expense account
☞Retained earnings –equity
☞Accrued expense - Liability
☞VAT account - Asset /Liability
☞Prepaid expense - Asset
☞Provision for warranty – Liability
☞Provision for gratuity - Liability
☞Income received in advance- Liability
☞Subscription - Income account
☞Income receivable - Asset
☞Life membership- Equity
☞Accumulated fund - Equity
☞Drawing - Equity

Double entries which use frequently

☞ **credit sales** - Debtors control Dr
Sales Cr
☞**Credit purchases** – Purchases Dr
Creditors control Cr
☞ **Sales Return** - Sales Return Dr
Debtors control Cr
☞**Purchase Return** - Creditors control Dr
Purchase Return Cr
☞ **Discount Received** - Creditors control Dr
Discount Received Cr
☞ **Discount Allowed** - Discount Allowed Dr
Debtors control Cr
☞ **Bad debts** - Bad debts Dr
Debtors control Cr
☞ **Doubtful debts** - Doubtful debts Dr
Provision for Doubtful debts Cr
☞ **Depreciation** - Depreciation Dr
Provision for Depreciation Cr
☞ **Closing stock** - Closing stock Dr
Cost of sales Cr
☞**Goods drawings** - Drawings Dr
Purchases Cr

Unit 04 – Prime entry books (Chronological book of Accounts)

SR NO	Transaction	Source document	Prime Entry Book
1	Cash Receipts	Receipt	Cash Receipt Journal
2	Cash payments	Payment Voucher	Cash Payment Journal
3	Credit sales - (Goods)	Sales Invoice	Sales Journal
4	Credit Purchase – (Goods)	Purchase Invoice	Purchase Journal
5	Sales returns	Credit Note	Sales return Journal
6	Purchase returns	Debit Note	Purchase return Journal
7	Petty cash transactions	Petty Cash Voucher	Petty Cash journal
8	All other transactions	Journal Voucher	General Journal
	• Opening entries (A & L)		
	• Closing entries (I & E)		
	• Rectification of errors		
	• Purchase of NCA on credit		
	• Sale of NCA on credit • Dishonored cheques		

List Price = 8 000 (Trade discount 10%)
Invoice Price = 7 200 should be recorded in purchase journal (**Always after deducting trade discount)**

If cash discount of 10% is received when settlement by cheque, double entry

Creditor Dr 7200
Cash Cr 6480
Discount received Cr 720

If this cheque is returned by the bank

Cash control Dr 6480
Discount received Dr 720
Creditor Cr 7200

If cheque issued for payment an expense returned by the bank
Cash control Dr xx
Accrued expense Cr xx

Credit purchases with VAT

Purchase Dr xxx (excluding vat) → Income statement
Vat control Dr xxx (vat amount) → asset
Creditors control Cr xxx (including vat)

Credit Sales with VAT
Debtors control Dr xxx (including vat)
Vat control Cr xxx (vat amount) → Liability
Sales Cr xxx (excluding vat) → Income statement

Petty cash imprest/Float – total amount given to petty cashier

Reimbursement - Amount given by the main cashier to refill petty cash imprest

Format of a Cash Receipt Journal

Date	**Receipt No**	**Description**	**Discount Allowed**	**Amount**	**Analysis Columns**				**VAT**
					Sales	**Debtors**	Income	Other	
			xxxxx		xxxxx	xxxxxx	xxxxxx	xxxx	xxxx

Discount Allowed Dr. → Exp. ↑
Debtors Control Cr. → Assets ↓

(Asset ↑) Cash Control Account Dr
(Income ↑) → Sales Cr.
(Asset ↓) → Debtors control Cr.
(Income ↑) → Income Cr.
(Liability ↑) → VAT control Cr.

Format of a Cash Payment Journal

Date	**Payment No**	**Description**	**Discount Received**	**Amount**	**Analysis Columns**				**VAT**
					Purchases	**Creditors**	Expenses	Other	
			xxxxx		xxxxx	xxxxxx	xxxxxx	Xxxx	xxxxx

Creditors Control Dr.
Discount Received Cr.

(Expense ↑) → Purchase Dr.
(Liability ↓) → Creditors Dr.
(Exp. ↑) → Other Exp. Dr.
(Asset ↑) → VATCcontrol Dr
(Asset ↓) Cash Control → Cr.

Format of a Petty Cash Journal

Date	**Voucher No**	**Description**	**Ledger Folio**	**Amount**	**Analysis Columns**				
					Postage	**Stationery**	**Cleaning**	**Other**	**Ledger (Creditors)**
					xxxxx	xxxxxx	xxxxxx	xxxxx	xxxxxx

Petty Cash Imprest is given by the main Cashier:

Petty Cash Control Dr. xxxx
Cash Control Cr. xxxx

Stationery Dr. xxxx
Postage Dr. xxxx
Cleaning Dr. xxxx
Other Dr. xxxx
Ledger (Creditors) Dr. xxxx
Petty Cash Control Cr. Xxxx

Format of a Purchase Journal

Date	Invoice No	Suppliers Name	Excluding VAT	VAT(15%)	Including VAT
1/20	**001**	Nimal	200	30	230
			200	**30**	**230**

- Credit Purchase of Goods (Including VAT) → Purchase Dr. (Expense ↑) | VAT Dr. (Assets)↑ | Creditors Control Dr.

Format of a Purchase Return Journal

Date	Debit Note No	Customers Name	Excluding VAT	VAT(15%)	Including VAT
1/25	**002**	Nimal	50	7.5	57.5
			50	**7.5**	**57.5**

Purchase Return Cr. (E)↓ | VAT Cr. (Assets↓) | Creditors Dr. (L↓)

Format of a Sales Journal

- VAT Column is needed only if the Business is a PLC or VAT registered only

Date	Invoice No	Customers Name	Excluding VAT	VAT(15%)	Including VAT
		Amal	300	45	345
			300	**45**	**345**

- Credit Sales of Goods → Sales Cr.(I) | VAT Cr.(L) | Debtors Control Dr (Asset)

Format of a Sales Return Journal

Date	Credit Note No	Customers Name	Excluding VAT	VAT(15%)	Including VAT
		Amal	100	15	115
			100	**15**	**115**

Return Dr → Sales Cr.① | VAT Dr.(c) | Debtors Cr.(A)

General Jouurnal

- The journal where entries that are not entered in the books of prime entry are made is introduced as the **General Journal** or Main Journal.
- The source document used to make entries in the General Journal is the Journal Voucher.
- The format of the General Journal could take the following form:

Date	Journal Voucher No.	Details	Folio Ref.	Debit (Rs.)	Credit (Rs.)
2017/xx/xx					
		Account to be debited		xx	
		Account to be credited			xx
(Narration)………………………………………………………………………………………					
……………………………………………………………………………………					

- Entries made in the General Journal will be shown in the double entry format.
- The reason for the journal entry must be stated and this is known as the "narration".
- The transactions recorded in the General Journal are posted to the Ledger in the same manner.
- The following types of transactions are recorded in the General Journal:
  - Opening entries
  - Adjustment entries
  - Correction of entries
  - Entries related to the purchase of Property, Plant & Equipment on credit, sale on credit, disposal and exchange
  - Closing entries
  - Notes for posting to ledger
  - Other notes

BANK RECONCILIATION

Causes for differences

Errors of Omission (standing order, bank charges, direct deposit)
Arithmetic Errors
Errors of Timing differences (Un-presented &unrealized)

Bank Balance 50 000
Bank Statement Balance 30 000

Reasons

Deposited dishonored cheques
Unrealized cheques
Bank charges
Standing orders

Bank Balance 30 000
Bank Statement 50 000

Reasons

Issued dishonored cheque
Unpresented cheques
Direct remittance

Error correction

Trial Balance - The Statement which shows mathematical accuracy of the accounting process

☞ if same amount has debited and credited to two accounts it is **not affected** to the trial balance

Error types - Omission
Under casting
Over casting
Principle (Different category different account)
Duplication
Compensation
Commission (Same category different Account)

Principle, Duplication, Compensation, Commission – not affected to trial balance

General Ledger – The record which include all the type of ledger accounts (except debtors and creditors personal accounts)

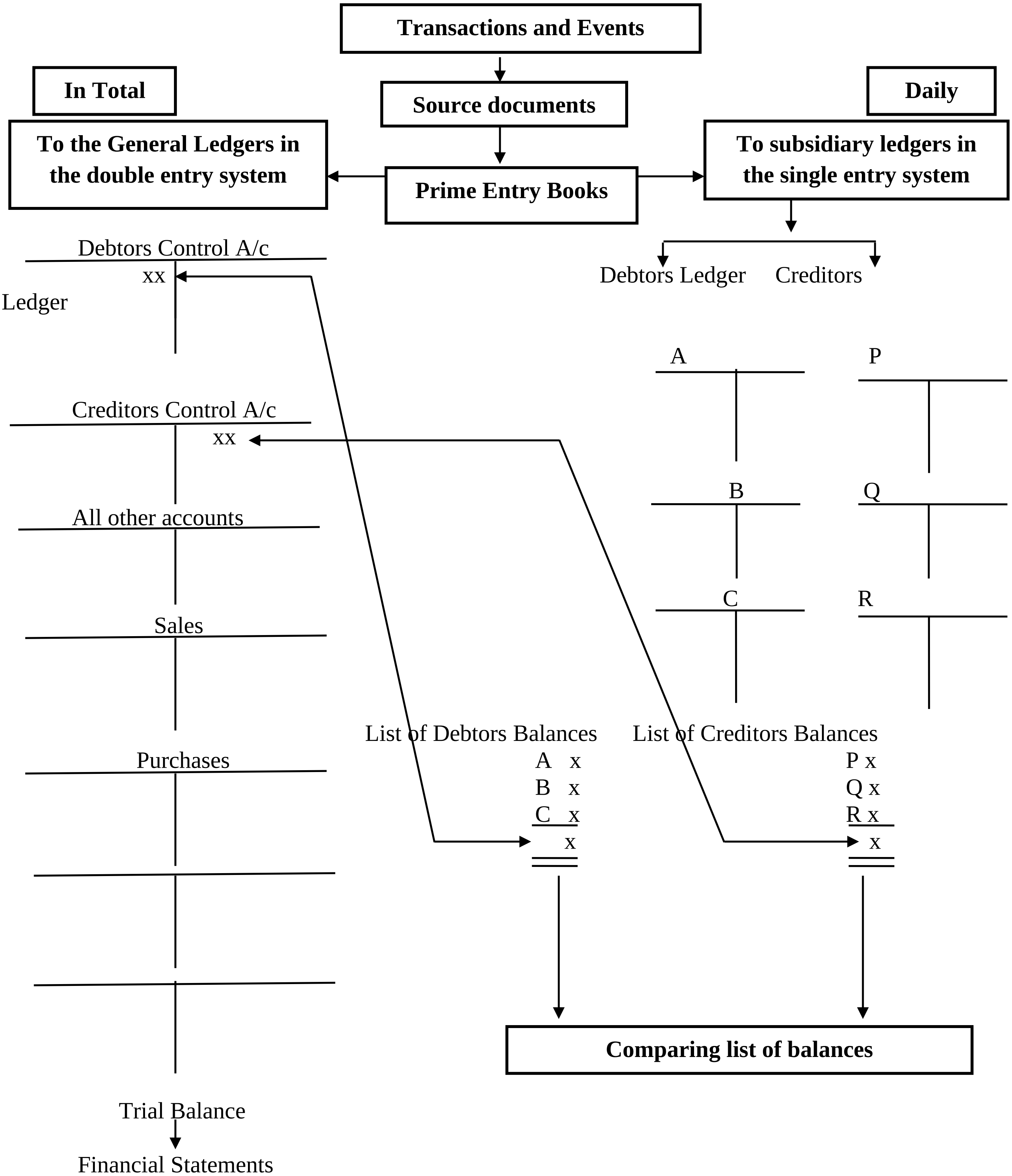
Profit Correction statement

When preparing Net profit correction statement

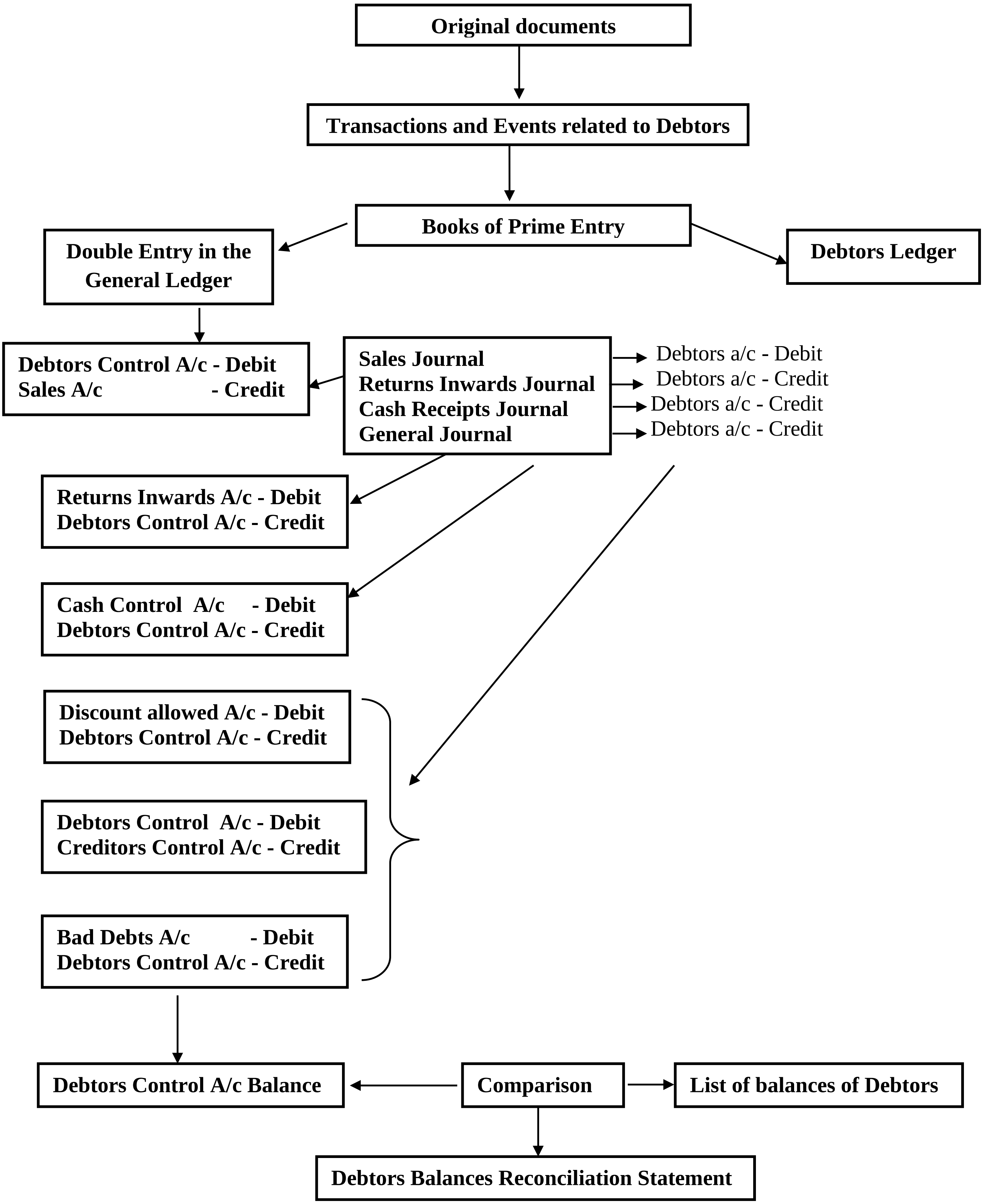
If Income or expense account **Cr**, it should be **added (+)** to the **NET PROFIT**
If Income or expense account **Dr**, it should be **Deducted (-)** from the **NET PROFIT**

When Income account **Cr** → Income Increase → Profit **Increase**
When Income account **Dr** → Income Decrease → Profit **Decrease**
When Expense account **Dr** → Expense Increase → Profit **Decrease**
When Expense account **Cr** → Expense Decrease → Profit **Increase**

Control Accounts



Debtors Sub Ledger and debtors Control Account



Unit 05 – Accounting concepts

ASSETS
☞Results of a past transaction
☞Controlled by the business
☞Present economic resource (Right that has the potential to produce economic benefits)

LIABILITY
☞Result of a past transaction
☞Present obligation
☞Transfer an economic resource

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

Similarity and difference between Liability and Equity
Similarity - As a result of a past transaction or an event
Difference – Equity represent obligation to the owner, Liability represent obligation to external parties

Income
Increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses
Decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.

RECOGNITION CRITERIAS (Accounting Elements)
☞ Relevant information about the asset or the liability and about any income, expense or changes in equity
☞A faithful representation of the asset or the liability and of any income, expenses or changes in equity
☞It should comply with the definition

BUSINESS ENTITY
☞Business Name
☞Drawings (deducting from equity)
☞Capital in liability side

GOING CONCERN
☛Assets and liabilities classified as current & non-current
☞Basis for depreciation

PERIODIC CONCEPT
Mentioning Accounting period
☞ I/S → for the year ended
☞ SOFP → as at

MONEY MEASUREMENT
Under this concept, business transactions which can be measured using the currency unit are recorded

☞ Eg: **‘RS’**

Non recognition of Employee Competency in Finance Statement

ACCRUAL CONCEPT – Paid or not the relevant amount for the period should be recorded

☞Accrued expenses
☞Receivable income
☞Received in advance
☞Debtors, Creditors
☞Pre-payments

SUBSTANCE OVER FORM

consider Economic substance rather than legal aspect

☞**Leasing**

Lease → faithful representation (relevant qualitative feature)

MATCHING CONCEPT

Income should be matched with relevant expense portion

☞Recognition of cost of goods sold as an expense and yearend inventory as an asset
☞deduct cost of Sales from sales to compute gross profit
☞preparing income statement (all expenses recorded in I/S)

*Cost- Monetary value of resource used to production (production cost)
* Expense- Cost of goods used to earning revenues

PRUDENCE CONCEPT

☞All the provisions are made based on this concept.
☞ Stock valued at lower of cost or NRV. (Historical cost concept is violated due to this principle)

CONSISTENCY CONCEPT

Maintaining same accounting policies
☞Eg: Use FIFO method to issue inventory each year
Maintaining same accounting policies → comparability (relevant qualitative feature)

MATERIALITY CONCEPT

The materiality mans the importance of an item recorded separately in the financial statements
Eg: Stapler Machine, loose tools

HISTORICAL COST CONCEPT

Assets should always be valued at historical cost (due to this relevance feature is violated).
Revaluation
Inventory Valuation at lower of cost or NRV } violated historical cost concept

Realization Concepts

☞ Recognize credit sales as an income
☞Sales in advance recognize as a liability

Disclosure Concepts

All accounting practices used must be disclosed.
Eg; Inventory issuing method

Unit 06 – Sole trader Adjustments

☞ **Accrued Expenses** - Relevant Expense Dr
Accrued Expense Cr

☞ **Prepaid Expenses** - Prepaid Expense Dr
Relevant Expense Cr

☞ **Income Receivable** - Income Receivable Dr
Relevant Income Cr

☞ **Income Received in Advance** - Relevant Income Dr
Income Received in Advance Cr

☞ **Goods in Transit** - Closing stock Dr
Cost of sales Cr

☞ **Closing stock adjustment** - Closing stock Dr (lower of cost or NRV)
Stock written off Dr (difference between cost and NRV)
Cost of sales Cr (Always Cost)

☞ **Stock damages with an insurance claim** - Insurance Receivable Dr
Stock loss Dr
Purchases Cr

☞**Stock sent on Sale or Return basis**

Eliminate sales entry from the books (when recorded as sales but not sold)

Sales Dr
Debtors control Cr

Added to closing stock

Closing stock Dr
Cost of sales Cr

☞ **Stock sold but not collected** - Cost of sales Dr
Closing stock Cr

☞ **Advances on Sales** - Sales Dr
Sales in Advance Cr

Unit 07 – Manufacturing Accounts

- ☞ DM + DL + DO = PRIME COST
- ☞ DM + DL + DO + POH = Manufacturing cost/ product cost /production cost
- ☞ DM + DL + DO + POH + Non production overheads = TOTAL COST
- ☞ DL + DO + POH = Conversion cost
- ☞ production overhead + non production overheads = Total overheads
- ☞ DM + Conversion cost + non production overheads = Total cost
- ☞ Prime cost + Total overheads = Total cost
- ☞ Total Direct cost + Total indirect cost = Total cost
- ☞ Prime cost + Total overheads – Non manufacturing cost = manufacturing cost
- ☞Prime cost + variable production overhead + fixed production overhead = manufacturing Cost

Cost of Sales = DM + DL + DO + POH + Finished goods

How to adjust Increase or Decrease in Stocks

Increase in Inventories

$$\left.\begin{array}{l}\text{Raw material}\\ \text{Work in progress}\\ \text{Finished goods}\end{array}\right\} \quad \textbf{(-)}\ \text{manufacturing Account}$$

Decrease in Inventories

$$\left.\begin{array}{l}\text{Raw material}\\ \text{Work in progress}\\ \text{Finished goods}\end{array}\right\} \quad \textbf{(+)}\ \text{manufacturing Account}$$

Unit 08 –Nonprofit Organizations

Differences

	Receipts & Payments	**I & E**
Basis	Cash basis	Accrual Basis
Purpose	To find the cash balance	To find surplus or deficit

ACCOUNTING FOR LIFE MEMBERSHIP

☞Treat it as an income in the year in which life membership were received
☞Treat it as a liability and a transfer agreed amount to income and expenditure account
☞Treat it as a direct increase in accumulated fund

Closing accumulated fund

AF closing	=	Closing Assets	-	Closing liabilities
AF closing	=	AF opening	+	Surplus
Surplus	=	AF_1	-	AF_0

Special fund

☞ R & P Dr xx
    Building fund Cr xx

When it is used for construction

☞ Building Dr xx
    R & P Cr xx

☞ Building fund Dr xx
    Accumulated fund Cr xx

Subscription Account

Opening Arrears	xxxx	Opening advance	xxxx
Income and Expenditure	xxxx	Receipts and Payments	xxxx
		Subscription w/off	xxxx
Closing advance	xxxx	Closing Arrears	xxxx
	xxxx		xxxx

Unit 10 - PARTNERSHIP

Section 24
Profits equally
No salaries
No interest on capital
5% interest on additional loan

Section 42 – 5% interest on retired partners loan

GOODWILL CALCULATION

1.Admission of a partner
2.Retirement of a partner
3. When partnership agreement change

Expense incurred by a partner on Behalf of the partnership

☞ Expense Dr
partners current a/c Cr

when Reimburse

☞ partners current a/c Dr
Cash Cr

New profit sharing ratio

	A	B	C
Old	$\frac{2}{3}$	$\frac{1}{3}$	
New	$\frac{4}{5} \times \frac{2}{3}$	$\frac{4}{5} \times \frac{1}{3}$	$\frac{1}{5}$
	$\frac{8}{15}$	$\frac{4}{15}$	$\frac{3}{15}$
	8 :	4 :	3

Goodwill Double entry

Capital a/c Dr (new profit sharing ratio)
Capital a/c Cr (old profit sharing ratio)

Equity of a Partnership = Capital Balances + Current Balances + Other Reserves if Available

Increase in Equity = Closing Equity – opening Equity

Closing Equity = Opening Equity + Net profit + Additional capital + other entitlement for partners (Loan interest, Rent) - Drawings

Special profit calculation method for partnership

Profit = Salaries + Interest on Capital + Profit shares

Total profit distributed to a partner = Salary + interest on capital + profit share
Total Income distributed to a partner = Salary + interest on capital + profit share + Loan interest and other entitlements

Unit 11 – Accounting standards

☞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.

☞ Two statutory bodies that have been established under the Sri Lanka Accounting and Auditing standards act No. 15 of 1995

1) Sri Lanka Accounting Standards Committee
2) Sri Lanka Auditing Standards Committee

☞Incorporation of Sri Lanka Accounting Standards Committee according to 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.

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.

Conceptual framework

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

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.

LKAS 02 - inventory

INVENTORIES
☞Held for sale in the ordinary cause of business (Finish goods)
☞In the process of production for such sale (work in progress) or
☞In the form of materials or supplies to be consumed in the production process (raw materials)

COMPONENTS OF COST OF INVENTORY
☞Purchase cost
☞Conversion cost (Direct labor, direct other, production overhead)
☞Other cost (incurred in bringing the inventories to their present location and condition)

Excluded cost from inventory valuation (2019A/L)
☞overhead selling costs
☞abnormal amounts of wasted material, labor and other production cost
☞general administrative overheads
☞Storage costs

NRV = Estimated selling price – (Estimated cost of completion + Estimated selling expenses)

ACCEPTED COST FORMULAS UNDER LKAS -02
☞FIFO
☞WAC

METHODS OF DETERMINATION Net Realizable Value
☞Item by item basis
☞group basis

Recognition of inventory as an expense

- At the time of selling inventories
- If there is a stock loss (when NRV of inventory is lower than it's cost)

DISCLOSURES OF INVENTORY → (included in notes)
☞ NRV determination method (Item by item basis, group basis)
☞ Cost formula (FIFO, WAC)
☞Inventories kept as securities
☞stock losses

LKAS 07 – Cashflow

Cash and cash equivalents - Cash
Bank
Treasury Bills and short term investments less than 3 months

Working capital relationship

Current assets **negative** → Cashflow

Current Liability **positive** → Cashflow

Following items have to be **adjust twice** when preparing indirect method cashflow statement

- Interest expense
- Interest income
- Dividend income
- Rent income
- Disposal proceed and gain/loss

Format of a Retained Earnings account

Retained Earnings

Dividend paid	xx	BBF	xxx
Transfer to G/R	xx	Profit for the year	xxx
Bonus issue using R/E	xx		
BCD	xx		
	xx		xx

Format of a Property plant and equipment account (at cost)

Property plant and equipment account (at cost)

BBF (Cost)	xxx	Disposal(cost)	xx
Revaluation Gain	xx	Dep. on revaluation	xxx
Aquisitions	xx	BCD (Cost)	xx
	xx		**xx**

Format of a provision for Property plant and equipment account

Provision for Property plant and equipment account (at cost)

Dep.on revaluation	xxx	BBF	xxx
Disposal	xx	Annual Depreciation	xxx
BCD	xx		
	xx		**xx**

Format of a Property plant and equipment account (at NBV)

Property plant and equipment account (at NBV)

BBF (NBV)	xxx	Disposal (NBV)	xx
Revaluation Gain	xx	Depreciation	xxx
Aquisitions	xx	BCD (NBV)	xx
	xx		xx

LKAS 08

Accounting Policies
Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements.

Selecting Accounting Policies
There are two ways of selecting an accounting policy.

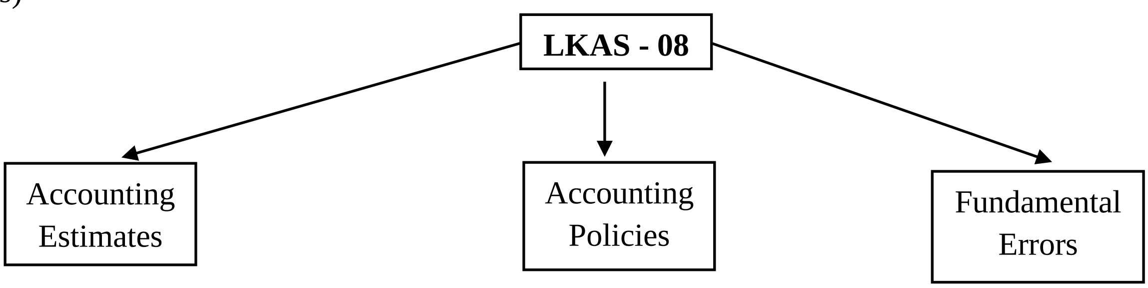
- If an accounting standard is clearly applied to a transaction or an event. The accounting policy should adhere to the standard.
  Eg -: FIFO or WAC as per LKAS 02
- In the absence a recommended accounting policy.

(The management of the entity should develop an appropriate accounting policy.

What is change of accounting policies?
Change in recognition, measurement and presentation.
Why accounting estimate?
☞Inherent uncertainties in business activities.
☞Many items in the financial statements are to be estimated since they can't be measured with accuracy.

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 in financial statements can arise on account of incorrect recognition, measurement, presentation or disclosure of items in financial statements. (Mainly focus on prior period errors)



Eg: Residual Value
Income tax
Depreciation%
Depreciation method
Useful life
Doubtful Debts
N.R.V

Change due to
New environment changes
New information or experience

Adjust
Present & Future
Period Financial Statement **(prospective Application)**

Eg: ☞inventory policy (FIFO/WAC)
☞Item by Item/Grouping method
☞using cost model or revaluation model for subsequent measurement

Change due to
- if Required by LKAS**(Prospective)**
- For more reliable presentation **(Retrospective)**

Adjust
Past, Present & Future, Financial Statement
(Retrospective or prospective Application)

Eg: last year closing stock under stated
Adjust
opening balance R/E A/c
(Retained earnings)
(Retrospective Restatement)

Example with workings
The following balances of Isuru PLC are given:

Provision for product warranty as at 01.04.2018	-	Rs.	12 000
Sales for the year ended 31.03.2019	-	Rs.	900 000

The company offers one year product warranty. Amount equal to 10% of current year sales are expected to incur as repairing expenses for the faculty products sold during the year under warranty. Repair cost incurred during the year Rs. 40 000 for current year sales. Previous year warranty has expired.

Required:
i. State the accounting treatment for previous year balance of the warranty provision with reference to the LKASs.
ii. Show the financial statement extract for the year ended 31.03.2019

Answer

i) Previous year balance should be excluded from distribution expenses. **(as it has already been expired)**

ii) **I/S extract** → **Distribution expense**

Last year over provision	(12,000)
Current year provision	90,000

SOFP extract → **Current liability**

Provision for warranty	50,000

LKAS 10

Events after reporting period
“Are those events, favorable and unfavorable that occur between the end of the reporting period and the date when the financial statements are authorized for issue

adjusting events

Those that provide evidence of conditions that existed at the balance sheet date (b)Those

Non adjusting events

that is indicative of conditions that arose after the balance sheet date

01.04.2022 → 31.03.2023 → 25.05.2023 Directors authorized date

Events occurring after the balance sheet date

Adjusting Events

Accounting treatment

Should be adjusted in current year financial statement

Eg-:

- ☞Bankruptcy of a debtor who owed substantial amount at the balance sheet date
- ☞Sale of inventory lower than cost at 31.03.2023
- ☞Decision of a court case delivered on 30.04.2023 confirming employee compensation. (court case should be filed before balance sheet date)
- ☞Actual value of an asset purchased during the accounting period was decided after the reporting period.

Non-adjusting events

Accounting treatment

Should be Disclosed as a note

Eg-:

- ☞Discontinued operations
- ☞Proposed dividend for O/S
- ☞Assets destroyed due to fire
- ☞Declining market value of Investments
- ☞ A part of a building taken over by the government after reporting period

Disclosure requirement

Date of authorization for issue

The person who authorizes

Discloses the situation as at the end of the period

Nature of non adjusting events

LKAS 16

PPE

Are held for use in the production or supply of goods or services or for rental to others or for Administrative purpose
Are expected to be used during more than one period

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.

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.
Except land other assets → **Depreciable asset**

Disclosures

- Depreciation Method used
- Useful life
- Dep. Rate
- Property kept as a security

Cost components

Initial Purchase Price
(+) Installation
(+) Initial Testing (except trial production unit cost)
(+) Legal Fees
(+) VAT
(+) Cost of removing unwanted constructions

(-) Trade discount
(-) Subsidies
(-) Income from removing unwanted constructions

PLC ⟹ VAT REGISTERED COMPANY

- Initial purchasing price - VAT should not be included if it is a VAT Registered Company
- If company is not registered for VAT – VAT should be added to the cost

Examples of excluded cost

☞ cost of opening a new facility or business (opening ceremony)
☞ Costs of introducing a new product or service (including cost of advertising and promotional activities) **2019A/L**
☞costs of conducting business in a new location or with a new class of customer (including **cost of staff training**)
☞Administration and other general overhead costs

The disposal of an asset/Exchange of Fixed Assets

1 Eliminate the cost value of the disposed asset

Asset disposal account	Dr.
Asset account	Cr.

2. Eliminate the provision for depreciation of the disposed asset

Provision for depreciation account	Dr.
Asset disposal account	Cr.

3. Any cost on asset disposal

Asset disposal account	Dr.
Cash	Cr.

4. Cash received on disposal

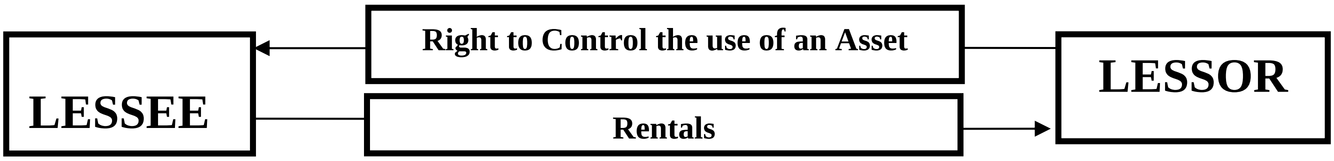
Cash	Dr.
Asset disposal account	Cr

- Finaly the balance in the asset disposal account will be transferred to the profit and Loss account.

Change in useful life, residual value, depreciation method or cost of an asset

Steps
1) find net book value
2) Add new cost
3) Deduct residual value
4) divide by new or remaining useful life

SLFRS 16 – Leases



Lessor - The party who transfers right to control the use of an asset in a lease contract

Lessee - The party who obtains the right to control the use of an asset in a lease contract

Accounting for Leases in the Books of Lessee

- **SLFRS 16 Do not apply for:**
  a) Short-term leases (a lease that, at the commencement date, has a lease term of 12 months or less)
  b) Leases for which the underlying asset is of low value.

Accounting treatment for above two situations:

Lease Rental	**Dr**	
Cash		**Cr**

Initial Recognition - Right of use Asset

- **Measure the right of use asset at cost at the commencement date**
- **The cost of the right or use asset comprises:**
  - the amount of the initial measurement of the lease liability
  - any lease payments made at or before the commencement date, less any lease incentives received.
  - Any initial direct costs incurred by the lessee
  - An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

Initial Recognition – Lease Liability

- **Measure the lease liability at the present value of the lease payments that are not paid at the commencement date.**
- **The lease payments are discounted using the interest rate implicit in the lease (If readily determinable)**
- **Lease payments included:**
  - Fixed payments less any lease incentives receivable
  - Variable lease payments that depend on an index or a rate.
  - Amounts expected to be payable by the lessee under residual value guarantees.
  - The exercise price of a purchase option of the lessee is reasonably certain to exercise that option.
  - Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Depreciation (finance Lease)

If Ownership is transferred at the end of lease period ⇒ Using useful life

If Ownership is not transferred at the end of lease period ⇒ lease period

The accounting for the lease in the books of the lessee.

- Initial deposit value / Down payment

Right of use asset	Dr	xxx	
Cash account		Cr	xxx

- Present value of minimum lease payment

Right of use asset	Dr	xxx	
Lease Liability account		Cr	xxx

- Interest on lease at the end of the period

Interest on lease account	Dr	xxx	
Lease Liability account		Cr	xxx

- Payment of installment

Lease Liability account	Dr	xxx	
Cash account		Cr	xxx

Classify Final Lease Liability as current and non current

Final Lease Liability ⇒ **Current Liability = Installment – Next year Interest**

Final Lease Liability ⇒ **Non Current Liability = Final lease liability – Current portion**

Format of a Lease Liability account

Lease Liability

		initial lease liability	xxx
Installment	xxx	Interest	xxx
BCD	xxx		
	xxx		xxx

BCD ⇐ **Final Lease Liability**

Example with workings

Supun PLC acquired a machine on lease basis on 01.04.2019. The following information is provided.

- Initial payment on 01.04.2019 - Rs. 500 000
- Annual installment - Rs. 200 000 (starting from 01.04.2019)
- Lease term - 4 years
- Initial direct cost incurred on 01.04.2019 by the lessee - Rs. 10 000
- The interest rate implicit the lease - 10%
- Discounting factors at 10% rate.
- Residual value - Rs. 143 800
- Useful life of the machine - 5 years
- The ownership of the machine will be transferred to Supun PLC at the end of 5^{th} year.

Year	:	1	2	3	4
Discount factor	:	0.909	0.826	0.751	0.683

Useful life of the machine - 5 years
Residual value - 50 000
The ownership of the machine will be transferred to Supun PLC at the end of the lease term.

Required to Calculate:

1. The amount of the lease liability
2. The amount to be recognized as right of use asset
3. Prepare lease liability account for the year ended 31.03.2020
4. Prepare financial statement extracts for the year ended 31.03.2020

Answer

1.

Year	:	1	2	3	4
Discount factor	:	0.909	0.826	0.751	0.683
Lease installment	:	200,000	200,000	200,000	200,000
Present value	:	181,800	165,200	150,200	136,600
Initial lease liability	:	633,800			

2. Right of use asset

Initial payment	500,000
(+) present value	633,800
(+) Initial Direct cost	10,000
	1,143,800

3. **Lease Liability**

		initial lease liability	633,800
Installment	200,000	Interest	63,380
BCD	497,180		
	697180		697180

Final Lease Liability

4. **I/S extract** **Distribution expense**

Right of use asset depreciation 200,000

Finance expense

Interest 63,380

SOFP extract → **Non Current Assets**

Right of use asset 943,800

Non Current liability

Lease Liability 346,898

Current liability

Lease Liability 150,282

Final Lease Liability

Current Liability = Installment – Next year Interest
150,282 = 200,000 - 49,718

Non Current Liability = Final lease liability – Current portion
346,898 = 497,180 - 150,282

SLFRS 15 – Revenue from Contracts with Customers

Main Features of SLFRS 15

- Introduces a Five Steps Revenue Model **(COPAR)**
- Five Steps Revenue Model

STEP 1 Identify the **C**ontract(s) With the Customer

STEP 2 Identify the Performance **O**bligations In the Contracts

STEP 3 Determine the transaction **p**rice

STEP 4 **A**llocate the transaction Price Between Performances Obligations

STEP 5 Recognize **R**evenue When a performane obligation is satisfied

Five Steps Revenue Model

Eg-: ABC PLC signed a contract to sell a machine to XYZ PLC and provide one year service contract for 30 million on 01.01.2019. The machine was delivered on 01.04.2019 and service started on 30.09.2019. The machine is usually sold without the service for 24 million and service is separately performed for 6 million. Full contract price was received on 01.04.2019. Accounting year ends on 31.03.2020

STEP 1

Contract - is a written, oral or implied agreement between 2 or more parties which create rights and obligations and it should be a legally enforceable.

Eg- ABC PLC came to an agreement to deliver a machine and provide service.

STEP 2

Performance Obligations - A promise to transfer a good/service

Eg- There are two performance obligations in this example

1. Supply of machine
2. Provide one year service

STEP 3

Transaction price – The amount of consideration which an entity expects to receive from a customer in exchange for transferring promised goods or service.

Eg- 30 million

STEP 4

Allocate - Transaction price should be allocated based on standalone selling prices of each obligation.

Eg-

Performance obligation	**Standalone selling price**	**Allocated price**
1. Supply of machine	24 million	24 million
2. Provide one year service	6 million	6 million
Total	**30 million**	**30 million**

(in this example there is no discount, therefore standalone selling price and allocated price between two performance obligations are equal.)

STEP 5

Recognize Revenue - An entity recognizes revenue when it satisfies the performance obligation by transferring promised goods or service to a customer.

Eg- Recognize 24 million sales revenue on 01.04.2019 (when the machine is delivered)
Recognize 3 million service revenue on 31.03.2020 (for the services already provided – 6million **x** 6/12)

Exercise 01

PQR PLC signed a contract to sell a machine to XYZ PLC and provide one year service contract for 25 million on 01.01.2019. The machine was delivered on 01.04.2019 and service started on 30.09.2019. The machine is usually sold without the service for 24 million and service is separately performed for 6 million. Full contract price was received on 01.04.2019.

Required

1. Performance obligations to be recognized?
2. Transaction price?
3. Total Discount amount?
4. Allocate the transaction price among performance obligations?
5. Journal entries

Answers

1) i) There are two performance obligations
1. Supply of machine
2. Provide one year service

2) 25 million

3) Standalone selling price - Transaction price = Total discount amount
30 million - 25 million = 5 million

4)

Performance obligation	**Standalone selling price**	**Allocated price**
1. Supply of machine	24 million	**25 x (4/5) = 20** million
2. Provide one year service	6 million	**25 x (1/5) = 5** million
Total	**30 million**	**25 million**

5) Journal entries

i) when transaction price is received
Cash Dr 25 million
Unearned revenue Cr 25 million

ii) when machine is delivered
Unearned revenue Dr 20 million
Sales revenue Cr 20 million

iii) Services already provided as at 31.03.2020
Unearned revenue Dr 2.5 million
Service revenue Cr 2.5 million

LKAS 37

Provision (Adjusted in financial statements)

Eg: Provision for warranty
Provision for compensation } Only liability provisions Are considered in LKAS 37

Provision is a liability of uncertain timing or amount. Legal or constructive obligation.

Characteristics: Present obligation (Legal or constructive obligation).
Reliable estimate
Probable outflow

Legal obligations may arise due to

- Operations of contractual law
- Operations of provisions in parliaments acts or
- Operations of other law

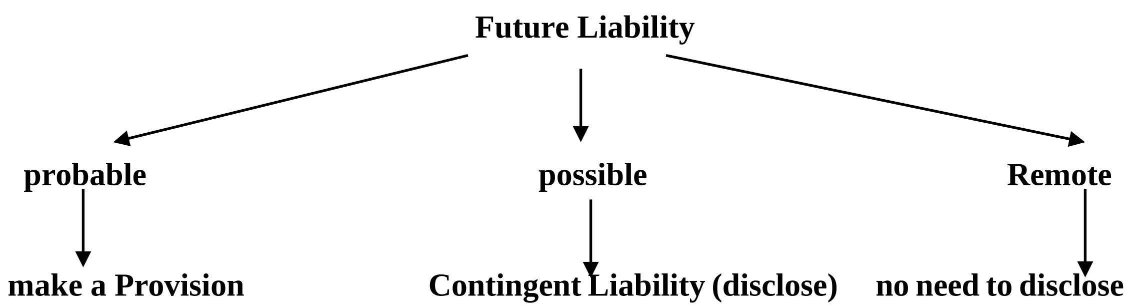
constructive obligation may arise due to

- established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and,
- as a result, a valid expectation created by entity on the part of those other parties that it will discharge those responsibilities.

Contingent liability (Disclose as a note)

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

Characteristics: possible obligation
Cannot estimate reliably



Contingent Assets

Possible asset that arises from past events whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent Assets Could not be recognized as an asset in the statement of financial position. Disclose only if there is a probability of an inflow of economic benefit.

Unit 12 – Limited company

Differences

	Bonus issue/capitalization or reserves	**Right issue**
Impact on cash	No change	Cash increase
Impact on Equity	No change	Equity increase

Bonus issue ⟹ Reserve Account Dr. xx
Share Capital Cr. Xx

Share issue

1) Receipts of cash with applications
   Cash Dr
   Share issue Cr
2) Rejection of applications or excess money
   Share issue Dr
   Cash Cr
3) Allotment of shares or capitalization of shares
   Share issue Dr
   Share capital Cr
4) Share issue expenses
   Share Capital Dr (Deducted from SOCE)
   Cash Cr

Total income	**Total Expense**
☞ Sales	☞ Cost of sales
☞ Other income	☞ Other expenses
☞ Revaluation gain	☞ Revaluation loss

Total Comprehensive income = profit for the year + Other Comprehensive income

Total Comprehensive income = Total income - Total expense

First time revaluation gain and subsequent revaluation loss

Cost	first time revalued amount	Subsequent revalued amount
1000	1500	800

Asset Dr 500
Revaluation reserve Cr 500

Revaluation reserve Dr 500
P & L Dr 200
Asset Cr 700

First time revaluation gain and subsequent revaluation loss

Cost	first time revalued amount	Subsequent revalued amount
1000	700	1,500

P & L (other expense) Dr 300
Asset Cr 300

Asset Dr 800
P & L Cr 300
Revaluation reserve Cr 500

Unit 13 – Accounting ratios

Profitability Ratios

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

To ↑GP ratio ⟶ ↑ S.P ↓ COS

Change in Inventory valuation policy (FIFO is more suitable)

In an **inflationary** Situation

FIFO ⟶ Closing Stock ↑ C.O.S ↓ G.P ↑

(Current Revenue is compared with the historical cost)

$$\textbf{Net Profit Ratio} = \frac{\text{Net profit after tax}}{\text{Sales}} \times 100$$

$$\textbf{Return on Equity} = \frac{\text{Net profit after tax}}{\text{Equity}} \times 100$$

$$\textbf{Return on Assets} = \frac{\text{Net profit after tax + Interest}}{\text{Total assets}} \times 100$$

☞**Liquidity Ratios**

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

$$\textbf{Quick ratio} = \frac{\text{Liquid assets}}{\text{Current liabilities}}$$

Liquid assets = Total current assets - (closing inventory + Pre-payments)

☞**Leverage ratios**

$$\textbf{Debt Ratio} = \frac{\text{Debt capital}}{\text{Total capital}} \times 100$$

Debt capital = Long term loans with fixed interest rate

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

$$\textbf{Equity Ratio} = \frac{\text{Equity capital}}{\text{Total capital}} \times 100$$

Equity capital = Ordinary share capital + reserves

Debt to Equity Ratio = Debt capital: Equity capital

or

Debt to Equity ratio = $\dfrac{\textbf{Debt}}{\textbf{Equity}}$

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

☞**Efficiency ratios**

Inventory Turnover Ratio = $\dfrac{\text{Cost of sales}}{\text{Average Inventory}}$

Inventory residence period = $\dfrac{\text{Average Inventory}}{\text{Cost of sales}}$ x 365 days

Debtors Turnover Ratio = $\dfrac{\text{Credit sales}}{\text{Average Debtors}}$

Debtors Collection period = $\dfrac{\text{Average Debtors}}{\text{Credit sales}}$ x 365 days

Assets turnover Ratio = $\dfrac{\textbf{Total sales}}{\textbf{Total assets}}$

Relationship between turnover ratio and residence/collection period

☞inventory turnover ↑ inventory residence period ↓ favorable situation

☞debtors turnover ↑ Debtors collection period ↓ favorable situation

☞**Investors' ratios**

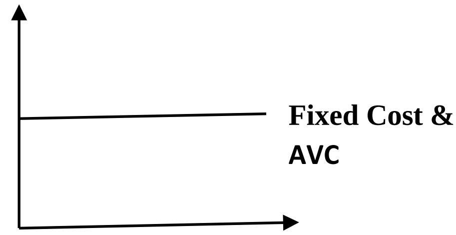
Earnings per share = $\dfrac{\text{Profit for the year}}{\text{Number of Ordinary Shares}}$

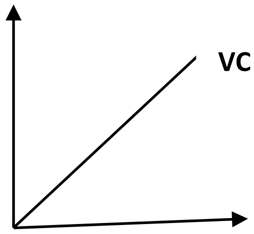
Dividend per share = $\dfrac{\text{Dividends for ordinary shares for the year}}{\text{Number of Ordinary Shares}}$

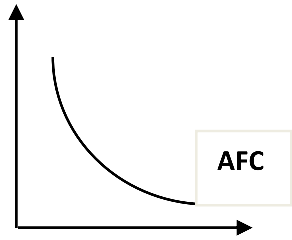
Cash cycle = Inventory residence Period + Debtors collection period - Creditors payment period

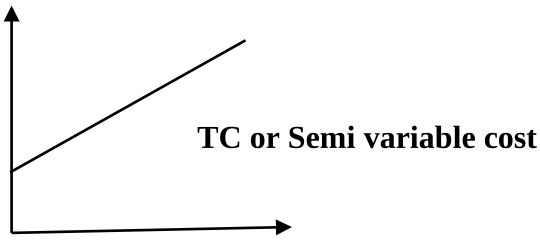
Unit 14- Cost Accounting

Cost unit - Any activity for which a separate measurement of cost is required is known as cost unit/cost object

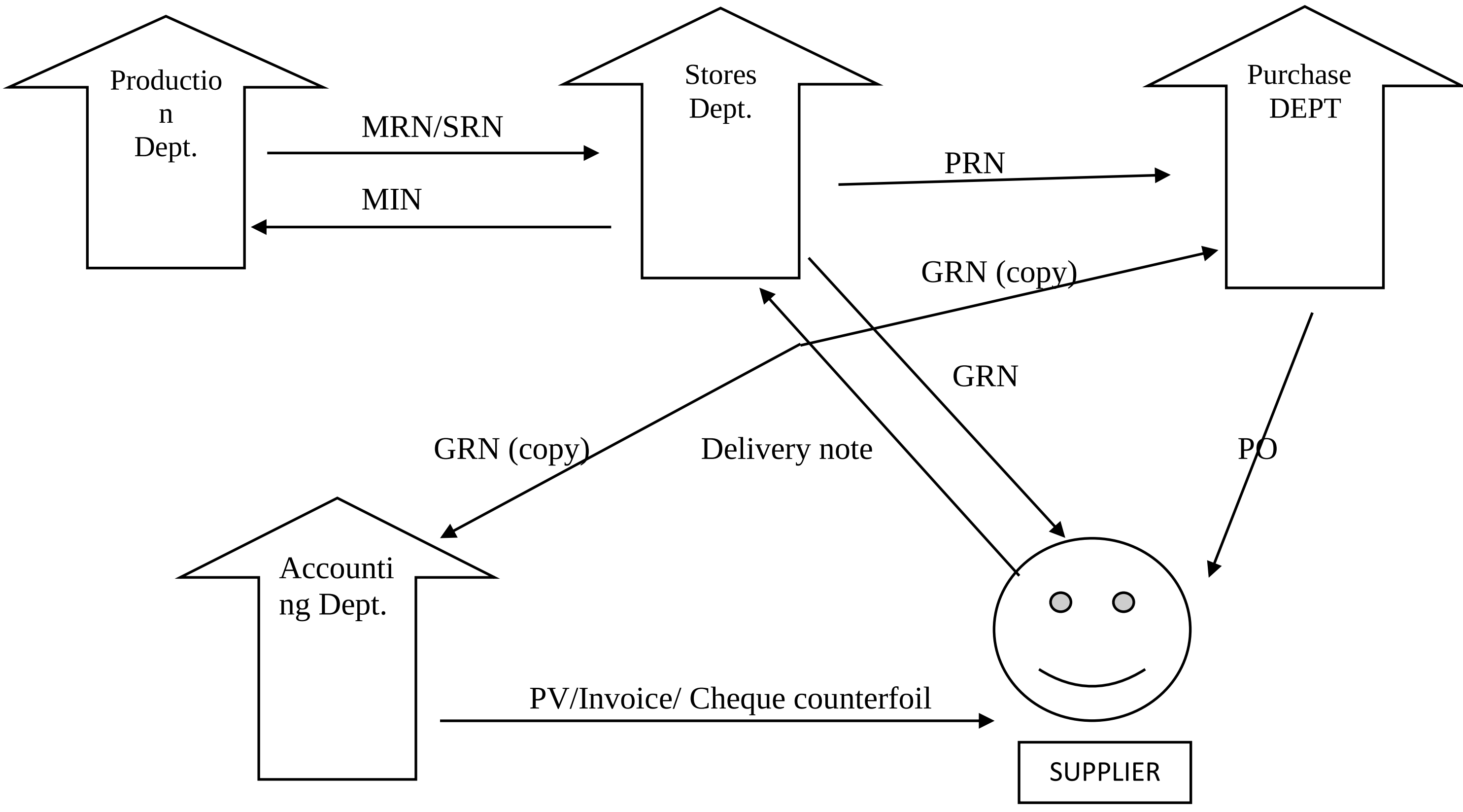








Material purchasing process



EOQ Assumptions
-Annual demand constant
-Holding cost per unit constant
-Cost per order is constant

Annual ordering Cost = cost per order X No of order

Annual Holding Cost = Average inventory X Holding cost per unit

EOQ X 50%

$$\textbf{EOQ} = \sqrt{\frac{\textbf{2DCo}}{\textbf{Ch}}}$$

Re –order level = maximum consumption X maximum lead time

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

Maximum stock level = ROL – (Minimum consumption **x** Minimum lead time) +EOQ

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

Or

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

Differences

Bin Card	**Stores Ledger**
Quantity Only	Value and Quantity
Maintain the stores	Maintain in the accounts department

Labour records

Active Time	**Retaining Time**
Job ticket	Attendance Register
Job cost sheet	Cards with bar codes
Daily time sheet	Finger printer machine

Documents required to prepare Pay sheet
Appointment letter
Time sheet
Attendance register

Journal entries relevant for Labour costing

1) Recording of Gross salary
Salaries and wages Dr
Salaries and wages control Cr
2) Deduction from salaries / wages
Salaries and wages control Dr
Relevant deduction account Cr
3) Payment of net salary
Salaries and wages control Dr
Cash Cr
4) Employer's contribution for the EPF (Employees Provident Fund)
EPF expense Dr
EPF payable Cr
5) Employer's contribution for the ETF (Employees Trust Fund)
ETF expense Dr
ETF payable Cr

Employee related total Expense = Gross salary + EPF by employer + ETF by employer

Direct Wages = Production employee related total Expense – (bonus based on Company Profit)

$$\text{OAR} = \frac{\text{Total budgeted Overhead of the relevant production department}}{\text{Total Budgeted basis}}$$

Absorbed Overhead = OAR X Actual Hours **(Budgeted will be taken if actual is not given)**

Under or (over) absorption = Actual overhead – Absorbed overhead

Different Overhead absorption rates

OAR **(as a % of DM cost)** $= \dfrac{\text{Total budgeted Overhead of the relevant production department}}{\text{Total Direct material cost}} \times 100$

OAR **(as a % of DL cost)** $= \dfrac{\text{Total budgeted Overhead of the relevant production department}}{\text{Total Direct Labour cost}} \times 100$

OAR **(as a % of Prime cost)** $= \dfrac{\text{Total budgeted Overhead of the relevant production department}}{\text{Total Prime cost}} \times 100$

Unit 15 – Marginal costing

BEP Assumptions

- Selling price is constant
- Technology constant
- All cost are divided as variable and fixed
- FC does not vary with quantity
- VC vary with quantity, VC per unit is constant at BEP
- Cost and income behavior as linear function

At BEP

- TR = TC
- Profit = O
- Total contribution = TFC
- Contribution Per Unit = AFC.

☞ Total contribution = TR – VC
Total contribution = TFC + Profit
Total contribution = Contribution per unit x no of units

☞ Contribution per unit = selling price – variable cost per unit
Contribution per unit = AFC + profit per unit

$$\text{Contribution per unit} = \frac{\text{Total contribution}}{\text{No of units}}$$

$$\text{Contribution per unit} = \frac{\text{Change in contribution}}{\text{Change in quantity}}$$

$$\text{Contribution per unit} = \frac{\text{Change in profit}}{\text{Change in quantity}}$$

☞ $$\text{Contribution sales ratio} = \frac{\text{Total contribution}}{\text{Total sales}} \times 100$$

$$\text{Contribution sales ratio} = \frac{\text{contribution per unit}}{\text{Selling price}} \times 100$$

☞ $$\textbf{Unit variable cost} = \frac{\text{Change in total cost}}{\text{Change in quantity}}$$

☞ $$\text{Breakeven point (Q)} = \frac{\text{Total Fixed cost}}{\text{contribution per unit}}$$

☞ Breakeven point (RS) = BEP (Q) x selling price

$$\text{Breakeven point (RS)} = \frac{\text{Total Fixed cost}}{\text{Contribution to sales ratio}}$$

☞ Margin of safety (Q) = Expected (Q) – BEP (Q)

Margin of safety (RS) = Margin of safety (Q) x selling price

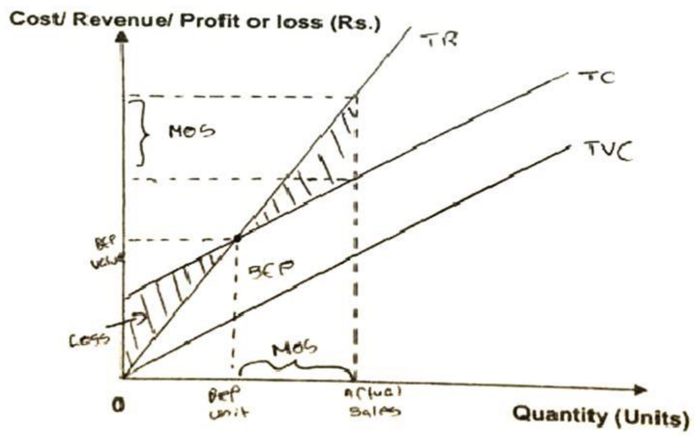
$$\text{Margin of safety (RS)} = \frac{\text{Net profit}}{\text{Contribution to sales ratio}}$$

☞ Profit = TR-TC
Profit = Total Contribution - Total Fixed cost
Profit = Margin of safety (Q) x contribution per unit

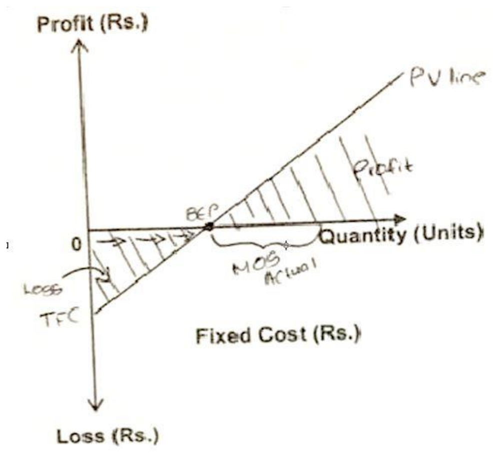
☞ Required/ Expected (Q) = $\frac{\text{Total Fixed cost + Expected profit}}{\text{contribution per unit}}$

If C/S ratio 40%, VC ratio should be 60%

Break even chart



Profit volume chart



Unit 16 - Investment Appraisal

Money has a time value due

It can generate returns when it is invested

$$\textbf{Average rate of return} = \frac{\textbf{Average net profit after tax}}{\textbf{Average investment}} \times 100$$

Average net profit after tax = Total net profit after tax ÷ Number of years

Average Investment = (initial investment + scrap value) ÷ 2

$$\textbf{Payback period months} = \frac{\textbf{deficit amount}}{\textbf{Next year net cashflow}} \times 12$$

Assumptions used in investment appraisal

- Initial investment cost should be incurred at the beginning of the investment (in the year zero).
- Annual cash flows are occurred at the end of each year.
- If there is any cash flow at the beginning of any year, it is occurred at the end of previous year.

Disadvantages of payback period

It fails to take into account the cash flows earned after the payback period.
It ignores the Time Value of Money (TVM)

Advantages of NPV

☞Consider time value of money
☞Consider all the cash flow of investment
☞Helps to select the investment which increase the owners wealth

Irrelevant Cost

☞Depreciation (Non cash item)
☞Market survey (feasibility study) sunk cost)
☞Interest expense
☞ Existing working capital

Reasons for increasing NPV

Cash inflows ↑
Cash outflows ↓
Discounting factor ↑
Cost of capital rate/Discount rate (money dep. Rate) ↓

Payback period ⇨ **Net cash flow = Net Profit + Dep**

ARR ⇨ **Net Profit = Net Cash flow - Dep**

NPV ⇨ **Net Cash flow = Net profit + Dep**