FINANCIAL LITERACY CURRICULUM

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Acknowledgment

The National Financial Inclusion Strategy (NFIS) of Sri Lanka represents a transformative framework designed embodies access to quality financial services while fostering meaningful usage across all segments of our population. This strategy represents our nation's unwavering commitment to building an inclusive financial ecosystem that not only facilitates access but empowers individuals, families, and communities to make informed financial decisions that enhance their economic well-being and strengthen resilience.

In pursuit of the NFIS objectives, the Financial Literacy Roadmap of Sri Lanka was meticulously developed and officially launched in May 2024, marking a pivotal milestone in Sri Lanka's journey towards financial inclusion. This strategic document serves as our nation's blueprint for systematic financial education, outlining evidence-based actions structured around four interconnected strategic pillars. The Financial Literacy Curriculum presented herein represents a cornerstone achievement under the Content Development and Harmonization pillar. This pillar is specifically dedicated to ensuring the delivery of consistent, culturally relevant, and pedagogically sound financial education across the breadth and depth of our nation, from urban centers to rural communities, encompassing diverse demographic groups and economic circumstances.

This groundbreaking initiative has been spearheaded by the Regional Development Department of the Central Bank. The curriculum development process exemplifies collaborative excellence, leveraging the distinguished academic expertise of the University of Kelaniya, whose contributions have been instrumental in ensuring theoretical rigor and practical applicability. The development process has been significantly enriched through active collaboration with key stakeholder departments within the Central Bank, alongside other stakeholders integral to the Financial Literacy Roadmap's success. These partnerships reflect a whole-of-system approach, where diverse perspectives, specialized knowledge, and varied experiences have converged to create a robust educational framework.

United Nations Development Programme (UNDP) in Sri Lanka, including through the Japan Supplementary Budget (JSB) ‘Promoting Economic Governance through Anti – Corruption Policy Support’ project, funded by the Government of Japan, extended invaluable financial and technical assistance in the development and design of this Financial Literacy Curriculum. This collaboration, formalized through our ongoing partnership, symbolizes the power of international cooperation in addressing shared development challenges and underscores the global significance of financial inclusion initiatives.

This Curriculum has been precisely designed to serve as the definitive standardized resource for deployment across multiple educational and awareness platforms. The curriculum's architecture encompasses seven strategically designed, inclusive chapters that collectively address the full spectrum of financial literacy needs: Economic Environment, Financial Environment, Personal Finance Management, Financial Management for MSMEs, Digital Financial Literacy, Financial Consumer Protection and Tax Literacy.

This Curriculum is conceived as a dynamic, living document that will undergo regular review and enhancement to remain current with the rapidly evolving financial ecosystem. Our commitment to continuous improvement ensures that the content remains relevant, accurate, and responsive to emerging trends, technological innovations, regulatory changes, and the evolving needs of our diverse population. We encourage and welcome constructive feedback, suggestions, and observations from educators, learners, practitioners, and all stakeholders engaged with this curriculum. Your insights are invaluable in our collective mission to enhance financial literacy across Sri Lanka. Please share your perspectives and recommendations with us at *nfissec@cbsl.lk*.

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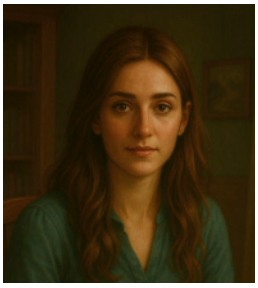
This is the Rathnayake family, they represent different roles of our society. We will use these characters to illustrate that everyone needs financial literacy.

Rathnayaka Family

Mr. Anil Rathnayake
is the father and head of the household. He is 50 years old and works as a manager in the private Sector

Mrs. Anusha Rathnayake
is a full-time mother and housewife. She is 45 years old and does not hold a job.



Ms. Gothami Rathnayake
is the eldest child (daughter) in the family. At 22 years old, she is a qualified young woman working in the private sector.

Mr. Dhananjaya Rathnayake
is the second child (son) in the family. He is 20 years old and is considering starting his own business, as he is not interested in pursuing further education.

Master Ayodya Rathnayake
is the youngest child (son) in the family. He is 12 years old and is in grade 7 at school.

Chapter 1

Economic Environment

1.1 Introduction

Learning outcomes

- Define and explain the economic environment of a country.
- Know the main macroeconomic variables of Sri Lanka.
- Be familiar with macroeconomic concepts of Gross Domestic Product, labour force & unemployment, inflation and exchange rate.
- Understand the Fiscal policy and public debt of Sri Lanka.
- Describe different types of taxes and their importance and impact to the economy.

The economic environment impacts both individual lives and business performance in which they exist. Following are few definitions given by famous authors.

"The economic environment consists of factors that affect consumer purchasing power and spending patterns. It includes income levels, inflation, unemployment, and overall economic growth, shaping the ability of businesses and consumers to thrive."

(Marketing Management by Philp Kotler)

"The economic environment refers to the external economic conditions and policies that influence production, consumption, and investment decisions within an economy."

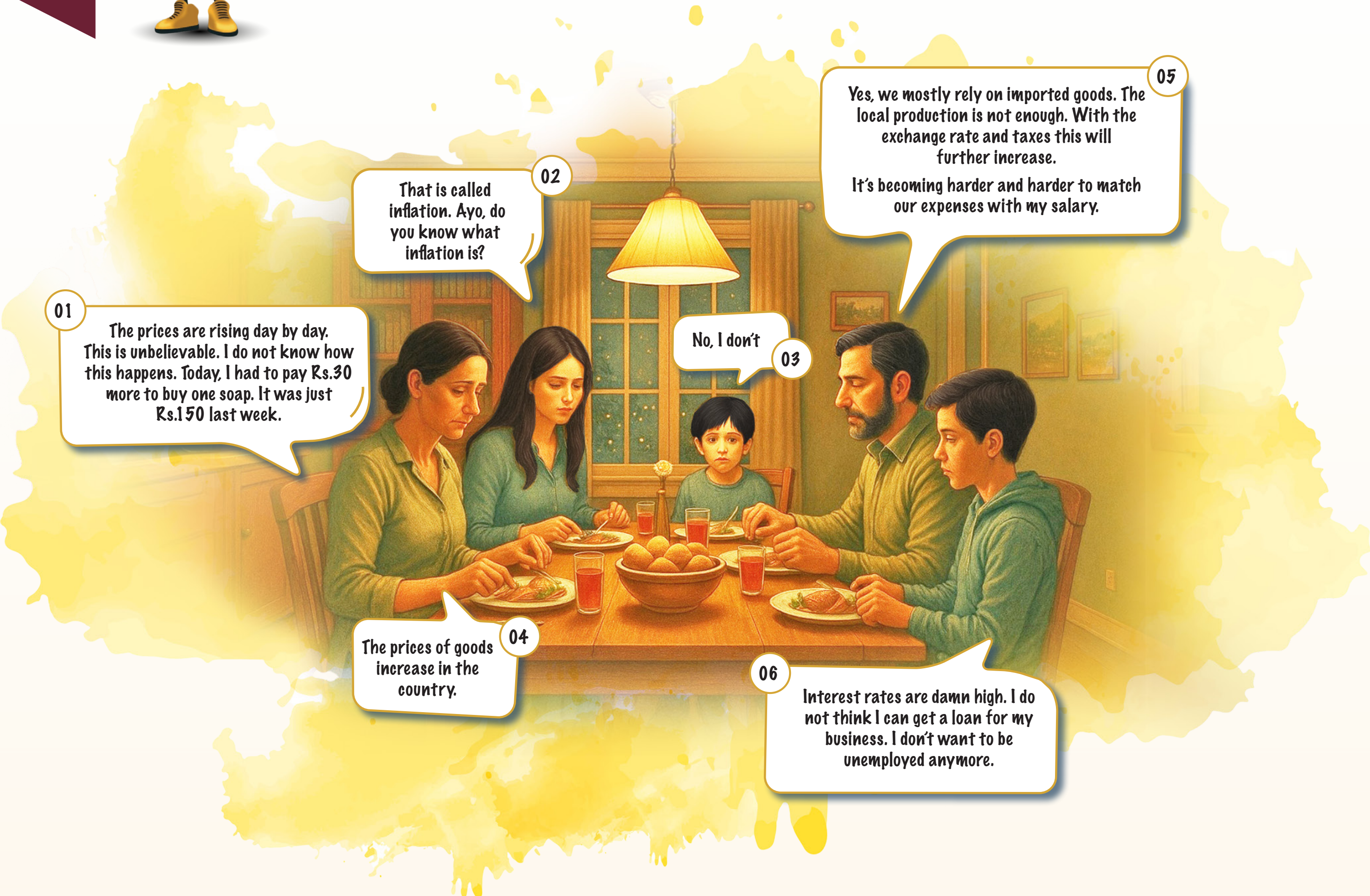
(Economics: An Introductory Analysis by Paul A. Samuelson)

"The economic environment encompasses the broader macroeconomic factors, such as market structures, economic stability, and competitiveness, which impact industries and their profitability."

(The Competitive Advantage of Nations by Michel E. Porter)

The above definitions establish that a strong economic environment, characterized by growth, low inflation, and stable financial markets, characteristically leads to higher job security, better remunerations, and access to credit, that can improve quality of life of the people. In contrast, an unstable economic environment, characterised by high inflation, recession or financial instability, can result in unemployment, low purchasing power, and financial hardships for people.

The Rathnayake family meets each other at dinner every day. They had the following conversation during their dinner time



The above family conversation emphasizes the importance of understanding the basic macro-economic factors of a country. These factors will affect the life of every family or any individual of Sri Lanka. Let us identify some common macro-economic variables of Sri Lanka and how those variables impact your life.

1.2. Gross Domestic Product and Economic Growth

What is the Gross Domestic Product (GDP)?

The GDP is the total value of all goods and services produced within an economy during a specified period. This covers the value added by all economic activities within the economy. The GDP is an important indicator used internationally, to compare the sizes of different economies.

As the national statistical agency, the Department of Census & Statistics (DCS) compiles national output statistics in Sri Lanka. The DCS publishes national income statistics on a quarterly and annual basis.

What is Economic Growth?

The economic growth during a given period is the percentage change in the GDP compared to the previous period.

An increase in the GDP is associated with higher production and usually indicates higher income earned by households and firms and tax revenue of the Government. It is also associated with more employment opportunities and reduced poverty. Hence when an economy grows at a sustainable rate, it translates into increased prosperity of the country.

Real vs Nominal GDP

When analysing the GDP growth, it is important to measure how much of that change is due to the actual increase in production and how much is due to the increase in prices of the goods and services produced. For this reason, there are two ways of measuring GDP: Real and Nominal.

What is Nominal GDP?

The Nominal GDP measures the total value of production in an economy during a specific period in terms of the prices that prevailed during the same period. This is called GDP at Current Market Prices in DCS publications.

What is Real GDP?

What if we need to know the value of production in the economy, excluding the impact of price changes. It is important to know how much production has increased in terms of the volume of goods and services produced without the impact of the changes in prices. The Real GDP measures the total value of production in an economy during a specific period in terms of the prices prevailed during a base year. At present, real GDP numbers are compiled based on prices prevailed in the year 2015. Therefore, the current base year is 2015. Which means, real GDP statistics published for the year 2015 and onwards thus far are expressed in terms of prices prevailed during 2015. Real GDP statistics are called GDP at Constant (2015) Prices in DCS publications (Meaning assuming prices remained constant since 2015).

When we talk about GDP growth or economic growth, the usual practice is to consider the change in the Real GDP, because it excludes the impact of price movements.

What is GDP per Capita?

GDP per Capita is the most common indicator used to measure how much a person earns during a year in the country, on average. GDP per Capita is derived by dividing the Nominal GDP reported during a specific year by the mid-year population.

When expressed in USD terms, GDP per Capita is an internationally used indicator of measuring the wealth of a country. The classification of Low, Middle and High income countries is carried out based on pre-determined GDP per Capita thresholds.

1.3. Labour Force and Unemployment

What is the Labour Force?

The labour force of an economy reflects the amount of labour available in the economy or the labour supply. The labour force consists of people over 15 years of age and employed or unemployed (but searching for a job) during a given period. The labour force is also known as the economically active population aged 15 and above.

It is important to note that people who are 15 years or older and unemployed but not interested in finding a job are categorised as not in the labour force and within the economically inactive population.

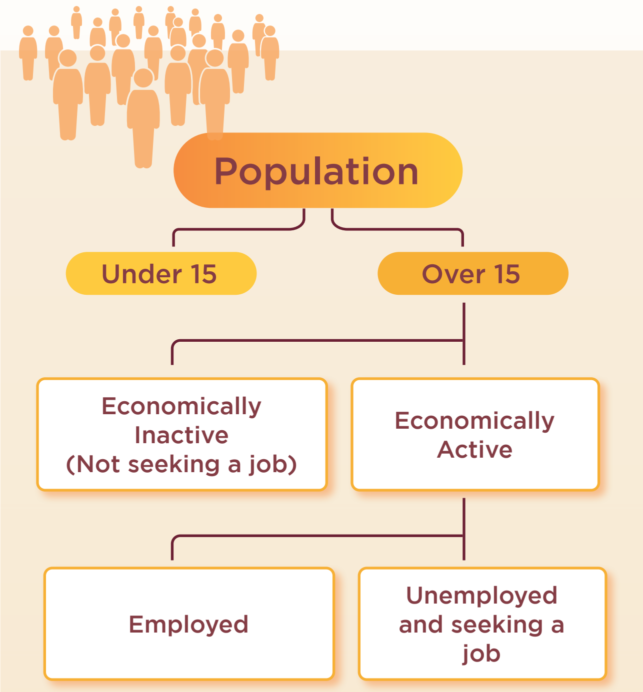


Figure 1.1: Labour Force

Unemployment rate

The unemployment rate is also a key indicator of the health of the economy as it reflects the status of the labour market. It is computed as the percentage of the labour force that is unemployed and seeking a job.

1.4 Inflation

What is inflation?

The term "inflation" generally refers to the increase in prices of goods and services in the economy. It is important to measure inflation, as it is an important indicator of the condition of an economy, and directly impacts the wellbeing of people in the country through their purchasing power.

How is inflation measured?

Inflation is measured by the percentage change in prices we pay for a basket of goods and services at two different periods.

We need a price index to measure the price of this basket of goods and services. The most common price index used to measure inflation is the Consumer Price Index (CPI). CPIs measure the total price of a basket of goods and services consumed by an average household for a given period (generally a month or a quarter of a year). Items in this basket change over time, depending on the consumption patterns of households. Prices of these items also change with demand and supply conditions in the economy.

So, how do we measure inflation? Inflation is the percentage change of the CPI between two periods. We can choose any two comparable periods to measure inflation. The Department of Census and Statistics (DCS) publishes official inflation numbers in Sri Lanka. The DCS publishes three different percentage changes of CPIs as inflation for each month. Let's take an example of how inflation in June 2024 is measured using these three ways.

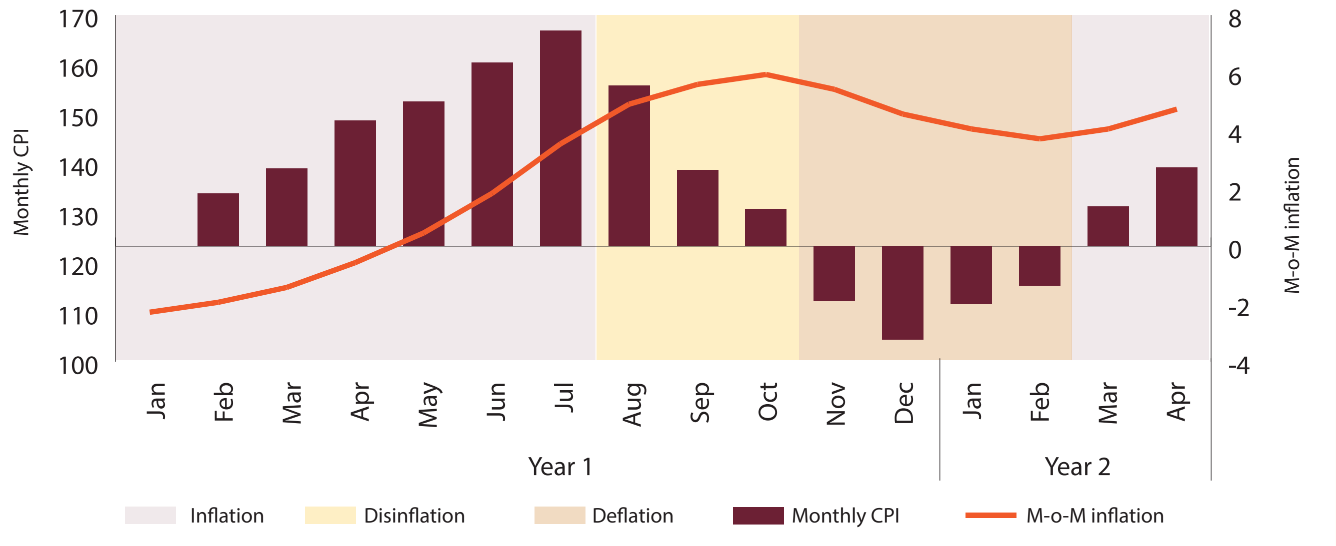
Table 1.1 : Three different methods of measuring inflation published by the DCS

Inflation measure	First Period	Second Period
Year-on-Year (Y-o-Y) Inflation in June 2024	June 2023	June 2024
Month-on-Month (M-o-M) Inflation in June 2024	May 2024	June 2024
12-Month Moving Average Inflation in June 2024	Year ending in June 2023	Year ending in June 2024

The DCS publishes two CPIs. The Colombo Consumer Price Index (CCPI) measures the general price level and inflation in urban areas of the Colombo District. The National Consumer Price Index (NCPI) covers the entire country. For more information on these CPIs and other price indices[1] compiled and published by the DCS, please visit **http://www.statistics.gov.lk.**

Some terminology related to inflation: Most of the time, we hear about the word 'inflation'; it is the increase in the CPI. There are two other terms associated with inflation: Disinflation and Deflation. Disinflation is the decline in inflation. During disinflationary periods, prices still increase, but at a slower rate than in the previous periods. Therefore, the CPI also increases. Inflation is still positive but smaller in number compared to previous periods. Deflation is the decrease in the CPI. During deflationary periods, inflation turns negative as prices decrease.

Figure 1.2 : An Illustration of Inflation, Disinflation and Deflation



Period	Year 1												Year 2			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Monthly CPI	110	112	115	120	126	134	144	152	156	158	155	150	147	145	147	151
M-o-M inflation		1.8	2.7	4.3	5.0	6.3	7.5	5.6	2.6	1.3	-1.9	-3.2	-2.0	-1.4	1.4	2.7

Factors that influence inflation:

The three main factors that affect inflation are demand, supply and the exchange rate of an economy.

If the demand for a good or service increases beyond the supply, the price would also increase due to excess demand. On the other hand, prices could decline if there is an excess supply of a particular good or a service. Furthermore, inflation expectations also impact the demand for goods and services and influence prices. In addition, prices of imported goods can increase due to demand and supply conditions in the global market and the exchange rate of the domestic currency. Usually, the full impact of the change in the exchange rate is not translated into the change in domestic prices. The change in domestic prices of imported goods and services due to fluctuations in the exchange rate depends on the level of exchange rate passthrough on domestic prices.

1.5. Exchange rate

What does the exchange rate measure?

The exchange rate indicates as to how many units of currency in one economy can be exchanged for one unit of currency in another economy. Therefore, the exchange rate is the value of one currency relative to

[1] The DCS publishes the Producer Price Index which reflects the changes in prices received by producers of domestically produced agricultural produce, manufacturing goods and utilities.

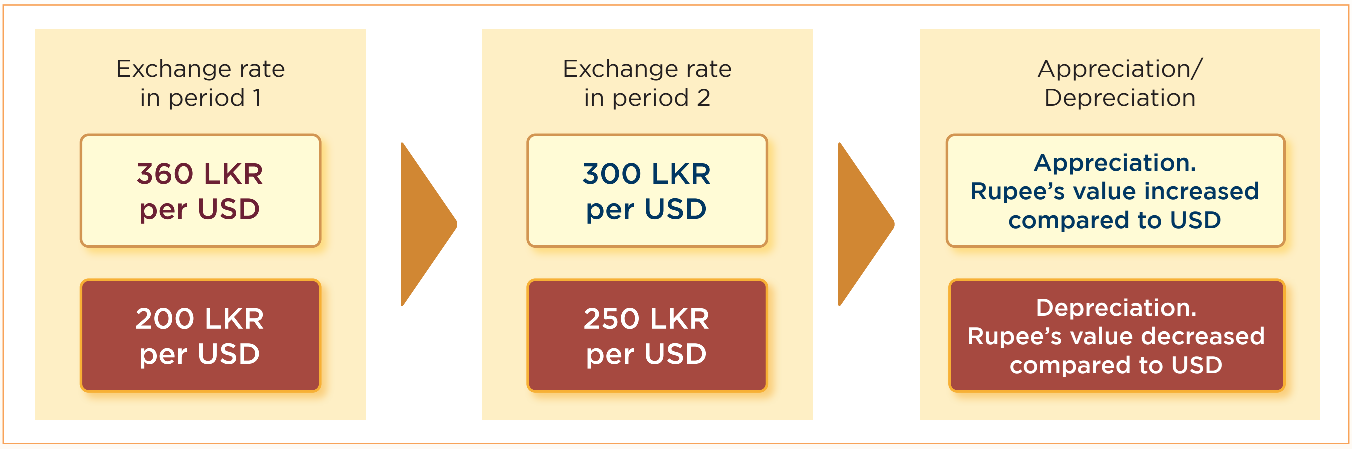
the value of another. In simple terms, it is the price we pay to buy one currency when we pay using the other. For example, if we need Rs. 300 to buy one USD, the exchange rate is LKR 300 per USD (conversely, we can say it is USD 0.267 per LKR). Internationally, the term LKR is used to identify the Sri Lankan Rupee. To keep this discussion simple, going forward, let's use the LKR per USD exchange rate only.

Using the exchange rate, we can determine how much a good or service in one currency is worth in another currency.

Appreciation vs Depreciation of a Currency:

When the LKR per USD exchange rate increases, the value of the Rupee falls in terms of the USD. This situation is called the depreciation of the Rupee. On the other hand, if the LKR per USD exchange rate decreases, the Rupee's value in terms of the USD increases, which is an appreciation of the Rupee.

Figure 1.3 : Rupee Appreciation and Depreciation Explained



How is the exchange rate determined?

The Sri Lankan Rupee is a 'floating' currency. This means the exchange rate or the price of a Rupee in terms of other currencies is determined by the supply and demand conditions in the foreign exchange market.

In a floating exchange rate regime, the Central Bank (monetary authority) may intervene in the foreign exchange market to curtail sudden drastic movements in the exchange rate, which are not driven by market fundamentals. These interventions can be purchases (to increase the demand) or sales (to increase the supply) of foreign currency in the market. Such activities are carried out to preserve broader macroeconomic stability. On the other hand, the Central Bank may influence supply and demand conditions in the foreign exchange market through purchases and sales of foreign exchange for foreign currency reserve management operations as well. Reserves are built during good times with the intention of using them during difficult times. In this context, foreign currency reserves are built as insurance to face future adverse movements in the exchange rate.

In addition to Central Bank interventions, there are many factors that can influence demand and supply in the foreign exchange market.

When foreign currency flows from abroad through sources such as export earnings, inward remittances, tourists' spending, investments and foreign currency borrowings from abroad, the supply of foreign currency in the foreign exchange market increases.

The demand for foreign currency in the foreign exchange market increases when activities such as importation of goods and services, payment made to foreign parties in terms of foreign currency debt obligations, Sri Lankans' spending abroad, and foreigners selling their Rupee investments.

Just as in an ordinary market, when the supply of foreign exchange exceeds demand for foreign exchange, the price of foreign currency (say USD) drops, the LKR per USD exchange rate declines, and the Rupee appreciates. On the other hand, when the demand exceeds supply in the foreign exchange market, the price of foreign currency rises, the LKR per USD exchange rate increases, and the Rupee depreciates.

It is important to note that these factors that affect demand and supply do not happen in isolation.

Furthermore, these factors are influenced by many other conditions, such as interest rate differentials between Sri Lanka and other countries, risk perceptions of investors and government policies etc. Therefore, the exchange rate is determined through various factors that could simultaneously affect the demand and supply in the foreign exchange market.

1.6. Interest Rates

What is the interest rate?

The Interest Rate is simply the price we pay for money. If you are borrowing money, the interest rate (or the borrowing rate) is the price you pay for the money you owe. On the other hand, if you lend money, the interest rate (or the lending rate) is the price you receive for the money you lent. When you save money in a bank deposit, after some time, you receive more money than you deposited because a savings rate is applied to your savings. The bank, in turn, will lend the money saved by depositors to businesses (the bank's role here is called financial intermediation. Financial intermediation will be discussed later in this handbook) and charge a lending rate on their borrowings.

Interest rates affect everyone in society, including households and businesses. For households, interest rates significantly impact on how much is left to spend after paying for mortgages, car loans, credit cards and other borrowings. Interest rates also influence households' savings and spending decisions. If interest rates are attractive, households tend to save more after spending on essentials. If interest rates are too low, households tend to spend and enjoy at present rather than trying to save for the future. Furthermore, retirees use their life savings to earn interest to supplement or fully cover their retirement income.

Interest rates affect businesses through the cost of funding. If interest rates are low, businesses are encouraged to borrow at a low cost and expand their businesses or to venture into new business lines. As businesses grow, they benefit people through employment opportunities, attractive salaries and wages and return on investment. It benefits the entire economy through improved activity. On the other hand, if interest rates are too high, businesses will find it too costly to carry out or expand their operations, hence the economy can slow down or even contract.

What is the Real Interest Rate?

Interest rates that are generally quoted are called Nominal Interest Rates. The Real Interest Rate is the nominal interest rate adjusted for inflation. This adjustment is done by subtracting the prevailing inflation rate from the quoted annual interest rate.

When the real interest rate is positive, using the money they save, and the interest earned, people can consume more in the future than now. If the real interest rate is negative, people will only be able to consume less than what you consume now, as the increase in prices is more than the interest you earned on their savings. Therefore, the real interest rate is an important consideration when deciding on a saving or an investment.

How are Interest Rates Determined?

Interest rates in the economy are mainly benchmarked by the policy decisions of the Central Bank. The set of policy tools that the Central Bank uses to influence market interest rates is called the Monetary Policy. In Sri Lanka, the Central Bank's primary objective is to maintain inflation at a low and stable level so that the economy can run smoothly. The Central Bank uses various Monetary Policy tools to achieve this objective. However, monetary policy alone cannot govern the movement of interest rates in the economy. There is an array of factors that influence interest rates, such as risk premia, inflation, financial sector policies and fiscal policy. Fiscal policy is also a powerful tool that influences the macroeconomic landscape of an economy.

1.7. Fiscal Policy

What is Fiscal Policy?

Fiscal policy is a tool that the Government uses to shape and manage the economy while providing its services to the citizens of the country. Fiscal policy involves decisions about the Government on its income, taxation, spending and borrowing to manage its budget deficit arising from the difference between its income and spending.

The Budget explains the government's plan for providing services to the citizens of the country and how it is financed. Usually, a Budget for the next calendar year is presented, debated, and approved by the Parliament before the end of the current year.

The Budget lays out the Government's plan of activities for the upcoming year, the required funding for such activities, how much of it is covered by government revenue and how much is to be borrowed.

If the Government's income exceeds spending, there is a budget surplus. Otherwise, there is a budget deficit. The deficit is covered by borrowing from the market (domestic or international).

Public Debt

What is Public Debt? Public Debt is how much the Government owes its domestic and international debtors at a given time.

Governments issue debt instruments to the public when government spending exceeds the revenue collected through taxes and non-tax revenue. The Government issues treasury bills and bonds or other securities, promising to repay these loans with interest over time. Government security holders (investors who purchased treasury bills and bonds) provide funds to the government, expecting periodic interest payments and eventual repayment of the principal at the maturity. These government security holders can be both local and international parties.

In addition to debt instruments issued by the Government, there are various sources that a Government can borrow from, such as international agencies (e.g. International Monetary Fund and the World Bank) and individual (bilateral creditors) or groups (multilateral creditors) of other countries that are willing to lend.

Taxes

What is a Tax? A tax is a compulsory payment charged by the Government on individuals or entities. Taxation is the Government's main source of revenue. Taxes are levied by the governments in almost every country, primarily to raise revenue to cover Government expenditures such as salaries of the employees in public service, health care, education, social safety nets and infrastructure like road development.

Different taxes charged in Sri Lanka

- **Personal income tax:** Tax on the income earned by individuals from wages, salaries, bonuses, returns on investments (interest, dividends), and other sources of income such as real estate.
- **Corporate income tax:** Tax on the profits earned by businesses and corporations.
- **Value Added Tax (VAT):** This is a consumption tax charged on a good or service based on the value added at each stage of its production to consumption. VAT is an indirect tax because the consumer who ultimately bears the tax burden is not the entity that remits it to the Government.
- **Withholding tax:** This type of tax is deducted at the source of income. The entity paying the income withholds a portion of the payment and remits it directly to the Government.

In addition, the Government collects revenue from various other taxes, duties and levies. The collection of taxes from individuals and entities is carried out by the Inland Revenue Department of Sri Lanka (IRD). The details about the tax rates are available on the official IRD website: **https://www.ird.gov.lk/en/publications/SitePages/Tax_Chart_2324.aspx?menuid=1404?menuid=1603**

Importance of Taxes

Taxes provide the necessary financial resources for governments to function and provide service to the public through various programmes.

The Government provides services such as national security, education, healthcare, law enforcement, regulation and infrastructure. Governments redistribute wealth to reduce income inequality and social equity through safety net programmes for vulnerable segments of society. In certain cases, governments use tax policies to address economic imbalances, such as supply and demand conditions, labour force and production. For example, tax cuts encourage household spending, leading to increased demand in the domestic economy, thereby stimulating production. Governments invest in research and development, promote sustainable practices and provide disaster relief when needed. As such, taxes provide funding to ensure the common well-being of the society through well-functioning, organised and fair Government services. Without tax revenue to provide its services to citizens, the Government will have to resort to borrowing or other sources of revenue, such as public enterprises. However, revenue from public enterprises may not be sufficient and cannot be relied upon. The practice of excessive borrowing is unsustainable and harmful to the country and the economy in the long run. Hence, taxes provide the foundation for a well-functioning Government service, which leads to a better society if funds are used prudently. Well-functioning Government systems can anchor the economy and society, providing support, consolation and assurance to citizens even under distressed conditions, such as pandemics, conflicts and natural disasters.

As we learned previously, taxes are mainly associated with the income or expenditure of individuals and entities. Hence, when activities in the economy increase, governments tend to collect more revenue, usually without harming the growth momentum of the economy.

Chapter 2

Financial Environment

2.1 Introduction

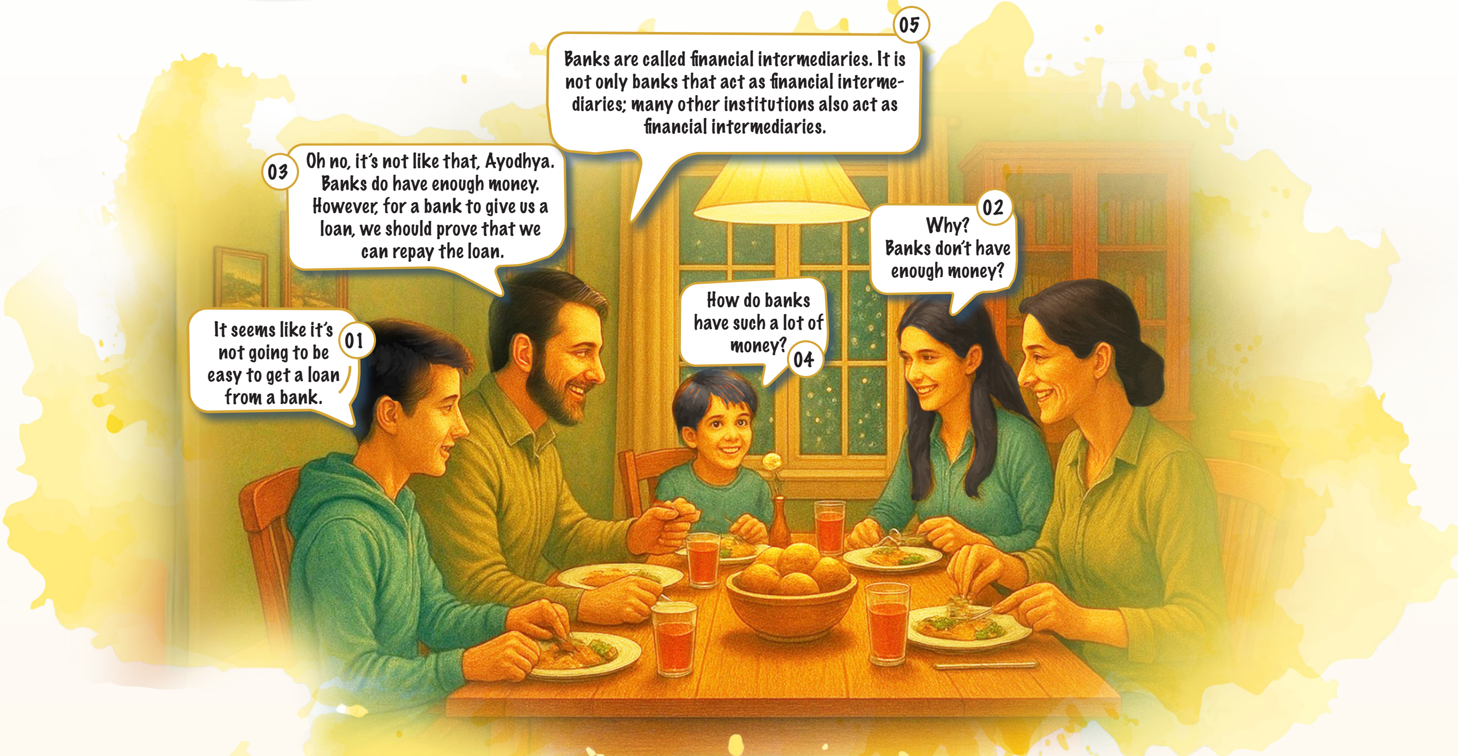
Learning outcomes

- Define and identify the main components of the financial environment.
- Understand the main functions of financial markets and financial institutions.
- Describe the role of the Central Bank of Sri Lanka.
- Identify and understand the institutions regulated and supervised by the Central Bank of Sri Lanka.
- Identify and understand the other financial institutions in Sri Lanka.

According to the definition adopted by the International Monetary Fund (IMF) the term "financial services" denote as to how consumers or businesses acquire financial goods. The financial services industry is one of the most critical sectors of the economy. Financial institutions and markets are leading actors in a country's economic environment.

Each actor has its functions in performing their roles. The figure XX illustrates the key players in the financial environment in Sri Lanka.

Rathnayake family had the following conversation.



2.2 Financial Market

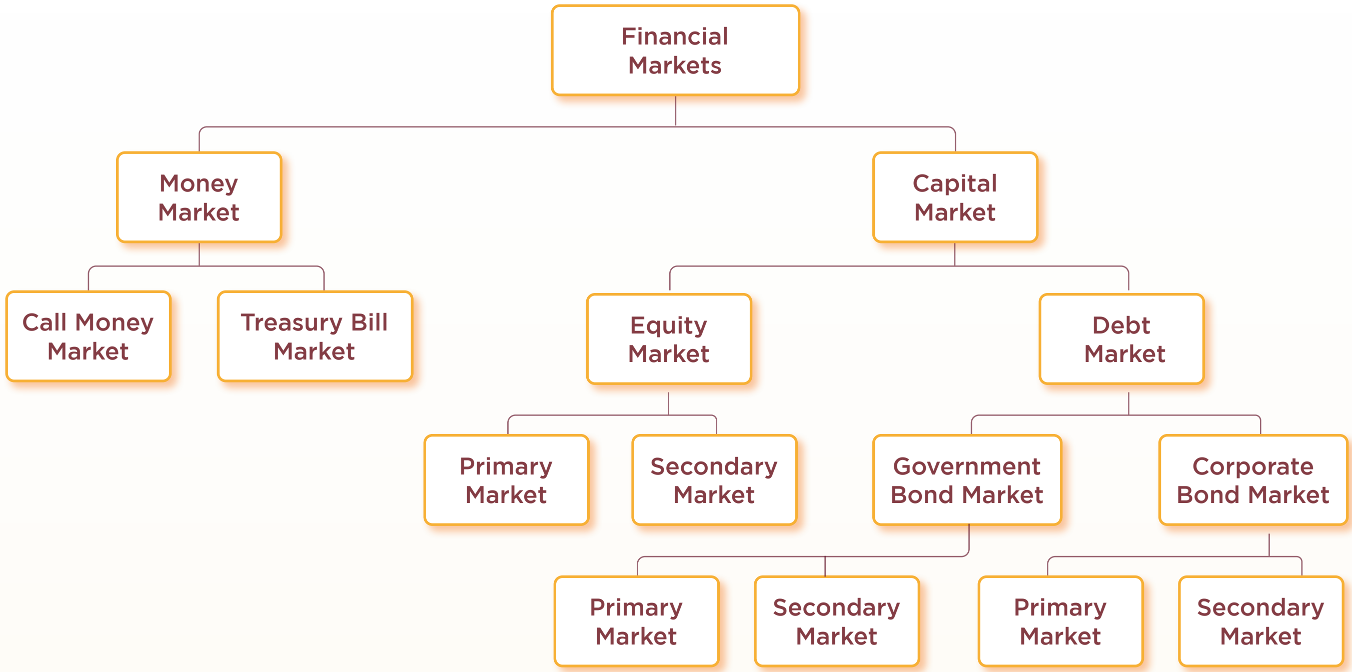


Table xx : Financial Environment in Sri Lanka

The Financial Market can be divided into the Money Market and the Capital Market, on the basis of different investor preferences.

Money Market

The money market is for short-term interest-bearing assets, usually with less than one-year maturities, such as Treasury bills, commercial papers, certificates of deposits, and short-term interbank borrowing and lending. The money market supports liquidity management in the economy. The leading issuers in the domestic money market are the Government, banks, and listed companies. In contrast, the leading investors are banks, insurance companies, and pension and provident funds. The interbank foreign exchange market is also closely connected with the money market. The interbank forex market is where currencies are traded between banks.

Capital Market

The capital market is for long-term assets, such as Treasury bonds, private debt securities (bonds and debentures), and equities (shares). The primary purpose of the capital market is to facilitate raising long-term funds. The leading issuers in the capital market are the Government, banks, and private companies. In contrast, the leading investors are pension and provident funds and insurance companies.

The capital market can further be classified according to traded instruments, such as the debt and equity markets.

Debt Market

The debt market is also known as the fixed-income securities market. Its segments are the Government securities market (Treasury bills and Treasury bonds) and the private debt securities market (commercial paper, private bonds, and debentures).

Equity Market

The equity market consists of both primary and secondary markets. The primary market is the market for new shares and debt securities issues. In contrast, the secondary market is the market in which such securities are traded after primary issuances.

Note: A detailed explanation of the financial markets is included in the investment management section of personal financial management.

2.3. Financial Institutions

Many financial institutions act as intermediaries to fund providers and fund seekers. These can be identified under two categories, namely, institutions that are regulated and supervised by the Central Bank and institutions that are not regulated and supervised by the Central Bank. The following section discusses the role of the Central Bank and the key financial institutions in Sri Lanka.

Central Bank of Sri Lanka

A central bank is the cornerstone of a country's financial system as it oversees the network of institutions that facilitate money flow in the economy. In addition, a central bank is responsible for managing a country's currency, money supply and interest rates. The institution operates as an independent entity, which enables it to take decisions without direct interference exerted on its functions by any external person or entity. While maintaining its independence, the Central Bank remains fully accountable for the performance of its duties and the discharge of its responsibilities.

As the nation's apex financial institution, the Central Bank of Sri Lanka (CBSL) handles key responsibilities. One of the primary functions of the CBSL is to issue currency and control the national money supply, through its monetary policy operations.

When the economy needs more cash—called liquidity—the CBSL can increase the money supply through its operations or by lowering interest rates. Lower interest rates make it cheaper for people and businesses to borrow money, encouraging them to spend more, which helps boost the economy.

In this context, the CBSL is vital in setting these interest rates. By adjusting the policy interest rate, the CBSL influences how much banks charge for loans and how much they pay for deposits. For instance, when the CBSL lowers interest rates, borrowing is more affordable, stimulating economic growth.

Another key responsibility is regulating licensed banks and other financial institutions. The CBSL ensures that these institutions comply with the applicable laws, and follow directions and rules that protect consumers and maintain financial stability. For example, suppose a bank is found to be making risky loans. In that case, the CBSL can impose regulations to mitigate those risks, helping to prevent bank failures that could affect people's savings.

If a licensed commercial bank is facing liquidity stresses, the CBSL may act as the lender of last resort, providing financial support to banks struggling to meet their obligations. This function helps to maintain public confidence in the banking system, as people know they can rely on the central bank in times of crisis.

In summary, the role of the Central Bank in maintaining the financial system stability can be identified as follows:

- Promoting and maintaining public confidence on the financial system.
- Promoting safety and soundness of individual financial institutions.
- In collaboration with other financial regulators, ensuring public confidence in the economic system through minimization of risks to the financial system.
- Acting as the lender of last resort .
- Resolving failing financial institutions in a manner that minimizes possible adverse implications of such an event on the overall financial economy.
- Regulating and supervising financial market infrastructure.

Central Bank of Sri Lanka is an independent institution that plays a vital role in assuring low and stable inflation and supervising financial institutions to ensure the stability of the financial system. Its ability to make independent decisions helps it to respond effectively to changing economic conditions, ultimately benefiting the public.

Authorized Financial Institutions (AFIs) Supervised by the CBSL

Central Bank of Sri Lanka (CBSL) oversees a network of institutions that facilitate money flow in the economy. This financial institution network includes licensed banks, licensed finance companies, registered leasing establishments, licensed micro-finance companies, primary dealers in government securities, Authorized Dealers in foreign exchange, Authorized Money Changers, and Authorized Money Brokers.

These institutions provide essential financial services and contribute to economic stability and growth. The CBSL ensures that Authorized Financial Institutions (AFIs) operate within a regulatory framework that promotes transparency, security, and consumer confidence, fostering a robust financial environment for all stakeholders. Let us explore the key AFIs supervised by the CBSL.

An Overview of the Authorized Financial Institutions in Sri Lanka

In the financial world, various institutions play essential and distinct roles in managing liquidity and supporting economic activities.

In Sri Lanka, licensed commercial banks accept deposits and provide loans to individuals and businesses, forming the backbone of the financial system. Non-bank financial institutions, such as finance companies, leasing establishments and micro-finance companies, offer specialized services like personal loans and asset leasing, addressing specific market needs and promoting financial inclusion.

Investment institutions, including primary dealers in government securities, help channel funds into various investment opportunities, contributing to economic growth. Authorized foreign exchange dealers and money changers facilitate currency exchange and international transactions, enabling global trade engagement.

The CBSL's oversight of these institutions ensures that they operate within a framework that promotes stability, transparency, and consumer protection. This financial ecosystem enables efficient money flow and supports the economy's development. Understanding these institutions' roles is essential for grasping how the financial system functions and impacts everyday life.

The following sections will detail the key AFIs supervised by the CBSL, highlighting their roles and contributions to the financial landscape.

Licensed Banks

Licensed Banks are formal institutions and are the primary pillar of Sri Lanka's financial system, accounting for a significant volume of transactions and services. These include state-owned banks which have extensive branch networks in remote areas and private banks, which often offer more specialized services in their centers.

In addition, foreign banks also operate in Sri Lanka, catering to businesses and expatriates. These banks offer various services, from basic savings accounts to complex trade finance solutions. They operate with different business modalities specifically focusing on trade finance.

Licensed Finance Companies (LFCs)

Licensed Finance Companies serve as specialized financial intermediaries, often catering to specific needs that banks might not fully address. LFCs offer higher interest rates than commercial banks for fixed deposits, attracting those looking to maximize their savings. They often provide loans with more flexible terms, helping a small-scale manufacturer to purchase machinery. Let's consider two specific examples from the Sri Lankan context to understand how they operate compared to banks.

Registered Leasing Establishments

Registered Leasing Establishments in Sri Lanka are specialized financial institutions primarily providing leasing services. They facilitate leasing assets such as vehicles, machinery, and equipment, allowing businesses and individuals to use them without purchasing them outright. Their services often include operational leasing, where the establishment retains asset ownership, and the lessee pays for its use.

Licensed Micro-Finance Companies (LMFCs)

These are the grassroots-level financial institutions reaching out to individuals and small businesses that might not have easy access to traditional banking services. Some Organizations provide small loans to entrepreneurs in rural areas, helping them start or expand their businesses. They are different from LFCs as they typically do not cater to a broader market segment or do not offer a wider range of financial services.

On the other hand, LMFCs focus primarily on serving low-income individuals and micro-entrepreneurs, often in rural or economically disadvantaged areas. Their core business is providing small loans, typically without collateral, to support income-generating activities or meet basic needs. For example, an LMFC might offer a small loan to a group of women in a village near Anuradhapura to start a handloom weaving business or offer micro-insurance products to small-scale farmers in Polonnaruwa. Unlike LFCs, LMFCs are not permitted to accept deposits from the public. Their funding usually comes from shareholder capital, borrowings from banks and other financial institutions, and sometimes from international donors or impact investors.

Primary Dealers

Primary dealers in government securities play an essential and unique role in the financial system of Sri Lanka. These specialized institutions help the Government raise money for important projects, like building roads, schools, and hospitals. They do this by selling treasury bonds and bills, essentially promises from the government to pay back borrowed money with interest over time.

When investors buy these bonds and bills, they lend the government money in exchange for a safe investment to earn interest. The activities of these Primary Dealers are significant because they help set economic interest rates, which influence how much it costs to borrow money. For instance, if the interest rates on government securities rise, banks may also raise the rates they charge for home loans and business financing. This means that the work of Primary Dealers impacts everyday people, businesses, and the overall economy, making them vital to national development and financial stability.

Authorized Dealers in Foreign Exchange

Authorized Dealers in Foreign Exchange facilitate our interactions with the global economy. The licensed commercial banks and some specialized banks are authorized dealers, helping businesses convert foreign earnings to local currency, assisting students in paying international tuition fees etc. Their services are essential in an increasingly interconnected global economy.

Authorized Money Changers

Authorized Money Changers are essential in Sri Lanka's financial landscape, particularly in supporting the tourism industry. These small exchange bureaus, often located in tourist areas, hotels, airports, and other international transit points, specialize in providing currency exchange services for travelers.

When a tourist arrives in Sri Lanka with foreign currency, such as US dollars or Euros, they need to convert that money into Sri Lankan rupees to purchase food, accommodation, and souvenirs. Authorized Money Changers facilitate this process by offering competitive buying and selling rates. For example, if a tourist exchanges $100, the Money Changer will provide a specific rate for buying dollars and then sell the equivalent amount in rupees at a different rate, ensuring their profit while providing a service to the customer.

These exchange rates can fluctuate based on market conditions, so travelers need to compare rates from different Money Changers to get the best deal. By helping visitors easily convert their money, Authorized Money Changers enhance the overall travel experience, making it more convenient for tourists to spend money in the local economy. This, in turn, supports local businesses and contributes to the growth of the tourism sector.

Authorized Money Brokers

Authorized Money Brokers assist banks and financial institutions in managing foreign exchange risks and facilitate interbank lending. Although they don't interact directly with the public, their activities are essential for ensuring liquidity in the currency market. They help financial institutions find the best rates for currency transactions, influencing overall exchange and interest rates in the economy. By providing this essential service, Authorized Money Brokers contribute to the stability and efficiency of the financial system, impacting various economic factors that affect businesses and consumers alike.

Funds & Other Financial Institutions

Funds & other financial institutions consist of entities not regulated and supervised by the Central Bank of Sri Lanka. They include insurance companies, Thrift and Credit Cooperative Societies, Rural banks, ETF and EPF, and CRIB.

Insurance Companies

Insurance companies are crucial in managing risk by providing financial protection against potential losses. They offer financial protection against losses and expenses incurred due to unexpected events like accidents, illnesses, natural disasters, and death. Let's take an example. There are two people, namely Nimal and Amila. One day, a fire breaks out in Nimal's bakery, causing a significant damage to his equipment, ingredients, and the building. As Nimal doesn't have insurance, he must bear the expenses and pay for all the repairs and replacement costs out of pocket. Unfortunately, the total cost is so high that Nimal can't afford to reopen his bakery, leading to the closure of his business and the loss of his income. Amila also faces the same unfortunate event: a fire damages her bakery. However, Amila has fire insurance. Her insurance covers repairing her building, replacing the equipment, and restocking her supplies. The insurance also helps cover the lost income while her bakery is closed for repairs. As a result, Amila can reopen her bakery within a few months without suffering significant financial losses. In this example, Amila's insurance protected her from a financial downfall, allowing her to recover and continue her business. In contrast, Nimal, without insurance, suffered a significant financial hardship. This highlights how insurance can safeguard against unforeseen events and provide financial stability.

Insurance helps individuals, families, and businesses manage risks by covering costs that would otherwise have to be paid out-of-pocket. Take another example: Imagine driving your car and accidentally hitting another vehicle. Without insurance, you would have to pay for the damage to both your car and the other vehicle, which could cost thousands of rupees. However, with car insurance, the insurance company will cover most of the repair costs, saving you from shouldering a significant financial burden.

The Insurance Regulatory Commission of Sri Lanka (IRCSL) is the insurance industry regulator established by the Regulation of Insurance Industry Act, No. 43 of 2000 (the Act) for developing, supervising, and regulating the Insurance Industry in Sri Lanka. As of 31st December 2023, twenty-eight (28) insurers are registered with the IRCSL. There are two main categories of insurance business: general insurance and long-term insurance. Fourteen (14) companies are engaged in long-term insurance businesses, and twelve (12) companies are engaged only in general insurance. Two (02) composite companies transact both Long Term Insurance and General Insurance business (https://ircsl.gov.lk/insurance-companies/). General insurance covers any other risk except for the life risk of the policyholder; life insurance covers mainly the life risk of the insured person.

Long-term insurance contracts cover life, contracts for granting disability and multiple indemnity, accident and sickness benefits, permanent health, capital redemption contracts and pension policies. All insurance businesses that do not fall within the definition of "long-term business" are deemed to comprise and include the sub-classes of marine, aviation, or transit insurance policy, fire insurance business, motor vehicle insurance business, health insurance business, employers' liability insurance business, miscellaneous insurance business. A general overview of these insurance products is given below.

Life Insurance: Offers financial support to beneficiaries upon the policyholder's death. Types include term life, whole life, and universal life insurance.

Health Insurance: Covers medical expenses, doctor visits, hospital stays, prescribed drugs, and other healthcare-related costs.

Marine, aviation, or transit insurance policy: Covers loss of or damage to ships, cargo, terminals, and transport between the origin and the destination.

Fire insurance: Covers damages and losses caused by fire to residential, commercial, or industrial properties.

Motor vehicle Insurance: Provides coverage for damages related to vehicles, including accidents, theft, and natural disasters.

Employers' liability insurance covers a range of liabilities, including public liability insurance, product liability, professional indemnity insurance, directors' and officers' indemnity and workers' compensation.

How Insurance Works

A policyholder is a person who owns an insurance policy and has the privilege to exercise the rights stated in the said insurance policy on the occurrence of a contingent event. Policyholders pay premiums (monthly or annually) to the insurance company in exchange for coverage. Insurers assess the risk of insuring a person or business through underwriting. Higher the perceived risk, higher the premium. When a policyholder experiences a covered event (e.g., an accident or illness), they can file a claim with the insurance company. If approved, the insurer compensates the policyholder or a third party, where applicable, for losses up to the policy's coverage limits.

For more details, visit *Chapter on Financial Environment - Insurance.pdf*

Thrift and Credit Cooperative Societies (TCCS)

A Thrift and Cooperative Credit Society (TCCS) is a village-level organization that mobilizes rural savings and makes credit available to its members when required at rates of interest well below those prevailing in the non-institutional credit market (i.e., with money lenders). The interest rates vary among TCCSs, and maximum limits on the quantum of loans and the conditions under which loans are granted also vary among TCCSs.

TCCSs are voluntary associations of low-income earning persons operating at a local level. Membership of a TCCS usually ranges from 40 to 60, but some societies have a membership exceeding 150 persons. TCCSs are owned by the members who use its services (a consumer cooperative or credit union), by people who work there (a worker co-op), or by those who live there (a housing cooperative). When different stakeholder groups share a common interest in the success of an enterprise, these groups can use other classes of membership in the cooperative's bylaws to organize how they can work together (a multi-stakeholder co-op).

The cooperative sector in Sri Lanka has been closely connected to the daily lives of most of the population for over half a century. The national level cooperatives are administrated by the Department of Cooperative Development which is under the Ministry in charge of cooperative development. The Cooperative Societies Act regulates the operations of cooperatives. National Cooperative Council of Sri Lanka (NCC) is the apex organization of cooperatives in the country. NCC oversees education & training, consultation, publication, coordination, and international affairs.

As such, many non-profit and for-profit organizations can follow the cooperative model. A key difference between a traditional structure and a cooperative's structure is in the order of priorities, which, for a co-op, are to first meet the needs of its membership in a productive, self-sufficient, and socially responsible manner. Cooperatives are built on values like helping themselves and each other, taking responsibility, being fair and working together. Members of cooperatives believe in being honest, open, socially responsible and caring for others. These values guide how cooperatives operate and make decisions.

Rural Banks

The rural bank scheme has been inaugurated in 1964 by the People's Bank to mobilize rural savings and channel credit to the rural sector. The scheme's objective was to assist primary cooperatives at the village level by incorporating concrete proposals to encourage the development of their banking functions on efficient lines and to raise their managerial and operational standards. According to the institutional structure, the People's Bank assists these societies through advances for re-lending to members, financing the purchase of equipment, etc. In collaboration with the Department of Cooperative Development, the People's Bank helps these societies formulate and implement development plans in their respective areas.

Rural banks are not commercial banks. However, during the last three decades, RBs grew in number, providing essential banking services to a large portion of the rural population. The multi-purpose cooperatives, begun by the government in 1970, provided the necessary framework for expanding the rural bank scheme nationally. In contrast, very few cooperatives qualified to have a rural bank during the inception. In addition to mobilizing savings through savings and fixed deposit accounts, these RBs provide credit facilities to the rural sector, especially for production, housing, electrification, debt redemption, consumption, and emergencies.

Rural Banks provides a range of banking and financial services to personal and corporate customers. The Company operates in three segments: Commercial, Retail, and Wholesale. Its main business activities are commercial, retail, and wholesale banking. The bank exists to provide superior financial services primarily to the cooperative movement and other selected customer segments through an established country-wide network within Sri Lanka in a socially responsible, profitable manner.

ETF and EPF

The Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) are statutory social security programs in Sri Lanka that are critical in securing employees' financial well-being after retirement.

The Employees' Provident Fund (EPF)

EPF was established in the year 1958 and by law, the membership of the fund extends to most private and some government sector employees. An employee's contribution to the Fund is 8% of the monthly salary. The employer contribution is 12% of the monthly wage, thus adding 20% in total. The Central Bank of Sri Lanka manages EPF.

The EPF is not only helpful to secure financial independence during retirement age but also provides several services which an employee may make use of whilst still in employment. The members can obtain a guarantee facility for housing loans and a 30 percent partial withdrawal to cater to housing and medical needs as pre-retirement benefits. Thus, EPF helps employees realize their dream of a 'home' before retirement by serving as a collateral for house mortgages and address health concerns.

When Can You Claim a Refund for Your benefits?

- When you reach the retirement age and cease employment
- Leaving employment on the grounds of marriage
- Cessation of employment due to total incapacitation
- Cessation of employment on leaving to a foreign country for permanent residency
- When engaged in a Permanent Pensionable Post in Government or Local Government Service
- Obtaining refund of benefits when government institutions become corporations, closure of corporations, and retrenchment of excess staff, nationalization, and resignation consequent on conversion into companies.

For more details, visit their website: https://epf.lk/

Employees Trust Fund (ETF)

The ETF was established in 1981 under the provisions of ETF Act No. 46 of 1980. The Employees' Trust Fund Board administers the Fund. Currently, the ETF Board functions under the Ministry of Finance, Economy, and Policy Development. All public sector employees who are not entitled to the Govt. Pension Scheme, and all private sector employees are members of this Fund. Unlike the EPF, only the employer contributes on behalf of the employee/member, where 3% of the gross earnings per month per employee will be remitted to the fund by the employer. Therefore, it is a non-contributory benefit to the member. Self-employed and migrant workers could contribute to the Fund independently and obtain membership.

For more details, visit their website https://etfb.lk/

Sri Lanka Social Security Board (SSB)

Sri Lanka Social Security Board has been established by an Act of Parliament, Social Security Board Act, No. 17 of 1996,and subsequently amended by Act No. 33 of 1999. Pension and social security benefit schemes have been introduced by an extraordinary Gazette Notification dated 25th September 2006 bearing number 1464/5. The role of the Sri Lanka Social Security Board is to provide pension and social security benefits to those who are not entitled to a government pension through a contributory pension fund.

Any member of the society could obtain a membership from the head office, District offices, and Divisional Secretariat offices of the Sri Lanka Social Security Board, Grama Niladhari Officers, or any other officer to whom the Sri Lanka Social Security Board has entrusted the responsibility.

For more details, visit their website: https://ssb.gov.lk/

Credit Information Bureau of Sri Lanka (CRIB)

The Credit Information Bureau of Sri Lanka (CRIB) has been established by the Credit Information Bureau of Sri Lanka Act, No. 18 of 1990, as amended by Act No. 8 of 1995 and 42 of 2008.

CRIB is an independent statutory body and a public-private partnership with the Central Bank of Sri Lanka, holding the majority of its equity. The rest of the shares are divested among other shareholder members of the bureau.

CRIB's prime statutory objective is to uphold its legally mandated responsibilities towards CRIB shareholder member lending institutions (shareholder members) and the general public as stipulated by the CRIB Act. Some of the main functions of CRIB include:

- Collect, Collate, and Synthesize Credit and Financial Information from relevant parties.
- To provide Credit and Financial Information to relevant parties on request for permissible purposes.
- To undertake the function of credit ratings and sell such Ratings to foreign and local agencies.
- To provide credit scoring for persons at the request of the bureau's lending and credit-granting institutions.
- To undertake research and training projects for shareholders lending institutions of the bureau and participating credit-granting institutions.
- To operate a filing office for secured transactions to register the security interest of movables.

Credit Score

Credit Score is an advanced tool that lenders use to help them anticipate how likely they are to repay their loan on time. Credit scores are also sometimes called risk scores because they help lenders assess the risk, that you won't be able to repay the debt as agreed.

Your score today is a snapshot reflecting how you have handled debts in the past. Credit scoring is about predicting your future behavior based on how you have managed your debt in the past.

A credit score plays an important role when you want to apply for a financial product from a lending institution, such as a personal loan, mortgage, or credit card. Banks and other lending institutions may use your credit score to evaluate the credibility of your financial health. It helps them understand the risks they might face if they decide to lend money to you. Essentially, it is an indicator of your financial health.

CRIB Score is the first credit score introduced by the CRIB. It is a 3-digit number ranging from 250 to 900 calculated based on credit information reported by the registered banks and finance/leasing companies (the member lending institutions of the Bureau) in Sri Lanka. CRIB issues two types of Scores:

- **CRIB Score - Individual**
- **CRIB Score - Corporate**

'Consumer CRIB Score' report can be obtained directly from the Bureau or applied through a Banking institution.'Corporate CRIB Score' report can be obtained from the bureau, but applying ONLY through a banking institution.

CRIB Tools and Service Overview

Services General Public

Tool/Service	Description	Purpose
Self Inquiry Credit Report (My Report) Services online/offline	Comprehensive credit history for individuals and businesses including credit score to derive an overall assessment on credit worthiness.	Facilitate the individuals/ corporate to obtain their own credit information.

Services for Lending Institutions

Tool/Service	Description	Purpose
General Credit Report	Comprehensive credit history for individuals and businesses to derive an overall assessment on credit worthiness.	Informed credit decisions, risk assessment, and mitigation of information asymmetry for lenders.
Credit Score	Numerical representation derived from a statistical model based on salient credit data points to gage the probability of default and the credit standing of an individual or a business.	Predictive credit risk assessment and promotion of credit inclusivity.
Portfolio Management	Tools for obtaining data/credit score in bulk manner to reviewing of existing borrowers.	Risk management, performance optimization, and early detection of potential defaults.
Business Analytics	Data-driven credit risk insights, scenario analysis, and performance forecasting. Risk, delinquency & market statistics management tool.	Mitigation of systemic credit risk and enhancement of credit decision frameworks for the progress of an economy.
Borrower Risk Profiles	Combined insights on credit history, repayment trends, and delinquency patterns along with demographics.	Avoidance of moral hazard and adverse selection.
Monitoring & Alerts Service	Monitoring the behaviours of existing borrowers subscribing to the Bureau and receive alerts.	Risk management, performance optimization, and early detection of potential defaults.

By integrating these tools and services into its offerings, CRIB enables a balanced, transparent, and efficient credit system that benefits lenders, borrowers, and the economy at large.

For more details, visit their website: https://www.crib.lk/

Chapter 3

Personal Financial Management

3.1 Introduction

Learning outcomes

- Define and understand the importance of personal financial management
- Identify the main components of personal finance.
- Describe the main steps to achieve personal financial goals

Personal Finance

A combination of financial awareness, knowledge, skills, attitudes and behaviours are necessary to make informed financial decisions and ultimately achieve individual financial well-being. (Organisation for Economic Co-operation and Development (OECD),2020)

Personal finance is about **managing your money and other financial assets effectively to achieve financial independence and security.** It involves budgeting, saving, investing, and controlling expenses, allowing individuals to live within their means and plan for short-term and long-term personal goals.

The Rathnayake family had the following conversation at their evening tea time.

The above is a typical conversation in a family, mainly when they have limited financial resources or are not managing their finances effectively. Any family or any individual can face financial difficulties. However, if you are financially literate, such issues can be resolved with less difficulty, even when dealing with unplanned or sudden expenses. Let us identify common financial problems faced by a family or an individual.

- **No permanent income or stable income**
- **Income is insufficient to cover expenses**
- **Lack of savings**
- **Difficulty in managing emergency expenses**
- **Mental distress due to financial instability**
- **Inability to achieve personal goals or dreams**

By improving financial literacy and positive financial behavior, anyone can work towards becoming financially independent.

Steps to become a financially independent person

You can follow three simple steps outlined below to become financially independent.

Step 1: Identify your current financial situation.

You should know,

- **your total current income –** salaries, wages, or profits
- **total commitment to expenses –** living expenses
- **total savings available –** fixed deposits, bank account balances, or any cash reserves
- **the total value of assets you own –** land, house, vehicle, furniture
- **the total value of obligations you need to settle–** bank loans, rent payments, or other liabilities

Step 2: Define the life goals that you want to achieve in the future.

List down your goals, dreams, and expectations,

- Goals that need to be achieved within the next three years
- Goals that will take more than three years to achieve

Step 3: Prepare your action plan to achieve your life goals.

You need to,

- Understand the gap between your current financial situation and your desired goals (mentioned in Steps 1 and 2)
- Develop strategies to improve your finances and bridge this gap.

These simple steps clearly describe how you should manage your finances.

Components of Personal Finance

Personal or family finance consists of five components that require effective management.

Robert Kiyosaki, the author of 'Rich Dad, Poor Dad,' says that it is not important how much money a person makes, but rather how much money is kept, how hard it works for the person, and how many generations the person keeps it for, will decide how well a person has accomplished their personal life goals.

This highlights the importance of personal finance in creating and protecting a person's wealth.

3.2 Managing Income

Learning outcomes

- Understand income management and available income sources for different focus groups.
- Learn about passive income and its importance.

Income is the money or value an individual or business entity receives in exchange for providing a good or service or investing capital.

Income management is the foundation of financial planning, as an individual's income determines their ability to cover expenses, save, invest, and manage debt. Understanding the nature of one's income and effectively managing it is crucial for financial stability and achieving future financial goals.

Children of the Rathnayake family had the following conversation

This conversation highlights that, regardless of age or gender, everyone desires some form of income.

Understanding the nature of your income is the first step in building a strong financial plan, as it helps determine the lifestyle you can afford to maintain.

However, your current income may not be sufficient to cover your expenses. To bridge this gap, individuals can consider alternative income-generating options in addition to their primary source of income.

Primary sources of Personal income

Earned Income	This is the money received in exchange for labour. It includes salaries, wages, bonuses, gratuities, and commissions. For most individuals, earned income is their primary source of income.
Business Profits	For business owners the profits from their business serve as their source of income.
Investment Income	This includes income from dividends earned by investing in company stocks, interest earned from bonds or savings accounts, and rental income from a property.
Government Benefits	Some individuals receive various payments from the government, such as social security, low-income benefits, disability payments, which help to meet their financial needs.
Miscellaneous Income	This includes one-time earnings such as gifts, lottery winnings, or inheritance.

Importance of Passive Income

Income can generally be categorized into two types: active income and passive income. Active income refers to money earned through your work that you actively engage in on a full-time or part-time basis. Passive income, on the other hand, is money earned in a way that requires little ongoing effort or engagement on a day-to-day basis. It comes from sources that already exist and continue to generate income without the need for active work on your part.

You become financially free when your passive income exceeds your expenses.

Examples of passive income include earnings from an intellectual property, affiliate marketing, or rental income from a property. These sources require little to no active work to generate revenue.

The following are some available opportunities for our focus groups to earn extra income.

Potential avenues to earn extra income

Employed individuals	Unemployed individuals	Children
• **Freelancing and online work** based on one's skills and expertise. • **Small business ownership** includes retail, providing services, online businesses, etc. • **Agriculture and livestock** are similar to traditional, modern, organic, and livestock farming • **The tourism industry** includes providing accommodation, working in hotels and restaurants, and freelance guides/ translators/ drivers. • **Taxi services and delivery services** • **Content creation and social media influence.**	• **Part-time jobs** • **Self-employment is** based on one's skills and expertise. • **Micro businesses** • **Freelancing and online work** based on one's skills and expertise. • **Agriculture and livestock** are similar to traditional, modern, organic, and livestock farming. • **Content creation and social media influence.**	• Pocket money • Cash gifts • Till money • Gift vouchers exchanged for cash by parents or friends • Balance money • Sale of old toys

The income-generating avenues mentioned above are just a few examples of how to improve your income. You may find other ways to earn an additional income based on your skills, experience, expertise, qualifications, creative ideas, and a positive attitude.

Skills and resources required to generate income

Income sources	Requirements
Private-sector & public-sector employment	• Educational qualification[s] • Professional qualification[s] • Vocational training • Job experience • Skills and expertise • Age requirement • Legal eligibility
Entrepreneurs	• Access to Capital • Business motive • Innovativeness • Legal Requirements • Physical infrastructure • Human resources • Other soft skills
Investments	• Capital • Financial literacy • Attitude to risk • Other soft skills
Freelancing	• Specific skills & expertise • Qualifications • Experience • Adaptability • Meeting deadlines
Agriculture and Livestock	• Land & buildings • Knowledge • Tools and equipment • Machinery • Access to finance

7 Tips to Enhance Your Income

1. **Be an expert in your specialized area**

   Identify your area of expertise and continually upgrade your skills and knowledge through continuous learning. Improve your interpersonal skills while also investing in other in-demand skills. Build a strong reputation and a personal brand in your field.

2. **Negotiate Your Salary**

   First, research the average pay for your role in the industry. Excel at your work and overperform beyond your job description. Then, showcase your contribution at the right time (such as during the performance review) to justify a salary increase.

3. **Explore opportunities to grow beyond your primary income.**

   Search for part-time jobs, freelancing, and consulting opportunities in your free time and develop a portfolio of alternative income streams.

4. **Think of a Passive income for you.**

   Explore passive income opportunities where minimal active work is required to earn an income. Remember, you achieve financial freedom when your passive income exceeds your expenses.

5. **Develop an Entrepreneurial Mindset**

   Introduce unique ideas or identify unmet needs in the market to pursue new business opportunities while learning from mistakes and challenges along the way.

6. **Manage Time Effectively**

   Prioritize high-value activities that directly contribute to income generation while maintaining a work-life balance. Stay productive without risking being burntout.

7. **Follow the Professional Advice**

   Don't forget to stay in touch with your mentors and career coaches to receive proper guidance throughout your career. Regularly review your skills and stay updated through continuous professional development

3.3 Managing Expenses

Learning outcomes

- Describe how to manage personal expenses
- Understand the difference between needs and wants
- Highlight the tips to manage your expenses

Expenses are the money an individual or family spends to fulfill various needs and wants.

Expense management is a key component of financial planning because it helps allocate enough money for savings, investments, and other financial goals that lead to efficient income usage. A person with poor expense management will become financially weak.

One busy morning, the following conversation took place at the home of the Rathnayake family.

It seems members of the Rathnayake family have many needs to be fulfilled on that day. Anusha will incur many expenses, and she needs to be very careful. If Anusha prepares a list of family expenses, she will get a good understanding of where the money goes.

- Many people spend money on things they don't have to buy or things they don't want. Mostly, people buy things to impress other people. Do not let your emotions control you when it comes to spending money.
- Financially independent people do not care if their friends change their phones. It does not impress them if their friends go out for dinner every weekend.
- It is crucial that your expenses not exceed your income. Once you have decided on your priorities, determine how much you need to pay. Make sure you plan not to spend more than you earn.

All of us have needs and wants. Knowing the difference between your needs and wants is the key to managing your expenses. The following section elaborates on these terms from a theoretical perspective.

Needs and Wants

As expenses are incurred to fulfill needs and wants, it is essential to know the difference between needs and wants. How different authors have defined and explained needs and wants is mentioned below.

In his book, "Marketing Management" (2016), Philip Kotler defines **needs as self-deprivation fundamental to human survival, such as food, clothing, and shelter. Wants are desires shaped by culture and individual personality that specify how needs are fulfilled.** For example, to fulfill the need for food, one may want rice and curry, and another may want bread. Kotler says that these wants are transformed into perceived needs by businesses through marketing.

In his book, *"Economics"* (2015), Richard Lipsey defines needs as **essential items for survival or basic functioning of human life and wants as items that improve quality of life or provide satisfaction** but are not necessary. Further, he says that needs are limited, but wants are unlimited and drive consumer behavior in a market economy.

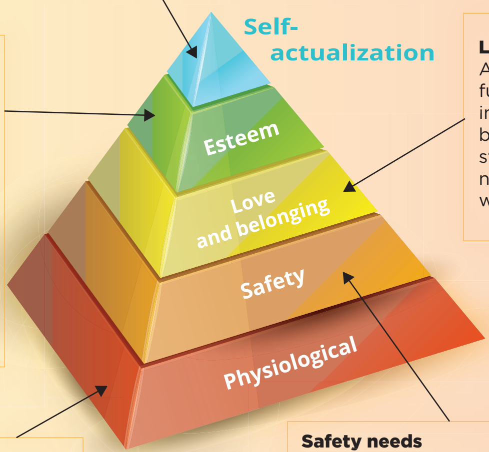
Knowing the difference between your needs (something you must have to survive) and your wants (something you desire but can do without) may help you meet your basic needs before considering luxuries. For example, ensure that your children's books are bought before you spend money on new electronics such as TVs, amenities such as expensive clothes, eating out, etc.

However, **Abraham Maslow** comes up with a more comprehensive analysis of needs. In his book, *"Motivation and Personality"* (1954), needs are categorized and shown in a hierarchy. There, needs are not identified as only fundamental, but they may appear in different ways at different stages of human life. This analysis is called "Maslow's hierarchy of needs," which proves Philip Kotler's opinion that marketing transfers wants into perceived needs.

Self-actualization
This level of need refers to what a person's full potential is and the realization of that potential. Maslow describes this level as the desire to accomplish everything that one can, to become the most that one can be. Individuals may perceive or focus on this need very specifically. For example, one individual may have the strong desire to become an ideal parent. In another, the desire may be expressed athletically. For others, it may be expressed in paintings, pictures, or inventions.

Esteem
All humans have a need to feel respected; this includes the need to have self-esteem and self-respect. Esteem presents the typical human desire to be accepted and valued by others. People often engage in a profession or hobby to gain recognition.

These activities give the person a sense of contribution or value.
Low self-esteem or an inferiority complex may result from imbalances during this level in the hierarchy.



Love and belonging
After physiological and safety needs are fulfilled, the third level of human needs is interpersonal and involves feelings of belongingness. This need is especially strong in childhood and can override the need for safety as witnessed in children who cling to abusive parents.

Physiological needs
Physiological needs are the physical requirements for human survival.

If these requirements are not met, the human body cannot function properly and will ultimately fail. Physiological needs are thought to be the most important; they should be met first.

Safety needs
with their physical needs relatively satisfied, the individual's safety needs take precedence and dominate behavior. In the absence of physical safety - due to war, natural disaster, family violence, childhood abuse, etc. - people may (re-)experience post-traumatic stress disorder or transgenerational trauma.

This level is more likely to be found in children because they generally have a greater need to feel safe.

8 Ways to Manage Your Expenses

1. **Focus on your needs, not your wants**

   It is evident that for our survival, we need air, food, water, and shelter. However, we want a flat-screen television, the latest smartphone, and a luxury house. Mostly, the focus on the needs is overwhelmed by the desires. Thereby, sometimes critical needs are sacrificed for wants. Irrationally chasing after our wants may make us momentarily happy. Yet our needs may remain unsatisfied. Therefore, it is crucial to give priority to needs when spending.

2. **Plan for your wants.**

   You do not have to forego your wants, desires, and dreams, but you can plan and achieve your wants effectively. Proper budgeting would help effective financial planning.

3. **Convert bad habits to good habits.**

   Converting bad habits like smoking, alcohol, and unnecessary expenses to good habits like saving not only preserves your physical health but also saves money.

4. **Do not fall into the discount trap.**

   Discounts given by traders may be seen as favorable for your budget. However, if carefully analyzed, they mostly do not favor your budget. Discounts lead you to buy more than you need to get the discount (buy one get one free offer, bundle offers). Discounts give you an **endowment effect** where you tend to overvalue things that you already have, and discounts can make you feel like you are "gaining" something, whereas you are not. Discounts would give you the feeling and **fear of missing out,** and as a result, you may feel compelled to buy sooner to avoid missing out. Discounts should be accepted only for items in your list of needs for the relevant period. Otherwise, it will destroy your money and budget plan.

5. **Remember your financial targets.**

   As humans, we tend to forget our limits and plans, especially when we are attracted to marketing and promotional campaigns. Therefore, always focus on your financial targets.

6. **Be aware of instalment schemes.**

   Instalment schemes are another trap you might fall into when buying unwanted goods. Installment schemes are good only if used carefully to satisfy the high-value goods necessary for your life. E.g., TV, Fridge, vehicle, land, house.

7. **Avoid impulsive buying**

   Unplanned purchases based on irrational thinking may affect your budget negatively. Mostly, impulsive buying happens when inspired by promotional and marketing campaigns, discounts, offers, etc. To avoid impulsive buying, create a "cooling-off" period, such as 24 hours a week before or even a month after making significant purchases. You will realize that most of your purchase desires fade away after the cooling period. Thus, saving you unnecessary expenses.

8. **Follow the 50/30/20 rule as a guideline:**

   From your total income,

   50% of income for basic needs, including food, house rent

   30% for wants to satisfy your needs

   20% for savings and debt repayment for future use and financial security.

   These proportions can be decided following your preferences, based on the categorization of expenses and requirements. However, ensure to cut down unnecessary expenses. You can choose how to cut costs based on your financial goals and preferences.

4 R's that Housewives can practice in Managing Expenses

These 4 R's (Reducing, Reusing, Recycling, and Refusing) are based on the concept of Thrift. Thrift means being economical and rational with money and other resources. People have valued thrift since ancient times across many different cultures around the globe. Therefore, the first step to save and cut expenses would be to create a thrifty lifestyle in a home environment.

The 4Rs are organized in a hierarchy, with the most crucial step being reducing unwanted expenses. Reducing and reusing as much as possible before recycling helps minimize unnecessary expenses.

Let us see how Anush can practice Thrift at her home.

- **Reuse**

Some people wear new clothes for each event. (Ex: Wearing a new saree for each wedding). But this may create an additional burden on your expense management. Wearing the same dress for two or more functions may help control expenses. Clothing and other consumer goods can be passed on from elder sister to younger sister, elder brother to younger brother, mother to daughter, father to son to reuse. Find things that can be reused in many ways and use them accordingly. This will reduce many purchasing requirements.

- **Recycle and Upcyle**

Recycle excessive rice from lunch to fried rice as dinner, old cloths to kichen napkins and rugs etc.

- **Reduce**

Reduce your wants and focus only on your needs.

- **Refuse**

Refuse unnecessary expenses have to be refused, no matter how small.

Homemaking culture through discussions

Discuss and make all the family members aware of the family's financial position. When everyone knows about the actual situation, they tend to think before asking, spending, etc. Encourage family members, especially children, to discuss, save, and forego fancy needs and wants. Include all family members for budget preparation.

"Allocating your expenses into needs, goals, and aspirations can help provide a better framework for managing your cash flow and living comfortably."

3.4 Managing Savings

Learning outcomes

- Understanding the importance of managing savings.
- Identify the strategic approach to save effectively.
- Know the tips to plan your savings.

In personal finance, savings refer to the part of your income you set aside for future use rather than immediately spending.

The habit of saving is critical in building financial security and achieving short-term and long-term financial goals. Savings can provide a safety net during emergencies, fund significant purchases, or help you reach key milestones like buying a home, funding education, or retirement.

It is a very special mother-daughter conversation at Rathnayake's house.

It seems that the Rathnayake family has understood the importance of savings. Savings can benefit you in the long run in many ways. Therefore, the habit of saving can be passed down from one generation to the next.

People often forget that saving money doesn't just build a more extensive bank account, but teaches other essential skills. It allows you to stay organized, practice self-control, and help you plan your future.

Saving provides many benefits that allow us to enjoy a better life.

"Do not save what is left after spending, but spend what is left after saving."

-Warren Buffett-

Importance of Saving

- **Emergency Preparedness and Debt Avoidance:** Life is unpredictable. Savings empower you to face unexpected costs like car repairs, medical emergencies, or job losses without falling into debt. Financial experts recommend setting aside 3 to 6 months of living expenses in a liquid savings account to cover sudden financial setbacks. If money has to be borrowed to cover emergency expenses, interest and bank charges will be added to the total costs. Therefore, savings ensure more control over finances in times of difficulty.
- **Financial independence:** Family savings can lead to some degree of economic freedom, especially for dependents with no income source. When home-makers and school children or any other person are given money, even in small amounts to spend by another person (husband to wife, parents to children, etc.), that small amount can still be saved. Therefore, even a dependent or non-active earner can lay a foundation for some financial stability.
- **Building Wealth and Achieving Life Goals:** Savings can fund future goals (buy luxuries, safe retirement) when invested in opportunities that generate returns over time. People with significant savings experience less financial stress and uncertainty about the future, contributing to their overall mental well-being. Thus, the basic foundation of making an average person wealthy is laid by savings.
- **National Interest:** Your savings lead to an increase in investments in the country thus will have an impact on economic stability and growth.

Structured Approach to Save Effectively

Saving effectively from your current earnings requires discipline, strategic planning, and a clear understanding of your financial goals. By adopting a structured approach, you can make the most of your income and build a healthy financial future. The following are the main steps that can be taken to save effectively.

Step 1: Set clear savings goals

Start by setting financial goals. Break them down into short-term and long-term goals

Time frame	Examples
Short-term - 1 to 3 years	Emergency fund Vacation
	Home renovations
	Paying off debt
Long-term - over 3 years	Buying a house Children's higher education Retirement

Step 2: Develop your budget

A budget is the foundation of any savings plan.

- **Calculate Total Income:** Know how much money you earn monthly.
- **Identify expenses**: Record all fixed and variable expenses (rent expenses, food expenses, bills, etc.).
- **Identify ways to save:** Find expenses that can be reduced and unnecessary expenses that can be avoided—examples: responsible consumption and avoiding non-essential costs such as entertainment and leisure.

Step 3: Plan your emergency fund

The priority should be given to an emergency fund. It is advisable to save an amount equivalent to 3 or 6 months of living expenses in a separate, easily accessible savings account.

- **Start saving with a small amount:** Set an initial target (Ex Rs. 5000 a month), and gradually build up the savings according to your income level.
- **Automate savings:** Start a separate savings account for the emergency fund and set up automatic money transfers to that account. You can get advice and support from the bank for this, and money transfers can be done very quickly through Internet banking services or standing orders.

Step 4: Use the right savings instrument

- **Savings Accounts:** Regular savings for short-term and high-return savings for medium-/long-term goals.
- Use a separate savings account for each (saving) goal.

Step 5: Revise savings plans by tracking income and expenditure.

- **Review monthly budget:** Ensure savings align with the plan and adjust spending/savings as needed.
- **Increase savings over time:** When you get a promotion, bonus, or extra pay, try to save a portion of it (up to 50% of extra income).

6 Tips for Your Savings Plan

- **Manage your expenses:** As income increases, do not increase costs accordingly. But you can strategically maintain your quality of life based on your social status.
- **Keep yourself motivated:** Do not forget your savings goals; keep them always in mind by using tools like a savings tracker or by frequently monitoring your savings progress.
- **Treat yourself for your achievements:** You should motivate yourself by arranging a small treat/celebration after reaching certain savings milestones. Reaching a particular savings goal is an intrinsic motivation by itself.
- **Use a savings tracker:** A savings tracker is a tool or method used to monitor and manage progress towards savings targets. A manually updated book or software can be downloaded to the mobile phone.
- **Avoid unregulated institutions:** Savings must be kept in financial institutions regulated by the relevant supervisory authority to avoid losing your savings.
- **Diversify your savings prudently**: Financial institutions offer different types of savings instruments, such as Minor savings accounts, Youth savings accounts, women's savings accounts, Retirement planning savings accounts, and Term deposits. They can be used according to your saving goals. Keeping all your savings in one account may distract you from achieving your savings goals.

Think Beyond Savings

Allocation of money for saving rather than spending is the first step to becoming wealthy. However, **mere savings will not make you rich.** Savings may give you a large sum of money that is idle and of no use.

Money is an asset that you can earn and grow itself. Therefore, to get the real benefit of money, you should **invest** it appropriately to multiply your savings by investment returns.

3.5 Managing Investments

Learning outcomes

- Understand investment management and its importance
- Know different types of investment opportunities in Sri Lanka.
- Identify the key factors that need to be considered for investments
- Understand the relationship between risk and return on investments
- Explain how diversification can minimize the investment risk
- Understand the concept of the time value of money
- Know the idea of simple and compound interest.
- Understand the application of the time value of money in Personal Finance
- Know the primary and secondary equity market of the Colombo Stock Exchange (CSE)
- Know the guidelines to invest in CSE
- Understand the debt securities
- Know the tips to select the right investment

Investments refer to investing your money in financial assets, projects, or businesses to earn an income in a future period. The main goal of investing is to grow your wealth and ensure your financial security in the future.

Rathnayake family members are at their dinner table at the end of one busy day.

Like the Rathnayaka family, most families depend on their primary source of Income. However, to keep up with rising costs, we must consider investments to grow our money faster than regular savings and generate additional revenue without extra work. It's like planting seeds that grow into a steady source of Income for the future. The following section has explained the importance of investments.

Importance of investing

- **Building Wealth:** Over time, investing enables you to increase your money and grow your wealth.
- **Achieving financial goals:** Investing allows individuals to finance large-scale expenses, such as buying a home or land, funding education, purchasing a vehicle, or financing retirement.
- **Defeating Inflation:** Inflation reduces your purchasing power over time. A good investment enables you to hold your money without surrendering to the effects of inflation.

Most popular investment opportunities in Sri Lanka

Type of Investment	Description
Investment in the Stock Market	A stock exchange is a market for buying and selling the ownership of a company in small shares(stocks). When a person buys a share of a company, they will acquire a small part of ownership of that company. As the company grows, the value of its stocks and investors increases; you can sell all or part of the shares you hold and earn a capital gain or dividend.
Investment in corporate debt securities	Corporate bonds are medium-term or long-term securities of private sector companies that obligate the issuer to pay interest and redeem principal at maturity. Corporate debt securities provide a fixed income for investors.
Investment in Treasury Bills and Bonds	The Government of Sri Lanka raises local currency debt mainly through short-term debt instruments, Treasury Bills (T-Bills), medium and long-term debt instruments, and Treasury Bonds (T-Bonds). At the end of the agreed period, the total amount invested in the bills or bonds is repaid with the corresponding interest.
Investment in Mutual Funds and Unit Trusts	These funds are created by a small number of investors who contribute relatively small amounts of money. Expert professionals with specialized skills and capabilities manage the fund. Those fund managers invest the fund in various investments like stocks and bonds and give returns to those who have invested in the fund. Experts manage the risk of the investment.
Purchase of Real Estate	Investing in real estate means purchasing houses, buildings, land, etc. An income can be earned by renting, or leasing the property, or selling it for more money after its value increases.
Purchase of valuables	Purchasing high-value raw materials like gold and silver, precious metals, etc.
Investing in a business	Starting a new business or investing in an existing business. The return on your investment will be the profits earned by the company.
Obtain an Insurance	Purchasing a specially designed Insurance package for investment purposes. At maturity, it will give a value higher than the initial investment.

Factors to consider when Investing

The objective of the investment

Investment aims to achieve specific financial goals, such as generating Income, preserving wealth, accumulating capital for future needs, or meeting long-term objectives like retirement or education funding.

Return from the investment.

Return is the total financial gain or loss realized on an investment, which includes any income generated from the investment (such as dividends or interest) and any capital gain (or loss) resulting from changes in the investment's value.

The return can be expressed as:

$$\text{Return} = \frac{(\text{Ending Value} - \text{Beginning Value}) + \text{Income}}{\text{Beginning Value}}$$

Where **the ending value** is the market value of the investment at the end of the period, the **beginning value** is the market value of the investment at the start of the period. We also called this 'capital gain' of the investment. **Income** is any cash flow from the investment, such as dividends or interest.

Inflation is a key determinant of the real return on investment. It reduces the purchasing power of future cash flows. It must be considered when evaluating an investment's expected profitability. The rate of return on the investment has to be greater than the prevailing/expected inflation rate of the economy.

Return frequency of the investment

Return frequency describes the periodicity with which returns are realized or distributed from an investment, such as daily, monthly, quarterly, or annually. It is a key factor in portfolio planning (having multiple investments) and cash flow management.

The risk and safety involved in the investment

Risk is the potential variability of returns and loss of the principal amount associated with a given investment. It arises from various factors, including the stability of the issuing entity, market conditions, economic events, and specific investment characteristics. An investment instrument issued by a company that adheres to regulatory frameworks and has a transparent financial disclosure is considered safe. Government-backed assets are considered the most secure.

The maturity period of the investment

The maturity period is the duration or lifespan of an investment or financial instrument, after which the principal is repaid, and the investment ceases to exist. It determines the time horizon for cash flows and is a critical factor in assessing liquidity and risk.

Tax impact of the investment

The tax impact of an investment is the extent to which tax obligations influence the net returns from an investment under applicable tax laws.

Liquidity of the investment

Liquidity is the ability to buy or sell an asset quickly and at a price close to its market value. It reflects the ease of converting an investment into cash with minimal loss of value.

Relationship between Risk and Return of an Investment

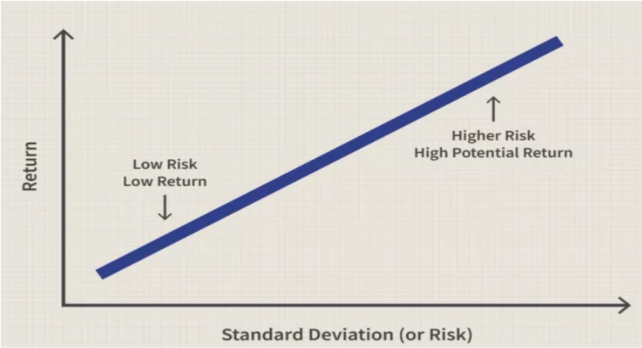
In the context of investing, risk can be defined as either the probability of losing some amount of the invested amount (maybe the total amount invested) or the volatility of returns of an investment over a given period of time. Investment return consists of investment income and capital gains.

When investors consider purchasing a very high-risk investment, they should know that it is likely to lose some or all of their investment. Return volatility means the deviation of the actual return from the expected return. It is measured by standard deviation.

An investment return can come in various forms, such as capital gains and dividends. This can be expressed as a percentage of the initial investment value.

High-risk investments generally give investors better returns, while low-risk investments give comparatively lower returns.

Investing in the stock market can be treated as a high-risk investment due to the high volatility of the stock values. However, high-risk investments do not always generate higher returns. That is indeed the 'high risk' involved in investing. The investor should be prepared for both circumstances, profit and loss. Investing in government treasury bonds is generally identified as a low-risk investment. This is because the likelihood of the government defaulting on their obligations is very low.



How do you minimize investment risk?

Minimizing investment risk involves understanding the sources of risk and employing strategies that diversify risk across different assets or investment types. By adjusting the portfolio structure, investors can reduce the likelihood of significant losses and ensure more stable returns.

The key strategy to minimize risk is diversifying the investments by maintaining an investment portfolio.

Diversification

Diversification is the practice of investing in various assets to reduce the portfolio's overall risk. Holding a mix of assets lowers the risk of a significant loss in any investment.

The American investor Warren Buffett has emphasized the importance of the famous idiom, **"Do not put all your eggs in one basket."** Eggs are incredibly fragile, and putting all of them in one precise basket makes them likely to break if dropped.

To maximize the chances that at least some of the eggs would stay unbroken, eggs have to be put in multiple baskets and those baskets be given to different people to carry. Similarly, if all the money is invested in one asset, it may destroy the whole value of the investment.

An investment portfolio with company shares, treasury bonds, and real estate assets would experience less volatility than an investment portfolio with only company shares.

As different assets often react differently to market conditions, adverse reactions by one asset may be compensated by favorable/neutral reactions of another asset in the portfolio. This may lead the investors to receive stabilized investment returns while reducing the overall risk.

Time Value of Money

The time value of money is the concept that a sum is worth now more than the sum that will be at a future date due to its earnings potential in the interim. For example, the value of a note of Rs 5,000 today differs from that of a note in one year.

The time value of money (TVM) is an important concept to remember. Because when your money is once invested, it can grow over time. Even if you were to just put it into a savings account or a fixed deposit, the money can earn compound interest, and the impact of compounding on investment growth can be significant.

On the flip side, money not invested will lose value over time. Consider what you could buy for Rs.100 as a child compared to what that same Rs.100 would get you today. This is because inflation and loss of potential earnings erode the value of your money. If you keep your money under your mattress for 10 years, not only will it be worth less because of inflation, but you'll also miss out on the interest it can earn when invested.

The time value of money is a fundamental concept that provides the foundation for practically every financial and investing decision. From taking out a loan to negotiating a salary or making a purchase decision, you can use the time value of money to evaluate the best financial course of action.

The mathematics of TVM

To calculate TVM, you need to understand the following variables.

Present value (PV)

Present value (PV) means today's value or the current value. This can be expressed as (Y0)

Future value (FV)

Future value (FV) is the value that a current sum of money (or asset) will have at a predetermined future date based on an expected return (or rate of growth).

For example, If you invest Rs 100,000 today (Y0) in a bank with an annual interest rate of 20%, the future value would be Rs. 120,000 in one year.

Discount rate (r)

The discount rate is the rate of return used to determine the present value of an asset or investment. Another way of putting this is that the discount rate is the return an investor would miss out on by accepting an amount in the future instead of accepting it immediately.

Compounding frequency (n)

The compounding frequency, or how often interest is assessed, can significantly impact future value. Suppose an investor puts money into an interest-bearing asset. In that case, this interest can be evaluated monthly or quarterly.

An example of a "timeline" can be shown as follows.

Period (n)	0 r=0.05	1	2	3	4	5
	1000	1050	1102.50	1157.63	1215.51	1278.28
	PV	FV_1	FV_2	FV_3	FV_4	FV_5

How to calculate TVM

Example: Mr. Saman has two financial options to collect money from his investments.

Option 1: Receive Rs 4.5mn today

Option 2: Receive Rs 5mn two years from now.

TVM teaches us that having Rs 4.5 mn today differs from having Rs 5mn in two years. But which option is more beneficial for him?

Imagine that you decided to have Rs 4.5 mn today and deposit that money in a savings account that pays 6% interest compounded annually.

You can calculate the balance in the savings account two years from now using the following formula, which includes the above-discussed variables.

Future Value of money = Present value $(1+ r)^{(n)}$

Where r = rate of return (interest rate) per compounding period

n = the number of compounding periods of interest

t = the number of years to take into consideration

Accordingly,

Value of savings account balance after two years = 4,500,000 ($(1 + 0.06)^2$

= Rs 5,056,200

Which is higher than the Rs 5,000,000.

Therefore, **collecting Rs 4.5 mn today is more beneficial to Mr Saman** than collecting Rs 5 mn after two years.

Compound interest

This refers to interest that is charged on top of interest that has already built up. For example, if you deposit Rs.1000 into a savings account that pays 8% interest yearly, it will be worth Rs.1080 at the end of the first year. However, at the end of the second year, it will be worth Rs 1,166.40, where the interest amount added during the second year is higher than the first year. (Rs 80 in the first year and Rs 86.40 in the second year)

Application of TVM in personal finance

Saving and Investments

A rupee saved and invested today will be worth more than the one saved and invested tomorrow. You can invest now in assets that will rise in value over time.

Debt management

Remember that a rupee eliminated from your debt today will be less costly than the one eliminated tomorrow (or further down the line).

Retirement planning

When planning for retirement, you can benefit from compound interest and convert your present value to a very high future value. But you need to understand the impact on inflation.

Inflation and its impact

Inflation hurts the TVM because it causes the purchasing power of money to decrease over time. In other words, one rupee will be worth less in the future than it is today.

Interested parties can overcome the inevitable deterioration of their purchasing power by investing in assets that generate positive returns at a rate greater than inflation.

Therefore, you must invest in assets where your rate of return should be more than the country's inflation rate.

Investing in the Stock Market

What is a stock exchange?

A stock exchange is a market for buying and selling the ownership of a company in small shares(stocks). When you buy a share of a company you acquire a small part of the ownership of that company. At the same time, you become an owner of the company. Then, you have invested an amount equal to the value of the shares bought in that company.

Colombo Stock Exchange

The Colombo Stock Exchange is the only stock exchange in Sri Lanka, and its main office is in Colombo. There are branches in Kandy, Jaffna, Negombo, Matara, Kurunegala, Anuradhapura and Ratnapura. It acts as a platform where investors can buy and sell shares of publicly listed companies on the stock market. The Colombo Stock Exchange is critical to the country's economy by facilitating investment and providing companies with the capital they need to grow. To learn more about the Colombo Stock Exchange, you can visit this website (www.cse.lk)

How does the Colombo Stock Exchange work?

1. Listing of Companies:

Public Companies: When a business wants to raise funds, it can become a "public company" by offering its shares for sale through an initial public offering (IPO). This means that anyone can buy a share of the company's ownership. Suppose a company plans to be listed on the Colombo Stock Exchange. In that case, it must meet specific criteria on financial stability and transparency.

2. Buying and Selling Shares

Once a company's shares are listed, they can be bought and sold by any individual (investor). Investors can buy stocks through stock brokers, who are intermediaries between buyers and sellers. Investors can place different orders, such as market orders (buy/sell at the current price) or limit orders (set a specific price to buy/sell).

Example of a market order: You place a buying or selling order at the current market price of the share.

Example of a market order: You place a buying or selling order at a predetermined price of the share.

3. Share price

Stock prices are determined by supply and demand. When there is more demand for a company's stock than what is available for sale, that company's stock price rises. Conversely ,when there are more shares available than the interest to purchase by the buyers, the price falls. In addition, day-to-day news about the country's political situation, changes in economic conditions, key management decisions, and investor sentiments about the company's future can also affect price determination.

Note: For more information, refer to the educational videos on the CSE website.

Primary market of CSE

The primary market is where stocks or bonds are sold for the first time. It is done through an initial public offering. When a company wants to raise capital, it can issue new shares to the public through an initial public offering (IPO) through the stock market. Proceeds from the sale of shares in an initial public offering go directly to the company concerned. This money can be used at the company's discretion for various purposes like capital expansion, research and development, or debt repayment.

Investors who buy shares in the primary market buy them directly from the company. They can buy shares at the IPO price, and if the share price goes up after the IPO, they can sell such shares in the secondary stock market and make a profit.

Investment banks often provide capital for initial public offerings, where the investment bank buys a parcle of stock and resells it to the public to ensure the company receives some capital. This minimizes the risk of the company's inability to raise capital through an initial public offering.

The secondary market of CSE

The secondary market is where investors buy and sell stocks they already own.

Shares purchased from the IPO will start trading on stock exchanges such as the Colombo Stock Exchange (CSE). Different investors can buy and sell these shares among themselves. The profit made by buying stocks when the price is low and selling them when it is high is called a capital gain. It is the positive difference between the net purchase cost and the net selling price of the share.

In the secondary market, the price of stocks fluctuates based on supply and demand. Factors like company performance, market conditions, and economic indicators also affect the determination of these prices.

The secondary market ensures liquidity of the investor's investments, allowing investors to quickly sell and buy shares without holding them until a predetermined date. It enables investors to cash their investments quickly. The company receives no money from selling shares through the secondary market.

Significant differences between primary and secondary markets

Elements	Primary market	Secondary Market
Objective	Sell new securities/stocks	Buying and selling of already issued securities/stocks
Capital flow	Funds directly go to the company.	No funds flow in to the company. Funds will be exchanged between investors.
Price determination	Determined by the Company and the Underwriters.	Determined by market forces (supply and demand)
Investor interaction	Investors buy directly from the company.	Investors trade among themselves.

Guide to Investing in Colombo Stock Exchange.

In the Primary market from a new share issue (Initial Public Offering)

- An investor who wishes to buy shares should open a Securities Account in the Central Depository System (CDS) through a stockbroker or a custodian bank.
- There are many licensed stock broking firms (Refer to the link: CSE - Co https://www.cse.lk/pages/trading-members/trading-members.component.html)
- The duly completed Client Account Opening Forms and the relevant supporting documents (copy of the national identity card and billing proof) must be handed over to the stockbroker or a custodian bank. Read and understand the contents of the forms before submission.
- The CDS system will generate a Client Account Number, which will be handed over to the stockbroker or a custodian bank confirming the CDS account opening.
- Through newspapers, websites, radio channels, and television, a company gives publicity to prospective investors when it wishes to be listed or is going to issue shares through an Initial Public Offering (IPO).
- The company publishes a booklet called “Prospectus” for a share issue with information about the company, financial status, plans, and the offer.
- A Prospectus can be obtained free of cost from a stockbroker/Manager to the issue at the Colombo Stock Exchange (CSE), its branches and website/ Bankers to the issue/ company offering the shares or any other place that the company indicates before the issue opening day.
- Investors must be over 18 years of age to apply for purchasing of shares in IPOs.
- The Prospectus must be read carefully, and the application form to purchase the shares must be completed accurately & clearly. If necessary, consult an expert for advice. Remember to indicate your CDS account number and National Identity Card number and place your signature on the application form.
- Send this form directly to the company concerned, a stockbroker, a custodian bank, or a manager to address the payment issue for the amount due through a cheque or bank draft. For example, if you request 100 shares and the issue price of a share is Rs 20.00, you have to write a cheque/draft amounting to Rs 2,000.
- The Prospectus indicates the share issue on the opening and closing days. Ensure to send the application form and the cheque/bank draft before the issue closing day. If an issue has more buyers than shares offered, the share issue will be closed on the opening day itself.
- Immediately after the share issue closes, the company will evaluate the demand for the shares. Suppose investors have asked for more shares than the company initially planned to issue (i.e., in the event of oversubscription). In that case, the company will announce the way in which they will distribute the shares.
- The allotted shares would be credited to the applicant’s CDS account electronically.
- Where an application is accepted only in part, the refund payment will be made as specified by the applicant due to oversubscription of the primary issue. For example, if you have applied for 1,000 shares at Rs. 20.00 per share (total value is Rs. 20,000), you might only get 600 shares due to oversubscription. The company must reimburse 400 shares (Rs. 8,000) within 10 Market days (working days) of closing, excluding the allocation list’s closure date.
- Thereafter, the CSE will announce the first trading day of the shares. Trading of shares will commence on Market days (working days) after the closing of the IPO.

- If the shareholder wishes to sell his shares, he can contact the stock broker and give instructions to sell the shares once the shares are listed.
- First-time investors often come to the stock market to apply for shares at an IPO. Newcomers should pay attention to areas such as the business environment, current management, tax incentives, future earnings, and the valuation of the company that will be listed. This information can be obtained from an investment advisor.

Buying and selling shares on the Secondary Market

This is a market in which an investor could either buy from or sell to another investor after the original issuance in the primary market. You must find a stock broker /custodian to open a CDS account through them.

How do you place an order with a Stockbroker?

- Any investor can maintain one or more CDS accounts through stock broker companies.
- The stock broker company will allocate you an investment advisor to advise you to buy/sell shares.
- Make sure that you deal with only "Certified Investment Advisors ."All investment advisors should obtain this qualification to advise investors.
- You can contact your broker through phone, fax, e-mail, personal visits, or the Internet to trade in the secondary market.
- You must provide your stock broker (investment advisor) with the company's name, price, and number of shares you want to buy/sell. An Investment Advisor will advise you as to what to buy/sell.
- The investment advisor will place your order, but the investor should decide to buy/sell.
- Once the order is processed, he will inform you of the shares you could purchase at the required price.
- Once the order is executed, you will receive a Bought/Sold note from the broker. This document confirms the transactions that have taken place with your approval.
- The broker dispatches Bought/Sold notes to the clients before the commencement of the next trading session.
- The buyer must make payment for shares bought by the 3rd trading day after the purchase (T+3). A first-time investor might have to make an advanced payment before purchasing shares. The seller will receive payment for shares sold by the 3rd trading day after the sale (T+3).
- Any investor can change their broker through the CDS without making a payment.
- After buying the shares, an investor can hold the shares for a desired period. The investor determines the selling price and the decision to sell. You can obtain research reports from your stock brokers to assist you with this decision.
- CDS should forward a monthly statement to the account holder if such an account were active during a particular month (monthly statement). An active account shall have at least one transaction (purchase/sale/deposit/withdrawal/transfer) during the above mentioned periods.
- You should check share prices and observe market activity regularly. You can do it by calling the stockbroker, going through daily newspapers, accessing the CSE www.cse.lk, or accessing your stockbroker's website or visit your stockbroker/ stockbroker branch office in Matara, Kandy, Kurunegala, Negombo, Anuradhapura, Jaffna, Ratnapura, and Ambalantota.
- The investment advisor shall not buy/sell shares without your instructions. If there is a query, be sure to contact the Compliance Officer of the stock broking company immediately.

Investing in debt securities

What are debt securities available for investing?

Mainly two categories of debt securities are available:

1. Debt securities issued by corporate bodies
2. Debt securities issued by the government

Debt securities issued by corporate bodies

Corporate Bonds

Corporate bonds are medium-term or long-term securities of private sector companies that obligate the issuer to pay interest and redeem principal at maturity. Corporate bonds that are not backed by a specific asset are called debentures.

Corporate Debentures

Debentures are unsecured, medium or long-term, interest-bearing bonds issued by private sector companies, banks, and other financial institutions backed only by the issuer's general credit. Large, well-established institutions usually issue debentures. The holders of debentures are considered creditors and are entitled to payment before shareholders in the event of the liquidation of the issuing company.

Commercial Paper Market

Commercial papers (CPs) are short-term, non-collateralized (unsecured) debt securities issued by private sector companies to raise funds for their use by banks and other financial intermediaries. CPs are generally issued by creditworthy (high-rated) institutions in large denominations and have additional bank payment guarantees. CPs are usually sold at a discount, although some are interest-bearing.

Benefits of investing in corporate debt securities

- Investors can gain fixed-income returns by periodic interest payments.
- They provide opportunities to diversify investments with different maturity periods and risk profiles.
- Investors can have a higher yield however with higher risk than that of government securities.

Investing in Corporate Bonds

Similar to the CSE investments

Debt securities issued by the government

Treasury Bills and Treasury Bonds

The Government of Sri Lanka raises local currency debt for budgetary purposes mainly through short-term debt instruments, Treasury Bills (T-Bills), medium and long-term debt instruments, and Treasury Bonds (T-Bonds).

The treasury bill market is a part of the domestic currency market. The highly liquid nature of Treasury bills provides investors with an alternative source of liquidity while generating a return on investment. Therefore, interest rate movements in the Treasury bill market provide a benchmark for the short-term debt market. In addition, changes in volumes and rates in the Treasury bill market affect financial institutions' costs, profitability, and liquidity.

The Central Bank accepts Treasury bills and bonds as collateral under open market operations. In addition, the regulator requires financial institutions to maintain a significant exposure to default-risk-free investments to enhance financial stability. This reinforces the importance of Treasury bills and bonds as being considered default-risk-free due to their inherent guarantee of repayment. Treasury bills and bonds are collectively called government securities in daily market terminology.

Treasury Bills and Treasury Bonds Market

The Government of Sri Lanka mainly raises domestic currency debt for budgetary purposes through,

- Treasury bills (T bills) which are short-term debt instruments issued under the Local Treasury Bills Ordinance No. 8 of 1923 (as amended) and;
- Treasury bonds (T bonds) are medium to long-term debt instruments issued under the Registered Stock and Securities Ordinance No. 7 of 1937 (as amended).

Central Bank of Sri Lanka (CBSL), as the agent of the Government of Sri Lanka, is responsible for issuing Treasury bills and bonds, as well as associated debt service payments comprising interest/coupon payments and maturity payments.

The Treasury bill market is a segment of the domestic money market. The highly liquid nature of Treasury bills offers investors an alternate source of liquidity whilst generating a return on investment. Therefore, interest rate movements in the Treasury bill market provide a benchmark for the short-term credit market. In addition, changes in the volumes and rates in the Treasury bill market affect financial institutions' cost, profitability, and liquidity.

Treasury bills and bonds are considered default-risk-free due to the inherent repayment guarantee by the Government.

Features of Treasury Bills and Bonds in Sri Lanka

Treasury bills are issued with 91-days, 182-days, and 364-days maturities (standard maturities issued at primary auctions) whereas, Treasury bonds are issued for maturities of from 2- 30 years as per the provisions of Local Treasury Bills Ordinance No. 8 of 1923.

- Treasury bills, generally issued at a discount, are repaid at face value at maturity.
- Treasury bonds carry bi-annual coupon payments and are repaid at face value at maturity.
- Treasury bonds can be issued at a discount, par, or premium
- Market-determined yield rates prevail
- Tradable in the secondary market
- Issued in script-less form
- Collateral for short-term fund raising

Benefits of Investing in Treasury Bills and Bonds

- It is considered default risk-free since the sovereign or government issues it.
- Since Treasury bills and Treasury bonds are tradable in the secondary market, they are highly liquid money market instruments. All receipts of interest and maturity proceeds by foreign investors are fully repatriable.
- It is possible to have joint investments.
- CBSL securely registers these investments in the Central Depository System (CDS), connected to an automated Scripless Securities Settlement System (SSSS).
- Treasury bills and Treasury bonds can be purchased at any time, from the secondary market, through Primary Dealers (PDs) or licensed banks. PDs are appointed by the CBSL to subscribe to issuances of Government securities through the primary market (initial issuance). Other persons wishing to invest in Treasury bills and bonds at the primary market may do so by placing bids through PDs.
- A Securities Account in the Central Depository System (CDS) (the registry) has to be created in the name of the investor/s by the dealer direct participant (licensed banks or primary dealers) of the CDS.
- Interest and maturity proceeds of Treasury bills and bonds are credited to the investor's account through respective dealer direct participants maintaining the investor's securities account on the due date.

Obtaining information on Treasury Bills and Bonds

Details on available Treasury bills and bonds and prevailing market rates can be obtained from licensed banks, PDs, and CBSL *(Government Securities Market | Central Bank of Sri Lanka).*

7 Tips to select your right investment

1. **Choose investments that match your financial goals.**

   If your financial goal is short-term, you should select short-term investments (e.g., Fixed deposit) with high liquidity. You should pick investments with high returns but less liquidity for long-term financial goals.

2. **Conduct thorough due diligence.**

   Before investing in a firm, you should investigate its financial soundness, profitability and liquidity, market potential, operational capabilities, and legal status. Further, you can research their past track records and the reputation they have built over the years in the investment world.

3. **Evaluate the creditworthiness**

   Obtain the credit ratings of the selected investments, especially for bonds or debt instruments. Agencies like Moody's, S&P, or Fitch provide ratings indicating the issuer's ability to meet its financial obligations.

   (High Ratings: AAA or AA-rated investments are considered very secure. Lower Ratings: Indicate higher risk and should be approached cautiously.)

4. **Check the collateral**

   Secured investments are often backed by collateral (secured assets) that safeguard investors in case of default.

7 Tips to select your right investment

5. **Verify regulatory compliance**

   Ensure your investment company is not doing any illegal business. It complies with local laws and regulations set by the relevant authorities. For example you can verify that the company is registered with SEC, CSE or Central Bank of Sri Lanka.

6. **Beware of unrealistic returns**

   Some investments promise unusually high returns with minimal risk. Such opportunities may be scams or involve hidden risks.Therefore, be cautious if promised returns far exceed market averages or seem too good to be true.

7. **Seek professional advice**

   Get support from financial advisors or investment professionals to assess whether a secured investment fits your financial objectives and risk profile.

3.6 Managing Debt

Learning outcomes

- Identify debt and the need for debt
- Know the formal and informal sources of debt
- Understand the factors to consider for borrowing decisions
- Understand the type of interest rates
- Know the questions to ask loan providers
- Know the tips to manage credit cards and debt
- Know the tips to avoid debt and safe borrowing
- Know good debt and bad debt

Debt is a financial liability where one party, usually called the borrower or debtor, borrows money or other resources from another party, called the lender or creditor, with the promise to repay the borrowed amount and interest over an agreed period. Debt is a vital tool individuals, businesses, and governments use to spend on activities or investments when sufficient funds are not immediately available.

The members of the Rathnayake family had a unique topic to discuss at the dinner table.

In the above conversation, Gothamie speaks about a person in trouble due to a debt burden. Debt helps us to finance our emergency needs. However, if not properly managed, we will be in trouble like Gothamie's office colleague.

Elements of Debt

Debt

Principal
The amount borrowed

Interest
The price of the borrowing

Collateral
Not a must, but claims defualt debt

Repayment terms
Repayment conditions, frequencies and maturity date

Importance of borrowing

Borrowing allows firms and individuals to **bridge the gap between current needs and future** Income. However, careful management is required to avoid financial distress and excessive interest costs.

Needs that are fulfilled by borrowing

The following are some examples of borrowing.

- **Purchasing a property**

A person may want to buy a house, land, or a building but not have enough savings to pay for it upfront. A loan facilitates the purchase of the property. Borrowing for the acquisition of properties is common in society because it allows individuals to spread the cost over time while gaining access to a valuable asset.

- **Education Expenses**

A student desires to attend a prestigious university but lacks the funds for tuition and living expenses. A student loan finances an individual's need for education. Therefore, education loans help individuals invest in their future earning potential, often providing returns in the form of higher lifetime income.

- **Emergencies**

A member of a family requires urgent surgery. A personal loan can cover the medical costs if sufficient cash or Insurance coverage is unavailable. Borrowing during emergencies can be unavoidable, but it should be used cautiously and repaid as soon as possible to avoid long-term financial strain.

- **Business Financing**

Someone who wants to become an entrepreneur plans to start a business but lacks the required capital to purchase equipment and rent a space. Business loans or borrowing from friends and family can satisfy the need for finance to start the business. Debt financing is a crucial resource for small business owners, allowing them to grab opportunities without diluting ownership.

- **Purchasing a vehicle**

An individual needs reliable and comfortable transportation but cannot afford to buy the desired vehicle outright. A vehicle loan can finance the purchase and satisfy the need. Loans for durable goods, like vehicles, are justified when asset purchases improve productivity and quality of life.

- **Debt consolidation**

If an individual has multiple high-interest credit card debts, a debt consolidation loan at a lower interest rate can streamline the payments and reduce the overall borrowing costs. Consolidating debt can simplify finances and reduce costs but requires disciplined repayment to avoid further financial challenges.

- **Lifestyle expenses or celebrations**

When a couple plan a wedding, they may lack the immediate funds to cover all expenses. A personal loan or use of a credit card can fulfill the cash requirement of the event. Borrowing for discretionary expenses can be tempting, but it should be approached cautiously to avoid unnecessary financial burdens in the future.

- **Coping with economic downturns**

Suppose an individual loses the job and needs to cover living expenses until such person is employed again. In that case, a line of credit or a credit card can manage daily expenses. Short-term borrowing can provide a safety net during financial instability but must be managed responsibly.

Sources of Debt

Formal sources

Financial institutions

Traditional bank loans are one of the most common financing methods for an individual. Depending on the borrower's creditworthiness and availability of collateral, these loans can be secured or unsecured. The borrower can negotiate with financial institutions about the collateral, based on the nature of assets owned by the borrower, and the loan facility provided by the financial institution.

For example, a young person might take an unsecured personal loan to fund further education or to start a small home-based business. All the banks and financial institutions offer various loan products with competitive interest rates and flexible repayment terms. You can refer to the CBSL website for the list of licensed banks and other financial institutions facilitating borrowings. (Authorized Financial Institutions | Central Bank of Sri Lanka)

Microfinance

Microfinance institutions (MFIs) cater to individuals who may not have access to traditional banking services. These institutions provide small loans, typically without collateral, making them ideal for low-income earners. Traders could obtain a microfinance loan to expand their inventory, significantly boosting their earning potential. The web page of Lanka Microfinance Practitioners Association (www.microfinance.lk) contains information on many MFIs in Sri Lanka.

Credit Cards

Credit cards offer a convenient financing method for everyday expenses and larger purchases. However, they come with high interest rates if not appropriately managed. Cardholders might use a credit card for emergency medical expenses, paying off the balance within the interest-free period to avoid extra charges.

Government-funded lending schemes

The government implements special debt facilities under different government-funded programs or with the collaboration of state banks to fulfill specific social development goals. Samurdhi loans are one example of such debt facilities. Such loan programs mainly aim to offer low-interest loans to individuals in particular income brackets or geographic areas. The borrowers can have subsidized interest rates and government backing. However, there are eligibility criteria to be matched.

Pawning (Gold Loans)

Borrowing money by pledging gold or jewelry as collateral from financial institutions and other pawning centers widely available all around the island. Pawning provides quick access to funds with relatively low risk; however, the borrower must pay high interest rates and take the risk of losing the pledged items if not repaid at the agreed time.

Informal sources

Friends and Family

Borrowing from personal networks is common, particularly for smaller amounts or for emergencies. The advantage of borrowing from friends and family is that no interest or formal agreements are involved. However, in case of a repayment failure, the relationship can be strained.

Moneylenders

Operates outside the formal banking system and offers quick loans with minimal documentation. Although they facilitate instant cash availability, the debt is subject to extremely high interest rates and potential exploitation.

Digital lending platforms

Emerging apps and online services offer small loans with quick processing. Even though money can be borrowed instantly with minimal or zero paperwork, potentially high interest rates are charged, and only small amounts can be borrowed.

When borrowing money, it is generally advisable to prioritize formal financial institutions over informal institutions for many reasons: offer lower and regulated interest rates, governed by laws and consumer protection regulations, helps to build your credit history which can make it easier to get future loans, clarity, transparency and usually offer structured and manageable repayment plans. Therefore, borrowing from formal financial institutions is generally safer, cheaper, and more sustainable in the long run. While informal sources may seem convenient in urgent situations, they carry significant financial and personal risks.

Factors to consider for a borrowing decision

Alternatives to borrowing

Before borrowing, individuals should evaluate whether alternative funding sources can meet their needs without incurring debt. Other options, such as using savings, selling assets, or deferring expenses, may be explored before deciding to borrow.

Purpose of borrowing

Borrowing should serve a clear, justifiable purpose, such as acquiring an asset, funding education, or addressing an emergency. The purpose determines the amount, source, period, and type of the loan. A loan should be viewed as a tool to achieve long-term financial stability and growth rather than satisfy short-term desires.

Affordability of repayments

Borrowing decisions must consider the borrower's ability to meet repayment obligations without endangering the borrower's financial stability. Therefore, a borrower must evaluate whether the repayments can be comfortably managed monthly without straining the budget or sacrificing essential expenses. For example, when a person wants to buy a car, monthly Income and costs need to be identified to calculate what type of car is most affordable so that the loan amount can be decided based on the borrower's ability to afford repayments of the loan installment.

Interest rates and other borrowing costs.

Minimizing the cost of debt is essential to maintaining a person's financial efficiency. Therefore, borrowers should compare interest rates, processing fees, and other charges to choose the most cost-effective option for borrowing, as all these are the costs borne by the borrower. These costs need to be minimal for efficient utilization of funds borrowed. Some factors, like loan processing time, may be compromised against lower borrowing costs.

Duration and Loan Terms

The choice of loan terms should balance affordability with the total cost of borrowing. The duration of the loan and terms should align with the borrower's financial plans and repayment capacity. Loans with longer maturity periods may have lower monthly payments and higher overall interest costs due to the extended repayment periods.

Understanding the "Interest rate."

Interest rate is the price paid for the funds borrowed, which is the main cost of borrowing. On the other hand, interest represents the lender's revenue.

Following are three key types of interest rates that are important to know for a borrower.

Nominal interest rate

The nominal interest rate is the stated interest rate of a loan, which implies the actual monetary price borrowers pay lenders for using their money. If the nominal rate on a loan is 10%, borrowers can expect to pay Rs10 of interest for every Rs100 borrowed from the lender. Nominal interest rates are typically expressed annually, such as 5%, 7%, or 10%, and they represent the percentage of the loan amount that must be paid as interest during the specified period.

Real interest rate

Unlike the nominal rate, the real interest rate factors inflation into account to give parties to the borrowing, a more accurate measure of their buying power after they redeem their positions. If the annual interest rate of a loan is 10% and the inflation rate is 4%, the real interest rate is only 6%.

Real interest rates are crucial for making informed financial decisions, especially on investments and loans. When evaluating the cost of borrowing and assessing investment opportunities, it is essential to consider the real interest rate to understand the actual economic impact and how inflation may affect the return on investment or the actual cost of borrowing.

Effective interest rate

Borrowers should also be aware of the effective interest rate, which considers the concept of compounding. Mathematically speaking, the difference between the nominal rate and the effective rate increases with the number of compounding periods within the period applicable for the borrowing. This is how the effective interest rate per year is calculated.

Annual Effective Interest rate (%) = $\left[\left(1+\frac{r}{n}\right)-1\right]$ x 100

Where,

r = nominal interest rate of the loan

n = number of interest payments per year

Questions must be asked from the loan provider

1. **How will the interest be calculated?**
2. **A fixed interest rate or a variable interest rate?**

   Flat basis or Declining basis?

A fixed interest rate will remain the same throughout the loan term. A variable interest rate will periodically increase due to increases in market interest rates during the loan term.

A fixed rate, although higher than a variable rate, allows you to predict your future payments accurately. Variable interest rates may lead to you paying a higher monthly payment at the lender's discretion if market interest rates increase.

Interest may also be calculated on a flat or declining basis. A loan with 15% declining interest will cost you less than a loan with 15% flat interest.

This is because with a "declining" interest rate, you only pay interest on what you owe the lender, while with a "flat" interest rate, you keep paying interest on the original amount of the loan until this amount is entirely paid back.

3. **What penalty interests and fines will be charged** if you miss an installment payment?
4. **How frequently is interest paid?**

Interest can be paid annually, semi-annually, quarterly, monthly, weekly, or daily. The longer the frequency of payments, lower the total interest cost of borrowing and larger the installment paid. The shorter the frequency of payments, higher the total interest cost of borrowing and smaller the installment paid. This is a result of an effective annual interest rate.

5. **What are the additional fees that may be charged?**

Some loans have front-end fees, stamp duty, early repayment, and loan processing fees. These can be negotiable, and some financial institutes waive these charges to win over customers.

6. **What are the security or collateral (something you own) and guarantees required?**

If you fail to repay your loan, the lender may have legal rights to take over the collateral provided or request the guarantor to repay your loan. Lenders that do not require security may charge very high interest rates because giving out a loan with no security is risky. If you are offered a loan without security, make sure you understand all the terms and conditions, including the cost of the loan.

7. **What amount do you have to pay back over the entire loan period?**

This includes,

The total amount borrowed + Interest cost for the whole period + Other fees or charges

8. **What will the tax impact be on taking the loan?**

Since the interest of certain loans is tax allowable, the actual loan cost is less than the nominal interest cost.

Managing Credit Card

A credit card is a valid and widely used payment card worldwide. A bank usually issues credit cards and allows the cardholder to borrow goods, services, and money in an emergency. After using the card, the repayment amount will be added to the statement. If a credit card is effectively used, you can build a strong credit history, access financial opportunities, and support long-term financial health.

7 ways to manage your credit card

1. **Pay on time, every time**

   Ensure to settle the credit card bill on or before the due date given for settlement every month. Timely payments would avoid late fees and interest charges on credit. Set up automatic payments or reminders to avoid late settlements or unpaid credit card bills.

2. **Pay complete than the minimum**

   Ensure to pay the entire balance to avoid interest. If you can't pay in full, try to pay more than the minimum amount to avoid the late payment fee, in which case, interest charges will be lower, and the debt amount will also be lower.

3. **Use your credit card only when essentials and emergencies**

   When you pay through credit cards, always question as to how essential that payment is. Can you postpone that? Make payments only on what you can afford to pay off immediately. Classify your needs and wants and use the credit card accordingly and prudently. Please don't use the credit card for the sake of having it.

4. **Select the right credit card for you**

   There are many types of credit cards available in the market. Make sure you select the right credit card that will suit your spending habits. Don't forget to check the cost of the annual fees, late payment charges, cash-back rewards, redeemable points, and interest rates. If you are a frequent traveler, select a credit card that gives you attractive discounts at your preferred hotels and restaurants.

5. **Don't apply for many credit cards**

   Applying for many credit cards will lead to unwanted spending patterns that may lead you into a debt trap. Just because you get new offers from other banks, don't apply for new cards and increase your credit limits.

6. **Remember to analyze your credit card statement**

   Don't forget to check your statements regularly. This will help you to be aware of your payment history and ensure your statement has no errors or fraud. If you find any unauthorized items, you must inform the bank immediately.

7. **Avoid cash advances·**

   Cash advances usually carry high fees and interest rates from day one. Use them only as a last resort.

Tips to Manage Your Debt

Effective debt management requires financial discipline, informed decision-making, and proactive strategies. By following these tips, individuals can minimize debt costs and protect their financial health.

1. Create a comprehensive budget.

Preparing a budget is essential to avoid overspending and falling behind on debt payments. For example, you can create a budget by allocating funds for crucial expenses you are committed to paying. Ex: monthly loan installment. You may have to manage your costs, and stay within the budget, and that will help you repay your debts with no delays or defaults.

2. Prioritize debts using the right strategy.

If you have multiple debts, decide how to repay debts for maximum efficiency. The following strategies can be followed to plan repayment of debt.

- Focus on settling high-interest debts first to save money over time.

  For example, if you have the following debts:

  Credit card: Rs 300,000 at 25% interest.

  Personal Loan: Rs 500,000 at 15% interest.

  Car Loan: Rs 30,000,000 at 10% interest.

First, you can focus on the credit card to minimize interest payments over time because it gives the highest interest cost. Once you settle the credit card debt, the monthly interest cost will be lower than before, as high interest-bearing debt is paid off.

- Start with the smallest debt to build confidence and motivation. This strategy gives psychological relief concerning the burden of debt repayment.

  For example, if you have three debts:

  a loan from a money lender amounting to Rs. 50,000, 25% interest,

  a personal loan of Rs. 400,000, with 15% interest and a car loan of Rs. 20,000,000, 10% interest

Using this method, you can settle the loan with the money lender to feel that your debt is being reduced.

3. Consolidate and refinance debt.

Financial institutions facilitate combining multiple debts into a single loan with a lower interest rate or refinance existing loans to reduce monthly payments. Debt consolidation and refinancing, simplify repayment and generally reduce the overall cost of debt.

For example, if you have the following loans to settle,

Credit card: Rs. 300,000 at 25% interest,

Personal Loan: Rs. 500,000 at 15% interest and

Car Loan: Rs. 30,000,000 at 10% interest,

You can get a separate loan equivalent to the amount required to settle all the above three debts at a 12% interest rate. Then you will not have many debts to pay at different interest rates, but one debt at 12% interest, where all your debt obligations are consolidated into a single loan at a lower interest rate.

However, you must research debt consolidation options available in the different financial institutions and check the total cost, including extra handling fees.

4. Negotiate with lenders (Restructuring of existing debt)

You can contact lenders to negotiate better terms, such as lower interest rates and extended repayment periods. Lenders would agree to negotiate as it mitigates the risk of default. Proactively addressing payment difficulties can prevent defaults for both parties.

For example, you can negotiate with the bank to explain your financial hardships in repaying loans and re-arrange repayment terms to lower interest rates with an extended repayment period.

Tips to Avoid Debt and Safe Borrowing

1. Build an emergency fund.

You can set aside money for unexpected expenses in your budget. Practice this as a habit, reducing reliance on borrowing during emergencies. It helps to prevent the need for costly loans when unexpected expenses arise.

For example, when your car breaks down suddenly, which you haven't planned for, you can use an emergency fund to fix the car back rather than seeking high-interest-bearing quick loans.

2. Avoid emotional spending

You can resist the urge to borrow for non-essential or impulsive purchases while maintaining a high level of purchase discipline unless you cannot settle the debt.

3. Avoid high interest-bearing debt.

Even if you need to borrow, try to limit borrowing from sources with high interest rates, such as personal money lenders or credit cards. High-interest debts accumulate quickly, making it harder to repay. Practical Tip: Compare borrowing options and prioritize low-interest sources like secured loans.

4. Understand the total cost of borrowing.

Consider the full financial impact of a loan, including interest, fees, and repayment terms, before borrowing. You can inquire about this information from the lender and make yourself well-clear about it.

For example, you can compare two loan options: one with a lower interest rate but high handling charges and another with no fees but a higher rate. You can calculate the total cost to choose the better option. There are online loan calculators to estimate total borrowing costs.

Good debt vs. Bad debt

Good debt is borrowing money to invest in something that can grow your wealth. Good debt typically has low interest rates.

For example, Educational loans, Housing loans, or business loans.

Bad debt is borrowing money to buy things that lose value over time or don't improve your financial situation. Bad debt can upset your finances, especially if it carries a high-interest or is hard to repay.

Examples include Using Interest Credit Cards for unnecessary purchases.

Debt is a powerful tool to help achieve your life goals if used wisely.

3.7 Personal Protection

Learning outcomes

- Explain personal protection through Insurance and retirement planning
- Describe retirement planning and its main steps
- Explain the application of TVM in retirement planning
- Describe the concept of Insurance and its importance
- Know the main types of personal Insurance
- Tips to consider when selecting the right Insurance policy

Personal protection refers to identifying the risks of unforeseen yet possible adverse events that may happen in the future. You need to be prepared to face these adverse events in advance. Retirement planning and Insurance are the most common strategies to guard against these unfavorable events.

Retirement planning

Retirement planning is preparing for financial independence during your golden years. According to labour laws, a person can be employed up to a maximum age. Once you reach that age, you need to leave your permanent employment. Even if your income came from any other source, due to not being physically fit or other medical reasons, there will be a time that you will not be able to earn any more actively. Planning for this time is crucial to maintain your financial independence.

It involves creating a savings and investment plan to provide sufficient income to cover living expenses after you stop working. Retirement planning is an essential aspect of financial planning. A retirement plan can help you achieve your goals and ensure a comfortable and secure retirement.

Steps to Retirement Planning

The following approach outlines the practical steps to retirement planning.

1. Set Your Retirement Goals

Deciding when you want to retire and estimating the value you need to fulfill your retirement life and expectations is essential. While considering your retirement plans, you must also forecast factors such as future inflation rates and health care expenses.

2. Estimate Your Current Financial Position.

Calculate your current wealth by accumulating assets and reducing your total debt or liabilities. Review your income, including extra and passive income sources and expenses.

3. Create a Savings Plan and Don't touch your Retirement Savings

Based on your required goal, set up a savings plan. Try to start saving early and use the compound interest rate to grow your retirement package. If you withdraw them early, you will not get the expected benefits. Further, it is wiser to understand the employer pension plans or other perks. Investing in retirement is essential for building wealth and generating income.

There are several types of investments that you can use to build your retirement portfolio, including stocks, bonds, mutual funds, EPF, and ETFs.

Each investment option has its risks and rewards, and it is essential to understand these before investing your money.

4. Review Your Retainment plan and Adjust

Once you set your plan, you should review and see whether any deviation from your end goal is essential. If there is, revise them accordingly.

How to use the Time Value of Money in retirement planning

You can use the time value of money to plan your withdrawals and investments.

Scenario 1

Suppose you save Rs 1000 monthly from your Income for your retirement from your first salary in a savings account that pays 8% interest compounded monthly. How much will you save in your retirement?

Assume now you are 20 years old, and you will retire at the age of 55.

You can use the following formula.

$$\text{Future value} = \text{Monthly payment X} \left[\frac{(1+(r/n))^{(n \times t)}-1}{(r/n)}\right]$$

Where,

r = Interest rate per year

n = frequency of compounding within a year

t = number of years applicable

Bank balance at the age of 55

$= 1000 *[(((1+ (.08/12))^{(12*35)}) - 1)/(.08/12)]$

= Rs 2,293,882.50

Scenario 2

You are now 30 years old and will retire at 60. According to your estimates, you'll need Rs10,000,000 by retirement. How much must you save monthly in a savings account that pays 7% annually, compounded monthly?

You can use the following formula.

$$\text{Monthly saving amount} = \frac{\text{Lumpsum required at the beginning or retirement}}{\left[\frac{(1+(r/n))^{(n \times t)}-1}{(r/n)}\right]}$$

Monthly saving amount

$= 10,000,000 / [(((1+ (.07/12))^{(12*30)}) - 1)/(.07/12)]$

= Rs 8,196.92

Scenario 3

You will retire at 55 with RS 50,000,000 saved funds. You plan to withdraw an equal amount monthly for 25 years during retirement. Assuming your retirement fund continues to earn 7% annually (compounded monthly), how much can you withdraw each month?

You can use the following formula.

$$\text{The monthly withdrawal} = \frac{\text{The lumpsum in hand at the beginning of retirement}}{\left[\frac{1 - (1 + (r/n))^{-(n\,x\,t)} - 1}{(r/n)}\right](1 + (r/n))}$$

The monthly withdrawal during retirement

$=50,000,000/[(1-(1+(.07/12))^{-(12*25)})/(.07/12))(1+(.07/12))]$

= Rs 351,340.10

Insurance

Insurance offers people a safety net and financial protection for their families. Personal Insurance policies are designed to protect individuals and families due to unexpected financial loss that may arise in the future. They cover various aspects of a person's life, health, Income, and assets

The above conversation reminds us that we live in a highly uncertain world where no one knows what will happen precisely at the next moment. But we all want whatever troubles appear in our lives, families, and valuables to remain safe. This is the time when Insurance plays a significant role in our lives.

Importance of Personal Insurance

- **Protect Your Assets**

Insurance plays a central role in safeguarding the high-value assets of an individual or family. It may act as a financial security when an individual or family suffers a significant financial loss from an asset.

- **Protect Your Family**

Ensures your dependents are taken care of in case of income loss, medical treatment, or loss of life. This helps minimize the disruption to your family.

- **Peace of Mind**

Insurance is a strategy that helps to transfer your risk to a third party. This will help to reduce your stress during unforeseen circumstances.

Common Types of Personal Insurance:

- **Health Insurance:** Covers medical expenses, hospital stays, surgeries, and preventive care.
- **Life Insurance:** Provides financial support to beneficiaries after the insured's death.
- **Disability Insurance:** Offers income replacement if the insured cannot work due to illness or injury.
- **Homeowners Insurance:** Protects homes and personal belongings from damage or theft.
- **Auto Insurance:** Covers vehicle-related damages, theft, and liability for accidents.
- **Travel Insurance:** Protects against medical emergencies or lost luggage during travel.

4 Tips to consider when selecting the right Insurance policy

1) **Identify the best Insurance company,**

   Consider their paying ability, as indicated by their credit rating, conditions, processes, and the time it would take to have your compensation paid.

2) **Get quotations from different Insurance companies.**

   Talk to them about your Insurance needs. Think carefully about the options, then choose a policy that meets your needs.

3) **Give correct information about yourself for the Insurance contract documents.**

   The Insurance company might not pay your claim if you don't give the correct information.

4) **Read your Insurance contract carefully.**

   Ask where you do not understand—only sign when satisfied on all points – including the Insurance cover and the premiums you will pay.

Points to Remember

- Suppose you think that the Insurance company has unfairly refused to compensate you or has not given you enough compensation. In that case, you can complain to the Insurance company.
- Suppose the Insurance company refuses to consider your complaint, or you think that the Insurance company has not responded relatively to your complaint. You can approach the IRCSL or the Sri Lanka Insurance Ombudsman in that case. Their services are provided free of charge.

For more details, visit *https://rdd.cbsl.lk/images/Financial%20Literacy%20Curriculum/Chapter%20on%20Personal%20Financial%20Management%20-%20Insurance.pdf*

3.8 Personal Budgeting

Learning outcomes

- Understand personal budgeting and the importance of preparing a budget.
- Explain the main steps to prepare a personal budget.

A personal budget is a financial plan prepared to track your Income and expenses for a specific period, usually a week or a month. It often includes a portion dedicated to saving money or investing for future goals, such as emergencies, education, or retirement. Preparing a budget for a future period (maybe for the next month or year) helps you manage your money in many ways.

Rathnayake's family had the below conversation at their dinner table.

In this conversation, it is noticed that Anusha has started noting down all the expenses she incurs. The children admired it and gave new ideas on how to improve Anusha's new task further. Is it a good idea to note down your spending?

Keeping track of your income and expenses is a good sign of being financially literate. It is a crucial element of preparing a personal budget, which is the ideal start to manage your money in day-to-day life.

Importance of preparing a personal budget

- **Helps in tracking Income and expenses**

A budget records all sources of Income and expenses, helping to categorize the costs. This enables you to identify where your money is going. It is essential to track the costs as it helps control unnecessary spending and ensures financial resources are used efficiently.

- **Supports Achievement of Financial Goals**

A budget aligns spending with short-term and long-term financial objectives, such as saving for a home, education, getting out of debt, or retirement. Preparing a budget to ensure resources are directed toward what matters most is essential. Budgeting translates financial goals into actionable steps, ensuring progress toward desired outcomes.

- **It prevents debt accumulation and helps with debt settlement.**

A budget ensures that individuals live within their means by setting spending limits. It is crucial not to overspend, which leads to debt and can hinder financial stability. On the other hand, budgeting helps you track and manage your current outstanding debt by setting a goal to get out of debt with less financial stress.

- **Builds savings and emergency funds**

A budget includes a dedicated allocation for savings as it provides financial security and reduces reliance on debt during emergencies by paving the way for savings.

- **Promotes better decision-making**

A budget clarifies financial resources, enabling informed spending, saving, and investment decisions. Budgeting helps you avoid impulsive decisions and focus on priorities. Your financial decisions will be well-aligned with personal values and priorities through the guidance given by your budget.

- **Prepares for life changes**

Budgets are adaptable and can accommodate significant life events such as marriage, parenthood, or career changes. Preparing for these changes ensures financial stability during transition.

- **Enhances financial discipline**

Regular budgeting cultivates habits of careful planning and spending. A budget reinforces living within your means and prioritizing needs over wants. You can set financial boundaries and encourage mindful spending discipline gained through budgeting.

How to prepare a budget?

Step 1

Have a snapshot of current incomes and expenses.

- List down all your income avenues.
- Identify relevant time frequencies with rupee values
- Categorize your Income as follows.

An example of the categorization of personal incomes

Income sources	Status of Income Active/ Passive	Frequency of Income Yearly/Monthly/ Weekly/Daily	Amount (Rs)
Fixed incomes:			
Wages and Salaries	Active	Monthly	
Pension income	Passive	Monthly	
Rent income	Passive	Monthly	
Interest income from fixed deposits	Passive	Monthly	
Aids from the government (Samurdhi, Aswasuma, elderly allowance, disability allowance, etc)	Passive	Monthly	
Family arrangements (ex: mother gets Rs10,000 from her son every month)	Passive	Monthly	
Variable incomes:			
Payments for freelancing	Active	*	**
Commissions	Active	*	**
Overtime payments	Active	*	**
Investment incomes like dividends	Passive	*	**
Bonuses	Passive	*	**
Business profits	Active	*	**
Part-time work	Active	*	**
Income from agriculture	Active	*	**

* The frequency of variable incomes is decided based on the relevant agreements between the employers/ customers or the work performed.

** An average income from variable sources can be determined for a specific period based on previous experience, weather conditions, etc.

- Calculate the total Income. Make sure that you do not overstate your variable income.
- List down all your expenses as follows.

An example of categorization of personal and family expenses

Expense item	Frequency of expense Yearly/Monthly/ Weekly/Daily	Amount (Rs)
Fixed expense:		
Rent	Monthly	
School van/Office transport fee	Monthly	
Loan installment	Monthly	
Insurance installment	Monthly	
Daycare fee	Monthly	
Tuition fees	Monthly	
Utility bills rentals	Monthly	
Taxation of fixed-income	Monthly	
Variable expenses:		
Food	*	**
Household expenses	*	**
Variable component of utility bills	*	**
Fuel cost	*	**
Personal care and hygiene (haircuts etc)	*	**
Medical expenses	*	**
Clothing and accessories	*	**
Entertainment (theatre, gatherings, and trips)	*	**
Gifts and donations	*	**
Vehicle maintenance (servicing cost)	*	**
Taxation on variable incomes	*	**
Medical expenses	*	**

Note: This is only an example of a list of expenses. You can prepare it in as much detail as possible to get a more accurate picture. You may have to keep listing your costs for a week or a month initially to identify and finalize your list of expenses, which is not overstated or understated.

* you can determine how frequently these expenses are incurred depending on your consumption and buying habits.

** An average value for each expense category may be derived based on your observation of consumption and buying habits for a specific period (maybe for a month).

Step 2

Match your Income with your expenses.

- Decide the period; it may be a month or a week. You can use a monthly budget if most of your income is from fixed sources. If the majority of your Income is from variable sources, and you can go for a weekly budget.
- Determine an average income and an average expense value for a specified period.
- Identify the nature of the gap.

Step 3

List down your financial goals.

- Identify these goals according to the time of achievement.
  - **Short-term goals:** goals that need to be fulfilled immediately, shortly, within a year, or not more than three years, based on your, and your family members', needs and wants. It can be any need, expectation, or wish.

    Examples: building an emergency fund, settling a loan, taking a vacation, setting education goals, etc.
  - **Long-term goals:** goals that need a longer time to accomplish. Any need, expectation, or wish that may take over three years.

    Examples: a house, a business, a vehicle, retirement, higher education of children, starting a business, etc.
- Make sure your goals are **realistic**.
- **Prioritize** your **goals** both in short-term and long-term contexts.

Step 4

Prepare your financial plan to reach the set goals.

- Determine the **cost of each goal.**
- You may need to research and find out about the alternatives to fulfill the goals with their respective costs and other factors like quality of the service or the product and choose the right option for you.
  - **Example:** If the goal is higher education for your child, you may need to understand and determine,
  - the preferred program of the child,
  - cost of the program at different universities,
  - the quality and the reputation of each university,
  - convenience of studying
  - affordability based on your current financial position
- Determine the **saving goals** to achieve the above goals.
- Be **realistic** when making saving goals.
- Prepare **timely** allocations according to your income patterns and amounts. You can save daily, weekly, or monthly.
- Determine which plan/s best fit/s for you.
- Determine **saving avenues** to achieve saving goals by,
  - Cutting down on non-essential, avoidable expenses
  - By conducting a psychological analysis of your current needs and wants, you can find out which needs and wants can be foregone based on your Income, lifestyle, preferences, and commitments. You need to analyze your current spending patterns to cut them down wisely. This may also lead to a change in your lifestyle, and you may need to prepare yourself psychologically.
  - Setting realistic spending limits for unavoidable essential expenses.
  - You may have to forego your current consumption for the sake of achieving your future goals until you uplift your wealth.
  - Please discuss this with your family and involve them when deciding spending limits for foregone expenses. It'll help you stay with the plan peacefully.
  - Allocating new extra Income for saving.
  - Find new avenues to earn and allocate them strictly to fulfill your saving goals, not for your current consumption.
- Prepare your budget, including all your Income, expenses (revised by cutting down and sending limits), and saving goals. The following is one example of a budget.

Sample personal budget

Month: Year:		Budgeted amount
Incomes		
Salary		
Overtime		
Extra incomes		
Total Incomes		
Savings *		
Saving goal 1 (emergency fund)		
Saving goal 2 (higher education)		
Total savings		
Expenses		
Food	Groceries	
	Vegetables	
	Fruits	
	Snacks	
Household	Soap/Cleaning liquids etc	
Education	Tuition fees	
	Stationary	
	School supplies	
	Uniforms	
Transportation	Fuel	
	Taxi fees	
	Bus fare	
	Vehicle maintenance	
Medical	Channeling	
	Drugs	

Fixed commitments	Rent	
	Insurance	
	Loan installment	
	Insurance premium	
	School fees	
	School van	
	Contributions to the pension fund	
	Office transport	
Entertainment	Movies	
	Dining	
	Travel	
	Gym/sports club	
Other	Clothing	
	Credit card payment	
	Transfers to children's savings accounts	
	Charity	
	Other occasional expenses (weddings, funerals, alms-giving, etc.)	
Total expenses		

* Savings can be included in the total as well.

Note: This is only a sample. You can create your budget format according to your preferences and the categorization of incomes and expenses.

Step 5

Monitor and review your budget regularly.

- **Compare actuals with the budget** after each period.
- If you have failed to achieve the budget, identify possible causes and take **corrective action**.
- Keep the budget shared and visible to all the **family members** to make them **aware and involved** in achieving it.
- Develop a habit among all the family members to **keep records** of all the transactions they do daily.
- Make you and your family members **accountable** for achieving the budget.
- **Take actions** to remind people about spending limits and reduce expenses, such as mobile phone alerts, credit card limits, standing orders for savings, etc.
- **Revise and update** your budget when necessary.
    - For example, when you get a salary increase or extra income, you can increase your savings goals.

- Due to changes in the economic environment, such as inflation, you may need to revise your budget.
- Due to life changes, the elder child finishes education and finds a job, another child moves abroad and starts studying for a qualification, and one family member is diagnosed with a serious illness.

Chapter Roundup

This chapter has looked at the role of financial literacy in personal financial management decisions. The key points to remember are:

- The main components of personal finance management are income, expenses, savings, investments, debt, and protection.
- Identification of available income-earning opportunities like employment, entrepreneurship, freelancing, agriculture, and livestock, as well as requirements like qualifications, training and experience, and soft skills, are essential in managing income.
- Passive income is vital in improving income and making life less stressful. You become financially free when your passive Income exceeds your expenses.
- It is expected that your expenses may exceed your income. Once you have decided on your priorities, determine how much you need to pay. Make sure you plan not to spend more than you earn.
- It is vital to identify various expenses and categorize and prioritize them based on the income level. A psychological analysis of expenditure, The Hierarchy of Human Needs by Abraham Maslow, helps to understand spending levels. Needs and wants must be clearly understood in order to follow the tips for good expenses management.
- Saving money doesn't just build a more extensive bank account; it also teaches other essential skills. It allows you to stay organized, practice self-control, and help you plan your future.
- Following a sound and rigid saving plan helps to face emergencies and fulfill all the financial goals.
- There are many factors to consider in investments, such as its objective, risk and safety, return, liquidity, return frequency, tax, and maturity period.
- Investing improves your financial independence and leads to reaching wealth maximization. Identifying the investment opportunities available in Sri Lanka, such as stocks, bonds, mutual funds, real estate, entrepreneurship, and bank accounts, and choosing the right investment tool, comparing relevant risks and returns, help to build wealth and, in turn, achieve financial goals.
- The time value of money is an essential tool to analyze investment options. Identifying the nature of compound interest helps enrich the values of investments.
- Debt is a vital source of financing that helps achieve future goals without delays. Proper management of debt is essential to avoid debt traps.
- Insurance covers future risks and uncertainties, and sound retirement planning will ensure peaceful and independent retirement for older people.
- Budget is a powerful tool for planning incomes & expenses and manage savings & debt.

Chapter 4

Financial Management for Micro, Small and Medium Enterprises (MSMEs)

4.1. Introduction

Learning outcomes

- Understand the importance of financial literacy for MSMEs.
- Discuss four steps to start a new business.
- Understand the importance of developing a business plan.

Financial literacy is the foundation of a successful business. It guides entrepreneurs to make informed decisions about their businesses by helping them to understand the key concepts of financial management, such as budgeting, cash flow management, and investment appraisal, from the inception.

Financial literacy helps entrepreneurs assess the startup cost, allocate resources effectively, and select a suitable funding method when initiating a business. It also evaluates the feasibility of the business model by projecting future revenues and expenses.

Financial literacy becomes even more critical once the business is functioning sustainably. It helps entrepreneurs manage their liquidity and debt while optimizing business profitability. Moreover, it permits businesses to grow through sustainable investments and to manage risks.

Dhananjaya Rathnayake meets the National Enterprise Development Authority (NEDA) representative officer in the Divisional Secretariat of his hometown.

The above conversation emphasizes that starting your business is an exciting yet a challenging journey. It requires an intense focus on planning, willpower, and a strategic approach.

Starting your firm in Sri Lanka may sound like a challenging task. You may have many questions on how to initiate the business, the main steps of this process, and how to finance, etc.

Entrepreneurship also comes with risks and rewards. It helps you to create a unique career path for your future. Further, your financial success may encourage many others to start their own businesses. The following steps in this guide may help you achieve your desired business dream.

4 Steps to start your own business

Step 1 Develop your Business Idea.

Developing a business idea is the initial step toward starting a successful business. It is a creative process that combines knowledge, innovation, and related skills. A great business idea should be feasible, unique, and aligned with your passions and customer needs.

A business idea is rarely perfect at the beginning. Be open to modifying and improving your idea based on market feedback, emerging trends, customer needs, and technology changes.

Step 2 Data Gathering and Analysis

After you identify your business idea, you should understand your internal and external business environments. This needs comprehensive research or a background study of your intended business.

Some of the factors that you need to research are,

- The current cost structure of the intended product or service
- Status of the competition (No of rivals, identify their strengths and weaknesses and their value propositions, new market trends, customer needs, preferences, and purchasing behaviours)
- Current pricing strategies and the profitability of the product.
- Existing technologies and the new technological trends on the intended business.
- Understanding the impact of the prevailing macroeconomic variables, such as inflation, interest, and exchange rates, on the new business.
- Possible new opportunities in the market and how to differentiate your product offering.
- Understanding the initial investment cost and evaluating the available financing methods of the firm.
- Calculating the break-even point of the firm.
- Evaluate and justify the new investment using investment appraisal techniques such as the payback period, net present value, Internal rate of return, discounted payback, and Return of Investment.
- Understanding the different forms of businesses and the legal requirements to establish a new company.
- Impact of the political and social environment on the intended business.
- Understand the risks associated with the business and current strategies to overcome them.
- Understand the firm's expected values and future business aspirations.

Step 3 Prepare a Business Plan

Once you develop your business idea and complete the data gathering and analysis, you must draft a business plan. A business plan sets the firm's roadmap and helps you attract investors or financial intermediaries to finance it. It also showcases the strategy for achieving the firm's goals and objectives.

A well-developed business plan consists of the following items.

- Mission, Vision, and Goals
- Outline of the business structure and management team.
- Nature of the business, product, or services
- competitive analysis that identifies competitors, their strengths and weaknesses, and market positioning and Target market
- Value proposition
- Operational strategies
- Marketing approach

- Financial projections
- Risk Management and Business Protection

A well-crafted business plan is vital for communicating a business's vision and viability to stakeholders.

Step 4 Execution & Review

In this stage, we execute the business plan into an action plan with a clear strategy. Some of the main actions to be implemented are,

- Register your business and obtain necessary licenses or permits while complying with relevant laws and regulations.
- Investing and financing the business
- Hire the right talent and establish the infrastructure, systems, and processes required to conduct the business operations.
- Execute the marketing strategy to create awareness and attract customers
- Working Capital Management and managing the liquidity of the business
- Maintain financial records and preparing financial statements
- Distribution decisions of the business.

4.2. Forming a Business

If you are interested in starting your own business, it is important to know which business forms would best suit your needs. Different businesses have different forms based on their ownership and legality.

Learning outcomes

- Identify the main four types of businesses based on ownership and legality.
- Discuss the ownership, legality, extent of liability, registration, and relevant laws for each form of business.
- Understand the tax obligation for each form of business.

Dhananjaya continues his discussion with the NEDA officer.

Ownership depends on contributors to the business's capital. Capital is the funding the owner(s) introduces for business operations. It is an investment made by the owner(s). Legality highlights the legal presence in terms of the law, registration, the extent of responsibility of its owners to settle the business liabilities, and relevant laws.

Let's identify the three main types of businesses based on ownership and legality.

- Sole Proprietorship
- Partnership
- Limited liability company

I want to be the exclusive owner → Sole Proprietorship
I want to be the exclusive owner → Private Limited company

I'd like to join my friends and family as owners of my business → Partnership
I'd like to join my friends and family as owners of my business → Private/ Public Limited company

The following table compares different types of business organizations.

Business form	Ownership	Legality	Extent of liability	Registration	Relevant laws at the registration
Sole proprietorship	Only one owner. Identify as the 'owner' of the business. The owner will solely enjoy profits/ bear losses.	No legal identity to the business. The owner should represent the business in legal matters. It can be sued in the owner's name.	The owner is responsible for settling the business liabilities, and their personal assets also might be needed to be used.	Registration is not compulsory. However, you can register your sole business at the provincial council of the area of the business registration address.	Not applicable
Partnership	Two or more owners. Owners are identified as partners. Profits/ losses will be shared between partners per the agreed-upon profit-sharing ratio at registration.	No legal identity to the business. Partners should represent the business in legal matters. It can be used in the partners' names.	Partners are jointly responsible for the liabilities of the partnership	Registration is compulsory if the capital exceeds Rs. 1000. You can register the partnership business at the provincial council of the area of the business registration address	Partnership Act of 1890 Registration of Business Names Act (No.07 of 1987)
Private Limited company	One or more owners. The owner (s) are identified as Shareholders. Only a part of the profits will be shared among shareholders as 'dividends.'	The business is identified as a separate person in legal matters.	Shareholders will be liable for the business liabilities only up to the share of capital.	Registration is compulsory with the Registrar of Companies. Registration can be done online. Visit: https://www.drc.gov.lk/	Companies Act No. 07 of 2007

Ensure that you obtain the business name registration and trading certificates from your municipal council or district secretariat. Further, registering with the appropriate government authorities and securing any licenses or permits required for your business is vital. This step ensures legal compliance and establishes your business's credibility with key stakeholders, such as customers, investors, and suppliers.

Based on the size and turnover of the business, Sri Lanka has the following criteria to categories Micro, Small and Medium enterprises.

Size/Sector	Criteria	Medium	Small	Micro
Manufacturing	Annual Turnover	Rs. 351 Mn – 1 bn	Rs. 21 – 350 Mn	Rs. 20 Mn or less than Rs. 20 Mn
	No. of Employees	51 - 200	10 - 50	Less than 10
Service Sector	Annual Turnover	Rs. 351 Mn – 1 bn	Rs. 21 – 350 Mn	Rs. 20 Mn or less than Rs. 20 Mn
	No. of Employees	51 - 200	5 - 50	Less than 05

Understanding the Tax obligations of different types of businesses

All businesses with a taxable business profit for a financial year, known as the year of assessment in income tax law, should pay income taxes on their business profit. Tax rules and regulations are subject to change regularly. In order to get the updated tax information, visit https://www.ird.gov.lk/.

Based on your business the liability will arise as follows.

Sole proprietorship	The taxable profit of the business will be identified as the owner's income source in their income tax calculation. (This is identified as a part of the Assessable income of the owner in income tax law). Therefore, the business profit will be subjected to income tax only if the owner's total taxable income (including business profit) is liable to income tax. If the business incurred a loss, it can be carried forward to the next year or set off against the Assessable income of the owner.
Partnership	A partnership's taxable profit can incur payment of income tax as an entity. The taxable profit of the partnership will be shared among the partners as per their profit-sharing ratio and will be considered as a part of the income source in their income taxation. To avoid the same profit being taxed twice, the total taxes paid by the partnership will also be shared among the partners, allowing them to deduct such payments from their individual income tax liability.
Limited liability companies (Private/ Public)	Companies are taxable on their taxable profit. Some businesses are liable to pay special tax rates than the general tax rates based on the industry.(Ex, liquor and tobacco businesses)

Based on your business income you should register your business for Value Added Taxes in Sri Lanka. Visit https://www.ird.gov.lk/ for more information.

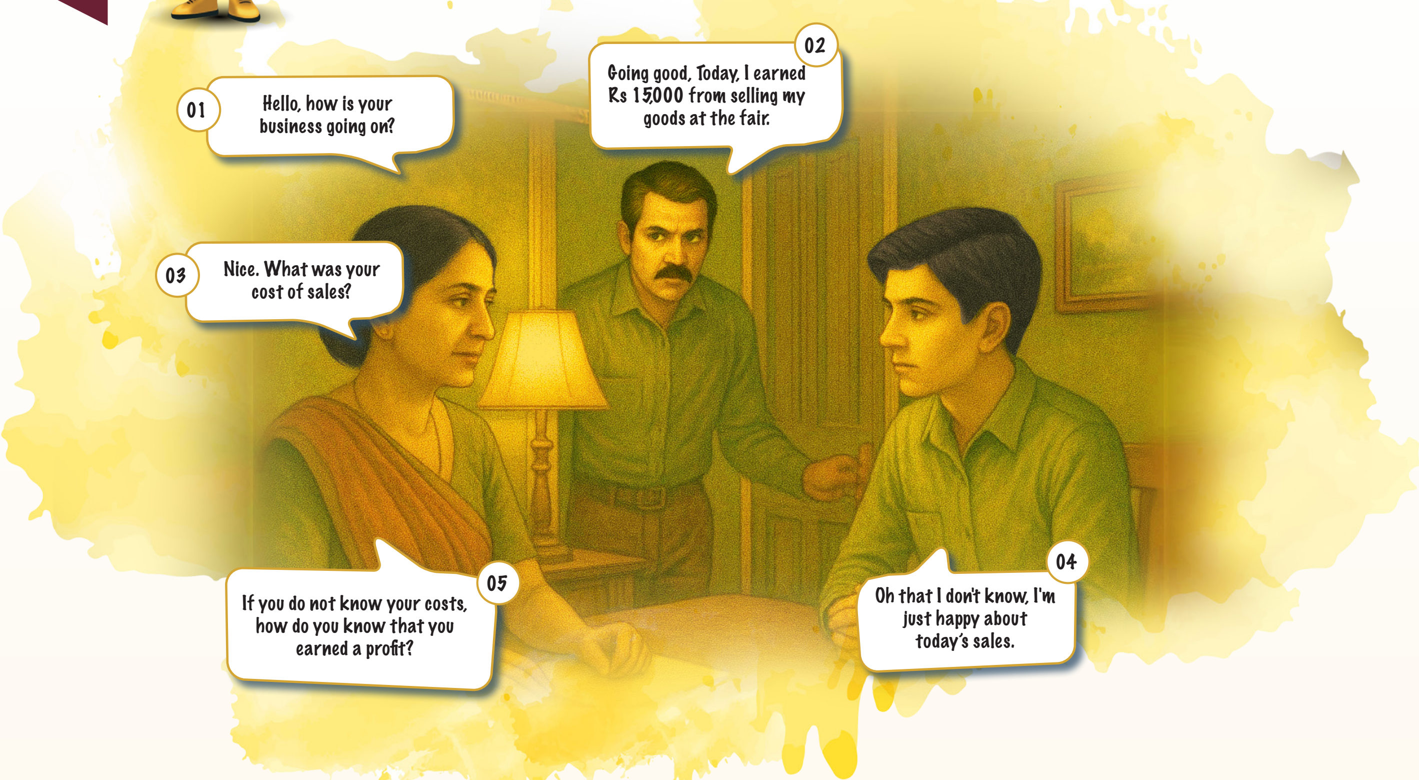
4.3. Identifying the Costs of a Business

The sole objective of your business is to generate profits. To achieve this, you must sell your products or services at a higher price than the **actual costs** of acquiring, making, or providing them.

Learning outcomes

- Understand the importance of analyzing the cost of your business.
- Discuss the concept of cost and classify cost based on traceability and behavior.
- Learn how to calculate the cost per unit using an example.
- Discuss the concept of a break-even point with an example.
- Identify the factors to consider when setting the price of the product.
- Know the common pricing strategies adopted by MSMEs

The discussion between the NEDA officer and Dhananjaya is interrupted by a visitor.



Why should an entrepreneur analyze the costs of the business?

1. **Resource Efficiency:** MSMEs often operate with limited resources. Cost analysis helps identify cost-saving opportunities while effectively managing the business resources.

2. **Pricing Decisions:** Understanding fixed, variable, and other costs is essential for calculating the actual cost and setting the product's accurate price.

3. **Profitability Analysis:** Cost analysis helps MSMEs determine the profitability of each product and helps to focus on high-margin products.

4. **Improved Decision-Making:** MSMEs decide whether to produce in-house, outsource, expand operations, or discontinue products. Cost analysis provides the required information for these decisions.

5. **Budgeting and Planning:** Cost analysis forms the foundation for effective budgeting, helping MSMEs plan for short-term and long-term operations.

6. **Monitoring and variance analysis:** MSMEs can track costs to monitor the firm's financial performance and manage and prevent cost overruns. If the business finds any unfavourable variances, it can take proactive measures to minimize them.

What is the cost?

The actual or nominal expenditure incurred to make and sell the product or service to earn profits.

The following are the possible costs for Dhananjaya's restaurant.

- Rent cost of the premises
- Electricity bills
- Water bills
- Business registration fees
- Legal fees for the rent agreement
- Cost of the ingredients to make food. (rice, vegetables, fish, meat, eggs, spices, oil, etc.)
- Salaries paid to the staff. (chef, cashier, cleaner, waiter, etc.)
- Cost of kitchen equipment
- Cost of dining utensils
- Cost of plates and dishes
- Cost of LP gas
- Cost of furniture (tables and chairs)
- Marketing cost (advertising)
- Cost of interior designing
- Depreciation of furniture
- Loan interest

How to classify the costs of your business

Once you identify all the possible cost items of your business, you can categorize these costs in many ways. The commonly used and most essential categorizations are:

1. **By traceability:** This classification is based on the degree of traceability to the final product of the business.
2. **By behavior:** This classification is based on how a cost changes about changes in the level of activity (Number of units produced or sold).

Cost classification by traceability

There are two types of costs according to the traceability of the expenses to the final product.

1. **Direct costs:** Direct costs can be easily identified with the product/service manufactured. These are the prime costs of a manufacturing business, where you cannot make the product or provide the service without incurring these costs.

   Example: Restaurant: The product is food served.

   - Ingredients of the food items (rice, flour, vegetables, fish, chicken, spices, oil, etc.) – These are called **material cost**
   - The payments for the chef – These are called **labour cost**
   - Other costs that are directly associated with the product (paper serviettes, packaging, labels, etc)- These are called **direct overheads**

2. **Indirect costs / indirect overheads:** They are expenses not directly related to producing a good or service. Indirect costs cannot be easily traced to a product.

   Example: Restaurant: The product is food served.

   The cashier's salary, rent, electricity bill, and advertising costs do not adjust according to the number of food items made and sold.

Cost classification by behaviour

Cost classification by behaviour categorizes costs as follows:

1. **Variable cost:** Variable costs vary with the Number of units produced

   Example: Restaurant: The product is food served.

   Direct material: rice, vegetables. Fish, meat, eggs

   Direct labour: paid on a piece-rate basis

   wages paid per one plate of rice (Not the monthly salary of the chef)

2. **Fixed cost:** Fixed costs do not vary with the Number of units a business produces over the short term.

   Example: Restaurant: The product is food served.

   Indirect costs do not vary with the number of units produced and sold.

   Rent cost, cashier's salary, and cleaner's salary do not vary with the Number of plates of rice cooked and sold.

3. **Semi-Variable cost.:** Costs that have both variable and fixed components.

   Example: An electricity bill has a fixed rental component that does not change according to the number of units produced or sold. However, the charge for electricity usage is also impacted by the time of business operation and activity level. This variability depends on the nature of the business and how electricity is utilized.

Classification of costs in Dhananjaya's restaurant

Cost item/ Classification	Traceability				Behaviour		
	Direct			Indirect	Variable	Fixed	Semi variable
	Material	Labour	Expenses				
Rent cost				✓		✓	
Electricity bills				✓			✓
Water bills				✓			✓
Business registration fees	Not a cost of business operation.						
Legal fees for the rent agreement	Not a cost of business operation.						
Cost of the ingredients to cook food. (rice, vegetables, fish, meat, eggs, spices, oil etc.)	✓				✓		
Salaries paid to the staff. (chef, cashier, cleaner, waiter, etc.)				✓		✓	
Cost of kitchen equipment	Not a cost of business operation.						
Cost of dining utensils	Not a cost of business operation.						
Cost of plates and dishes	Not a cost of business operation.						
Cost of LP gas				✓	✓		
Cost of furniture (tables and chairs)	Not a cost of business operation.						
Marketing cost (advertising)				✓		✓	
Cost of interior designing	Not a cost of business operation.						
Depreciation of furniture				✓		✓	
Loan installment (if a loan has been obtained, find the capital)				✓		✓	

How to calculate the cost per unit

The simplest way to calculate cost per unit is to calculate the variable cost per unit as follows.

Material cost per unit	xxx
Labour cost per unit	xxx (only if labour is paid at piece rate)
Direct expenses per unit	xxx
Total variable cost per unit	xxx

Example: The variable cost per plate of rice and curry in Dhananjaya's restaurant can be calculated as follows.

Direct material cost:

Rice (Rs230/kg x 0.125kg)	28.75
Three vegetables (Rs400/kg x 0.04kg x 3)	48.00
Dhall (Rs 300/kg x 0.03kg)	09.00
One egg	45.00
Total direct material cost per plate	130.75

Hint: Direct labour cost is not applicable here because the cook or chef, practically, is not paid piece-based. They are paid a monthly salary irrespective of the number of plates sold.

Therefore, the variable cost per plate of rice is = Rs 130.75

If Dhananjaya sells this plate of rice for Rs 350, the contribution from one plate is Rs 219.25 (350-130.75). However, this is not his final profit. He must deduct the overhead cost from the contribution to arrive at his final profit.

Selling price per plate 350.00

Variable cost per plate 130.75

Contribution per plate 219.25 (Selling price – (only) variable cost)

Break-even Point (BEP) Units

BEP is the Number of sales units that cover the total cost of the business.

Dhananjaya can calculate how many plates he should sell to cover all the indirect costs, which are fixed by nature, like rent, gas, salaries, utility bills, etc. as follows:

Total fixed cost of the business = BEP in Units

Contribution per unit

If Dhananjaya's restaurant incurs a total fixed cost of Rs 150,000 (including rent, salaries, utility bills, etc) per month, the number of plates he should sell to cover his total cost is:

150,000/219.25 = 685 plates in a month.

Break-even value/ Sales

Break-even value= BEP in Units * Expected Selling Price

He can cover the total monthly cost when he sells 685 plates of the above-mentioned menu monthly.

Therefore, the BEP value should be= 685 plates* Rs 350/- (Selling price) = Rs 239,750/=

Target Profit

Any additional plates sold will start making profits for the business.

If Dhananjaya wants to earn Rs 100,000 profit in a month, he has to sell,

(150,000+100,000)/ 219.25 = 1,141 plates

As illustrated in the above example, an entrepreneur can significantly benefit from analyzing the costs of the business when making decisions.

How to price your product

Factors to consider when setting the price of the product

- **Understand the target market:** Who is your target market, and what are their needs? How much they are willing to pay for your product? It is crucial to have a good understanding of the target market to set prices that are affordable to the target customers.
- **Consider your product or service:** What are its unique features and benefits? How does it compare to the competition? You need to be able to justify your prices based on its value.
- **Type of your costs:** What are your fixed costs? What are your variable costs? You need to ensure that your prices cover your expenses and allow you to profit.
- **Analysis of your competition:** What are the prices offered by your competitors? What are their strategies? Before setting your prices, you must fully know your competitors and their strategy.
- **Be flexible:** Your pricing strategy may change over time as your business grows and changes. Be prepared to adjust your prices as needed.

Common Pricing strategies adopted by businesses

- **Penetration pricing:** This strategy involves setting prices to attract new customers by offering a lower cost than your competitors. It can be a good strategy for new businesses or businesses trying to enter a market with intensive price competition.
- **Cost-plus pricing** is a traditional pricing strategy in which the business calculates its product cost and prices it by adding the expected profit markup.
- **Value-based pricing:** In this strategy, the firm may set prices based on the perceived value of your product or service. This can be a good strategy for businesses that offer unique or high-quality products or services.
- **Premium pricing:** This strategy involves setting high prices to create a sense of exclusivity. This strategy can be good for businesses that sell luxury goods or services.

4.4. Investment Decisions for MSMEs

Investment decisions are the key to maximizing a firm's wealth. Setting up an MSME itself is an investment decision. Investment decisions involve risk-taking. An entrepreneur has already taken a risk by investing in a business. However, investment decisions need to be followed by proper investment appraisals to understand the viability and profitability of the investment.

Learning outcomes

- Understand the key information required for investment appraisal
- Identify the standard investment appraisal techniques.
- Learn how to evaluate an investment with an example.
- Know the main limitations of investment appraisal.

Dhananjaya continues the discussion with the NEDA officer at the Divisional Secretariate.

Information required for investment appraisal

- **Value of the investment -** This is the initial investment value. The total cost of the investment is determined by how much you need to spend on it.
- **Future cash flows -** You need to be able to project future cash inflows and outflows from the investment. That means you need to be able to estimate the expected future revenues from the investment and the expenses that need to be incurred to earn revenue.

- **The risk associated with the investment** - risk assessment aims to identify and categorize the potential risks associated with an investment.

Common Investment Appraisal Techniques

1. Payback period (PB)

The payback period is the time required for an investment to recover its money. It is mainly expressed in years and months. The shorter the payback, the more attractive an investment becomes. Determining the payback period is helpful for anyone and can be done by dividing the initial investment by the average cash flows.

2. Net present value (NPV)

NPV is the difference between the present value of future cash inflows and outflows over some time. The present values of future cash flows are calculated using the time value of money (previously explained in the personal finance chapter). A proper discount rate has to be used to calculate the present values. Projects with a positive NPV are generally accepted, while those with a negative NPV should be rejected.

3. Discounted payback period

The discounted payback period determines how long it will take for an investment's discounted cash flows to cover its initial cost. This is calculated to avoid the main drawback of the payback period, which is not considering the time value of money when calculating an investment's recovery period. Therefore, discounted payback is more accurate than the standard payback period.

Example: Evaluate the investment of Dhananjaya's Restaurant

Step 1: Collecting information

Dhananjaya decided to collect quantitative and qualitative information by conducting formal and informal market research. He went to all the restaurants in his hometown and had informal discussions with their employees.

Then, he met the divisional secretariate's NEDA secretariat and obtained advice.

Step 2: Initial planning.

Dhananjaya decided as to what type of products to sell as a start. He listed restaurant furniture, equipment, kitchen and dining utensils, and other physical assets that were required. Then, based on that list, he calculated the initial cost of the investment, plus business registration, legal fees on the rent agreement, etc.

Step 3: Operational planning

Based on Dhananjaya's research, he planned 250 plates of rice and curry per week.

Expected demand: 250 plates of rice and curry per week

Accordingly, his cashflow predictions for the first year are:

Sales revenue (cash inflow) = 250 x Rs 350 x 52 weeks =	Rs. 4,550,000
Variable cost (cash outflow) = 250 x Rs 130 x 52 weeks =	Rs. (1,690,000)
Fixed cost (cash outflow) = 100,000 x 12months =	Rs. (1,200,000)
Net cashflow per year =	Rs. 1,660,000

Dhananjaya has ascertained that **Rs 2,000,000** is required to start his restaurant.

Step 4: Project evaluation

Payback period:

Payback period =	**Initial investment/average annual net cashflow**
	= 2,000,000 / 1,660,000 = 1.2048 years
	= 1.2048 x 12 = **14.46 months**

The payback period is approximately 14.5 months. This means Dhananjaya can recover his investment by **14.5** months.

Net Present Value

Dhanajaya assumes the above forecasts will continue for the next three years. The net cashflows are discounted at the cost of capital, called the discounting rate. The cost of capital calculation is illustrated in the price of capital section.

If Dhananjaya financed his loan through a bank loan at an interest rate of 15%, the net present value of his business investment is calculated as follows.

Year	Cashflow	Discounting factor at 15%	Present value
0 (beginning)	(2,000,000)	$(1+0\ .15)^0$	$(2,000,000)/\ (1+\ .15)^0 = (2,000,000)$
1	1,660,000	$(1+0.15)^1$	$1,660,000/\ (1+0.15)^1 = 1,443,478$
2	1,660,000	$(1+0.15)^2$	$1,660,000/\ (1+0.15)^2 = 1,255,198$
3	1,660,000	$(1+0.15)^3$	$1,660,000/\ (1+0.15)^3 = 1,091,477$
Net present value			**1,790,154**

The NPV of this investment is a positive value. Therefore, this is a viable project.

Discounted payback period

Year	Cashflow	Discounting factor at 15%	Present value
0 (beginning)	(2,000,000)	$(1+0\ .15)^0$	$(2,000,000)/\ (1+\ .15)^0 = (2,000,000)$
1	1,660,000	$(1+0.15)^1$	$1,660,000/\ (1+0.15)^1 = 1,443,478$
2	1,660,000	$(1+0.15)^2$	$1,660,000/\ (1+0.15)^2 = 1,255,198$
3	1,660,000	$(1+0.15)^3$	$1,660,000/\ (1+0.15)^3 = 1,091,477$

Discounted payback period =	**1.631 years (31.57 months)**
Total Investment	Rs. 2,000,000
Year 1 Present Value	(Rs. 1,443,478)
Balance	Rs. 556,522
So, the Discounted payback period would be, = 1 year and 0.4434 years (556,522/ 1,255,198) =	**1.4434 years**

Limitations of investment appraisal

- Accuracy of cashflow projections
- Appropriateness of discounting factor
- Accuracy of period predictions
- Ignoring other environmental factors that influence business operations.

4.5. Financing Decisions for MSMEs

Financing decisions for MSMEs involve choosing the appropriate sources of finance, capital structures, and terms of funding to meet the business's operational and growth needs. These decisions are critical because MSMEs often operate under resource constraints and have limited access to capital markets compared to larger enterprises.

Learning outcomes

- Understand the sources of short-term and long-term financing for MSMEs
- Know the advantages and disadvantages of equity and debt financing.
- Understand the concept of cost of finance.
- Learn how to calculate the cost of finance with an example.
- Understand the importance of managing short-term finance.
- Identify the primary sources of short-term finance for MSMEs.
- Identify the questions to be answered before selecting your method of finance.

Dhananjaya seeks assistance from his family to find capital for his potential business idea.

Financing decisions are addressed in two ways.

1. **Long-term financing decisions** involve fulfilling the capital requirement to start the business and future business expansions.

2. **Short-term financing decisions** involve managing finances necessary for day-to-day business operations. This is called **Working Capital Management**.

Long-term Financing Decisions (Capital Decisions)

Identification of the source of finance so that the cost of financing (cost of capital) is minimized are essential in financing decisions. A business can mainly obtain finances from equity and debt sources.

Equity financing

All the funds and economic resources given by the owner are called equity.

1. **Owners' savings:** Most MSMEs rely on the owners' saved funds for startup capital and business expansions. The retained earnings of the business, which are again owners' claims, can also be used for expansion.

2. **Love money:** Funds given by family member(s) or friends without expecting repayment and allocating a stake in the business or any return. Mostly parents, wealthy relatives, or friends.

3. **Angel investors:** Angel investors provide initial seed money for startup businesses, usually in exchange for ownership equity in the company. They don't offer loans. They invest in an idea they like, expecting a reward only if and when the business takes off.

Debt financing

Funds that a business raises by borrowing from lenders or investors must be repaid with interest.

1. **Banks:** Any commercial bank and other financial institutes (may) have offered different loan schemes for MSMEs. By visiting the relevant

financial institute, the necessary information can be obtained.

2. **Microfinance:** Microfinance loans are designed for individuals and small businesses generally not served by traditional banks. These loans are usually offered by specialized financial service providers known as Microfinance institutions. However, many other financial institutes provide micro-credit for startup businesses. (The list of Microfinance institutions registered under the Central Bank of Sri Lanka https://www.cbsl.gov.lk/en/authorized-financial-institutions/licensed-microfinance-companies)

3. **Government-funded loans:** Government-funded small business loans are guaranteed by government agencies and offered by qualified lenders. They are designed to help small businesses get the funding they need with lower risk and more straightforward terms.

   (For more information: https://www.treasury.gov.lk/web/frequently-asked-questions/section/msme%20loans)

Advantages of Equity Financing

There are many **advantages** of equity financing for MSMEs seeking to raise capital, including:

- There are no repayment obligations.
- There is no additional financial burden, and it is safe.
- The company may gain access to investors with expertise and connections.
- Company health can be improved by decreasing debt-to-equity ratio and credit score.
- Ability to access significant equity investments through the listing.

Disadvantages of Equity Financing

Equity Financing also has some **disadvantages** as compared to other methods of raising capital, including:

- The company's existing ownership will be diluted.
- Management may be forced to consult with new investors when making a decision.
- Equity typically costs more than debt financing due to higher risk.
- It is often more challenging to find an investor than a lender.
- Financing through listing may be costly and time-consuming,

Advantages of Debt Financing

There are **advantages** of debt financing for MSMEs seeking to raise capital, including:

- The lender has no control over the business operation.
- Prevents ownership dilution.
- Interest paid on debt is tax-deductible in most situations. Therefore they can enjoy tax benefits.
- Easy access to arranging debt compared to issuing shares.

Disadvantages of Debt Financing

Debt Financing has some **disadvantages** as compared to equity financing, including:

- Financial covenants on lending agreements may limit specific actions of borrowers.
- A high value of outstanding debt may increase the businesses' financial risk.
- Business owners may be required to guarantee the debt personally.
- Assets could be seized as a result of payment default.
- Access for debt may limited to the value of the business collateral or the value of fixed assets.

Cost of Financing (Cost of Capital)

None of the financing is complimentary for the business. Even if the owner's funds are being used as capital, there also is a cost. Identifying the cost of capital is based on the sources of capital; where is the price that has to be paid for the capital used in the business?

Cost of Debt Capital

Debt financing costs are defined as the interest and other costs incurred by the business when borrowing funds. They are also known as "borrowing costs."

The actual cost of borrowing for MSMEs extends beyond the generally focused costs such as interest rates and processing fees.

Here's a breakdown of the key components of the cost of debt:

- **Interest rates:** This is the primary cost of borrowing and is typically expressed as an annual percentage rate (APR).
- **Processing fees:** Fees charged by lenders for processing the loan application, including documentation and administrative costs.
- **Prepayment Penalties:** Charges imposed on the borrower if they repay the loan before the scheduled term.
- **Collateral Requirements:** Some loans may require collateral, such as property or vehicles, where you must obtain valuation reports, title insurance, and other legal requirements.
- **Loan Insurance:** Sometimes, loan insurance is required to protect the lender against specified risks, adding to the overall cost of the loan.
- **Late Payment Fees:** Penalties for missed or late payments can increase the total cost of borrowing.
- **Other Hidden Charges:** Any additional fees or charges not explicitly mentioned in the loan agreement but can impact the overall cost.

"It is crucial for MSMEs to accurately assess the total cost of borrowing and make informed financial decisions."

Cost of Equity for Capital

Multiple formulas and theories can identify the cost of equity. However, MSMEs can calculate their financial cost using the following path.

Owner's savings, love money and patient capital

There is no obligation to pay a periodic return, and no processing charges are involved in these funds. However, these funds are not free of cost, and there is an opportunity cost.

Opportunity cost is the forgone benefit that would have been derived from an option other than the chosen one. When you use your savings for the business, you forego the interest income by investing it in a fixed deposit.

The opportunity cost of equity is born by the person who grants the funds to the business. However, if the company uses(invests) its retained profit to grow, then the business bears the opportunity cost.

How do you calculate the cost of capital for your business?

The capital of the business may comprise,

1. Only equity or
2. Only debt or
3. Both equity and debt

If the capital consists of only equity:

Cost of capital (COC)= Cost of equity

Cost of equity = Opportunity cost of the owner's savings/love money/patient capital

Hint: The opportunity cost is the value of the forgone benefit that would have been derived from an option other than investing in the business. In Sri Lanka, money is deposited in a bank that pays interest. Therefore, the foregone benefit of the funds invested in the business (equity capital) is the interest income that could have been earned. The opportunity cost is the interest income. Therefore,

Cost of equity= average savings interest rate

Example: If you invest Rs 100,000 in your business, which was a fixed deposit in a bank that paid you 10% interest per year,

The capital of your business = Rs 100,000

Source of capital = Equity

Cost of capital = 10% per year (the lost income from the fixed deposit)

If the capital comprises only debt:

COC = cost of debt

Cost of debt = loan interest

Hint: When a loan is obtained from a bank (or any financial institution), interest has to be paid. That is the cost of the capital (debt). However, when your business pays taxes to the government, the amount paid as tax is calculated after deducting loan interest, where interest payment saves some tax.

Therefore,

Cost of debt = Loan interest rate x (1- tax rate)

Example: If you invest Rs 100,000 in your business that is received as a bank loan at an interest rate of 15%, and the business has to pay 25% of the profit of the business, The capital of the business = Rs 100,000

Source of the capital = Loan

Cost of capital = 15% x (1-25%) = 11.25% per year.

If the capital comprises both equity and debt:

The cost of capital will be the weighted average of the cost of equity and debt.

$$COC = \frac{\text{(Cost of equity x Equity capital) + ((Cost of debt x Debt capital)}}{\text{Total capital}}$$

Example: If you invest Rs 50,000, which was in your savings account that paid you 8%, and Rs 50,000 from a bank loan at 20%, and the business has to pay 25% tax on profit,

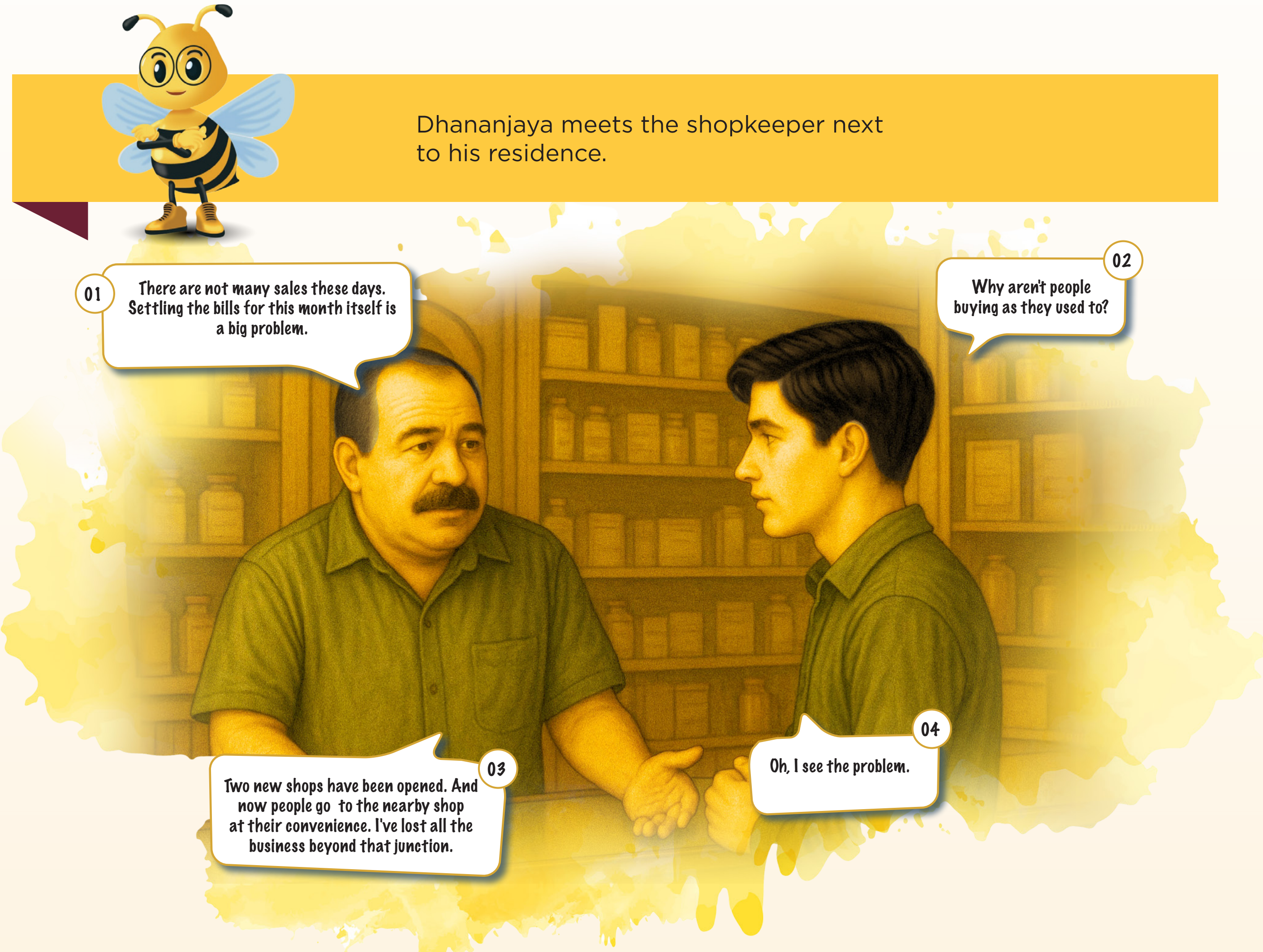
$$COC = \frac{(50{,}000 \times 8\%) + (50{,}000 \times (20\% \times (1 - 25\%))}{100{,}000}$$

COC = Rs 4,000 + 7,500 per year

COC = (11,500/100,000) x 100 = **11.5% per year**

Short-term Financing Decisions / Working Capital Management

Short-term financing refers to obtaining funds to meet immediate financial needs or cover short-term obligations. Businesses commonly use it to manage cash flow fluctuations, finance working capital requirements, or seek short-term investment opportunities.



Importance of managing short-term finance

Short-term sources of funds are essential for day-to-day business operations. They provide the necessary liquidity to cover payroll, inventory purchases, and utility bills.

Further, businesses often face seasonal fluctuations in demand. Short-term financing helps bridge the gap between revenue cycles. Sometimes, businesses require immediate funds to manage unexpected situations such as events, equipment breakdowns, natural disasters, or supply chain disruptions.

Moreover, when the business environment changes rapidly, short-term financing provides the flexibility to adapt to market shifts, manage suppliers and customers, and strengthen business relationships.

Sources of Short-term finance for MSMEs

1. Trade credit:

Trade credit involves buying goods or services from suppliers on credit terms. The buyer receives the goods immediately but pays the supplier later (usually within 30 to 90 days).

Example: A retailer purchases inventory from a wholesaler and agrees to pay the invoice amount within 60 days.

2. Bank overdrafts:

A bank overdraft allows a business to withdraw more funds from its checking account than the available balance. The bank charges interest on the overdrawn amount.

Example: A small business faces a temporary cash shortage and uses an overdraft facility to cover payroll expenses.

3. Short-term loans:

Businesses can obtain short-term loans from banks, finance companies, or private lenders. These loans have fixed terms (e.g., 3 months, 6 months) and are repaid with interest.

Example: A startup secures a 6-month loan to purchase equipment for a new project.

4. Factoring:

Factoring involves selling accounts receivable (unpaid invoices) to a third party (a factor) at a discount. The factor provides immediate cash and assumes the risk of collecting dues from customers.

Example: To improve cash flow, a textile manufacturer sells outstanding invoices to a factoring company.

5. Inventory financing:

MSMEs can pledge their inventory as collateral to obtain short-term loans. Lenders assess the value of the inventory and provide funds accordingly.

Example: An electronics retailer uses inventory financing to purchase popular or high-demand products before the holiday season.

It is important to note that choosing the method of financing depends on factors like the cost of finance, the urgency of the need for finance, and the business's creditworthiness or credit score.

Questions to be answered before selecting your method of finance

1. What is the purpose of financing and the ability to repay?

It is essential to understand the main need for financing. Examples: new investment opportunity, working capital requirement, repaying another loan. Sometimes, the investment is hazardous and may not promise stable returns. Hence, it is advisable not to borrow debt due to the difficulty of servicing it. Here, equity finance will be a safer option for the firm.

2. What source of funding is easily accessible for the company?

Debt financing can be easier to source for a business as finding an equity capital provider may be more challenging. Due to its high risk, private investors expect significant returns from the firm. However, traditional debt financing is not available to early-stage companies.

3. Can the original owners maintain control of the company?

In equity financing, the business owner must share the company's ownership with the new holders. However, when utilizing traditional debt financing, the owner maintains complete ownership without dilution.

4. Do the new investor's goals align with the vision of the business?

It may also be necessary for a business owner to leave the business goals unchanged. Business owners should clearly understand the new investor's aspirations before closing the deal.

5. Is it the right time to finance?

The business should know their financing requirements and when to access them. For example, debt financing is more suitable when the debt financing environment is favorable and interest rates are low.

4.6. Budgeting

Learning outcomes

- Understand the key benefits of budgeting for your business. Financing for MSMEs
- Identify the basic steps to develop a budget for MSME.
- Understand the ways to manage the MSME with Financial Literacy.

A plan quantified in monetary terms prepared and approved before a defined period usually shows planned income to be generated and/or expenditure to be incurred during that period and the capital to be employed to attain a given objective.

CIMA (UK)

A budget is a tool for deciding, planning, and using money to achieve your goals. It can help you to determine how to spend your money wisely and save to reach your goals.

A budget helps you to measure your business's success. It should be part of your overall business plan.

Anil and Dhananjaya are in the bank manager's room.

Key Benefits of Budgeting for your Business

Helps you predict cash flows and avoid

Demonstrates loan repayment strategy

Quickly highlights areas that need

Helps you keep your operations running

Helps you project the future and take

Essential Steps to Develop a Budget for MSMEs

Research indicates that most MSMEs fail to draw a formal budget, so it is no surprise that they suffer from severe cash flow crises. The key to successfully managing your income, expenses, savings, debt, and investments is making and sticking to a clear business plan. In this journey, developing a budget plays a pivotal role in business success.

Preparing a budget for an MSME involves creating a financial plan that outlines expected income, expenses, cash flow, and profits for a specific period. Here's a step-by-step guide:

1. Assess your income

A business may have many income streams, such as the sale of products and services, investment incomes, or grants. Estimating the selling prices and forecasting the volume for each revenue source will help the firm estimate the accumulated income for the future.

In the process, the business needs to analyze past results, seasonal variations, and market trends. It must also follow a conservative, realistic approach to setting its revenue goals.

2. Identify fixed and variable costs

In this step, the business lists all the possible operation expenses. It must mainly classify the costs into fixed, variable, and mixed costs for the firm.

Fixed costs are the expenses that remain constant over time, irrespective of the change in production units. Examples include:

- Rent or lease payments
- Salaries for staff
- Insurance payments
- Loan repayments
- Subscriptions or software fees

Variable costs may directly fluctuate with the activity level of the business. Examples include:

- Raw materials purchases
- Shipping and delivery costs
- Commission-based wages
- Utilities that vary with usage

Mixed cost represents the costs with a combination of both fixed and variable costs. Examples include:

- Utilities with fixed rentals may vary with usage
- Salaries with fixed wages and vary with overtime costs.

Further, businesses need to estimate their future capital expenditures, such as those for acquiring equipment, buildings, machines, vehicles, furniture, and computers.

Based on that, the firm can set the cost targets for the future.

3. Estimate the profit target.

Once businesses set their revenue and expense targets, they can estimate the firm's profit target for the future period by deducting operational expenses from the revenue.

If the business has a specific target, it must revisit and adjust the estimated costs and revenues accordingly.

4. Estimate and Adjust Cash Flows

The business must also develop a budget with estimated cash inflows and outflows for a given period. This will enable the firm to forecast future cash deficiencies and surpluses and initiate strategies to overcome them.

5. Regular review and adjust

Once businesses set their budgets and execute their operations, reviewing all the budget line items with the actual cost and revenues is imperative. This leads to identifying all the firm's favourable and adverse variances in a given period. Further, it helps to analyze the root cause of unfavourable variances and take early and necessary action to fix them.

Further, the business should be vigilant about the changes to the economic and business environment and adjust the budget periodically.

Usage of Financial Literacy for MSME Operations

Financial literacy plays a critical role in MSMEs in Sri Lanka. It will directly impact the firm in every stage of its life cycle. After you convert your business idea to a clear business plan, the next step is starting and running the operation. This is the time for the MSME entrepreneur to face challenges in an uncertain environment and run a business with limited resources. Financial literacy helps MSME owners and managers run the business mainly in the following areas.

6 ways to Manage Your MSME with Financial Literacy

1 **Manage your cash flows.**

Financial literacy helps you understand your cash flow patterns, manage cash inflows and outflows, and avoid cash deficiencies. This will help your business function smoothly in your day-to-day operations and achieve long-term success.

2 **Planning and budgeting**

Financial literacy concepts can guide your MSMEs in setting realistic budgets to achieve their short-term and long-term goals and objectives. This includes forecasting revenue flows and managing expenses to achieve profit targets.

3 **Analysis and boost your profitability and manage your liquidity**

Financial literacy helps you report all your business transactions and prepare financial statements, enabling you to understand firms' economic performance and position. It also allows you to analyze a firm's profitability and measure its ability to generate profits for each product and service using financial ratios. Finally, it helps you measure and manage your liquidity status.

4 **Credit and debt management**

Small business owners often need financing. Financial literacy provides insight into evaluating different financing options, calculating the interest cost, and managing debt.

5 **Manage your legal compliances and tax efficiencies.**

Financial literacy will help you to understand and manage your firm's regulatory and legal requirements and tax obligations.

6 **Appraise your investment opportunities.**

Financial literacy can help you to evaluate all potential investment opportunities through various tools and techniques and make informed investment decisions to maximize your firm's wealth.

4.7. Maintaining Financial Records of MSMEs

Research found that most micro and small enterprises fail to maintain their financial records. The following section may highlight the key benefits of maintaining accounting records for your firm.

Learning outcomes

- Understand the importance of record-keeping for MSMEs.
- Identify the basic steps to maintain financial records in a Microbusiness.
- Identify the basic steps to maintain financial records in an SME business.
- Learn how to record transactions using the double-entry system.
- Learn how to summarize the ledger accounts and prepare a business's trial balance and financial statements.
- Discuss the concept of risk management for MSMEs.

  Identify the steps to develop an effective risk management strategy for MSMEs.
- Know the benefits of insurance for MSMEs.

Dhananjaya enquired with the shopkeeper about learning more about business operations.

Importance of record keeping for MSMEs

- **Manage your cash flows.**

Cash and liquid assets are critical aspects of a business. Record-keeping continually records all the movements of these assets, allowing the business to manage them efficiently. Record-keeping significantly helps manage the firm's cash flows

and provides information to make accurate projections of the business finances.

- **Assist present and future business decisions.**

Every rupee in your business is crucial and should be well-spent. Therefore, it is critical to understand where your money comes from and how it is spent. As an MSME owner, you can use this information to make accurate future projections of your business and grow your business profits.

- **Prevent fraud or theft.**

Maintaining a proper accounting system enables you to implement a fraud and error prevention process.

- **Pay your taxes and comply with the laws.**

Maintaining proper accounting practices enables you to pay your taxes accurately.

Further, a thorough accounting system is essential for businesses to comply with government rules and regulations.

Basic steps to maintain financial records in a Micro- business

Step 1

Record all the transactions that occur in the business. This information can be recorded as single entries without following proper accounting journals or prime books since it may be difficult for a micro-level business person to understand.

Step 2

Then, the list of transactions needs to be categorized into five main types of accounts: Income, expenses, equity, liabilities, and assets. Let us understand these main types of accounts with examples,

1) **Incomes/revenues:** Revenue is the value of all the sales of goods and services and other incomes received or recognized by the business. It is essential to record each income separately.

Examples:

- Sales revenue of the business
- Interest income from a fixed deposit
- Rent income by renting out extra space in the business building

2) **Expenses:** Expenses refer to the money spent and the costs incurred by the business in pursuing revenue. It is essential to record each expense type separately.

Examples:

- Salaries of the staff
- Rent of the building
- Cost of sales (the purchase value of the goods sold)
- Utilities
- Advertising
- Transport
- Loan interest

3) **Assets:** Assets are the resources owned or controlled by a business that generate future economic benefits.

Examples:

- Cash in hand/bank
- Inventory (stocks of goods unsold)
- Trade receivables
- Other receivables (rent income)
- Prepayments/early settlements of expenses
- Land and buildings
- Machinery
- Equipment, fixtures and fittings
- Furniture
- Vehicles

4) **Liabilities:** Liabilities are simply what a business owes. They are obligations that will sacrifice the firm's future economic benefits.

Examples:

- Trade payables
- Other payables of expenses
- Bank Overdraft
- Loans

5) **Equity** is called the owner's contribution or the value that the owner invested in the business. When the owner injects more capital from time to time, the equity value will increase and be reduced when he uses assets for his personal use (drawings).

Examples:

- Capital

These five main accounts are derived from the accounting equation, which is the foundation of financial accounting. The equation says that at any given time, the accumulated value of assets and expenses of the business must be equal to the accrued value of total liabilities, income, and equity. This can be referred to as follows,

Assets + Expenses = Equity + Liabilities + Incomes

Step 3: Identification of the impact of the transactions on the business

Each transaction that occurs in a business has two aspects or two effects. This is also called dual aspects of accounts. For example, the cash assets and equity will increase when the owner contributes money to the business. If the business borrows money as a loan, cash (asset) and the bank loan (liability) will also increase. Cash (asset) and bank loans (liability) will be reduced when the firm settles its liabilities. It is important to note that at the end of every transaction, both sides of the accounting equation must tally.

The following table demonstrates how Dhananjaya's restaurant's basic transactions impact revenue, expenses, assets, liabilities, and equity during the first week of operations.

Transaction *	Income		Expenses			Assets				Liabilities		Equity
	Sales income	Other incomes	Cost of sales	Transport cost	Salaries	Cash/ bank balance	Raw material inventory	Trade receiva bles	Furniture & Equip ment	Trade payable	Bank loan	Capital
1) The owner allocates Rs 100,000 to the business						+ 100,000						+ 100,000
2) Purchased furniture and equipment for Rs 50,000						- 50,000			+ 50,000			
3) Purchased ingredients on cash to cook meals Rs 10,000						- 10,000	+ 10,000					
4) Purchased ingredients on credit to cook meals Rs 15,000							+ 15,000			+ 15,000		
5) Sold 100 meals for Rs 350, which costs Rs 220 per meal. Received cash from customers	+ 35,000		+ 22,000			+35,000	-22,000					
6) Sold 10 meals for Rs 350, which costs Rs 220 per meal. Customers promise to pay later.	+ 3,500		+ 2,200				- 2,200	+ 3,500				
7) Five customers paid who purchased meals on credit. (Rs350x5)						+1,750		- 1,750				
8) Paid Rs 10,000 to the whole seller.						- 0,000				- 10,000		
9) Obtained a loan from a bank. Rs 500,000						+ 500,000					+ 500,000	
10) three-wheeler fee	Rs 500	- 10,000		+ 500		- 500						
11) Salaries	Rs 10,000				+ 10,000	- 10,000						
Total	38,500	0	24,200	500	10,000	556,250	800	1,750	50,000	5,000	500,000	100,000
	38,500		**34,700**			**608,800**				**505,000**		**100,000**

* The detailed description of each transaction type is given below.

1. **Allocation of initial funds to the business.** This amount of funds is your investment in the business, and it is called the "Capital." The first cash inflow to the business. This is not income from business operations; it is just an inducement of cash to the business.

2. **Purchasing furniture, tools, machines, and equipment necessary to run the business operations**. This is a cash outflow from the business. These are not expenses of business operations and, therefore, are not considered in calculating profit. These expenses occurred to acquire necessary assets for the business. Thus, these would be purchases of fixed assets.

3. **Purchasing raw materials** to produce or goods to sell paying cash is a cash outflow from the business. The purchased raw materials are considered an asset of the business. However, once the finished products are sold, the cost of the raw materials used to make those sold products is converted to an expense called cost of production/cost of sales.

4. **Purchasing of raw materials to produce or goods on credit terms.** There is no cash outflow from the business. Instead, a liability is created as trade payables. The purchased raw materials are considered an asset of the business, as with cash-based purchases. However, once the finished products are sold, the cost of the raw materials used to make those sold products are converted to an expense called cost of production/cost of sales.

5. **Selling products** manufactured (or goods purchased) **on cash terms.** This is a cash inflow to the business and an income generation by the business, identified as sales income. With this sale, the finished products.

6. **Selling products manufactured** (or goods purchased) **on credit terms.** There is no cash inflow to the business. Instead, trade receivable (an asset) is created in the business. However, sales income is generated even on credit terms, and once the finished products are sold, the cost of the raw materials used to make those products is converted to an expense called cost of production/ cost of sales.

7. **Settling cash** by customers who purchased on credit (trade receivables). This is a cash inflow to the business and the amount of trade receivables available reduces. This is *not an income*.

8. **Settling cash to suppliers** to whom we purchased goods on credit (trade payables). This is a cash outflow from the business. And the amount of trade payables decreases. *This is not an expense*.

9. **Obtaining a loan** from the bank (or any lender). This is a cash inflow to the business. As the business is obliged to settle the loan back, it is a liability of the business.

10. **Paying cash** for various **expenses** such as salaries, utility bills, rent, transport costs (bus fare, hiring charge of a truck, fuel cost), advertising, etc., is a necessary part of running a business. When these expenses are paid in cash, the business experiences a cash outflow.

Step 4: Calculating your profits

If you have kept your records accurately by the above table, you can sum up the columns and arrive at the total value of the firm's assets, expenses, incomes, liabilities, and equity for a given period. Then, you can calculate the business's profit or loss using the following formula.

Total profit = **Total income** of the period – **Total expenses of the period**

Profit for the first week = **Income** of the first week – **Expenses** incurred during the first week

Profit for the first week = 38,500 – 34,700 = 3,800

This profit figure is different from the cash balance available in the business. This is because the firm has credit transactions and follows the accrual concept in modern accounting. The table will also showcase the following:

- Total assets of the firm at the end of a given period and the value of each asset.
- Total liabilities of the firm at the end of a given period and value of each liability of the firm.
- The total equity value of the firm at the end of a given period.
- The cash column shows the cash inflows and outflows in business operations during the period.

It is important to note that this simple table can help you to understand your business profits and identify the firm's financial position (Equity, assets, and liability). Further, it enables you to understand the firm's liquidity position (Cash position) at the end of the given period.

Note that the above method of record keeping is acceptable with micro-level businesses and at the starting level of a small-scale business. When the business grows, you have to move to a proper financial accounting process, either manual or automated.

Preparing Financial records for small and medium business

Maintaining a proper accounting system is essential when the business grows. In this stage, the firm should follow a double-entry system to maintain its financial records. First, the business should keep a record of all its transactions, and the relevant information can be taken from those records when preparing the accounts. The records of transactions, assets, and liabilities should be in chronological order and dated so that transactions can be related to a particular period (e.g., daily, weekly, monthly, yearly).

This section introduces double-entry bookkeeping for small and medium business people, the cornerstone of accounts preparation.

The Nominal Ledger or General Ledger

The nominal ledger is an accounting record summarising a business's financial affairs. It contains accounts for each asset, liability, capital, income, and expenditure. It consists of many different accounts, each with its purpose, name, and identity code.

The format of a ledger account

The ledger account has two sides and a heading on top, and it is usually called a 'T' account. If it is kept in an actual book, its format is as follows.

Debit				Accounts Name			Credit
Date	Narrative	Ref	(Rs)	Date	Narrative	Ref	(Rs)

Double entry book-keeping

The double-entry bookkeeping system means that for **every debit, there is an equal credit**. In other words, every transaction has two effects: the **debit effect and the credit effect.** This dual impact is recorded in the ledger as debit and credit entries.

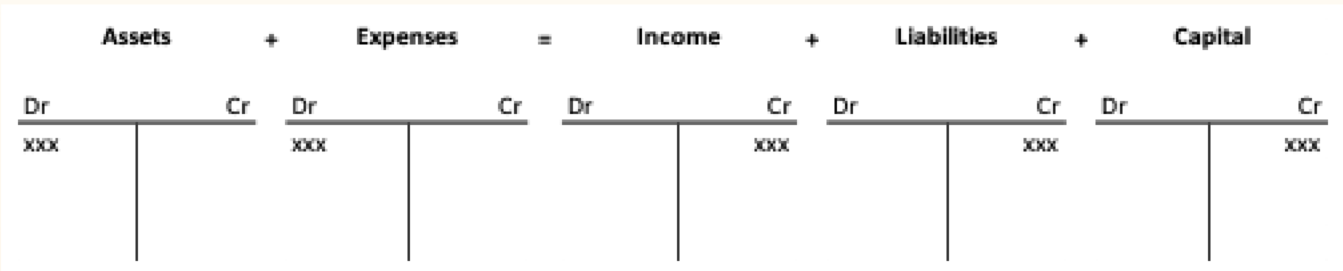
Remember the accounting equation.

Assets + Expenses = Capital + Liabilities + Income

As per the equation, the total liabilities plus capital plus income always equals total assets and expenses. Therefore, any transaction that changes the total assets or expenses must also change the total liabilities and Income plus capital.

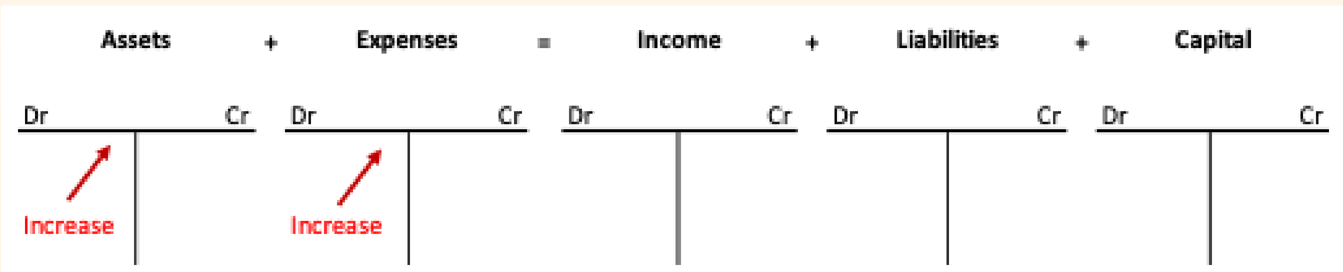
The rules of double-entry bookkeeping

The basic rule is that Asset and Expense accounts should have **debit balances** and liability capital and Income accounts should have **credit balances**.



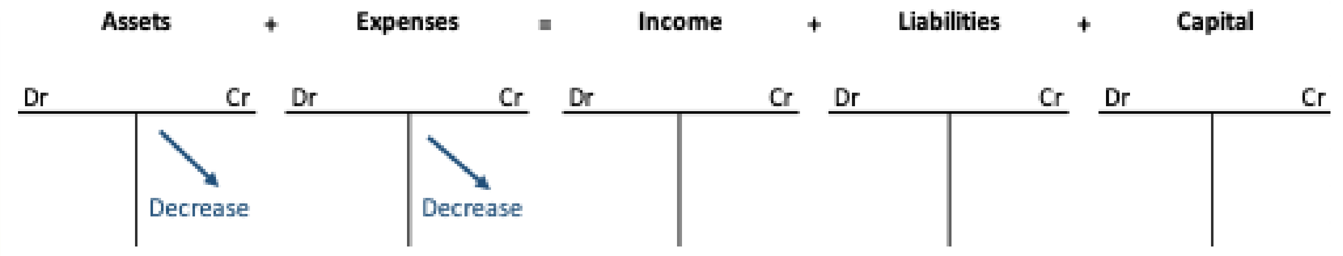
Therefore, when assets and expenses are increased, a debit entry is made to the respective accounts.

Increase of an asset or expense A/c



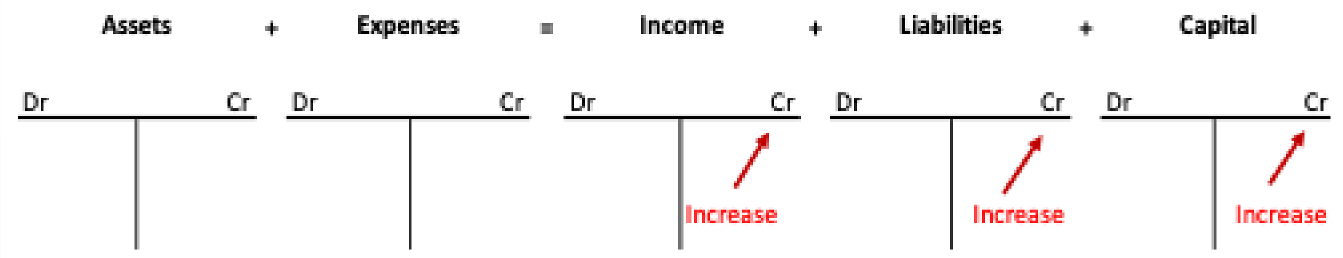
Similarly, a decrease in assets and expenses is a **credit entry**.

Decrease of an Asset or Expense A/c



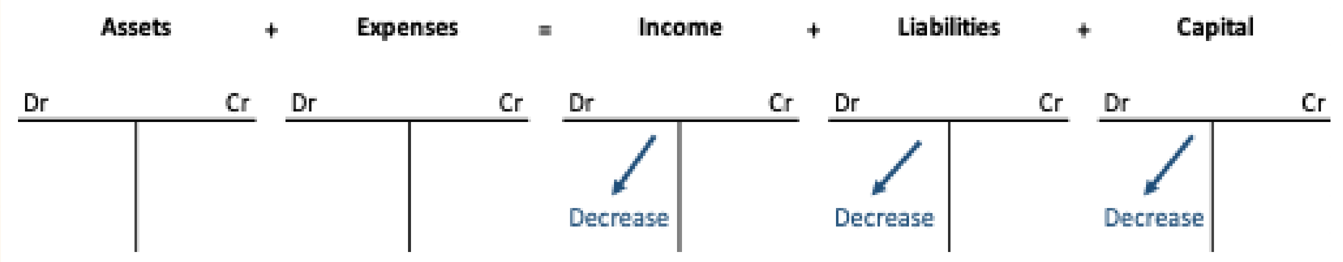
When incomes, liabilities, and capital increase, it is a **credit entry** to the respective accounts.

Increase of an Income, a liability, or Capital A/c

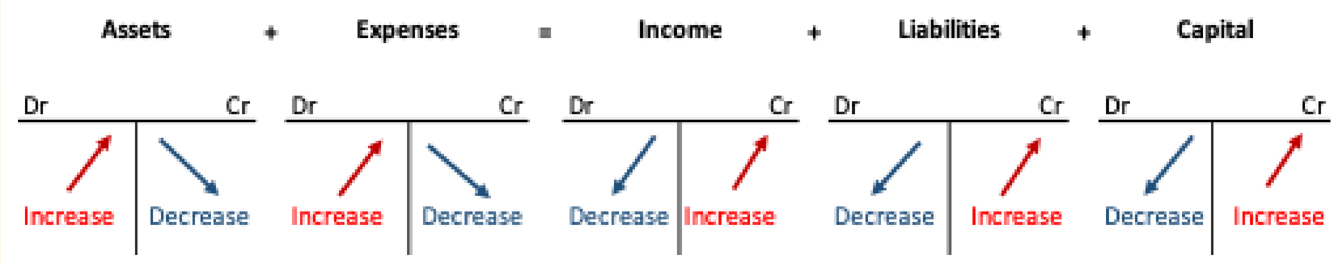


Similarly, a decrease in income, liabilities, and capital is a **debit entry**.

Decrease of an Income, a liability, or Capital A/c



Summary of the rules



Accounts	To record	The entry in the account
Assets	an increase	Debit
	a decrease	Credit
Liabilities	an increase	Credit
	a decrease	Debit
Income	an increase	Credit
	a decrease	Debit
Expenses	an increase	Debit
	a decrease	Credit
Capital	an increase	Credit
	a decrease	Debit

The basic rule is that every financial transaction gives rise to two accounting entries, one debit and one credit. Therefore, the total value of debit entries in the nominal ledger always equals the total value of credit entries.

Let's learn more about the double entry system with the use of the following example:

1) *Mr. Dhananjaya started a business, investing Rs 100,000.*

In this example, the initial investment, the business's **capital**, is increased, and the capital account is credited. When capital is introduced to the company in cash terms, **assets** (cash is an asset) are increased, and the cash account is debited.

Cash A/c (Dr) 100,000
Capital A/c (Cr) 100,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
increased			=					increased

Asset (Cash) account

Debit	Credit
Capital 100,000	

Capital account

Debit	Credit
	Cash 100,000

2) *The business bought Rs 25,000 worth of furniture on cash terms*

In this transaction, the assets(cash) are decreased, and the assets(furniture) are increased.

Furniture a/c (Dr) 25,000
Cash a/c (Cr) 25,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Decreased Cash 25,000 Increased Furniture 25,000								

Asset(Furniture) account

Dr	Cr
Cash 25,000	

Asset(Cash) account

Dr	Cr
	Furniture 25,000

3) *The businesse bought goods worth Rs 25,000 on credit terms.*

This transaction increases the assets(inventory) and creates a liability (creditors)

Inventory (Dr) 25,000
Creditors (Cr) 25,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Increased Inventories 25,000						Increased Creditors 25,000		

Asset(Inventory) account

Dr	Cr
Creditors 25,000	

Liability(Creditors) account

Dr	Cr
	Inventory 25,000

4) *The business sold goods for Rs 5,000 on cash terms, and the sale cost was Rs 3,500.*

There are two sections in this transaction.

1. Recording the sales value

2. Recording the COS value

Recording the sales value

When goods are sold, cash is increased, and an income is generated.

Cash (Dr) 5,000
Sales (Cr) 5,000

Recording the COS value

At the same time, inventories decrease due to goods being sold out, and the cost of sales needs to be identified. Therefore, a separate account called the cost of sales is debited.

Cost of sales (Dr) 3,500
Inventory (Cr) 3,500

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Increased Cash 5,000				Increased Sales 5,000				
Decreased Inventory 3,500		Increased COS 3,500						

Asset(Cash) account

Dr		Cr	
Sales	5,000		

Income (Sales) account

Dr		Cr	
		Cash	5,000

(Asset) Inventory account

Dr		Cr	
		COS	3,500

(Expense) Cost of Sales account

Dr		Cr	
Inventory	3,500		

5) Business paid rent Rs 2,000

In this transaction, the expenses (Rent) are increased, and Assets (cash) are decreased.

Rent expense (Dr) 2,000
Cash (Cr) 2,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Decreased (Cash 2,000)		Increased Rent 2,000						

Asset(Cash) account

Dr		Cr	
		Rent	2,000

Expenses (Rent) account

Dr		Cr	
Cash	2,000		

6) The business sold goods for Rs 15,000 on credit terms. The cost of the goods was Rs 10,500.

In this transaction, there are two sections. So, there are four effects.

Recording the sales value

When goods are sold on credit terms, an income is generated, but no cash is received by the business and is expected to be received in the future. Therefore, an asset called debtors (accounts receivable) is created.

Debtors (Dr) 15,000
Sales (Cr) 15,000

Recording the COS value

At the same time, inventories decrease due to sold-out goods, and the price of the goods sold also needs to increase the cost of sales.

Cost of sales (Dr) 10,500
Inventory (Cr) 10,500

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Increased Debtors 15,000				Increase Sales 15,000				
Decreased (Inventory 10,500)		Increased COS 10,500						

(Asset) Debtors (accounts receivable) account

Dr		Cr	
Sales	15,000		

(Income) Sales account

Dr		Cr	
		Debtors	15,000

(Asset) Inventory account

Dr		Cr	
		COS	10,500

(Expense) Cost of Sales account

Dr		Cr	
Inventory	10,500		

7) The business received a sales return worth Rs 1,200. These goods were sold on cash terms, and the sale cost was Rs 800.

This transaction has four effects: two on the sales value and two on the cost of sales.

First, income will be reduced, and cash will be returned (since the goods sold as sales have been returned). Therefore, the sales returns account is debited by the returned sales value, and the cash account is credited.

Sales Returns A/c (Dr) 1,200
Cash A/c (Cr) 1,200

Then, inventory needs to be increased as goods are received back; hence, the cost of sales must also be reduced. As a result, the price of the returned goods debits the inventory account, and the cost of the sales account is credited.

Stock A/c (Dr) 800
Cost of Sales A/c (Cr) 800

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Decreased (Cash 1,200)				Decreased (Sales 1,200)				
Increased Inventory 800		Decreased (COS 800)						

(Income) Sales Returns account

Dr		Cr	
Cash	1,200		

(Assets) Cash Account

Dr		Cr	
		Sales Returns	1,200

(Asset) Stock account

Dr		Cr	
COS	800		

(Expenses) COS account

Dr		Cr	
		Stock	800

8) The owner took Rs 2500 from the business's cash drawer for personal use.

Cash (assets) and capital (drawings) are reduced in this transaction.

Drawings (Dr) 2,500
Cash (Cr) 2,500

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Decreased (Cash 2,500)			=					Decreased (Drawings 2,500)

(Asset) Cash account

Dr		Cr	
		Drawings	2,500

(Capital) Drawings account

Dr		Cr	
Cash	2,500		

9) The business obtained a bank loan of Rs 50,000

Cash (assets) and liabilities (bank loans) are increased in this transaction.

Cash (Dr) 50,000
Bank loan (Cr) 50,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Increased Cash 50,000			=			Increased Bank loan 50,000		

(Asset) Cash account

Dr		Cr	
Bank loan	50,000		

(Liability) Bank loan account

Dr		Cr	
		Cash	50,000

10) The business bought a building for Rs 50,000 in cash.

In this transaction, assets increase as buildings are built and decrease as cash is paid.

Buildings (Dr) 50,000
Cash (Cr) 50,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Decreased (Cash 50,000) Increased Building 50,000								

(Asset) Cash account

Dr		Cr	
		Buildings	50,000

(Asset) Buildings account

Dr		Cr	
Cash	50,000		

11) The business received a rent income of Rs 10,000 by renting out the building.

In this transaction, both cash and rent income are increased.

Cash (Dr) 10,000
Rent income (Cr) 10,000

Assets	+	Expenses	=	Income	+	Liabilities	+	Capital
Increased Cash 10,000				Increased Rent income 10,000				

(Asset) Cash account

Dr		Cr	
Rent	10,000		

(Income) Rent Income account

Dr		Cr	
		Cash	10,000

Balancing the Ledger Accounts

At the end of an accounting period, we need to get the summary or the closing balance of each firm's ledger account. First, we need to total all the debits and all the credits of the account. If the total debits exceed the total credits, there is said to be a debit balance on the account. If the credits exceed the debits, the account has a credit balance. If the ledger accounts have only one entry each, so there is no totalling to do to arrive at the balance on each account.

Refer to the following ledger account after balancing.

Asset (Cash) account

Dr			Cr
(1) Capital	100,000	(2) Furniture	25,000
(4) Sales	5,000	(5) Rent expenses	2,000
(5) Bank loan	50,000	(7) Sales Returns	1,200
(11) Rent income	10,000	(8) Drawings	2,500
		(10) Buildings	50,000
		Balance c/d	84,300
	165,000		165,000
Balance b/f	**84,300**		

When we balance all the ledger accounts, we can check their mathematical accuracy by preparing the trial balance. It is a list of the firm's ledger account balances. The format of the trial balance is as follows.

Trial Balance as of 31st Dec 202X

Name of the account	Debit	Credit
Asset A/c	xxx	
Expenses A/c	xx	
Liability A/c		Xx
Income A/c		xxx
Equity A/c		xxx
	xxx	xxx

When the debit and credit sides of the trial balance are equal, we can conclude that the accounts are mathematically accurate. Then, we need to make accounting adjustments such as closing stocks, accrual and prepayments, correcting errors, deprecation, and other provisions.

Preparing the financial statements for SME Businesses

Accountants can prepare the final accounts, known as financial statements, based on the records and source documents that you keep for the year.

1. **Statement of Income** – This statement shows the income and expenses during the year and the net profit of the business at the end of the year

2. **Statement of Financial Position**—This statement shows the value of assets and liabilities, including the business's owner's capital, at the end of the year.

3. **The Cash flow statements** shows how the business managed its cash, including money in the bank, operations, investments, and financing activities during the year.

4. **Statement of Changes in Equity** (Only applicable to the companies) – This statement shows how the opening shareholder capital, reserves, and net profit changed during the year.

According to the Companies Act No. 07 of 2007, all companies should have their financial statements audited by an independent auditor. Auditing will increase the trustworthiness of the information in the financial statements and enhance the confidence of shareholders and other investors. However, auditing financial statements is not compulsory for sole proprietorships and partnerships.

Format of an income statement and statement of Financial position (balance sheet) is shown below,

Income Statement for the period ended xxxxxx

	Rs. 000
Revenue	98,000
Cost of sale	(73,500)
Gross profit	24,500
Operating costs	(17,150)
Operating profit	7,350
Finance cost	(1,400)
Profit before tax	5,950
Income tax	(1,750)
Profit for the year	4,200

Statement of financial position as at date xxxxxxx

	Rs. 000	Rs.000
Assets		
Non-current assets		
Property and shop fittings		53,550
Current Assets		
Inventory	17,850	
Bank	1,750	19,600
Total assets		73,150
Equity and liabilities		
Equity		46,550
Non-current liabilities		
Loan		14,000
Current liabilities		
Trade payables	9,450	
Current tax payable	3,150	12,600
Total equity and liabilities		73,150

4.8. Risk Management and Protection of MSMEs

Small to medium businesses are constantly exposed to risks. These risks can directly affect day-to-day operations. As a result, the business may decrease revenue or increase expenses, ultimately not achieving the desired goals. Some risks may be severe enough for the business to fail.

Most business owners know that insurance can be used to cover some risks. However, all businesses face many other dangers, some of which are overlooked or ignored. Every business is subject to possible losses from unmanaged/ nonmitigated risks. Sound risk management should reduce the probability that a specific risk event will occur. If it does, sound risk management should reduce its impact and help to protect business wealth.

Steps to develop an effective risk management strategy for an MSME:

1) The first step for any business is to identify the possible risks that will disrupt or cause losses, including financial, operational, reputational, compliance, natural, and business risks.

2) Once the business identifies the risks, it must analyze them in terms of likelihood and impact.

Likelihood refers to the chance or probability of the risk occurring. It can be remote, medium, or high probability.

The impact is the potential damage it can cause to the business. The effect can be low, medium, or high and measured in rupee value.

Based on the above parameters, a business can develop a **risk matrix**. This matrix will help the business to identify critical risks.

3) Based on the **risk matrix**, the business should attend to the firm's most likely and most expensive risk.

4) **Develop a Risk Response Plan**. Businesses should prepare contingency plans and procedures for all their high-priority risks. Such risks need to be handled by assigning clear roles and responsibilities. Further, businesses should communicate those plans to their stakeholders.

The most common strategies to handle risks would be,

Avoid: Eliminate activities that create unnecessary risks.

Reduce: Implement safeguards to minimize the likelihood or impact of risks.

Transfer: Shift risk through insurance or partnerships.

Accept: prepare to manage the risk (acknowledge low-impact risks)

5) Monitor and Review

Managing risk is a continuous process—a journey, not a destination. When the business environment changes, the risks may also change. Therefore, businesses must closely monitor and review their risk management plans.

Benefits of Insurance for MSMEs

In the previous section, we discuss how insurance can be used as a risk response strategy, where the business can transfer its risk to a third party. One of the most important ways to protect the business against risks is to obtain and maintain sufficient insurance. With insurance, you can decide which risks you must insure against and which can be covered by the business or its owners.

The following table shows a common type of insurance policy and what it covers.

Type of Insurance	What It Covers
Property Insurance	Physical assets like buildings, inventory, and equipment.
Business Interruption	Lost income due to events like fires, floods, or natural disasters.
Workers' Compensation	Employee injuries or illnesses related to work.
Professional Liability	Mistakes or negligence in professional services.
Cyber Liability	Cyberattacks, data breaches.
Product Liability	Damages caused by defective or harmful products.
Auto Insurance	Vehicles used for business purposes.
Key Person Insurance	Financial loss from the death or incapacitation of a key employee or owner.

When choosing an insurer, the business has to consider many factors. First, they should identify the risks that need insurance coverage. Then, they need to inquire with insurance companies (Insurance Regulatory Commission of Sri Lanka) in the area and select the right insurance that gives value for money. Further, the business needs to review coverage limits, exclusions, and deductibles to avoid surprises during claims. Finally, the insurance coverage must be revisited annually to fulfil their growing needs.

Chapter 5

Digital Financial Literacy

5.1 Introduction

Learning outcomes

- Understand the conveniences of using cash and using digital finance as an alternative mode of payment.
- Understand the importance of using digital payments.
- Identify all available modes of digital financial services.
- Identify good practices which promote safety and security while using digital financial services.
- Use different types of digital financial services for regular transactions.

Digital Financial Literacy

Digital financial literacy (DFL) is the capacity to efficiently use digital platforms, tools, and technologies to access, manage, and make well-informed decisions regarding financial products and services while being aware of related concerns like cybersecurity and data privacy. It encourages financial well-being and inclusion in the digital economy by fusing digital skills to understand financial principles.

DFL can be understood as the intersection of digital literacy and financial literacy. It equips individuals to:

- Navigate digital financial tools and platforms.
- Make informed financial decisions.
- Understand and mitigate risks (e.g., fraud, cybersecurity).

The Rathnayake Family had the following conversation while they were having breakfast recently.

This type of general conversation can happen in many families today, especially considering the digital literacy gap between the older and younger generations. In this case, parents were reluctant to use digital financial tools due to lack of familiarity with their functions and security features and also, limited awareness of their benefits.

The younger generation is comfortable using digital tools and apps for payments, savings, and expense tracking. As DFL ambassadors, they can actively promote migration into digital solutions to adults.

With proper guidance and trust-building (e.g.: Dhananjaya demonstrating secure features), older generations can gradually adopt digital financial tools.

The benefits of digital financial literacy

- **Convenience:** Automating payments and avoiding penalties.
- **Cost Savings:** Avoiding overspending.
- **Security Awareness:** Using secure apps with authentication.
- **Budget Tracking:** Managing expenses effectively.
- **Savings Tools:** Automating savings for financial goals.

5.2 Digital Financial Services

Learning outcomes

- Understand digital transformation in banking.
- Define digital banking.
- Differentiate digital banking modes.
- Understanding opening and managing online bank accounts.
- Comprehend the advantages of digital banking.
- Define digital payments.
- Identify various types of digital payment systems.
- Understand popular digital payment methods and products.
- Understand the role of digital investment tools in transforming financial accessibility.
- Identify popular digital platforms for stock trading and mutual funds in Sri Lanka.
- Recognize the potential of blockchain and cryptocurrencies in modern financial systems.
- Evaluate the benefits and risks associated with digital investment tools.

Digital Financial Services **(DFS)**

comprise of a wide range of financial services, such as payments, savings, credit, insurance, and investment, delivered and accessed through digital remote means, including mobile phones, computers, and other digital devices. They include services like digital payments, savings, credit, insurance, and investments and are a worldwide cornerstone of financial inclusion efforts.

DFS Vs Traditional Financial Services

DFS offers advantages over cash payments or traditional financial services accessed physically, such as visiting a bank branch.

Traditionally, to make a payment in cash, the buyer had to hand in cash and coins to the seller. Depending on the distance between the location of the seller and the buyer, this caused people to travel long distances, incurring significant costs and wasting their time at the risk of being robbed.

In the current state of globalization and rising digitalization, most traditional financial services have been extensively replaced by tech-driven digital financial services.

Traditional Financial Services	Digital Financial Services
Brick-and-Mortar Banking	Mobile Banking
Traditional Loans	Fintech Lending Platforms
Traditional Currency	Cryptocurrency
Cash Transactions	Peer-to-Peer (P2P) Payments
Physical Wallets	Digital Wallets
Traditional Financial Advisors	Robo-Advisors

Importance of Digital Financial Services

Access to financial services like loans and banking plays a significant role in helping people, especially women and youth, become economically stronger. If you can't use formal financial services (like getting a loan from a bank), you're considered financially unserved or underserved. In Sri Lanka, many people have mobile phones, which can be used to access financial services. Despite owning smart devices (like phones, laptops, or smartwatches), most people don't use them for:

- Sending or receiving money
- Paying bills
- Making mobile payments
- Checking spending habits
- Looking up credit scores
- Getting advice on investments

The main reason is that many people lack the knowledge and skills in technology and finance. Lack of knowledge stops them from fully deriving benefits from the growth in the economy.

The easiest way is to use your digital devices and connect to financial services, which makes it simple and convenient to meet your financial needs through licensed financial institutions.

Different Digital Financial Services

Digital financial services listed below assist us in our daily personal and business financial management activities.

1. Automated Teller Machines (ATM)
2. Digital Banking
3. Digital Payments
4. Digital Currencies
5. Digital Investment Tools

Automated Teller Machines (ATM)

An ATM is a computerized device that interacts with your bank account to provide various financial services.

ATM, commonly known as the ATM has a universal presence in the modern society, offering individuals access to their funds and a variety of financial services around the clock.

Anusha and Gothamie are in their hometown for some shopping.

Gothamie: Let's buy my shoes first.

Anusha: Before that, we should go to the bank and get cash.

Gothamie: Amma, why aren't you using an ATM card.

Anusha: Oh god, those give me additional charges.

Gothamie: Okay. Now, tell me this amma. The charge you pay per transaction when using the ATM card and the bus fare you spend to go to the bank, which one is higher?

The above conversation highlights that lack of financial literacy in analysing cost and benefit of using ATM services.

Benefits of using ATMs

1. Round-the-clock availability: ATMs provide any-time access to banking services, making them convenient for easy withdrawals.
2. Global access and convenience: ATMs are available in many areas, allowing people to easily avail of services.
3. Reduced bank queues: ATMs help reduce the need to wait in long lines at physical bank branches.
4. Quick transactions: Withdrawals and other banking services can be done rapidly using ATMs.
5. Variety of banking services at fingertips: ATMs offer more than just cash withdrawals, including balance inquiries and utility payments.

Step-by-step breakdown of how an ATM works

Step 1: Insert the ATM card

Step 2: Select a language

Step 3: Enter your 4-digit ATM pin

Step 4: Select the type of service:

- Withdrawal
- Withdrawal for multi-listed account
- Mini statement
- Balance inquiry
- Transfer
- Transfer to another card
- Fast cash
- PIN change
- PIN unblock

Step 5: Select the type of account

Step 6: Enter the withdrawal amount (if you want to withdraw cash)

Step 7: Collect the cash

Step 8: Take a printed receipt, if needed

Step 9: Take the card

**These steps may slightly differ from bank to bank and ATM to ATM*

Tips for safe use of ATMs

- Protect Your PIN: Keep your Personal Identification Number (PIN) confidential and NEVER SHARE it with anyone.

- Inspect the ATM: Before using an ATM, check for any unusual devices attached to it that might be used to steal card information (skimming devices).
- Secure Location: Use ATMs in well-lit and busy areas. Avoid standalone machines in secluded places as far as possible.
- Cover the Keypad: Shield your PIN while entering it to prevent others from seeing.
- Do not seek assistance from strangers to use the ATM.
- Contact the bank immediately in case of lost ATM cards, frauds or any other emergency/ assistance.

Digital Banking

The banking industry has undergone a profound digital transformation, reshaping the modes by which financial services are delivered and consumed. One of the key drivers of this digital revolution is the growing demand for personalized and on-the-go financial services. The younger generation seeks seamless and insightful banking experiences catering to their evolving needs.

Digital banking refers to the process of delivering traditional banking services through electronic platforms. It enables customers to access financial products and services online without needing to visit a physical branch.

The Rathnayake Family had the following conversation.

This family conversation highlights the growing curiosity about digital banking, yet it reflects the lack of awareness regarding the processes and the benefits involved.

Digital banking includes various categories, namely, online banking and mobile banking. Further, integrating various digital channels allows you to access financial services 24/7 without physically visiting a bank and conducting transactions through paper cheques, deposit slips, or hard-copy receipts. Mobile banking development is considered a significant milestone in digital banking as banks commenced introducing mobile apps to provide banking facilities.

With the evolution of digital banking, setting up and managing online bank accounts has become an essential skill for individuals and businesses. Online banking offers convenience, allowing you to access banking services anytime, anywhere, through your computer or mobile phone.

In digital banking, KYC (Know Your Customer) refers to a process by which banks and financial institutions verify the identity of customers before they open accounts or access financial services. Other illegal activities such as fraud, money laundering, and terrorism can be prevented through it.

Key Aspects of KYC in Digital Banking

- Identity Verification: Customers must provide official identification documents (e.g., national ID, passport, or driver's license) to confirm their identity.
- Address Verification: Banks may require proof of residence, such as utility bills or bank statements.
- Biometric Authentication: Some banks use facial recognition, fingerprint scanning, or iris recognition to verify customers.
- AML (Anti-Money Laundering) Compliance: KYC ensures that customers are not involved in money laundering or other financial crimes.
- Ongoing Monitoring: Banks continuously monitor transactions and customer behaviour to detect suspicious activities.

Benefits of Digital Banking

- Enable viewing the transaction history: Online accounts record all transactions, including deposits, withdrawals, transfers, and payments.
- Conduct online transactions: Make Peer-to-Peer transfers by making payments to family, friends, or other individuals. For each transaction, you can include references where you can reconcile the payments later.
- Enable to verify the account balance: Ensure that your account balance aligns with your expectations and detect any unauthorized transactions early.
- Make bill payments for utilities and subscriptions.

Steps to follow to open an online bank account:

1. You should select a bank that meets your requirements.

2. Submit the required documents to open the online bank account (Personal identification documents and account opening application form).

3. Fund the new account (through a bank transfer or deposit cash).

4. Set up alerts via email or SMS notifications: The account holder can receive notifications for transactions and other specific activities, such as low balances, large transactions, or payment due dates. This will ensure safety of your online account as you will be aware of all the transactions that occur in real time without a time lag.

5. Use an available device (smart phone, any computer or tablet) to login to your account and enjoy easy and fast banking service.

After the account is set up, managing it effectively is crucial to maximize its benefits.

If you use a mobile phone or a tablet, then you can download a banking application provided by the respective bank which will make things easier.

Banking Web Portals/Apps and Mobile Payment Apps

Banking Web Portals/Apps refer to online platforms provided by banks that allow their customers to perform a wide range of banking activities from the comfort of their own homes. Further, Mobile Payment Apps are applications installed on smartphones that enable users to make financial transactions using their mobile devices.

The Rathnayake Family had the following conversation.

This family conversation highlights the growing curiosity about Banking Web Portals/Apps and Mobile Payment Apps. Yet, it reflects the lack of awareness regarding the processes and the benefits involved. Mobile payment apps are typically accessed through an app provided by the bank, which is available for download on iOS (Apple) and Android devices and smartphones in app stores. Customers can obtain various services through, Banking Web Portals/Apps and Mobile Payment Apps. Mobile banking apps offer a wide range of features to make banking fast, convenient, and easy.

Steps to set up your banking app or mobile payment app:

1. Download the official banking/payment app from the Apple App Store or Google Play Store.

2. Register yourself if you are a new user. (log in using your credentials (username and password) if you are already registered for online banking.)

3. The bank may ask several questions to confirm your identity to fulfil the bank's KYC requirements.

4. Create a PIN or Password to secure access and enable Biometric Authentication or Multi-Factor Authentication (MFA). (Justpay fintech apps have no wallets – as they are directly linked to a bank account).

5. Payment apps by banks and finance companies will have wallets or account opening facilities.

Once the account is set up, managing it effectively is crucial to maximize its benefits.

Benefits of banking app/mobile payment app

- Enable to view the transaction history.
- Conduct fund transfers and bill payments.
- Enable to view the account balance.
- Open fixed and savings deposits and manage them.
- Access past monthly statements.
- Customer support and chatbots to handle customer queries.

Mobile payment app provides convenience and allows you to manage your account 24/7 from anywhere with an Internet connection without visiting the bank physically. Further, transactions such as bill payments, fund transfers, and even cheque deposits can be done quickly without the delays associated with visiting a branch or ATM.

Digital Payments

Digital payments refer to transactions carried out electronically through digital channels without exchanging physical cash. These payments involve the transfer of funds, merchant payments, government payments, and remittances through digital channels like mobile apps, websites, or contactless technology. Digital payments have transfered now individuls and business conduct transactions, offering spee, converience and security.

Digital payment methods include

1. Payment Cards

Payment cards (ATM/ credit/ debit/ stored value cards) enable cardholders to access their account linked to the card or value stored in the card and obtain cash or make payments for goods and services.

2. Internet Banking

Enables payments and other banking transactions to be conducted using the internet through various devices such as mobile phones and computers.

3. Mobile Payment Applications

This is a software application that can be run on a mobile device which enables making payments for utility bills, fund transfers and other banking transactions.

4. QR Code

Transactions are initiated by scanning a QR code using a smartphone app.

5. Mobile Phone-based e-money

Registered customers of mobile phone-based e-money systems can purchase Mobile phone-based e-money by making payment to the e-money agent, which can then be used as a means of payment.

6. Point of Sale – QR and Cards

Point of Sale (POS) systems are devices used by merchants to process customer transactions. They can accept payments through various methods, including QR codes and payment cards.

7. Government Payments

Government Payments refer to transactions made to the government entities for various services, taxes, customs duties, fines, and other obligations. These payments can be made through multiple channels, including online portals, bank accounts, GovPay and LankaPay Online Payment Platform (LPOPP) online portal.

8. Payment Exchange Name (PEN)

This feature of the LankaPay Online Payment Platform allows the users to make payments directly to their mobile phone numbers. The users can create a personalized nickname for their bank account, provide mobile payment with the payer and make seamless payments.

9. Sri Lanka Interbank Payment System (SLIPS)

This payment and settlement system is managed by the Central Bank of Sri Lanka. It facilitates the real-time transfer of funds between banks and other financial institutions. Organizations use SLIPS to make bulk transfers such as salaries.

10. JustPay Web

This is an online payment platform developed by LankaPay, designed to facilitate seamless and secure transactions. Through JustPay, the users can pay using third-party app by linking any bank account, bank transfer, or LANKAQR.

11. Payme

This innovative payment solution developed by LankaPay is designed to simplify and secure transactions. This allows users to send payment links that recipients can use to make payments instantly through their preferred app.

12. LANKAQR

In Sri Lanka, LANKAQR is the national standard for local payments. By downloading any LANKAQR-certified mobile payment application, any person can pay a merchant who has displayed a LANKAQR code by linking any current account/savings account of the individual of any bank.

JustPay and LANKAQR are interoperable. Therefore, the users can use any app and connect their bank and authentication.

Benefits of LANKAQR

1. No special equipment is needed for the merchant - a smartphone is required only for the customer. Merchants may use a feature phone to receive an SMS notification when they receive funds.
2. Greater convenience to the customer - no requirement to carry cash/cards. Only a mobile phone is required.
3. Quick and easy to use.
4. Low cost to the merchant compared to card payments.

The Rathnayake Family had the following conversation in an evening.

Anil: "Gothamie, what's this thing I keep seeing at shops—those little square boxes with patterns? Everyone seems to be scanning them."

Gothamie: "Ah, Thaththa, those are QR codes! They're a quick way to pay or access information using your phone."

Anusha: "So, instead of carrying cash, you scan that pattern? How does it work?"

Gothamie: "Exactly, Amma! You open a payment app, scan the code, enter the amount, and confirm the payment. It's super fast and convenient."

Ayodhya: "That sounds cool, but what else can you do with QR codes?"

Gothamie: "Lots of things! Some restaurants use them for menus, you can check prices in stores, or even use them to log into apps securely."

Dhananjaya: "This could save so much time at my shop. Do you think I can set it up for payments?"

Gothamie: "Definitely! It's easy to set up, and customers love the convenience."

Ayodhya: "I'm curious now. Can you show me how to scan one and where to find these payment apps?"

Gothamie: "Of course, Nangi! Let's find a QR code and try it together."

This family conversation highlights the growing curiosity about QR codes, yet it reflects the lack of awareness many still have regarding the processes and the benefits involved.

Quick Response (QR) code payments

QR code payments involve scanning a two-dimensional, machine-readable barcode (QR code) to initiate and complete a payment. The QR code stores data such as payment details, merchant information, or links to payment gateways, and it can be scanned by a smartphone camera using a payment app. QR code payments eliminate the need for physical cash or cards. You simply need your smartphones to make transactions seamless and fast.

There are two types of QR codes

1. Static QR Codes: These codes are fixed and cannot be modified after creation. They are often used for repeated transactions in small shops or stalls. If you want to make a payment, you can scan the QR code and manually enter the transaction amount before paying.

2. Dynamic QR Codes: These codes are generated uniquely for each transaction and contain specific payment details, such as the amount. They offer more security and automation, reducing manual input errors.

Steps to follow on LANKAQR Payments

For a customer

1. Open the Payment App: open a mobile payment app that supports LANKAQR code payments.

2. Scan the QR Code: The merchant presents the LANKAQR code using the app's smartphone camera.

3. Confirm Payment Details: The app displays the payment details, including the merchant's name and the transaction amount (if using a dynamic QR code. If there is a static QR, the customer has to type the amount)

4. Complete the Payment: You can confirm and authorize the payment, often using biometric authentication (fingerprint or facial recognition) or a PIN.

5. Receive Confirmation: You will receive confirmation of the successful payment.

For the Merchant

1. Generate or Display the LANKAQR Code: As a merchant, you can either display a static QR code for repeated use (e.g., a printed code at a checkout counter) or generate a dynamic QR code for each specific transaction.

2. Scan and Confirm: After the customer has scanned the LANKAQR code and paid, you will receive a confirmation notification from their payment system. (In Sri Lanka, all payment QRs must be LANKAQR standard compliant. This makes them interoperable. Any LANKAQR-enabled app can scan any LANKAQR).

   - QR codes can be scanned by any smartphone, making them accessible to customers and merchants.

   - To prevent unauthorized access to the account, payment apps require customers to authenticate transactions using multi-factor authentication, such as PINs, biometrics (fingerprint, facial recognition), or one-time passwords (OTPs).

Other popular Digital Payment methods and products

In addition to QR code payments, customers and businesses use several other digital payment methods to facilitate transactions.

Mobile Wallets	Peer-to-Peer (P2P) Pay-ments	Buy Now Pay Later (BNPL)	Payment cards	Direct Debit
These mobile wallets let you securely store your credit, debit, and prepaid card details on your devices.	Peer-to-peer (P2P) payments refer to the transfer of money between two persons through a digital platform (email address or phone number) without the involvement of banks or physical cash. P2P payments are particularly popular for splitting bills, paying friends, or making small business transactions.	BNPL services allow you to make purchases and pay for such purchases in instalments overtime without the need for traditional credit cards.	Payment cards (credit, debit, stored value/ prepaid, charge cards) can be used for payments at Point-Of-Sale (POS) terminals (an electronic device used to process card payments at retail locations) and cash withdrawals at ATMs at any time on any day. Payment cards can be used to purchase goods or services (at online merchant stores) through the Internet.	This is a facility where, as per the instructions of a customer, the financial institution of a third party (e.g., Electricity Board, Water Board) pulls a certain amount of funds from the customer's account for recurring payments such as electricity bill settlement/ water bill settlement, without the customer having to initiate the payment each time it becomes due.
You can make contactless payments by simply tapping your phone/ device at compatible terminals.		BNPL services allow you to split your purchases into three interest-free installments over two months.		
E.g: Frimi mCash (Powered by Mobitel), ezCash (Powered byDialog), Bank-Integrated Apps (NSB Pay, NDB Neos, Q+ Payment App, Sampath WePay, Peoples Pay, HNB SOLO, SMART Pay, SEYLAN PAY, FriMi) Well-known payment apps abroad – Samsung, Apple, Google pay.	E.g: CEFTS, Justpay and many payment apps facilitate P2P transfers in Sri Lanka.	E.g: KOKO app	E.g: In Sri Lanka, banks issue payment cards under international card schemes such as Visa, MasterCard, Amex, and UnionPay.	

Digital Currencies : Cryptocurrencies and Blockchain

Digital currencies are financial assets that exist in digital form and can be used for transactions, investments, or other financial activities.

Cryptocurrencies, a subset of digital currencies, are digital or virtual currencies secured through encryption, operating independently of central authorities like banks. This decentralized nature distinguishes them from traditional currencies.

The Rathnayake Family had the following conversation while watching news on TV.

This conversation emphasizes many people's curiosity and lack of clarity regarding digital currencies. It sets the stage for the subsequent discussion, highlighting the need to understand digital currencies' underlying technology, risks, and opportunities before making informed decisions.

The Central Bank of Sri Lanka (CBSL) has consistently cautioned the public about the risks associated with virtual currencies (VCs), commonly known as cryptocurrencies. These digital assets are not recognized as legal tender in Sri Lanka and operate without regulatory safeguards. CBSL emphasizes that cryptocurrencies are unregulated investment instruments and are not considered as an asset class in Sri Lanka.

The CBSL highlights several concerns:

- Regulatory Status: Cryptocurrencies are not recognized as legal tender in Sri Lanka and lack regulatory safeguards.
- Financial Scams: There is a growing number of financial scams promising high returns based on crypto-investments. These scams often deceive individuals into investing in fraudulent cryptocurrency projects, leading to significant financial losses.
- Regulatory Authorization: CBSL has not issued licenses or authorized any individual or business to operate schemes involving cryptocurrency, including Initial Coin Offerings (ICOs), cryptocurrency mining operations, exchanges, or investment advisory services.

Given these risks, CBSL advises the public to exercise caution and refrain from engaging in cryptocurrency transactions to avoid potential financial losses and legal consequences.

Digital Investment Tools

Digital investment tools are technologies and platforms that enable individuals to manage, invest in, and digitally monitor their financial assets.

They provide accessible and user-friendly ways to participate in financial markets, offering a range of investment options and data-driven insights.

The evolution of digital investment tools has significantly transformed the Sri Lankan financial market, providing individuals with convenient and accessible avenues to explore diverse investment opportunities.

The Rathnayake Family had the following conversation during a recent vacation.

Anil: "Did you know Anusha that you can now invest in stocks directly from your phone?"

Anusha: "Really? That sounds so convenient. But how do you even start?"

Gothamie: "Amma, I've been using an app my friend recommended. It lets you trade in stocks and even invest in mutual funds. It's all digital now!"

Dhananjaya: "I should look into this too. It might be a great way to grow my savings for my business."

Ayodhya: "Does it also teach you how to use it? I might need a bit of help."

Anusha: "Seems like everyone in the family is getting curious. Let's explore these digital tools together!"

This family conversation highlights the growing curiosity about digital investment tools, yet it reflects lack of awareness regarding the processes and platforms involved.

Many individuals remain uncertain about how to commence investing digitally or evaluate the risks and benefits associated with it. By exploring these tools, individuals can learn to make informed decisions, leveraging digital platforms to enhance their financial wealth while addressing these knowledge gaps.

This section explores the most popular digital investment tools in Sri Lanka, focusing on

- stock trading platforms,
- mutual fund platforms, and
- alternative investment technologies.

Stock Trading Platforms

Sri Lankan stockbrokers primarily utilize two real-time trading platforms: **DirectFN** and **ATrade**. These platforms are accessible via web-based interfaces and mobile applications, enabling seamless trading of securities listed on the Colombo Stock Exchange (CSE).

Key features of these platforms include:

- **Advanced Charting Tools:** Provide investors with technical and analytical insights.
- **Market Data and Analysis:** Offer real-time market updates to make informed decisions.
- **Trading Execution:** Facilitates buying and selling orders for stocks and other listed securities.
- **Portfolio Management:** Includes features for monitoring investments and accessing historical data.

These platforms are beneficial to active traders and investors seeking in-depth market analysis and advanced trading capabilities.

For more information, visit the Colombo Stock Exchange (CSE) https://www.cse.lk.

Mutual Fund Platforms

Several asset management companies in Sri Lanka provide digital platforms to manage mutual fund investments. A mutual fund is a professionally managed investment vehicle that pools money from multiple investors to invest in diversified financial instruments like stocks, bonds, or other assets. It is often considered a preferable investment method due to its ease of access, professional management, and risk diversification, making it suitable for novice and experienced investors, alike.

Key Functions of a mutual fund platform

Function	Description
Purchase Units	Allows buying mutual fund units through digital interfaces.
Switch Funds	Enables movement between funds to optimize returns.
Redeem Units	Offers the ability to cash out investments with ease.
Portfolio Monitoring	Tracks performance of funds and provides insights for decision-making.

For more information, visit *https://www.cse.lk/pages/mutual-funds/mutual-funds.component.html*

5.3. E-commerce

Learning outcomes

- Define e-commerce and identify various types of e-commerce platforms.
- Describe the key elements and understand the steps involved in online shopping.
- Understand different digital payment methods available for online shopping.
- Identify key safety practices and apply the best practices for safe online shopping.

E-commerce

E-commerce (Electronic commerce), or, in the simplest form, online shopping, refers to buying and selling of goods and services using the Internet. It includes activities ranging from purchasing products through online marketplaces to conducting financial transactions digitally.

The Rathnayake Family had the following conversation.

Anil: I've been thinking about trying online shopping. I've never really bought anything online before. What should I know before I start?

Anusha: That's a great idea, Anil. The first thing you need to do is to choose reputed websites.

Gothamie: Yes, and make sure the website is secure. Look for HTTPS in the web address.

Ayodhya: Thaththa, you can find so many cool things online! I always check the customer reviews before buying anything. It helps to know what other people think about the product.

Anil: What about payments? Is it safe to use my credit card online?

Anusha: It's generally safe if you shop from reputed sites. In most Sri Lankan websites, when you pay using your credit/ debit cards, you will get a One Time Password (OTP) to your registered mobile before processing the payment, which makes it safer to use. You can also use payment services like PayPal, which offers buyer protection.

Dhananjaya: And don't forget about delivery times and costs. Sometimes, a product might be cheaper, but the shipping costs can make it more expensive overall. Always check the total cost before finalizing your purchase.

Anil: This all sounds very helpful. Would buying groceries and other everyday items online be a good idea?

Anusha: Definitely. Many supermarkets have online stores now. It saves time, and you can often find the same deals online as in-store. Just make sure to check the delivery times to ensure they fit your schedule.

Gothamie: Remember to create strong, unique passwords for your accounts and never share your personal information with untrusted sites.

Anil: Thank you all for the tips. I feel more confident about trying e-commerce now. I'll start with something small and see how it goes.

Anusha: That's a good plan. Take your time, get comfortable with the process, and soon you'll be enjoying the convenience of online shopping.

This conversation highlights the incomparable convenience that online shopping offers. With the rise of digital banking and payments, e-commerce has become an essential component of our lives. Online shopping is a way of life in our technology-driven world, as avoiding it is no longer practical.

Despite its benefits, online shopping does present certain security risks. It is crucial to be aware of these potential issues and take appropriate measures to mitigate them. By gaining proper knowledge and understanding of how to protect yourself, you can enjoy the advantages of online shopping while minimizing the risks.

There are six major e-commerce platforms based on the nature of transactions.

1. **Business-to-Consumer (B2C):** Companies sell products or services directly to consumers. Examples include Amazon, and local online stores.
2. **Business-to-Business (B2B):** Businesses sell products or services to other businesses. This type of e-commerce often involves wholesale or bulk purchasing.
3. **Consumer-to-Consumer (C2C):** Individuals sell products or services directly to other individuals through platforms. Ex : Airbnb.
4. **Social E-Commerce:** E-commerce is enabled by social networks and online social relationships. Examples: Facebook Marketplace.
5. **M-commerce:** Use of mobile devices to enable online transactions.
6. **Local E-commerce:** E-commerce focuses on engaging the consumer based on geographic location. Examples: Uber, Pick me.

Online Shopping

Online shopping, part of e-commerce, involves browsing products or services online and purchasing them by making the selection and payment using digital platforms.

BASIC ELEMENTS ONLINE SHOPPING

PRODUCT LISTINGS
Detailed product descriptions, images, specifications, and prices

SHOPPING CART
A virtual cart where users can add products they want to buy and proceed to checkout

USER ACCOUNTS
Options for users to create accounts, track orders, and view purchase history

SEARCH & FILTER OPTIONS
Tools that helps to find products based on categories, price ranges, and other preferences

PAYMENT GATEWAYS
Secure platforms that process payments via credit/debit cards, digital wallets, or bank transfers

ORDER TRACKING
Ability to monitor the status of orders, from dispatch to delivery

Steps that customers need to follow in Online Shopping

Step 1: **Browsing and Searching -** Consumers can search for products using keywords or browse through various categories on an e-commerce site. Search filters can help narrow down results based on brand, price, or product specifications.

Step 2: **Product Selection -** Once a product is selected, customers can view detailed descriptions, images, and user reviews. They can compare different products based on features, prices, and reviews to decide which one best suits their needs.

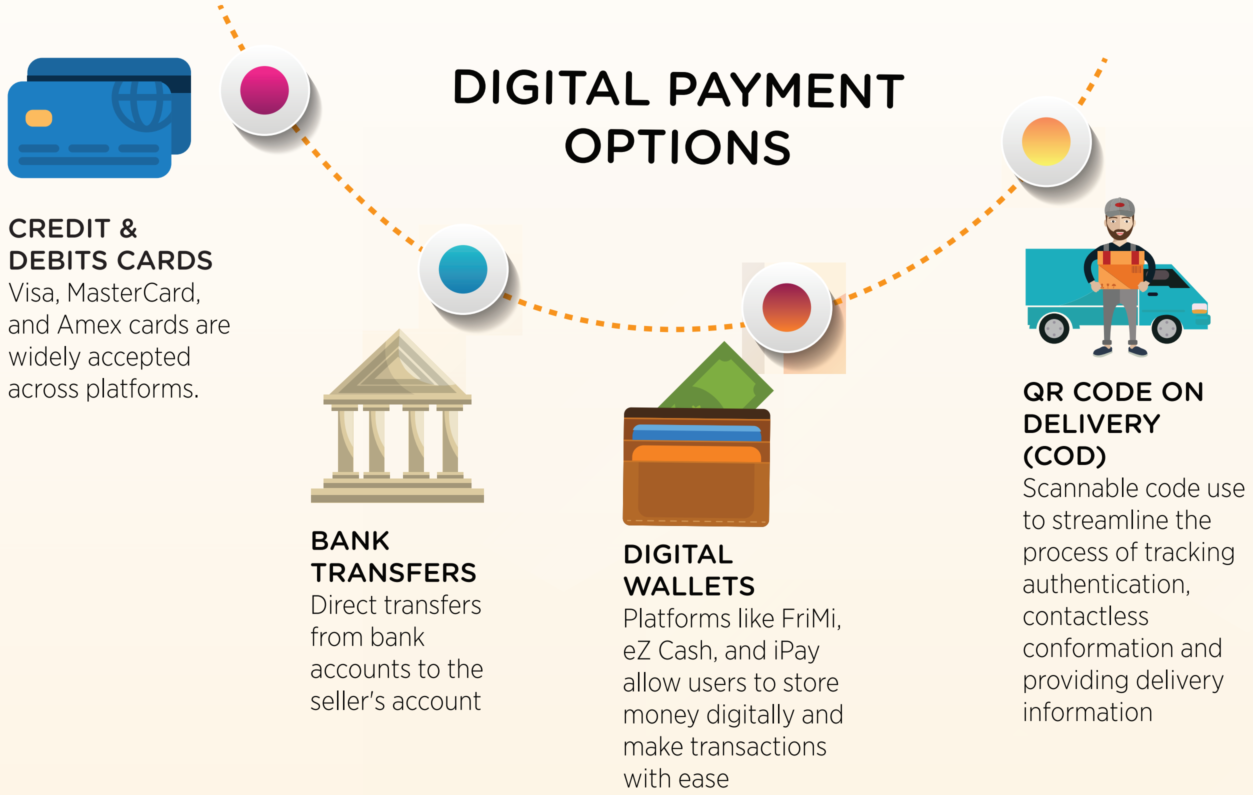
Step 3: **Adding to Cart and Checkout -** After selecting a product, customers can add it to their virtual shopping cart and continue shopping or proceed to checkout.

Step 4: **Making Payments -** Customers can add a product to their virtual shopping cart and at the checkout; they must provide shipping details and choose a payment method. E-commerce platforms offer multiple payment options, such as credit/debit cards, bank transfers and digital wallets.

Step 5: **Order Confirmation and Delivery -** After payment, customers receive an order confirmation with details about the expected delivery time. They can track their order status through the platform until it reaches their doorstep.

Digital Payment Options in E-commerce

Digital payments are essential to the e-commerce ecosystem, providing secure and efficient transaction completion methods.



7 Tips for Safe Online Shopping

While online shopping offers convenience and variety, it is crucial to follow safety practices to avoid fraud and ensure secure shopping experience.

1. Shop from Trusted Websites: Choose reputable platforms with good reviews and secure payment options.

2. Check for HTTPS in the URL: Ensure the site uses HTTPS (a padlock symbol before the URL) to secure data.

3. Use Strong Passwords: Create strong, unique passwords for your e-commerce accounts to prevent unauthorized access.

4. Verify Payments with OTP: When making a payment, ensure that the OTP sent to your registered mobile or email is entered to authenticate the transaction and prevent unauthorized access.

5. Avoid Public Wi-Fi: Do not purchase over unsecured public Wi-Fi networks, as they are prone to hacking.

6. Be Aware of Phishing Scams: Do not click on suspicious links or share personal information via email or text.

7. Read Return and Refund Policies: Before purchasing, understand the platform's policies on returns, exchanges, and refunds.

5.4. Digital Budgeting Tools

Effective personal finance management is essential for financial well-being. Digital budgeting tools provide a structured approach to tracking budgets, monitoring expenses, and achieving financial goals.

For additional resources on personal budgeting tools, explore the Budgeting Resources at the Central Bank of Sri Lanka.

Advantages of digital budgeting tools

- **Allocate income across spending categories such as housing, groceries, entertainment, and savings.**
- **Ensure financial discipline and avoid overspending.**

Key Features of Digital Budgeting Tools

Function	Description
Expense Tracking	Automates categorization sends real-time updates and pro-vides reports.
Financial Goal Setting	Supports goal creation, automated savings, and progress visu-alization.
Savings Allocation	Helps to allocate funds effectively toward emergencies and goals.

5 Tips for Smart usage of Digital Budgeting Tools:

1. **Set Realistic Budgets:** Ensure your budgets reflect your income and necessary expenses.

2. **Automate Savings:** Use automation features in budgeting tools to allocate funds consistently toward savings goals.

3. **Review Reports Regularly:** Analyze the insights and reports the tools provide to understand your spending habits.

4. **Categorize Expenses Accurately:** Properly categorize expenses to understand where your money goes.

5. **Update Budget for Life Changes:** Adjust your budget promptly when there are significant changes in income or expenses.

3 ways that digital devices can make you financially smarter

1. To prepare your budget with ease

Mobile apps let you link your credit cards and bank accounts, import your transactions, and group them into budget categories. Such applications also have tools to assist you in managing your finances.

2. To pay down debt faster

Some applications are designed to help you get out of debt faster by saving small amounts daily and then making extra monthly payments. These applications are linked to your savings account. For example, paying the dues on your credit cards or personal loan.

3. To cut recurring expenses

Certain applications combine budgeting with features designed to help you pare down recurring expenses. After connecting to your bank and checking accounts, the app imports transaction and balance data and tracks your spending, offering you insights on that spending and the option of creating a budget.

Chapter 6

Financial Consumer Protection

6.1 Introduction

Learning outcomes

- Understanding the concept of Financial Consumer Protection (FCP)
- Identify the importance of the Financial Consumer Protection framework.
- Learn the FCP framework in Sri Lanka.
- Know the responsibilities of financial service providers about FCP.
- Know the rights and responsibilities of consumers about FCP
- Understand the complaint handling and redress mechanism

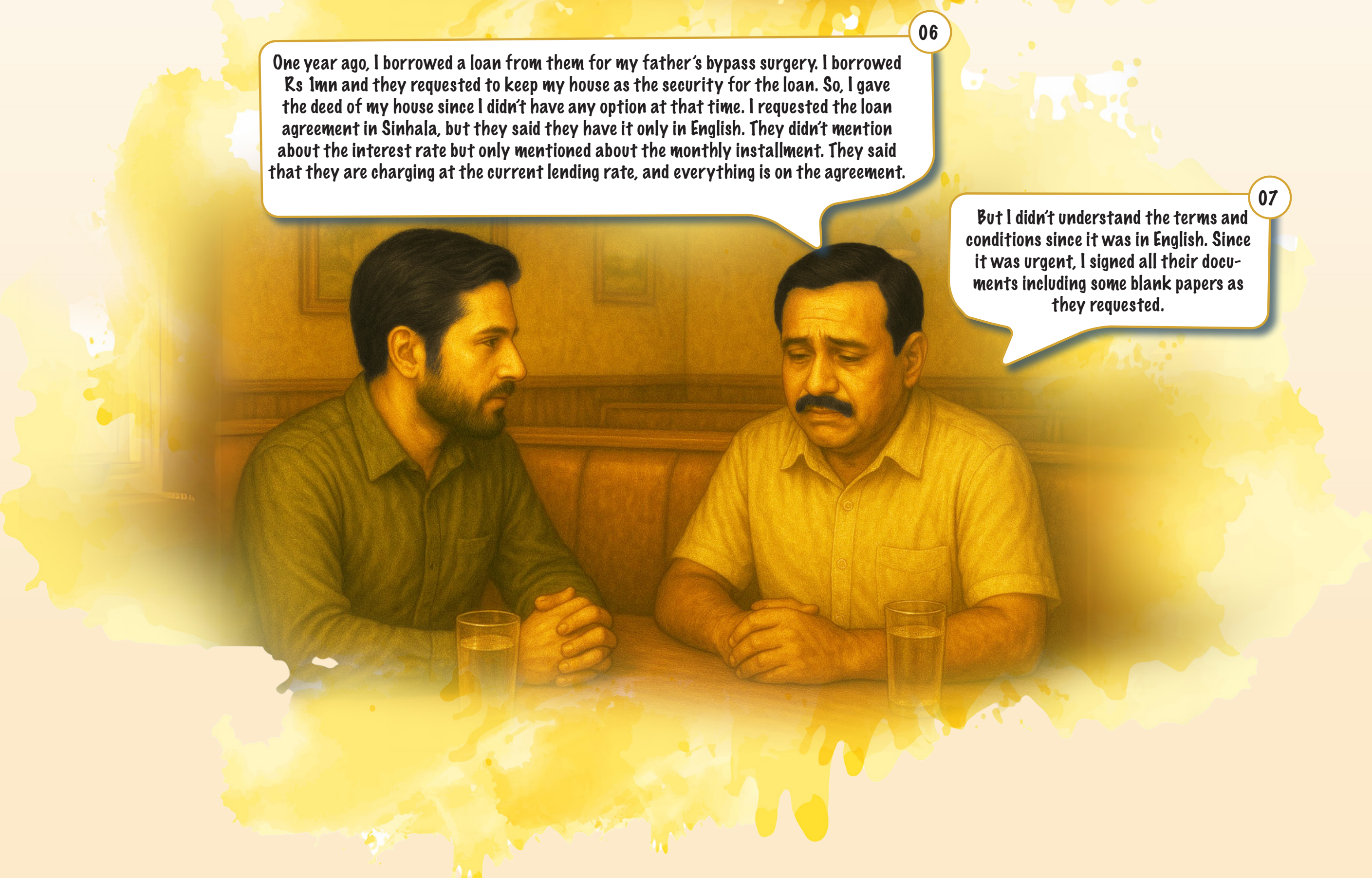
Easy access to financial products and services offered by Financial Service Providers (FSPs) has made your life comfortable. It is essential to be aware of the ability to use and enjoy such financial products and services conveniently without being subjected to harmful, unfair, and irresponsible business conduct.

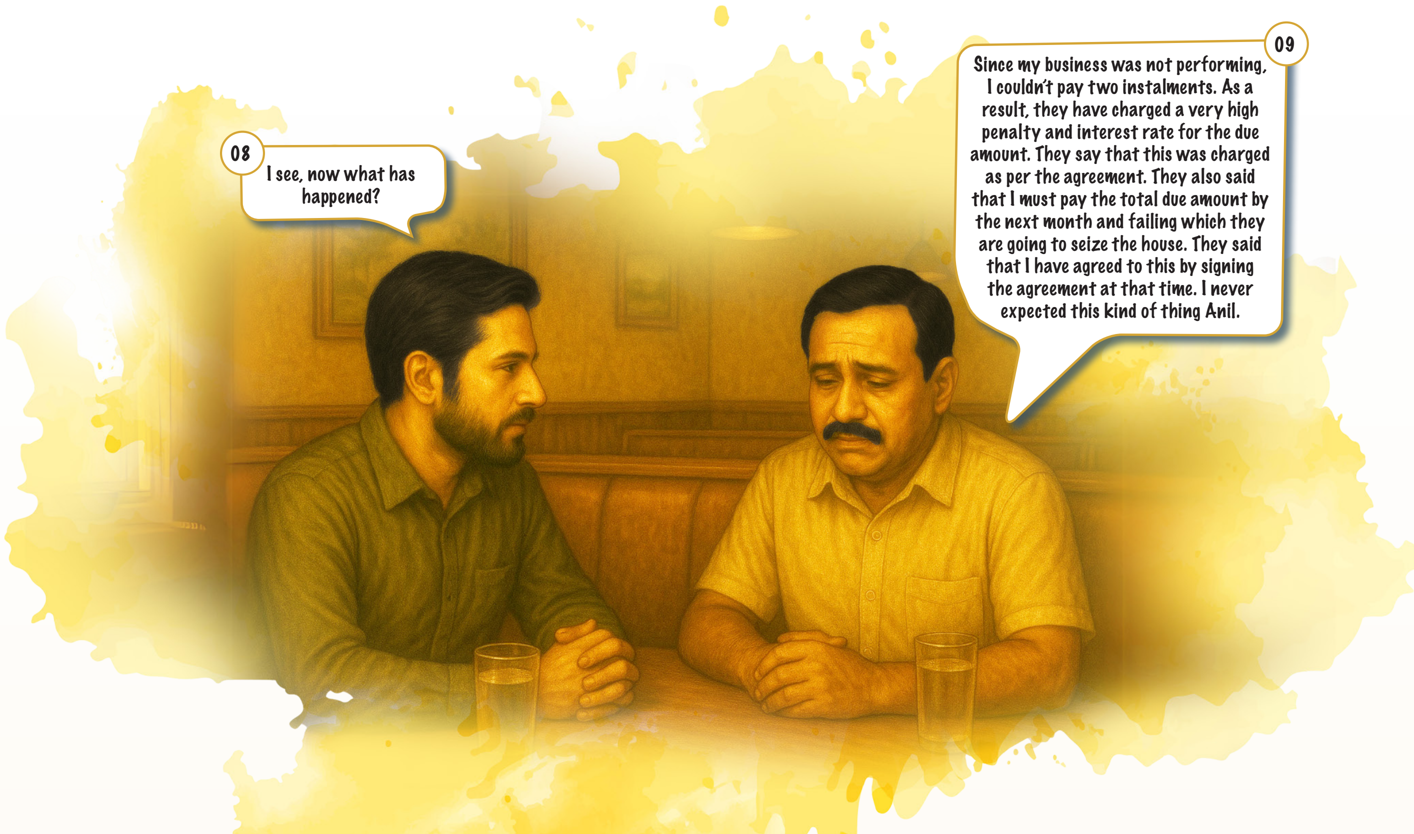
6.2 Financial Consumer Protection (FCP) Framework

FCP Framework refers to laws, regulations, and practices designed to safeguard financial consumers' rights and interests when interacting with financial products and services provided by financial service providers.

The main goal of the FCP framework is to ensure that financial consumers have access to fair, transparent, and secure financial services while protecting them from fraud, discrimination, exploitation, and unfair and irresponsible business conduct.

Anil met his old office colleagues Sarath. He noticed that Sarath was not in a good mood.





The above conversation emphasizes the risk of blindly signing loan agreements and destroying all your wealth. Therefore, it is paramount for financial consumers to be educated on the Financial Consumer Protection framework of Sri Lanka.

The importance of the FCP

The importance of the FCP is vast and crucial for individual financial consumers and the financial system's stability. Here are some key reasons why the FCP Framework is essential.

- Ensure Fair Treatment of Financial Consumers: FCP ensures that financial institutions treat financial consumers fairly.
- Prevent Financial Exploitation: Financial products and services can be complex, and without adequate protection, consumers may be vulnerable to improper financial products and services.
- Provide Efficient Dispute Resolution: In case of disputes between consumers and financial institutions, consumer protection mechanisms provide avenues for fair and efficient resolution.
- Protect Consumer Privacy and Data Security: As financial institutions handle sensitive personal and financial information of financial consumers, FCP laws require these institutions to implement strong security measures to safeguard such data from theft, misuse, or unauthorized access.
- Encourage Financial Literacy and Education: FCP often comes with efforts to improve financial literacy among consumers. By fostering awareness about the terms and conditions of financial products, interest rates, fees, and other aspects, consumers are better equipped to make informed decisions.
- Promote Financial Inclusion: FCP ensures that underserved and vulnerable populations, such as low-income individuals, minorities, and older adults, can access affordable and suitable financial products.
- Build trust in the Financial System: When financial consumers feel protected and assured that their rights and interests are safeguarded, they are more likely to trust and participate in the financial system.
- Support Financial System Stability and Economic Growth: When consumers are confident in their financial dealings, they are more likely to engage in saving, investing, and spending, all of which drive economic growth.

FCP is globally accepted and considered a fundamental component of a stable, fair, and inclusive financial system. While the specific regulations and frameworks may vary by country, global standards have been established by several international jurisdictions to ensure that financial consumers are treated fairly and have access to safe, transparent, and equitable financial services.

Significantly, the World Bank has highlighted financial consumer protection as a critical element for promoting financial inclusion, supporting economic development, and protecting consumers from harmful financial products and services. It developed Good Practices for FCP, which offers a global framework that guides policymakers and financial regulators on the principles of FCP.

In Sri Lanka, FCP is also recognized as an essential element for promoting trust, transparency, and fairness in the financial sector. Over the years, Sri Lanka has made progress toward strengthening FCP through various Directions and Regulations, aligning with global best practices while addressing local needs and challenges.

The main Directions and Regulations related to FCP issued by the Central Bank of Sri Lanka (CBSL) can be listed as follows:

- Financial Consumer Protection Regulations No. 1 of 2023 (Financial Consumer Protection | Central Bank of Sri Lanka)
- Banking Act (Customer Charter of Licensed Banks) Direction No. 8 of 2011
- Finance Companies Act (Financial Customer Protection Framework) Directions No. 1 of 2018(https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Business_Act_Directions_No_1_of_2018_e.pdf)
- Finance Leasing Act (Financial Customer Protection Framework) Directions No. 1 of 2018 (https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Leasing_Act_Directions_No_1_of_2018_e.pdf)
- Banking Act (Addendum to Customer Charter - Accessibility to Banking Services for Customers with Special Needs | Central Bank of Sri Lanka) Direction No. 06 of 2022.

As evidenced by the above Regulations and Direction related to FCP, CBSL has made significant progress in establishing a regulatory and legal framework to protect financial consumers, especially developing comprehensive FCP provisions in 2023, Financial Consumer Protection Regulations No. 1 of 2023 (FCP Regulations).

FCP Regulations

Under these FCP Regulations, you are entitled to various protections that help safeguard your interests when interacting with FSPs.

Am I a financial consumer?

You are a financial consumer if you

a) are currently using financial products or services,

b) have used a financial product or service or

c) expect to use a financial product or services provided by FSPs.

Who are FSPs?

As per the FCP Regulations, the following financial institutions are considered as FSPs.

- Licensed Banks
- Licensed Finance Companies
- Specialized Leasing Companies
- Licensed Microfinance Companies
- Authorized Primary Dealers
- Authorized Money Brokers
- Participants of the Payment and Settlement System

Responsibilities of FSPs about FCP

FSPs are critical in ensuring that financial consumers are treated fairly, have access to transparent information, and are safeguarded from harm and other risks in the financial services sector. Further, their responsibilities are aligned with the principles of FCP Regulations. Below are the key duties of financial service providers about FCP.

- Adopt FCP policies and procedures.
- Appoint Senior Officers to oversee the initial FCP function
- Ensure the effective implementation of FCP within the organization
- Ensure all employees are always aware of FCP and compliance with FCP requirements

Main Principles of FCP Regulations

The main principles of FCP Regulations are designed to ensure that financial consumers are treated fairly, have access to transparent and understandable financial products, and are protected from harm. These principles serve as a foundation for the creation and implementation of financial consumer protection frameworks in the financial services sector in Sri Lanka. While specific regulations may vary by jurisdiction, FCP Regulations enacted FCP principles mainly include the following:

- Fair Treatment and Responsible Business Conduct
- Disclosure and Transparency

- Complaint Handling and Redress Mechanism
- Protection of Financial Consumers' Assets and Information

FCP principles can often be viewed as consumer rights. These principles are designed to uphold and safeguard the rights of consumers within the financial system in Sri Lanka. When CBSL enforces FCP regulations, they recognize that you have specific rights when accessing and using financial products and services offered by FSPs in Sri Lanka.

Under FCP Regulations, you are entitled to various rights that help safeguard your interests when interacting with FSPs for your financial needs. The primary protections are:

1. Fair Treatment and Responsible Business Conduct

FCP Regulations ensure that financial consumers have a right to equal and fair financial services regardless of income, physical ability, gender, or any other social status.

Accordingly, you are entitled to

- receive notification before making changes to the interest rate, fees, charges, or terms and conditions of a product or service
- be informed when making changes to the contract
- prevent FSPs from adding unfair terms to the contract
- have proper guidance before accepting a product.

Further, you are free from

- public shaming
- aggressive marketing and advertising
- harassments or intimidation
- contacting family members, friends, or office of customers unnecessarily by FSPs.

Particularly, if you are a disabled person, you have the right to;

- access all websites and mobile applications maintained by FSPs
- request documents in accessible formats
- use thumbprint as a signature
- have personal assistance.

Accordingly, these rights aim to ensure you can access financial products and services reasonably, transparently, and securely.

2. Transparency and Disclosure

As you need proper information to make informed financial decisions, you have the following rights regarding transparency and disclosure regulations.

- Right to receive all information in your preferred language, such as Sinhala, Tamil, or English.
- Right to receive details on the interest rate, all fees, and charges associated with loan agreements entered by you.
- Before entering a contract, the right to receive information on all contract terms and conditions.

Further, FSPs must ensure that contracts for financial products and services are:

- Clear and easy to understand and should include
- Explanation of the consumer's rights and responsibilities.
- Details of any associated risks.
- Information on interest rates, fees, and charges.
- Contact information for customer support.

As a financial consumer, you have two primary sources to find information about all products and services offered by FSPs.

- Official website of the respective FSP
- Key Facts Document (this is a document prepared by FSPs on each product or service to provide key information to the customers that should be available for you)

Under these disclosure and transparency regulations, the protections aforementioned ensure that you can make informed decisions and are not misled by ambiguous or hidden terms, as FSPs are required to disclose full details of their offerings in a way that is easy to understand.

3. Complaint Handling and Redress Mechanism

You can lodge complaints and seek redress if your FCP wronged you. This includes access to clear and efficient processes for addressing complaints and grievances, with options for escalation of such complaints to alternative dispute resolution mechanisms, if needed.

Under this, you can act against violating your rights by FSPs. Accordingly, you can complain to the relevant FSP,

- using multiple channels
- free of charge

And, regarding the said complaint that you lodged, you have the right to

- receive an acknowledgment in writing within a reasonable time with contact details of the officer/officers handling your complaint

- resolve the matter within 21 calendar days

- get a clarification from the FSP if the FSP is unable to provide redress for your complaint

- receive information on the complaint handling process of the respective FSP

If you are not satisfied with the response of the FSP or your complaint has not been attended to by the FSP in the required manner, you can submit your complaint to the Financial Consumer Relations Department (FCRD) of the CBSL.

FCRD is a department established under the Central Bank which is empowered to handle financial customer complaints lodged by consumers.

Accordingly, your complaints can be submitted to the FCRD via email at fcrd@cbsl.lk. When you make such a complaint at FCRD, you should be mindful of the following:

- Your complaint should relate to a licensed financial institution.

- You must provide details of the initial complaint made to the respective FSP.

- Your complaint should be made before exceeding a period of one year from the date of making the initial complaint to the FSP.

- FCRD may stop proceeding to act on your complaint if you take any action to unduly influence the outcome or take any legal action concerning said complaint.

- making a complaint with FCRD does not prevent you from taking any legal action

Further, as a financial consumer, you can contact the FCRD for more information on financial consumer protection by calling the 1935 hotline or perusing the relevant information on CBSL's official website.

Accordingly, this protection ensures that consumers can hold financial institutions accountable for poor service or violations of their rights and that they have a clear path to resolve issues and obtain compensation when necessary.

4. Protection of Financial Consumers' Assets and Information

In this, you have the right to protect your personal and financial data and your assets.

As per these regulations, your data is protected against

- unauthorized access

- alteration

- disclosure

- loss, or destruction by employees of the financial institution.

Apart from that, you have a right to maintain your privacy. No FSP employee can reveal or share your personal information with a third party without your consent unless the laws permit it. You are also entitled to request a correction of any inaccuracies in the personal data held by the financial service provider.

Given the above, under these FCP Regulations, you are granted a wide range of rights designed to protect you from harmful, unfair, or deceptive practices in the financial system in Sri Lanka. These protections ensure that you are treated fairly, have access to transparent information, can make informed decisions, and have avenues for resolving complaints and seeking redress when necessary. As these protections are often embedded in regulatory frameworks, FSPs help to create a safer, more equitable financial environment for all financial consumers in Sri Lanka.

General Responsibilities of financial consumers when using financial products

Financial consumers also have responsibilities when using financial products and services. These responsibilities ensure that you make informed decisions, responsibly use financial services, and maintain your financial well-being. Below are some key responsibilities of financial consumers:

- Refrain from borrowing beyond your affordable repayment capacity limit.

- You should not allow the repayments or installments to go into arrears.

- You need to inform FSPs if you have difficulties in repaying loans.

- You must notify the FSP of any changes to your information, such as your address and contact details.

- You should have the full knowledge and understanding of the product/service offered before entering into the contract.

- Read carefully before signing any document.

- You should not sign on any blank paper.

- You should exercise due care in all transactions with financial institutions.

6.3. Understanding Pyramid Schemes

Learning outcomes

- Identify Pyramid Schemes.
- Understanding How Pyramid Schemes Work
- Identify the Legal and Regulatory Framework in Sri Lanka
- Build resilience against Pyramid Schemes through enhanced financial literacy.

Learning outcomes

A “Pyramid Scheme” is a scheme Where the participants receive benefits based on the increase in the number of the participants in the scheme or increase in the contribution made by the participants in the scheme.

How does Pyramid Schemes work

Let's look into this with an example.

Last morning, Dhananjaya met one of his school-time friends, Sakuna. Sakuna introduces him to an exciting business opportunity in which he can earn thousands of rupees monthly. Sakuna explained below how the Scheme unfolds.

Step 1: Initial Investment

Dhananjaya was asked to attend a seminar organized by the organizers. The requirements are too simple.

- He needs to pay Rs.5000 as a “membership fee” to join
- He will earn commissions by recruiting others to join under him.

Organizers also highlighted that the more people Dhanajaya recruits, the more money he will make. There are no tangible products to sell, only the promise of wealth.

Step 2: Recruitment of Others to the Scheme

To proceed with the Scheme as agreed, Dhanajaya connected three other friends (Amara, Saman, and Piumi). They also paid Rs.5000 each to join the Scheme. For each connection, Dhanajaya earns Rs.1000, totaling Rs.3000.

Dhanajaya keeps promoting the Scheme to Amara, Saman, and Piumi, encouraging them to bring in more people. Each time they connect someone, some fees flow up to Dhanajaya and the Scheme's organizers.

Step 3: Exponential Growth and Collapse

Amara, Saman, and Piumi recruited three people, each paying their joining fee of Rs.5000. Dhanajaya is now earning additional income from these new connections.

Step 4: Exponential Growth and Collapse (Cont..)

For the Scheme to be sustained, more and more people must join. This becomes problematic because:

- The number of potential participants is finite and limited.
- The pool of prospective member pools tends to dry up as the Scheme grows.

Eventually, the Scheme collapses when recruits cannot be found. The top-level operatives may walk away with loads of cash. At the same time, most lower-level members are left with significant financial losses.

Now let's look at the impact this creates on Dhanajaya as a young individual trapped in this illegal Scheme.

- David's reputation suffers as his connections (close friends) feel betrayed.
- Many recruits lose their Rs.5000 investment, as they couldn't recruit enough people to recoup their money.
- Legal authorities investigate the Scheme, and Dhanajaya could face penalties if found promoting an illegal pyramid structure.

Tips to Identify Pyramid Schemes:

Have you ever been approached by someone who has asked you to join a scheme that would make you rich quickly without much effort?

Be careful; this may be a Pyramid Scheme, which is illegal in Sri Lanka.

According to the CBSL, investors should be aware of these features of pyramid schemes:

1. false/unrealistic promises of earnings and hasty promotion to join
2. such goods and services may not retain a market demand
3. the purchased item may not be resold or returned
4. entry fee into the Scheme may be abnormally high
5. commission/payments are not depending on sales but new recruitments
6. mainly focusing on recruitment rather than selling goods or services
7. business location and relevant contact details are hardly traceable
8. no proper training opportunities in sales or recruitment may be given
9. no specific operational areas are specified
10. no proper customer care service

Types of Pyramid Schemes?

There are two types of pyramid schemes.

1. Naked Pyramid Scheme
2. Product-based Pyramid Scheme

The Naked Pyramid scheme is one in which no product is offered. Like in the above Dhananjaya's example. Here, we talk more about how it works;

Structure of the Scheme

- A promoter starts a scheme requiring 10 people (Level 1) to join, each contributing Rs.100.
- Each person in Level 1 must recruit 10 additional people (Level 2), who will also pay Rs.100 each.
- The recruitment and payment process continues across levels, with each participant responsible for recruiting 10 more participants.

When new participants can no longer be recruited, the Scheme collapses, leaving most participants at the bottom with no returns.

The Product-based Pyramid Scheme is operated in most instances as a Multi-level or Network Marketing Scheme in which a participant is required to purchase a product at an inflated price in return for which he receives:

- the right to sell a product and
- the right to receive a return for recruiting other participants into the program.

Structure of the Scheme

A promoter launches a scheme to sell watch priced at Rs. 100,000 per unit. Normally the real value or the market value of this product is less.

To join the Scheme, a participant must:

- Purchase one watch at Rs.100,000 where its market value is around Rs 60,000.

- Recruit three others to do the same.
- Each recruited person must also recruit three more participants, creating a pyramid structure.

The funds from the sale of products do not contribute to any legitimate business activity. However, they are used to paying commissions to earlier participants to sell products and recruit others for the Scheme. Here's how the commissions are structured:

Level 1 (Direct Recruits): Participant earns Rs.30,000 per sale from 3 recruits.

Level 2 (Recruits of Recruits): Participants earn Rs.10,000 per sale from the following nine recruits.

Level 3 (Recruits of Level 2): Participants earn Rs.5,000 per sale from the following 27 recruits.

As the Scheme grows, the number of required recruits increases exponentially:

For example, By Level 6, 729 new participants are required, and By Level 10, over 59,000 participants are needed.

When recruitment slows or stops, most participants cannot sell products or recover their investments, leading to financial losses.

Other Financial Scams

In addition to the above-mentioned pyramid schemes, a few other financial scams or structures have been operated in contemporary settings.

Investment Schemes (Ponzi Schemes)

A Ponzi scheme is a fraudulent investment scheme where returns to earlier investors are paid out using the capital from newer investors rather than legitimate profits. In a Ponzi scheme later participants fund the returns of earlier ones.

For example, an individual promises high returns on investment and asks investors to contribute.

They then use the funds from new investors to pay returns to earlier investors, creating the illusion of a profitable venture.

As long as the number of new investors grows, the Scheme can continue, but it will collapse once the influx of new money stops.

Ponzi schemes are illegal in Sri Lanka as no person shall accept deposit without obtaining license from the Central Bank of Sri Lanka.

Gifting Circles or Chain Gifting

This is also known as "Blessing Looms," "Sou-Sou," or "Women's Circles" in some cultures. In this scam participants contribute money or gifts to others in the group, expecting considerable benefits as the Scheme grows. Individuals should be careful of this type of system as you may typically join after being invited by a trusted friend or a family member.

For example, Participants at the top collect contributions from each participant who gifts a specified amount (e.g., Rs.1,000) to the center person. These contributors are then added to the circle and encouraged to add others to move through the tiers. The person at the center collects all the gifts from recruits, exits the Scheme, and leaves the next tier to split and form new circles. Such a system requires exponential recruitment for everyone to profit, which is unsustainable.

Knowing that some of these gifting circles are formed to support community efforts with emotional and cultural appeals is essential, such as women empowerment, building wealth in close-knit communities, and shared values of mutual support.

Cryptocurrency Schemes

Promoters use blockchain or crypto-related jargon to recruit investors for unsustainable business models promising unrealistic returns. Examples include Fake crypto coins, investment plans, or mining schemes.

Do You Know: Participating in Pyramid Schemes is a Punishable Offence in Sri Lanka

Any person who directly or indirectly initiates, offers, promotes, advertises, conducts, finances, manages, or directs a scheme in contravention of the provisions of Section 83C of the Banking Act No. 30 of 1988 shall be guilty of a punishable offense.

The punishments for such offenses include imprisonment for a period not exceeding three years or a fine not exceeding one million rupees or both imprisonment and fine.

Where the offense is committed willfully or knowingly, or with the knowledge that the act will cause damage or harm to any other person, he/she is liable to rigorous imprisonment for a term not less than three years and not more than five years and a fine of rupees two million or twice the aggregate amount in Sri Lanka currency revealed or divulged to have been received from the participants in the Scheme, whichever is higher.

Accordingly, the public is informed to refrain from such activities which may be punishable by law

Why do pyramid schemes continue to exist

Victims Silence and Shame	Persons who have lost money do not divulge the facts, as they tend to be ashamed of being deceived. Victims often blame themselves as losers.
Revolving Door Group	The bottom layers of a Pyramid become a "revolving door group," with the losers leaving and being replaced by new members.
Heavy Lobbying & Strong Pressure	Promoters lobby government officials and often ingratiate themselves by contributing to political parties.
Deception practiced by Promoters	Promoters do not divulge the average level of payouts to participants but focus on the earnings of the handful of customers (usually the promoters themselves) who have gained from the Pyramid Scheme.
Complexity of the Scheme	Promoters deliberately introduce complexity to the Scheme and the rules of participation so that the ordinary person finds it difficult to understand its true nature.

Damage caused by pyramid schemes

- By its design, a large number (usually 90%-99%) of those participating in pyramid schemes would sustain losses, resulting in the inevitable collapse of such schemes. In extreme cases, the collapse of such schemes has even led to social unrest and violence.
- As persons tend to recruit friends and relations to the Scheme, the collapse of the Scheme would sour human relations and destroy trust. Pyramid Schemes have been known to have caused divorces and even suicides.
- As some of those engaging in Pyramid Schemes are likely to be those who are already financially vulnerable, they are likely to sink into poverty when the Scheme collapses. There could also be a significant alteration in the distribution of income and an increase in inequality in a country due to large-scale operations of these schemes, which transfer funds from the large number at the bottom of the pyramid to the few at the top.
- Persons participating in Pyramid Schemes may use funds borrowed from financial institutions to engage in this activity, hoping to repay out of earnings from the Scheme. A collapse of the Scheme would cause large-scale defaults and threaten the economy's financial stability.
- If payment for participation in a Pyramid Scheme has to be made abroad in foreign currency, there could be a significant drain of foreign exchange from a country owing to the operation of such a Pyramid Scheme. This could cause volatility in the exchange rate, balance of payments problems, and reduce the country's foreign exchange reserves.
- Participants in pyramid schemes may increase their demand for goods and services based on the expectation of future income that would accrue to them from the Scheme. This may cause inflation and a deterioration of a country's current account (due to an increase in the demand for imports). With the inevitable collapse of the Scheme, many persons would sustain severe losses. As a result, there would be a contraction in demand, which could lead to deflation and reduced output.
- Pyramid Schemes would distort savings and investment in an economy, with participants using their savings to invest in such schemes rather than engaging in productive assets. It also could cause a misallocation of resources such as human resources and time, with people withdrawing from productive employment to engage full-time in these schemes, resulting in a loss of output.

How to identify pyramid schemes?

Most Pyramid Schemes presently operate as multi-level or network marketing schemes, and therefore, people should be wary of participating in such schemes, especially as the promotion of such schemes is now a violation of the law. The following tips are presented to help you identify Pyramid Schemes.

1) Beware of anyone who tells you you can make vast amounts of money with little effort. They are almost certainly not telling you the truth and are trying to deceive and cheat you. You will most likely not only lose money but even find yourself subject to legal prosecution for fraud.

2) Avoid any sales plan that sells a product at an inflated price (higher than the product's intrinsic value) and offers commissions for recruiting other purchasers. Even if a money-back guarantee is included, be cautious as there are likely to be several conditions attached to receiving money back, which makes it impossible to do so.

3) Be cautious of plans that claim you will make money exponentially through the continued growth of your "downline," i.e., the commissions on sales made by those recruited by you instead of sales made by you.

4) Avoid plans where advancement is based on recruitment rather than retailing and where promoters provide training/ motivational seminars focused on recruiting/enrolling members rather than retailing goods to the public.

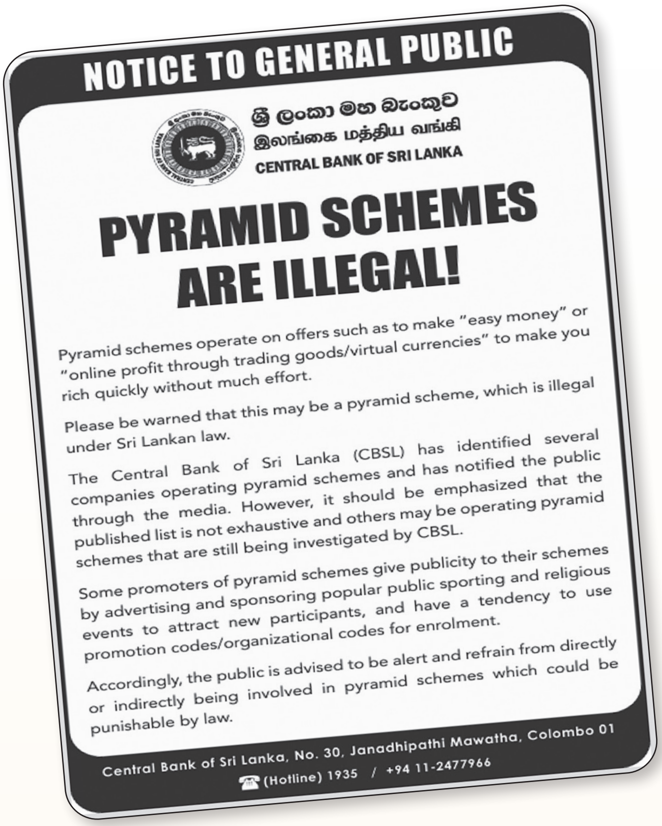
5) Please stay clear of plans where there is no evidence that many sales persons earn most of their income from retailing. Legitimate multi-level marketing schemes offer products and services sold through a network of distributors. Any commissions paid to distributors are related to selling goods and services to end users (those who buy the goods for their own sake and not to obtain the right to recruit others to the Scheme). The lack of retailing to end users is the chief characteristic by which Pyramid Schemes can be distinguished from genuine multi-level marketing schemes.

6) Beware of decoy references - persons claiming to have made windfall profits through participating in a marketing plan. The promoters may have paid these people to do so.

7) Do not make payments or sign contracts to participate in a marketing scheme in any seminar or other high-pressure situation. Consider carefully whether the Scheme could be a Pyramid Scheme and discuss the matter with a knowledgeable person such as an accountant, lawyer, or banker before committing.

8) Be careful not to be fooled by "business opportunities" and "get rich quick" schemes offered online or unsolicited emails. With the growth of e-commerce, Pyramid Scheme operators increasingly use electronic media to attract potential participants globally at a relatively low cost.

9) Be wary of schemes that claim to have secret plans, overseas connections, and unique relationships.



The Central Bank of Sri Lanka (CBSL) has recently received many public complaints indicating that some schemes operating through online platforms are misleading investors into depositing money/investing in these schemes by stating factors such as indicated below in an attempt to justify that they are lawful schemes:

- The Scheme is protecting investors' funds by adhering to the regulations of CBSL;
- The Scheme is paying the relevant taxes to the Government;
- Participants of the schemes have to pay a personal income tax from their funds to CBSL to withdraw funds, and if not, their funds would be frozen by CBSL;
- The Scheme has had discussions with CBSL.

CBSL vehemently denies the above statements and wishes to inform the public that these statements have no truth.

What are the responsibilities of the public in combatting prohibited schemes?

- Do not directly or indirectly initiate, offer, promote, advertise, conduct, finance, manage, or direct prohibited schemes
- Not getting caught in fraudulent activities
- Immediately report to law and enforcement authorities
- Be aware and aware of other people, too

To where does the public report on pyramid-type schemes?

The public can complain to the

- nearest police station, or
- Financial Consumer Relations Department of the Central Bank of Sri Lanka

Through address,

The Director,
Financial Consumer Relations Department,
Central Bank of Sri Lanka,
No 30, Janadhipathi Mawatha, Colombo-01.
Telephone Nos: 0112477966 / 1935
Email: dfcrd@cbsl.lk

Tips to Avoid Pyramid Schemes: Be a Vigilant Customer

You may have recently encountered pyramid schemes. Otherwise, your loved ones, close friends, and family members are suffering since they were exposed to pyramid schemes. Let's examine some important factors you need to consider while investing in financial schemes to prevent those people from suffering.

- Assess whether the scheme or entity's work is lawful and whether the required permits and approvals from the appropriate authorities or regulators are available to carry out their activities.
- Verify if they have a thorough business plan that outlines how customers or participants will profit from compensation, commissions, bonuses, discounts, and other benefits, among other things.
- It is better to compare the benefits and rate of return the schemes offer with those offered by similar plans/benefits in the market.
- Ask questions from the representatives to get information regarding the aspects of the Scheme below.
    - The nature of the product offered or service rendered, including the price, quality, characteristics of the products, availability of products...etc.
        - Basic information about the company, including its location, address, contact details, etc.
        - Similar products or services are available in the market.
        - Nature of business plans that offer the same product and services in the market
- Availability of after-sale services/customer care services and reasonable and applicable terms and conditions regarding consumer protection.
- Ensuring transparency when entering into agreements with relevant parties by providing all necessary information, including legal obligations.
- Not to be fooled by "business opportunities" and "get rich quick" schemes offered through the internet or unsolicited emails, as there are no legal/valid ways to earn money easily and quickly.
- Taking the social responsibility to be cautious of claims of low or no-risk investment opportunities with minimum effort. Understanding the reality of the qualifications, skills, and leadership qualities often determines one's earning capacity.

Chapter 7

Tax Literacy

7.1 Introduction

Learning outcomes

- Understand taxes and why we should we pay taxes.
- Understand the 4 Rs of Taxation.
- Understand how Taxes becomes the lifeblood of a nation.
- Learn about Tax Identification Number (TIN) and how to obtain that.
- Know the various type of taxes in Sri Lanka.
- Understand the Taxation for MSME and applicable standard Income Tax and VAT rates in Sri Lanka.

What are taxes?

1. Taxes are mandatory payments that individuals and businesses must make to the government based on their income, profits, wealth or consumption.
2. Tax is a mechanism or instrument through which citizens hold governments accountable for how their money is spent.
3. Taxes are mandatory contributions levied on individuals or corporations by a government entity—whether local, regional, or national.
4. Tax revenues finance government activities, including public works and services such as roads and schools, or programs such as nutrition for kids, etc.

Why pay taxes?

Through the payment of taxes, the taxpayer contributes to funding infrastructure projects such as roads, bridges, railroad network and public services such as education and health.

The purposes for which taxes may be levied can be grouped into various categories. The most commonly used categories include :

1. providing government functions such as government infrastructure and military;
2. providing other public goods and services such as education and healthcare;
3. implementing social security schemes like pensions and support for the ageing population.
4. creating greater equality through redistributive functions; and
5. guiding behaviour in society (as tax can serve to provide guidance as to acceptable and unacceptable behaviour)

Through the levy of taxes, the government can meet many social and economic objectives.

1. Encourage savings and capital formation through tax benefits for investments.
2. Enable sustainable development through the achievement of the United Nations Sustainable Development Goals (SDGs).
3. Encourage small businesses through concessionary tax rates.
4. Encourage the use of green energy sources through tax deductions on the installation of solar panels connected to the national grid.
5. Fiscal reforms through reducing budget deficits.
6. Encourage regional development through tax reliefs for investments in backward areas.

4 'R's of taxation

Revenue
collecting funds to spend on services

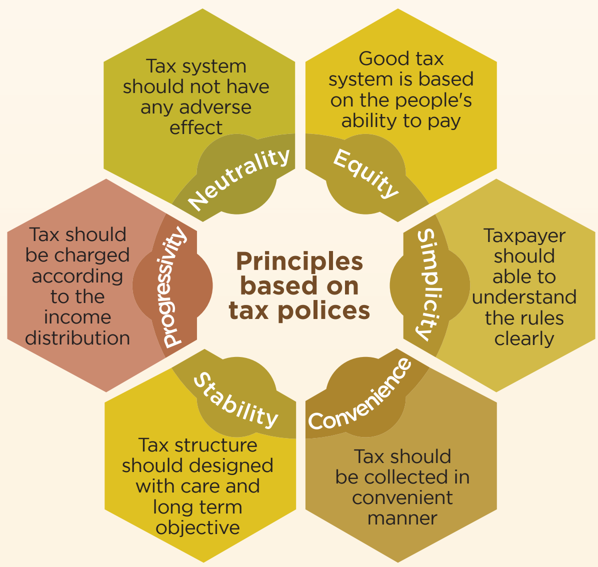
Redistribution
transferring wealth from the rich to the poor

Repricing
encourage/discourage consumption

Representation
rulers tax citizens, who then demand accountability

Principles of fair taxation

1. Neutrality
2. Equity
3. Progressivity
4. Simplicity
5. Stability
6. Convenience



The family has gathered for dinner and Gothami is describing an online video created by the Inland Revenue Department about the importance of paying taxes which was forwarded to him by his friend Niranjan.

Gothami	Today I want to show you this interesting video which was shared by my friend Niranjan. This illustrates how revenue from taxes is being used to build roads, government schools, hospitals and other public utilities.
Dhananjaya	This is very interesting.
Gothami	Yes. I have finished 13 years at school without paying hardly anything. My friends who are reading for degrees in the public universities too, pay only nominal fee. I met some of my college mates when I visited the town last week and found that they had to pay substantial amounts as tuition fees, enrollment fees, field trip charges, technology fees and so on. These charges are significant, making private schools at least 5 to 10 times more expensive, and thereby far less accessible to many families. In private schools, fees are ranging from Rs. 30,000 per term to Rs. half a million per term. Private universities charge over Rs. 2 million per programme with term fees anywhere between Rs. 3 lakh to Rs. 5 lakh.
Anusha	Is that true? But how is the government able to provide free education for so many children?
Anil	Yes, we have about 10000 government schools where nearly 4,000,000 children are enrolled. So we are looking at very big government expenditures here.
Anusha	These are very big numbers, many times the number of children in our village.
Dhananjaya	This is quite a puzzle. While every child I know here has gone to the local school, I can barely see any taxpayers in the village.
Gothami	Exactly, while we don't pay taxes directly, there are many ways the government collects revenue from us indirectly. I will tell you more about this later. It is this revenue that provides for free education and other services that benefit everyone. Look at our neighbouring village, Habarakada for example. There are many professionals from that village who have settled overseas. They regularly remit money to their families and invest in local businesses. Their village has grown significantly, with a vibrant market, big shops, and excellent facilities. The taxes paid by the residents of Habarakada has been used to build a big school and a specialty hospital for the community.
Ayodhya	Is paying for public services the only role that taxes play?
Gothami	Not at all! Taxes are also tools for meeting social and economic objectives. For instance, the government offers tax incentives to encourage investments in research, the growth of IT services and capital investment for manufacturing industries and so on.
Anusha	What exactly are tax incentives?
Anil	Tax incentives can be in the form of reduced tax rates or complete tax exemption called tax holidays. They are given to encourage certain behaviours and activities. On that note Anusha, do you know that taxes can also disincentivize or discourage certain behaviors or sectors. For example, tobacco and liquor are taxed at a higher rate of 45% called the 'Sin taxes'. FYI gaming companies are also taxed at a higher rate of 45%.
Dhananjaya	Oh that's interesting, never knew taxes can influence human behaviour . It is good that there are higher taxes on the use of tobacco and liquor as these create many health problems for young and old alike. The part about gaming companies is interesting too. I have seen many videos where children in the town spend hours playing video games. I am sure these kids find it difficult to handle their studies.
Anusha	That is a very dangerous habit particularly for young minds.
Dhananjaya	True. Also, gaming companies not only includes creators of online video games but also casino operators who face the higher tax rate of 45% as well. In this way the government tries to ensure that betting and gaming companies pay their fair share of income tax to the government.

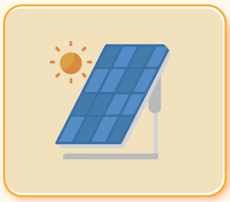
	Not only that, taxes also promote economic equality and fairness through the redistribution of wealth. Those with higher incomes pay more tax which helps to create a more balanced society.
Anusha	That seems fair. But I am not sure that the rich are losing their wealth by paying higher taxes. What I see is, the rich and the poor remain as they are in spite of how much tax they pay or save.
Anil	It may seem so. But the fact is that by paying higher taxes, the rich contribute more towards revenue collected by the government. The poor contribute too, but much less so as not to dent their pockets and to leave enough for meeting their basic necessities.

Taxes as the life-blood of a nation:

Taxes are what we pay for use of roads, trains, schools, hospitals, emergency services etc.

Public services are available for all whereas private goods and services are limited to those owning it or paying for it - Around 10,000 government schools and 550 government hospitals for primary care provide low cost education and medical care for ordinary households.

Taxes can discourage health hazards such as the use of tobacco and alcohol.



Taxes can encourage green energy sources through incentives for use of solar panels

Revenue from taxes can help achieve the SDGs.

Taxes promote savings and capital formation.

Short quiz/ assessment

1. Name 5 public utilities around you which have been funded by taxpayer money.
2. How are they different from private institutions providing similar services?
3. List 3 sectors which enjoy tax incentives.
4. List 3 ways taxes can contribute to better physical health of the population.
5. List 3 ways taxes can improve equity through providing opportunities for economic empowerment of women, rural businesses and other disadvantaged groups.

7.2. Tax Identification Number (TIN)

What is a TIN

A **TIN** or Taxpayer Identification Number is essential for paying taxes or importing/ exporting or obtaining any services from the Inland Revenue Department.

TIN can be obtained by using the IRD e-Services or by visiting the Primary Registration Unit at the 2nd Floor of the IRD Head Office or any Regional offices.

Persons who can obtain a TIN include individuals, partnership businesses, corporations and others.

The process of obtaining a TIN is simple.

Individuals must submit -

(i) National Identity Card/ Valid Driving License/ Senior Citizen's Identity Card. Foreign nationals must submit a valid passport.

(ii) Business Registration Certificate (if a proprietorship is to be added).

(iii) Utility Bill / Landline Telephone Bill / Statement of Bank Account or Passbook / Grama Niladhari Certificate (if address is different from NIC). For foreigners, local address proof is required.

What does it mean to have a TIN? Necessity and benefits

For individuals 18 years or older and residents of Sri Lanka, getting a TIN is mandatory from 1st January 2024. Quoting of TIN has also been made mandatory for –

1. Opening any type of bank account.
2. Obtaining approval for a building plan.
3. Registering a motor vehicle and renewing a license.
4. Registering a land or a title to a land.

At present, these provisions are not being enforced, such as in the case of renewal of the vehicle licenses, but these provisions are part of the law.

Interactive role-play – Anusha has just returned from a meeting of village women, which was addressed by a visiting government official, Ms. Fernando, working at the IRD headquarters. Ms. Fernando is a friend of the Principal of the village school, and the purpose of the visit was to inform them about the new legal provisions regarding TIN registration, which have become compulsory since 1st January 2024.

Ms Fernando	Please remember that although the government has relaxed mandatory registering for TIN for individuals 18 years and older it continues to be important for accessing many services. You can apply for TIN online or submit it personally or send the form by post.
Lalitha	Yes, it means d that if you fail to register for TIN you no longer have to pay any penalty or fine. But the Department of Motor Transport (DMT) has communicated that TIN is mandatory for availing its services from 15th April 2025.
Rohini	Ms Fernando, my husband is a local auto mechanic, does he need to apply for TIN, given that his income is much below Rs. 150,000 per month.
Kamala (Grocery shop Owner)	Exactly my question too. We village people have very low incomes. Does it make a difference if we register for TIN or pay taxes?. Anyways I do not see any point of paying taxes out of my hard earned income. Is the tax money really being put to any good use?
Ms Fernando	Good question. But just to remind you that these thresholds are not static but can be changed in the annual Budgets. So it is best to check the latest rates from the IRD website. https://www.ird.gov.lk

	That apart, just look around you – the village school where children get free education, dispensary for free primary care, post office and other public amenities – all of this is funded out of the revenues collected by the government. Therefore, it is our civic duty not only to pay taxes, but to also ensure its utilization by the government in a transparent and efficient manner. We need to spread tax literacy and also discourage tax corruption and crime by reporting it. On the topic of TIN, applying for TIN is not only required by law but also mandatory for availing the following services: 1. Opening any type of bank account. 2. Obtaining approval for a building plan. 3. Registering a motor vehicle and renewing a license. 4. Registering a land or a title to a land. Without a TIN you cannot avail the above benefits.
Kamala	Thank you. Why should we open a bank account when our entire business is in cash?
Ms Fernando	That might work for now, but think about the future. When your business grows, having a bank account will give you access to overdrafts, credit, and even government schemes designed to support small businesses. A bank account isn't just a convenience—it's a key to growth and opportunity. Also to inform you that as per new tax rules, all payments above Rs. 500,000 have to be made through banks to avail any tax benefit.
Anusha	True. Also, I have been trying to buy a small plot of land since last year and have been facing lots of issues with title deed and paperwork. I don't want TIN to get in the way. I will get my TIN registration form ready ASAP.
Kamala	Right. I have to renew my 3-wheeler license soon. Its now clear, I will need TIN for this too.
Ms. Fernando	Right now you can renew the vehicle license without TIN. But very soon it will be made mandatory I think.
Kamala	OK
Saroja	Ms Fernando, thank you for clarifying on the need for TIN. For obtaining the TIN, my husband tried the online method at the village internet café but could not submit it as the system is very slow with a weak internet connectivity.
Ms Fernando	I am sorry to hear that. You may please hand over the physical TIN registration forms to me and I will deliver it at the IRD headquarters in Colombo. Others can also contact IRD via their email taxpayerservice@ird.gov.lk. Next step is click on 'Access to e-services', and then 'Taxpayer Registration' at www.ird.gov.lk. Here you can follow the steps, fill up necessary details, upload the National Identity Card and other supporting documents for obtaining TIN. Also, IRD has many regional offices which can also receive the completed forms.
Anusha	Where are these offices located? Which office is located nearest to our village?
Ms Fernando	Thanks for the question. There are regional offices throughout the country and three within the metropolitan region of Colombo. The complete list can be accessed here Metropolitan and Regional Offices.
Kamala	Sure, thanks. Also, Ms Fernando, If I get a TIN will I automatically have to pay tax?
Ms Fernando	No Ms. Kamala. Merely having a TIN does not automatically mean you start paying taxes. You will have to pay tax only if the income earned by you is more than Rs. 1,800,000 per annum (or Rs. 150,000 per month) from the current Assessment Year (1st April 2025 till 31st March 2026) and so on. Of course these rates can be changed in the subsequent Budgets and the current figures from the February 2025 Budget can be obtained from the IRD site. Inland Revenue (Amendment) Bill, 2025 - Lanka Law

Saroja	The IRD has simplified the process of obtaining a TIN and given that there is penalty of Rs. 50,000 for not registering, we should immediately apply for it.
Kamala	But is it true that the IRD website crashed last year? My friend from the town was mentioning it.
Ms. Fernando	You are right. There were technical glitches on the tax filing deadline date last year. But the IRD was able to address that in a few hours. Since last year the website has been updated and made more user friendly too.
Villagers	Thank you Ms. Fernando

TIN journey

- TIN stands for Taxpayer Identification Number.
- TIN registration has been made mandatory for residents above 18 years of age from 1st of january 2024. Non compliance will attract penalty upto Rs. 50,000
- Merely obtaining a TIN does not imply filing of taxes.

TIN has been made mandatory for

- Opening any type of bank account with a bank
- Obtaining approval for a building plan
- Registering a motor vehicle or renewing a licence
- Registering a land or title to a land

TIN applications can be submitted in person at the IRD headquarters in Colombo or in any of the regional offices.

Online applications can be submitted on the IRD website

www.ird.gov.lk - > Access to e-services -> Taxpayer registration

Short quiz/ assessment

1. What is the full form of TIN and why is it necessary? (Answer will be for filing taxes, export/ import and accessing IRD services)?
2. List 4 services which cannot be accessed without a TIN.
3. Does obtaining a TIN automatically imply that taxes have to be filed?

7.3. Types of Taxes

Taxes can be classified into main two types as (1) Direct and (2) Indirect.

Direct taxes are levied on taxpayer's income and profits. An individual earning employment income, a small business owner earning profits, a person earning professional receipts such as a doctor, lawyer, or a person earning interest or dividends on investments - all pay income taxes directly to the government.

The higher the income, the greater the burden of direct taxes. This explains the progressive nature of direct taxes.

Indirect taxes are paid not on income but on the consumption of goods and services. For example, VAT is added to restaurant bills, private taxi hires, clothing purchases, etc. Every person pays VAT while paying for these services or goods. In this manner, compliance is easy and simple.

Consumption increases with income, but low and middle-income families spend a higher proportion of their income, particularly for basic amenities such as food, housing, and healthcare. In this way, indirect taxes are regressive and place a disproportionate burden on those whose incomes are lower.

The taxpayer who is the manufacturer of goods or provider of services pays indirect taxes to the government, but the amount of tax is recovered from another person, who gets the benefits, i.e. the final consumer.

Examples of indirect taxes in Sri Lanka are Value Added Tax (VAT), Excise duty and Customs duty.

At present, certain essential items, such as wheat and wheat products, and infant food, are exempt from VAT.

Excise duty is included in the purchase of certain items such as alcohol and petroleum products.

	Direct taxes	Indirect taxes
Definition	Paid directly to the government by taxpayers.	Collected indirectly by intermediaries from consumers.
Example	Income tax, corporate tax, property tax.	Value Added Tax (VAT), Excise duties, Import duties.
Burden	Falls directly on the taxpayer and cannot be transferred.	Can be transferred to others along the supply chain of the goods/services.
Basis	Income, assets and wealth	Consumption and transactions
Ease of administration	Need greater resources and collection machinery	Easier to collect at point of sale/service
Distributional impact	Progressive and equitable as higher income means higher the tax burden.	Disproportionately affect lower income groups who pay higher percentage of their income for use of goods and services.

Interactive role-play – Ayodhya and Gothami are discussing the recent trip Gothami undertook with her friends at the workplace.

Ayodhya	What is the interesting incident you mentioned about your trip to the town last week?
Gothami	Yes, it was eye-opening! Remember I mentioned to you about indirect taxes last week. Turns out, we all are paying taxes, even without realizing it.
Ayodhya	What? Not me for sure. I am still schooling and I have no income, also no requirement for having a TIN.
Gothami	That's what I thought too, but hang on till you hear this. Today, we decided to have lunch at a nearby restaurant. We calculated that we would have to pay a total of Rs. 2000 for which 5 of us could contribute Rs. 400 each. When we received the bill, we found that that it was for Rs. 2360.
Ayodhya	Wait, why the extra Rs. 360?
Gothami	Exactly, what we thought! It turns out, it was Value Added Tax (VAT) at the rate of 18%. So, we ended up paying tax of Rs. 72 each.
Ayodhya	But you have not yet received your TIN. How did you pay the tax?
Gothami	TIN is required for paying income tax which is a direct tax. VAT, on the other hand is a consumption-based tax. This is an indirect tax, paid by the owner of the restaurant but passed on to us the customers by adding it to the bill.

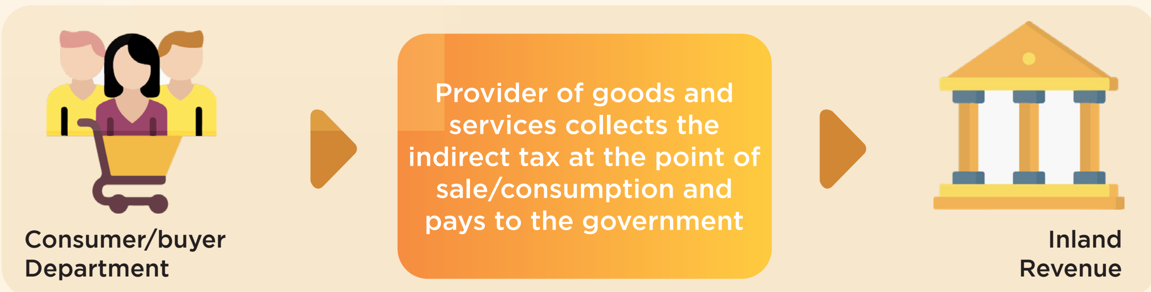
Ayodhya	Interesting indeed. So even though I am not paying any income tax, I am still contributing to government revenue by paying VAT every time I purchase a good or use a service. But how do you know all of this?
Gothami	Remember my friend Niranjan, the son of the school Principal, Mr Perera. He is very interested in the topic of taxes and wants to become an accountant someday. Another interesting fact was that when we received our lunch bill, the cashier told us he would give us a discount of Rs. 200 if we did not insist on the bill. But Niranjan was like "no way".
Ayodhya	Why not take the discount?
Gothami	Because it is illegal. Niranjan explained that cash payments were meant for under-reporting income and that is tax evasion. The money collected in this manner is also used to bribe corrupt officials who try to avoid detection by dealing entirely in cash. Not so cool.
Ayodhya	True! Given that taxes are used for so many free services which people like us really need in the village. Tax evasion needs to be punished and there should be some way for ordinary people to report such practices to the tax authorities.
Gothami	Exactly. It is our civic duty to ensure full and fair tax collections. We should not only insist on receiving a bill but also report this to the authorities. The IRD has recently taken steps to tackle corruption by encouraging people to report such cases along with evidence with the assurance that the informant's identity will be protected and kept confidential. Details can be sent by email to the Commissioner General of Inland Revenue at cgir@ird.gov.lk. The regional offices can also receive these details and their contact numbers are available on the IRD website. Metropolitan and Regional Offices. After examining the cases on merit, they can be referred by the IRD to the Commission to Investigate Allegations of Bribery and Corruption (CIABOC) which is also setting up a complaint box at the IRD head office premises. The contact details including phone numbers of different officers are available on the IRD website
Ayodhya	That's a great step towards deterring tax crimes.
Gothami	Also, Niranjan added another layer to this. If we fail to report these businesses for violating tax laws, they may feel encouraged to bypass regulations in other areas, and compromising food quality and safety can pose serious risks. Thus it is in everyone's best interest to encourage tax compliance.
Ayodhya	By the way, are there other instances where we are paying VAT without realizing it?
Gothami	Oh yes. Take a look at the bill for the dress I bought you in town. Even our Pickme ride from the bus stop to the university included VAT.
Ayodhya	This is interesting but kind of unfair dont you think? We are just simple villagers with little or no income, yet we are paying the same VAT as rich city people.
Gothami	You are right. Niranjan echoed the same thing. VAT is a regressive tax as it is not based on the ability to pay. Whereas direct taxes are progressive; the higher your income, the more you pay.
Ayodhya	Can you make it a little clearer?
Gothami	VAT applies the same rate to everyone, but the proportion of income that goes to consumption decreases as income increases. Therefore, low-income households spend a larger portion of their income on consumption than high-income households.
Ayodhya	Then why don't we simply shift to direct taxes?
Gothami	Not so simple. Direct taxes depend on people voluntarily reporting their income and paying the necessary taxes. That's harder to enforce and monitor.
Ayodhya	Yes, there are thousands like the owner of that restaurant who want to seize every opportunity to avoid paying taxes.

Gothami	It is a humungous task for the Inland Revenue department to track this scale of tax corruption. Indirect taxes, like VAT, on the other hand are much easier to administer as they are collected automatically at the point of sale. That's why VAT is Sri Lanka's largest source of tax revenue.
Ayodhya	Yet I feel that direct taxes are fairer and it should be the main source of our revenues.
Gothami	You nailed it! Hence the tax base for direct taxes should be broadened and more people should be encouraged to file taxes on different categories of income earned by them. That's why the Government is pushing for Mandatory TIN registration as a first step towards a fairer tax system.
Ayodhya	Got it. So TIN is not about paying taxes, but about making the whole system work better leading to a better society.
Gothami	Spot on my little brother!
Ayodhya	The topic of tax is so interesting. I think it should be taught to us in high school. Or we could ask our Principal to arrange some knowledge sessions by IRD officials in our school.
Gothami	Great idea!

The invisible hand of taxes in goods and services

Direct Tax & Indirect Tax: Direct Tax is a tax that is paid directly by the taxpayer (individual/ business/ others) on whom it is imposed. Direct tax cannot be shifted to another individual or entity. Indirect taxes, on the other hand, can be shifted from one taxpayer to another. Indirect Tax is the tax that increases the price of a good or service so that consumers are actually paying the tax along with the price of the goods or service. Indirect tax is collected at the point of consumption of the goods or service e.g. Value Added Tax (VAT), Excise duties and import duties.

- **Direct taxes are paid on income earned by the taxpayer.**
- **Indirect taxes are paid at the point of consumption (restaurant, petrol pump, cinema hall, ride-sharing etc). Paid by the provider of goods and services but collected at the point of consumption.**
- **Direct taxes are progressive and based on the ability to pay. Higher income more taxes.**
- **Indirect taxes are regressive as they collect higher proportion of income from low-income earners.**
- **Administration of indirect taxes is simpler than direct taxes.**



Indirect taxes		
Value added tax (VAT)- on goods and services	Excise duty - on products like petroleum	Customs Duty - on imports
VAT - collected when we purchase goods (exemptions for certain essential items like wheat, locally produced dairy, etc) and avail services such as in restaurants, malls and pay for taxis		
		

Short quiz/assessment

1. What is the difference between direct and indirect taxes? Answer should include the point of burden, progressive vs regressive, ease of compliance etc.

2. Explain with at least two examples each of the types of direct and indirect taxes respectively.

3. Mr Akram with an annual income of Rs. 1,300,000 and Mr Roshan whose annual income is Rs. 500,000 both enter a fashion store for Christmas shopping. Mr Akram buys a pair of shoes and a shirt for himself for Rs. 3000 while Mr Roshan's purchases for his entire family totals Rs. 3000.

   (i) What is the VAT paid by Mr Akram and Mr Roshan respectively (VAT rate 18%)?

   (ii) What does it tell us about the nature of VAT?

7.4. Taxation for MSMEs

How is income tax applicable to MSMEs

If the MSME operates as a sole proprietorship, the business profit is treated as part of the owner's personal income and taxed under individual income tax. Therefore, the MSME must calculate its business profit in accordance with the rules of the Inland Revenue Act, and aggregate this profit with the owner's other sources of taxable income.

If the business incurs a tax loss, it can be set off against other business profits or investment income of the owner. If there are no such profits to offset, the loss can be carried forward for up to six years until it is fully utilized.

Standard Income Tax Rates (Effective from 01.04.2025)

After deducting Rs. 1,800,000 as personal relief (tax-free allowance), the following individual income tax rates will apply:

Example

Taxable income	Tax on taxable income equal to the lowest range (Rs.)	Tax on excess taxable income over the lowest of the range
First 1,000,000	60,000	6%
Next 500,000	90,000	18%
Next 500,000	120,000	24%
Next 500,000	150,000	30%
Balance		36%

Estimated qualifying payments (example) – deductible out of income

a) Donations to approved charities which provide institutionalized care to sick and needy people (limited to 1/3 of Taxable income or Rs. 75,000, whichever is lower), approved government institutions, and the President's fund.

b) Contribution made by a resident individual to establish a shop for a female individual who is from a Samrudhi beneficiary family (subject to approval from the Samurdhi Department).

   Eligible reliefs out of the aggregate income of an individual from different sources.

c) Statutory relief – Rs. 1,800,000.

d) Solar panel relief – Rs. 600,000 per year

e) Rent relief (25% of the gross rent income, irrespective of actual repair done)

Income Tax Rates applicable for companies

Standard rate – 30%

Business of liquor, betting and gambling – 45%

The thresholds for VAT registration are

(i) Value of goods and services (other than financial services) -exceeds Rs. 15 million per quarter and Rs. 60 million per annum.

(ii) Value for financial services – exceeds Rs. 3 million per quarter and Rs. 12 million per annum.

Voluntary registration is also allowed.

Solved example -

Mr. Karunanayake is a Chief Financial Controller (CFO) of the company "KDT". His expected income for the year of assessment 2025/2026 is as follows;

- Employment income Rs. 6,600,000 (Rs. 550,000x12) - Rs. 1,494,000 of APIT deducted.
- Gross Interest income received on 01.05.2025 Rs. 2,200,000 (AIT has been deducted at the rate of 10%)
- Business income Rs. 5,000,000

He has donated Rs. 250,000 worth of books for a state university in Sri Lanka during the year of assessment. In addition, Mr. Karunanayake has installed a solar panel in his residential place connected to the national grid at Rs. 750,000.

He paid taxes of Rs. 250,000 per quarter on self-assessed basis.

Calculation of Tax Payable		(Rs.)
Employment Income		6,600,000
Interest Income		2,200,000
Business Income		5,000,000
Assessable Income		**13,800,000**
Less - Reliefs		
- Personal relief		(1,800,000)
- Solar panel		(600,000)
Less – Qualifying payments		
- Donation to the National Hospital		(250,000)
Estimated Taxable Income		**11,150,000**
Estimated Tax Liability (based on rates prevalent in January 2025)	1,000,000 x 6% = 60,000	
	500,000 x 18% = 90,000	
	500,000 x 24% = 120,000	
	500,000 x 30% = 150,000	
	8,650,000 x 36% = 3,114,000	
Total Tax Liability		**3,534,000**
Deduct – APIT		(1,494,000)
- AIT on interest		(220,000)
- Self-assessed payments		(1,000,000)
Estimated Tax Payable (A)		**820,000**

Unlocking the Benefits of Formalization for Rural MSMEs:

- **MSME owners should register for a TIN and transition to the formal economy.**
- **With a TIN, MSME owners become eligible for opening a current account where they can deposit their earnings.**
- **Once their income crosses the threshold of 1,800,000 LKR they are required to file taxes.**
- **By depositing small sums of money regularly they can invest in retirement savings and plan for their future needs.**
- **This includes one-time earnings such as gifts, lottery winnings, or inheritance.**

Short quiz/assessment

1. What is marginal tax rate and effective tax rate ?

2. What kinds of taxes are paid by small businesses? (Answer to include Income Tax, APIT, WHT and VAT).

3. Arif owns an auto-repair shop and earns Rs. 100,000 per month for 5 months and Rs. 150,000 per month for the remining 7 months. He has old investments and earns gross interest of Rs. 400,000 as on 31.03.2026. Calculate the tax payable by Arif for year of assessment 2025/26.

4. Dr. Wasumathi is a General surgeon at the Karapitiya Teaching Hospital. Also, she maintains her own medical centre. She engages in private practice and earns additional income. Her income for the year of assessment 2025/26 is as follows;

   (i) Employment income is Rs. 9,200,000

   (ii) Professional income is Rs. 31,000,000 from her own medical centre

   (iii) Gross Interest income received on 01.06.2024 amounting to Rs, 5,000,000

   (iv) Income from private practice is Rs. 500,000

   (v) Rent income is Rs. 900,000

   (vi) Employment income includes estimated cash and non-cash benefits.

   (vii) She has donated Rs. 200,000 to an approved charity and spent Rs. 1,200,000 during the year to acquire solar panels to fix on her premises and connected to the national grid.

Calculate the tax payable by her for the year of assessment 2025/26. (Source : IRD SET guide 2023/24)

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Regional Development Department
Central Bank of Sri Lanka
No. 30, Janadhipathi Mawatha
Colombo 01, Sri Lanka
www.rdd.cbsl.lk

United Nations Development Programme (UNDP)
UN Compound,
202-204,
Bauddhaloka
Mawatha,
Colombo 7,
Sri Lanka.