IAS1 = Presentation of Financial Statements. Going Concern & Matching.
IAS2 = Inventory valuation.

IAS

IAS 7 Statements of Cash Flows

The main requirements of IAS 7 are covered in A Level Chapter 1.1.3 Limited Liability Companies.

IAS 8 Accounting Policies

In full the title of this standard is Accounting policies, changes in accounting estimates and errors.

IAS 8 provides a definition of accounting policies:

The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting in financial statements.

'Bases' means accounting methods used to implement policies: for example the choice of FIFO for inventory valuation; the choice of the straight line method of depreciation.

The standard stipulates:

- All accounting policies specifically detailed in any of the international standards must be implemented.
- Where the standards do not cover particular situations, the directors must take their own decision as to the appropriate policy to be applied.
- Directors should base their judgment on the overriding requirement to provide a true and fair view of company's affairs, by ensuring users are given reliable, relevant and understandable information.
- Directors must ensure that their policies are applied consistently to similar situations.

In regard to errors, the standard requires any material errors in financial statements to be corrected when discovered. Comparative figures would also need to be amended if they are affected by error.

IAS 10 Events after the Reporting Period Important

This standard covers the treatment of events that occur after the date of the statement of financial position but before the statement is authorized by the directors. The standard described two types of events after the ~~repeating~~ reporting period.

Adjusting Events

These are events after the reporting period, which provides further evidence of conditions that existed at the end of the reporting period.

Where such an event would have a material effect on the financial statements, they must be changed before they are authorized by the directors.

Non-Adjusting Events

These are events that have arisen after the end of the reporting period. There is, therefore, no adjustment necessary to the financial statements. However, where the event is material, then the matter should be disclosed in notes to the accounts.

Proposed dividends are regarded as non-adjusting events and are, therefore, not shown in a statement of financial position. Information about proposed dividends is shown by way of a note to the accounts.

Illustration 5: Distinguishing between Adjusting & Non-Adjusting Events

The directors of MaxiForm Ltd prepared financial statements for the year ended 30 September 2014. The directors were due to authorize the publication of these financial statements on 31 December 2014.

The following events have come to the attention of the directors. The company's accountant has indicated whether the event is an adjusting or a non-adjusting event.

Event	Type
Fraud has been discovered which shows that the value of certain items in the financial statements is incorrect.	Adjusting
A major credit was declared bankrupt in November 2014 and will not make payment for goods sold in August 2014.	Adjusting
A warehouse was flooded in December 2014 resulting in significant damage to some of the company's products.	Non-Adjusting
In December 2014 the directors announced the decision to open a new store in July 2015.	Non-Adjusting
Some vehicles were in the process of being sold in September 2014. The actual selling price was agreed in October 2014.	Adjusting

Non-Adjusting → Notes

IAS 16 Property, Plant & Equipment

This standard prescribes the required treatment of tangible non-current assets i.e. they have a physical presence. Non-current assets should be recognized in accounts when the cost of assets can be measured reliably and when it is probable that future economic benefits will flow to the entity.

Non-current assets should be recorded at cost, which could include not just the purchase price but also other costs incurred in order to prepare the asset for use: delivery charges, installation

Adjusting events are the events that can be adjusted before directors reports can be published but they occur after preparations of financial statements.
Non-adjusting events are the events that cannot be adjusted & occur after the reporting period.

costs, import duties, etc. In the case of property, additional costs might include legal fees and architect's fees.

Non-current assets may be included in the financial statements using the cost model or the revaluation model.

- **The cost model:** the asset is recorded at its historical cost, less any accumulated depreciation to produce a figure that is called the carrying amount, i.e. the net book value.
- **The revaluation model:** the asset is recorded at its fair value which in most cases will be the market value if the asset were to be sold. In the case of land and buildings, however, the standard requires a professional revaluation to be carried out. The standard also requires that all of a category of a non-current asset must be revalued. For example, it would not permissible to revalue part of a company's property; all of the land and buildings would have to be revalued.

The standard clarifies that day to day servicing cost and repairs should be repeated as revenue expenditure to be charged to the income statement. Regular replacement of non-current assets, on the other hand, can be treated as part of the carrying amount.

Tangible Non-Current assets, with the expedition of lands, are subject to depreciation. The standard requires that the cost of an asset is systematically spread over its useful life using either straight line or reducing balance method.

The useful life of an asset must be determined by considering the following

- Expected usage of the asset.
- Expected physical wear and tear
- Obsolescence
- Legal limits imposed on the use of the asset

The standard uses the term 'derecoginition' to cover the situation where an asset is sold or is no longer providing any economic benefit to the company. The profit or loss on the disposal of any non-current asset is shown in the income statement.

The standard required published accounts to include a schedule of non-current assets. A schedule of non-current assets includes the following information

- Opening and closing costs
- Additions at cost
- Disposals at cost
- Revaluation adjustments
- Opening and closing accumulated depreciation
- Adjustments to depreciation arising from disposals
- Depreciation of the year
- The net book value of non-current assets at the beginning and end of the year.

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- Adjustments to depreciation arising from disposals
- Depreciation of the year
- The net book value of non-current assets at the beginning and end of the year.

Illustration 6: A Schedule of Non-Current Assets

Here is an example of a schedule of non-current assets.

Salz Ltd.

Schedule of Non-Current Assets at 31 March 2015

	Premises	Plant & Machinery	Equipment	Total
	$000	$000	$000	$000
Cost				
At 1 Apr 2014	1 400	450	110	1 960
Revaluation	600	-	-	600
Additions	-	80	30	110
Disposals	-	-	(20)	(20)
At 31 March 2015	2 000	530	120	2 650
Depreciation				
At 1 Apr 2014	70	225	32	327
Revaluation	(70)	-	-	(70)
Provided in year	-	53	18	71
Disposals	-	-	(16)	(16)
At 31 March 2015	-	278	34	312
Net Book Value				
At 31 March 2015	2 000	252	86	2 338
At 1 Apr 2014	1 330	225	78	1 633

IAS 36 Impairment of Assets

Means disability due to inefficiency.

The purpose of this standard is to ensure that non-current assets are not shown in financial statements at a value higher than what is called the recoverable amount. This term is used to mean the higher of an asset's fair value (the amount for which the asset could be sold less any selling costs) or value in use (the total of estimated future cash flows). An impairment loss arises where the recoverable amount is less than carrying amount (NBV). The standard requires any such loss to be recorded in the income statement.

The standard requires all non-current assets to be reviewed at the date of each statements of financial position in order to establish whether any impairment has occurred. This requirement includes goodwill.

Recoverable Amount
↓
Higher of — Fair value less cost of sales
— Value in use

Illustration 7: Calculating an Impairment Loss

At 31 December 2014 the following information was available about a company's motor vehicle.

Valuations	Definition	Amount
Carrying amounts	Net book value	$146 000
Fair value	Value if sold less any selling costs	$139 000
Value in use	Estimated future cash flows	$135 000
Recoverable amounts	Higher of fair value and value in use	$139 000

The recoverable amount for the motor vehicles at 31 December 2014 is less than the carrying amount by $7000 (i.e. $146 000 less $139 000). Therefore, there is an impairment loss of $7000 recorded in the company's income statement for the year ended 31 December 2014.

There are a number of signs that the impairment of a non-current asset may have occurred. For example, the asset:

- Is no longer in use
- Has been damaged
- Has become obsolete
- Has suffered a decline in its market value

IAS 30 Provisions, Contingent Liabilities & Contingent Assets

The purpose of the standard is to provide guidelines for ensuring that users of published financial statements are properly informed of the details concerning liabilities, contingent liabilities, providing & contingent assets.

- Arises from past events
- Is a current obligatory of the company
- Is expected to result in an outflow of resources (i.e. payment) on settlement.

So the purchase of goods on credit from a supplier will give rise to a liability of a known value (i.e. the amount stated on the invoice) and is shown on the statement of financial position.

Provisions are defined as a liability of uncertain timing or amount. In other words, it is known that an obligation exists but the amount can only be estimated.

The standard requires that provisions must be shown as liability in the financial statements where:

- The obligation arises from past events
- The amount of the obligation can be reliably estimated
- Payment is probable (a higher than 50 % chance)

A contingent/Conditional liability arises from past events when:

- The obligation is possible (less than 50% chance)
- The amount of the obligation cannot be reliably estimated
- The obligation is dependent on uncertain future events

In all cases a contingent liability is a possible obligation. The standard requires contingent liabilities to be disclosed in a note to the accounts. If the likelihood of a liability arising is regarded as remote then no disclosure is required.

A contingent asset is a possible asset that will arise from past events but only when certain future events occur which are not in the control of the business. Probable contingent assets must be disclosed as a note to the financial statements, but possible or remote contingent assets are not disclosed. As an example, a contingent asset would arise if a company was suing another business or individual and where, if the case was successful, the company would receive damage.

Illustration 8: Provisions, Contingent Liabilities & Contingent Assets

TXQ Wholesale Chemicals Ltd's financial year ended on 31 December 2014. In September 2014 an accident occurred involving some of the company's products was sued by a number of individuals.

Case 1: was decided in early December and the court requires the company to pay $18,000 to damages.

Case 2: had not been decided by 31 December 2014, but the company has been advised that it is probable the company will lose the case and be required to pay damages estimated at $15 000.

Case 3: will be brought before the courts in March 2015. The company has been advised that there is 25 percent chance of the company losing the case and being required to pay damages estimated at $25 000.

The treatment of each of these situations in the financial statements at 31 December 2014 will be as follows.

Case	Treatment in Financial Statements	Reason
1	Liability in statement of financial position	Current obligations which must be paid
2	Provision in statement of financial position	Probable liability; reliable estimate an hour
3	Contingent liability	Possible obligation (less than 50 per cent certainty) dependent an outcome of court case

IAS 38 Intangible Assets

An intangible asset is defined as an identifiable non-monetary asset without physical substance.

An intangible must have the following characteristics:

- It must be identifiable
- It must be controlled by the entity
- The entity must be able to obtain future economic benefits from the asset

Intangible assets may be purchased from an external source or might be self-generated.

Intangible assets include the following:

- Parented technology, e.g. computer software
- Trademarks
- Customer lists
- Marketing rights
- Franchise agreement

An intangible asset can be recognized when

- It is probable that the future economic benefits attributable to the asset will flow to the entity, and
- The cost of the asset can be reliably managed

When their criteria cannot be met then expenditure must treated as an expense in the income statement.

Research & Development Costs

Research expenditure arises from investigations that are conducted with the intention of gaining new scientific knowledge of a general nature. Research expenditure is regarded as an expense to be shown in the income statement on the grounds that it would be impossible to know whether any economic benefit will arise.

Development expenditure arises where knowledge is applied to the production of new or improved products. The treatment of development expenditure is based on the possibility that future economic benefit could arise for the business. Where this is the case development expenditure can be treated as an intangible asset (i.e. the expenditure can be capitalized) as long as:

- The project is capable of completion.
- The business intends to complete the project leading to use or sale
- The business can demonstrate how the project will generate economic benefit

The standard stipulates that the following cannot be regarded as intangible assets and that expenditure must be charged to the income statement:

- Internally generated brands, customer lists etc.
- Internally generated goodwill
- Startup costs
- Training costs

- Advertising & Promotional Costs
- Relocation Costs

Intangible assets must be valued at either cost or at valuation:

- **Cost:** The asset is shown in the statement of financial position at cost less accumulated amortization (i.e. depreciation) and impairment losses.
- **Revaluation:** The asset is shown in the statement of financial position at a revalued amount based on its fair value less accumulated amortization and impairment lossed.

Standard Costing

Standard Costing & Its Purposes

Standard costing is a technique that determines what a resource should cost or how long a process should take and then compares this standard with what actually happened. In this way, organizations are able to see how efficiently they are working by comparing what should have been achieved with what actually was achieved by calculating a variance.

Standards will be set for material costs and the amount of material that should be used, together with labor costs and the amount of time that a process should take.

Standard costing may be used in a variety of different businesses, but it is most commonly found in a manufacturing business. The most important uses of standard costing include:

- Acting as a control device so that managers can compare that standard with what actually happened and take corrective action where necessary.
- Assisting in the budget setting process.
- Providing information when quoting for a job.
- Providing targets and motivation for employees.
- Assisting in decision making for the future.
- Providing costs of inventory.

Types of Standard

There are different type of standards:

- **Ideal Standard:** This assumes that there will be no breakdown of machinery, that all employees will work at 100 % efficiency and that there will be no idle time, there will be no wastage and that the ideal price will always be paid for both materials and labor. Standards set on this basis is usually unrealistic.
- **Attainable Standard:** This recognizes that ideal conditions will not always exist, that there will be wastage of materials, employees will not be 100 % productive and machines may break down. As a result, realistic consideration is given to these facts in setting the standards.
- **Basic Standard:** This refers to a standard set and never reviewed. Standards should be constantly reviewed and amended when circumstances dictate.

The Advantages and Disadvantages of Standard Costing

Advantages

- By comparing standard costs with actual costs, managers are able to control the business more effectively.
- Productivity should improve as a result of increased motivation of staff having realistic and achievable targets.

- Budgets and forecasts can be prepared more easily due to the standard data having been prepared.

Disadvantages

- Standards must be reviewed regularly and if they amended if they are to be use.
- Collecting the necessary information and maintaining the system can be a time consuming and costly process.
- Standard costs are more suitable for businesses with established repetitive processes.

Investigating the Reasons for Variances

When variances have been calculated, managers will want to know why their budgeted figures are different to what actually happened. Variances on their own do not explain any differences, they only highlight areas that require further investigation by managers to enable corrective actions to be taken.

There are many possible causes for variances to arise and some of these are listed below.

Variance	Direction	Possible Cause
Material Price	Adverse	Higher prices changed by supplier. Unexpected delivery costs. Better quality materials No bulk discounts Scarcity of materials
	Favorable	Lower prices changed by suppliers Lower quality materials Unexpected discounts
Material Usage	Adverse	Lower quality materials Theft, deterioration, obsolescence Lower skilled workforce
	Favorable	More skilled, efficient workforce Efficient production processes Higher quality materials
Labor Rate	Adverse	Unexpected overtime Productivity bonuses Higher skilled workforce Pay increases
	Favorable	Lower grade workforce No overtime bonus paid

Labor Efficiency	Adverse	Lower quality material Lower skilled workforce Lack of training or supervision Machine breakdowns Bad working conditions
	Favorable	More skilled workforce Better quality materials Better training/supervision Advances in machine technology
Sales Price	Adverse	Respond to increased competition Respond to changes in fashion Respond to lack of demand
	Favorable	Lack of competition Better quality product so higher demand Market leader
Sales Volume	Adverse	Changes in trends/fashion Loss of market share Low quality resulting in lack of demand
	Favorable	Changes in trends/fashion Higher quality increasing demands Lack of supply by competitors

Ratios

Formula	Description
$\text{Gross Profit \%} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$	Atleast 2.5% is considered good. Higher shows that company has monopoly. Lower shows competition in the market.
$\text{Net Profit \%} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$	Atleast 10% is considered good. Higher means that company is keeping proper control on expense. Lower shows poor internal control.
$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$ $\text{Acid Test Ratio} = \frac{\text{Current Assets expect stock}}{\text{Current Liabilities}}$ Acid test ratio is known as quick ratio.	Current ratio should be between 1.9 – 2.9 Acid test ratio should be between 0.9 – 1.4 If the above ratios are below in limit, it means that company will not be able to pay liabilities on time. Above limits means that cost reserves are not properly used to generate more income.
$\text{Stock turn} = \frac{\text{Cost of goods sold}}{\text{Average Stock/Closing Stock}}$ (in times) $\text{Stock turn} = \frac{\text{Average Stock}}{\text{Costs of goods sold}} \left(\begin{matrix} \text{into 12 for months} \\ \text{into 52 for weeks} \\ \text{into 365 for days} \end{matrix} \right)$	The higher the better but generally 10 times is considered good. Low ratio shows that huge amount is stuck in closing stock and business might face cash shortage in future.
$\text{Debtors Days} = \frac{\text{Debtors}}{\text{Credit Sales}} \times 365$	Below 30 days shows the good credit policy. Above 30 days increases chances of bad debts.
$\text{Creditors Days} = \frac{\text{Creditors}}{\text{Credit Purchases}} \times 365$	Below 30 days is good. Above 30 days means that company is not paying liabilities on time, so it will be difficult to get more credit in future.
$\text{Fixed Assets to Sales} = \frac{\text{Fixed Assets}}{\text{Net Sales}} \times 100$	The lower the better
$\text{Sales to Fixed Assets} = \frac{\text{Net Sales}}{\text{Fixed Assets}} \times 100$	The higher the better
$\text{Return on Total Assets} = \frac{\text{Net Profit before interest}}{\text{Fixed Assets+Current Assets}} \times 100$ $\text{Return on Net Assets} = \frac{\text{Net Profit before interest}}{\text{Fixed Assets+Current Assets−Current Liabilities}} \times 100$	The higher the better are these ratios, lower ratios shows that assets are not properly utilized to generate more sales. Higher ratios shows that assets are properly utilized to generate more sales by the company.

Overall Analysis

The company having worst ratios needs to apply proper internal central system and should took for new markets and outlets to improve the ratios.

The company having good ratios should continue with its current activities in the future.

Manufacturing

Manufacturing account is prepared to calculate cost of production for the year.

Prime cost means addition/submission of all direct cost.

Prime cost = Direct Material + Direct Labor + Royalties + All Direct Expenses

Total Cost of Production = Direct Material + Direct Labor + Royalties + Factory Overheads + Opening Work in Progress – Closing Work in Progress

Factory Profits/Unrealized Profits

One of the main reason why businesses manufactures their own goods rather than purchase it from another buyer is because goods can be manufacture at a lower cost rather than outside purchase. The difference between cost of manufacturing and outside purchase is known as Factory Profit.
Factory Profit is usually calculated by adding up percentage in the cost of production for the year and calculate transfer price.

Factory Profit is a non-cash profit. The amount of closing inventory includes amount of factory profit in its valuation. This means we are going against prudence concept which disallows any expected profits. Therefore, we need to create a provision for any profit on unsold inventory. This provision for unrealized should be treated in the same way as any other provision. It is always calculated on inventory of finished goods. Any change in provision, if increase will be an expense and if decrease would be an income.

Variances

(1) Sales Variance

Sales Price Variance = Actual Units (Actual Selling Price – Standard Selling Price)
Sales ~~Value~~ Volume Variance = Standard Selling Price (Actual Units – Standard Units)
Total Sales Variance = (Actual Units x Actual Selling Price) – (Standard Selling Price x Standard Units)

(2) Material Variance

Material Price Variance = Actual Quantity (Standard Price – Actual Price)
Material Wage Variance = Standard Price (Standard Quantity for Actual Units – Actual Quantity)
Total Material Variance = (Standard Quantity for Actual Units x Standard Rate) – (Actual Quantity x Actual Rate)

(3) Labor Variance

Labor Rate Variance = Actual Hours (Standard Rate – Actual Rate)
Labor Efficiency Variance = Standard Rate (Standard Hours for Actual Units – Actual Hours)
Total Labor Variance = (Standard Hours for Actual Units x Standard Rate) – (Actual Hours x Actual Rate)

(4) Variable Overheads Variance = Fixed Variable Overheads – Actual Variable Overheads

Total Quantity Variance

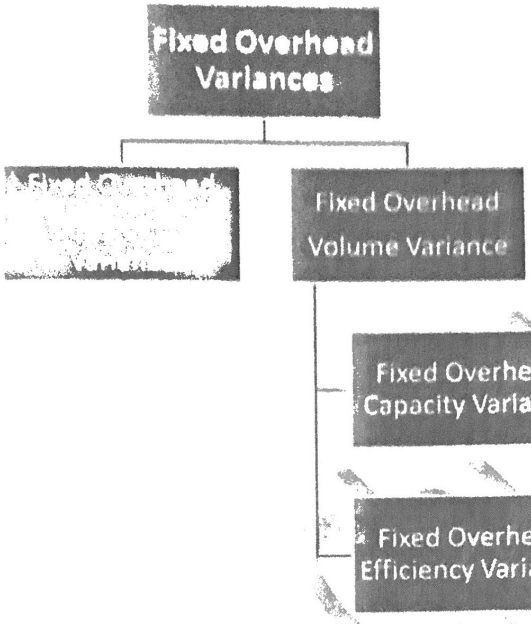
Quantity Variance = Standard Contribution Per Unit (Actual Units – Standard Units)

Quantity Variance = Flexible Budget Profit – Budgeted Profit

In reconciliation of master budget profit with actual profit all variances are included except sales volume variance.

In reconciliation of master budget profit with flexible profit all variance are taken except quantity variance.

Fixed Overhead Variances



(1) Fixed Overhead Expenditure Variance = Budgeted Overhead – Actual Overheads

(2) Fixed Overhead Volume Variance = OAR (Actual Units – Budgeted Units)

(3) Fixed Overhead Capacity Variance = OAR/Hour (Budgeted Production Hours –Actual Production Hours)

(4) Fixed Overhead Efficiency Variance = OAR/Hour (Flexed Production Hours – Actual Production Hours)

(5) Total Fixed Overhead Variance = Absorbed Overheads - Actual Fixed Overheads

Partnership Dissolution

Steps of Realization Account

(1) Written off all assets given in the statement of financial position (except cash at bank and Loan to Partner)

(1) Realization xx
Assets xx

(2) Write off all liabilities/provision in the Statement of the Financial Position (except loan from Partner and Bank Overdraft)

(2) Liabilities/Provisions xx
Realization xx

(3) Enter the proceeds Sale of Assets

(3) Capital A/c/Bank xx
Realization xx

(4) Enter the payments of liabilities & liquidation expenses

(4) Realization xx
Bank/Capital A/c xx

SI Post b/l of Capital Account from Statement of Financial Position.

SII Write off Current A/c balances of each partner against Capital A/c.

Debit Balance (Negative)	Credit Balance (Positive)
Capital A/c xx	Current A/c xx
Current A/c xx	Capital A/c xx

SIII Write off any loans or given or received from partner against Capital A/c.

Loan to Partner	Loan from Partner
Capital A/c xx	Loan to Partner xx
Loan to Partner xx	Capital A/c xx

SIV Reverse port all transactions from realization A/c and

Activity Based Costing

Introduction

The fundamental difficulty in costing is trying to establish an accurate total cost for a product. Knowing the cost of making a product is critical to the success of manufacturing organizing production.

- It forms the basis for deciding the selling price of the product.
- It helps manager to know whether the business is truly competitive and whether they need to focus on reducing costs.
- It helps managers know whether part of the business's output is no longer economic and should be abandoned.

It follows that if a business fails to accurately assess the cost of its products, either the business will make insufficient profits by charging too little for its products, or alternatively it will face a fall in demand because its prices have been set too high in what may be a very competitive market.

There is no difficulty concerning the allocation of direct costs of materials and labor to a unit of production. The problem that every costing technique attempts to address is how to ensure the absorption of overheads. Traditional methods use what may be called a simplistic approach by dividing overheads by the number of machine hours or labor hours to determine an absorption rate. These methods can provide rather poor quality information for managers, particularly as has been seen in times when overheads over increasingly formed a higher proportion of total costs.

Activity Based Costing (often called ABC) approaches the problem of overhead absorption with far greater precision, enabling a more accurate determination of the cost of making a product, leading to managers having the opportunity of setting a selling price which can produce the desired level of profits while also being competitive. ABC is useful in service industries as well as manufacturing industries.

The Concept of Activity Based Costing (ABC)

ABC is a relatively new technique that attempts to establish exactly what causes overheads to arise, i.e. what activities during the production process create overheads costs. These techniques then apportions these overheads to products but in proportion to the activities caused by the manufacture of each products but in proportion to the activities caused by the manufacture of each product: the more a particular product causes an overheads, the higher the amount of the overhead that will be allocated.

First activities are organized into groups of costs, referred to as cost pools. In other words a cost pool includes all the costs which are incurred when certain operation are performed with an organization. Cost pool often coincide with departments or service centres. The intention is usually to ensure cost pool deals with a specific activity as it improves the outcome in terms of accuracy of costing a product.

The technique establishes what are called cost drivers, i.e. activities that cause costs to arise (drive costs) within each cost pool.

Here are some examples of cost pools and cost drivers

Cost Pool	Cost Driver
Machine Set ups	Number of times a set-up is required for particular products.
Quality Checks	Number of quality checks required for particular products
Raw Material Supply	Number of transfers required from stores for particular products.
Transfer of Partly Finished Goods	Number of transfers from one machine to another required by particular products.

Advantages & Disadvantages of Activity Based Costing (ABC)

The main advantages of ABC are:

- It provides more reliable information for decision making.
- It is possible to set selling prices that will achieve the desired level of profit, because the cost of a unit of product is established with greater precision.
- Managers will become more aware of aspects of the production process that are closely scrutinized this technique. This may lead to closer attention being paid to looking for situations where costs can be reduced by being more efficient. This idea is sometimes called activity based management.

The main disadvantages are

- It is expensive to develop, implement and maintain system of ABC. This is because each aspect of the production process requires a detailed study to establish cost drivers. In the case of each product it will be necessary to determine the extent to which each cost driver affects production.
- ABC may require an extensive program of training.
- It is often the case that specialist consultants are required to set up the system.
- Operating a system is likely to be time consuming.

Oretex Ltd manufactures high quality garden seats. The company's total overheads for a year are $800 000. The company has available a total of 10 000 labor hours per year. The labor rate is $15 per hour. The company makes garden seats to order for a number of well-known distributers. The profit margin used by the company is 20 per cent on cost.

Recently the company received an order for 150 garden seats of a particular design from Abadi Ltd. It is expected that the order will require five labor hours per unit. The material will cost $60 per unit.

It has been established that the company has the following cost pools and cost drivers.

Cost Pool	Cost Driver	Overhead Cost Per Year	Forecast Annual Total	Order from Abadi Ltd.
Machine set ups	Number of times a set up required for particular products	$400 000	1 600 set ups	200 set ups
Inspections	Time taken to carry out inspections	$240 000	4 000 hours	75 hours
Packaging and Dispatch	Number of units	$160 000	3 200 units	150 units
Total Overheads		$800 000		

Metrex Ltd manufactures a product called 'twex'. The product comes in two forms: basic and deluxe.

The company has the following cost pools and has established that the cost drivers within each cost pool are as shown.

Cost Pool	Cost Driver	Overhead Cost Per Month	Information about each product
Machine set ups	Number of times a set up required for particular products	$21 000	Basic: 2 set ups per unit Deluxe: 4 set ups per unit
Quality Checks	Number of quality checks required for particular products	$4250	Basic: 1 quality checks per unit Deluxe: 3 quality checks per unit
Transfer of Partly Finished Goods	Number of transfers from one machine to another required by particular products	$22500	Basic: 3 transfers per unit Deluxe: 7 transfers per unit
Total Overheads		$47 750	

During January 2015 the company's production was:

	Number of Units
Basic	8000
Deluxe	3000

Investment Appraisal

Decision Criteria (In Order of Preference)

(1) **NPV:** Should be higher positive
(2) **Payback:** Should be less than the life of proper
(3) **IRR:** Should be more than cost of capital
(4) **ARR:** Should be more than existing interest rate

Notes

(1) Only revenue receipts and revenue expenditures are used in the calculation of cash flows.
(2) Improvements to the project should be considered as revenue expenditure.
(3) Assume all revenues and expenditures occur at year end. Revenues and expenditures at start of the year should be considered as part of end of previous year.

	IRR	
	8%	**20%**
NPV	+	+ IRR
NPV	+IRR	-
NPV	IRR-	-

Cost of Capital

This is the aggregate average of interest and dividends which the company pays on different sources of finance.

Cash Flows

(1) Cash Flow = Profit + Depreciation
(2) Cash Flow = Net Receipts – Net Payments
(3) Cash Flow = Sales – Variable Cost – Fixed Cost Excluded
(4) Cash Flow = Contribution – Fixed Cost Excluding Depreciation
(5) Cash Flow = Increase in Revenue Increase in Expenditure Excluding Depreciation
(6) Cash Flow = Payment to Outsiders – Cost Incurred on Depreciation Project

Note: The cost of investmental receipts and payments is applied in the calculation of cash flows.

Joint Venture Accounting

A Joint Venture arises when two or more business decide that it is in their interests to work together on a specific project or a series of project.

Features

(1) Participants will agree on profit/loss sharing ratio for the Joint Venture.
(2) Each participant keeps his/her own record. (for small scale)
(3) In case of large scale, a separate accounting system, a separate bank account kept/maintained properly.

Accounting Records for Joint Venture

(1) Each participant will set up a Joint Venture Account.
(2) Joint Venture Account will record all transactions which involves any proceeds from sales and amounts paid out of expenses.
(3) At the end of the project, profit or loss on Joint Venture will also be recorded in Joint Venture Account.
(4) Profit or Loss is calculated in a separate account, This account is known as memorandum account; in which all incomes and all expenses of Joint Venture are recorded irrespective of who received the proceeds or paid expenses.

There are four metho o capita investment to be considered:

- payback
- accounting rate of return (ARR)
- net present value (NPV)
- internal rate of return (IRR).

Payback

Payback is the time it takes for the cash inflow generated by a capital project to equal the cash outflow. Put more simply, it is the length of time that is required for the net cash inflows to cover the cost of investment: the shorter the payback period, the better. This is especially important if the business has cash flow problems or will have to borrow the money for the capital project, as the inflows can first be used to reduce the loan and then can be used for other potential income-earning purposes.

The advantages and disadvantages of payback

Advantages

- It is easy to calculate, simple to understand and widely used.
- It is used by many businesses as the need for quick cash flow has grown in importance in recent years. It should be remembered that a small manufacturer is unlikely to want to wait long for payback, whereas a large organisation can perhaps wait a little longer as it may have better access to cash flow or more reasonable rates of borrowing.
- It recognises that cash received earlier is preferable to cash received later in a project's life, as this reduces the risk involved in the project.
- It recognises the project that most benefits a business's liquidity.

Disadvantages

- It ignores the time value of money (e.g. $3000 received today does not have the same purchasing value as $3000 received in three years' time).
- It ignores the money made after the payback date (e.g. very little money might be made after the payback date or, alternatively, considerable money might be made after payback, but neither of these possibilities is considered).
- It ignores the fact that different projects have different patterns of cash flows. Some projects take longer to get off the ground yet generate more net cash flows over a longer period.
- It ignores the whole life of the capital project. The project may last a long time after the payback date, during which time large cash inflows are received and/or large outflows are paid out (for example expensive repairs for updating the capital project). These net cash inflows are ignored so that a capital project which makes significant net cash inflows over the long term is rejected in favour of a capital project with a quicker payback but which only makes smaller total net cash inflows.

The advantages and disadvantages of the ARR

Advantages

- It is fairly easy to calculate.
- The results can be compared with the present profitability.
- It considers the aggregate earnings of the project.

Disadvantages

- Like the payback method, it does not consider the time value of money.
- Again like the payback method, it does not recognise the timing of the cash flows.

Net present value (NPV)

In order to make a meaningful comparison between today's original cost of a capital project and its future net cash flows, it is necessary to use a discount factor to discount the value of future cash flows back to the present, so that they are equivalent in value to a cash flow now. This enables a like-with-like comparison to be made.

Using the net present value (NPV) method, the discount factor is called the cost of capital and is usually based on the weighted average cost of capital available to the business; that is, the average cost that is needed to raise the required amount of capital to fund the project.

The advantages and disadvantages of NPV

Advantages

- It considers the time value of money by using discount factors.
- It includes all of the net cash flows from the whole life of the capital project.
- Greater importance is given to earlier cash flows.

Disadvantages

- It is more complex to calculate than the payback and ARR methods.
- The life of the project is difficult to predict.
- Inflows and outflows are difficult to predict.
- The current cost of capital may change over the life of the project.
- It is based around selecting the relevant cost of capital, which may be difficult to determine with any reliability: the higher the cost of capital, the lower the NPV.

The advantages and disadvantages of the IRR

Advantages

- It considers the time value of money by using discount factors.
- It includes all the net cash flows from the whole life of the capital project.
- Greater importance is given to earlier cash flows.

Disadvantages

- It is more complex to calculate than the payback and ARR methods.
- The life of the project is difficult to predict.
- Inflows and outflows are difficult to predict.
- The current cost of capital may change over the life of the project.
- The calculation requires an element of trial and error to find a positive NPV and a negative NPV.
- It is not 100 per cent accurate.

Sensitivity analysis

Sensitivity analysis is an assessment of what could go wrong with a project. It measures the effect on one variable element in an appraisal if there is a change in another. For example, what would happen to cash inflows if a key customer pulled out? With capital investment appraisal, sensitivity analysis measures the effect on the decision to invest if there are changes to the cash inflows or outflows. Many capital investments involve large amounts of money and long periods of time. Forecasting for the life of the investment can, therefore, be difficult and potentially unreliable. Sensitivity analysis tries to ascertain how sensitive an investment is to changes that affect the forecasts by calculating different outcomes based on levels of risk.

Illustration 7: Sensitivity analysis and net present value

The directors of Hunterfeld plc are considering expanding their operations by opening a new plant. The capital investment will be $24m and a net present value analysis based on a discount factor of 10 per cent has shown a positive result of $3.2m. The finance director has asked for a sensitivity analysis based on the likelihood that the cost of capital could be higher or lower. The following summary has been prepared.

Discount factor	Risk	Net present value $m
8.5%	60%	5.8
9%	70%	5.3
9.5%	75%	4.8
10%	80%	3.2
10.5%	75%	1.1
11%	65%	(0.8)
11.5%	50%	(2.4)

The summary illustrates that the project is worth carrying out on the current assumption about the cost of capital and for a range of discount factors close to this assumption. However, there is 50–65 per cent chance that the cost of capital would be too high for the project to be worthwhile, causing a negative net present value.

Writing a report on a potential capital investment

You may be required to write a report on a potential capital investment project, assessing whether the business should invest in the project or not. When evaluating a capital investment project, you will be expected to give a balanced answer of the benefits and the limitations of investing in the project, considering both financial and non-financial factors.

Using the information on Jacklyn Ltd plus the additional information below it is possible to draw up a report on the potential financial and non-financial considerations of the investment project.

Additional information:

Jacklyn Ltd will have to borrow the money to pay for the new machine. This debt has to be paid back over three years. It is also expected that the workforce will have to be trained how to use the new machine. The carbon footprint is expected to be larger with this machine.

Report contents should include, among other factors, the following.

Financial considerations

- The payback and discounted payback periods are in a short period of time and before the debt has to repaid to the bank.
- The training of the workforce will cost time and money.
- There will be interest to pay on the debt. Was this included in the outflows? If not it is an extra cost that needs to be considered.
- Borrowing for this machine may reduce the opportunities for borrowing to fund other areas of the business (e.g. health and safety).
- How long is the machine expected to last – will it need replacing not long after the payback period?
- Can the machine be leased and not purchased? This may be a cheaper option which will mean that there is no need to borrow from the bank. This will aid cash flow as no interest charges are paid.
- The NPV is positive at a cost of capital of 10 per cent.
- The ARR is 50 per cent for this investment project.
- The IRR is higher than the cost of capital, so the project should be selected.

Non-financial considerations

- Some of the staff may feel threatened by the introduction of a new machine and may resist change by not wanting to be retrained.
- Staff may fear being replaced by the machine and may be demotivated by the lack of money put into other areas of the business.
- Staff may be concerned at the lack of liquidity within the business and may be concerned that there will be no future wage rises or productivity bonuses. This could cause a fall in morale.
- How much disruption will there be while the machine is being replaced?
- Can the production process continue without the machine being replaced? If not, then unless there are cheaper alternative replacement machines, this machine must be purchased.

The main features of consignment accounting are:

1 The consignor retains possession of the goods until they are sold by the consignee. This has important implications for the way consignment transactions are recorded.

2 It is usual for the consignor to send the consignee a pro-forma invoice. This document provides the consignee with detailed information about the goods in the consignment. Unlike an ordinary invoice it does not notify the consignee that any payment is due.

3 When the consignee sells goods an account sales is sent to the consignor. This document informs the consignor of the amount due from the consignee based on the sales proceeds less the consignee's expenses.

4 The consignee's reward for acting as an agent for the consignor is a commission based on the sale proceeds.

5 In some cases, the consignee agrees to take responsibility for any irrecoverable debts that may arise from the sale of goods. Where this arrangement is made, the consignee receives an additional reward called a del credere commission. Any irrecoverable debts that arise in these circumstances are a loss to the consignee and do not reduce the amount owed by the consignee to the consignor.

Consignor's accounting records

The consignor will use the following accounts to record transactions relating to a consignment:

- **Consignment outwards account:** to record the value of any goods sent to a consignee.
- **Consignment to (name of consignee) account:** to record all income and expenses relating to the consignment. The balance of this account represents the profit or loss on the consignment.
- **Consignee account:** the purpose of this personal account is to record the amount due from the consignee and settlements made by the consignee.

Notes:

1 The balance of the consignment account (E) represents a profit (or loss) on the consignment and is transferred to the consignor's income statement.

2 At the end of the consignor's financial year, the consignment outwards account is closed by transfer to the credit of the purchases account. This transfer ensures the consignor's income statement records the gross profit on goods sold other than on consignment as a separate record of profits on these goods appears in the consignor's books (the consignment account).

3 Any loss in the value of inventory is not recorded in the accounts. Any loss of inventory or damage to inventory will affect the profit on the consignment as the sales figure will be less than it would otherwise have been.

Consignee's accounting records

The consignee never owns the goods received on consignment, so the only accounting records required are as follows:

- **Personal account for consignor** to record the amount owing to the consignor
- **Commission account(s)** to record the income from the consignment.

Unsold inventory

It is highly likely that some part of a consignment will be unsold at the end of the consignor's financial year. This inventory is valued in strict accordance with accounting concepts. As a result, it is necessary to ensure that the value of the inventory takes account of not just the cost of the goods but also any expenses incurred that relate to those goods.

Ratios are used to analyse and interpret nanci data for the interested stakeholders. One of the most important groups of stakeholders for a limited company is the equity shareholders, who are particularly interested in the gearing, the general solvency of their business, and the investment ratios. Equity shareholders are interested in the return on their investment which is variable and dependent on: the business's performance; whether the business has enough cash to survive everyday trading; plus the market value of the shares and the degree of risk within the business.

Gearing

Gearing ratio

Gearing is the relationship between fixed cost capital and total capital. Fixed cost capital is made up of debentures and preference shares. Debenture holders receive a fixed rate of interest however profitable a

business is, and preference shareholders receive a fixed rate of dividends if there are sufficient profits available.

Available cash funds are first used to pay both the debenture interest and the preference dividends, with equity shareholders' dividends being dependent on the remaining levels of profit and the availability of cash funds. Gearing is, therefore, important to an equity shareholder as it measures the level of risk.

Gearing is calculated as:

$$\frac{\text{Fixed cost capital}}{\text{Total capital}} \times 100$$

Alternatively it can be expanded to:

$$\frac{\text{Non-current liabilities + Preference share capital}}{\text{Issued ordinary share capital + All reserves + Non-current liabilities + Preference shares}} \times 100$$

Using the information provided for Assessment Ltd, the gearing ratio is:

$$\frac{20\,000 + 10\,000}{136\,200 + 20\,000} \times 100 = 19.2\%$$

When the ratio is less than 50 per cent, the business has low gearing. This means that it has low borrowing or low fixed cost capital as a proportion of its total capital and long-term finance.

- 19.2 per cent of its total capital is provided by people other than ordinary equity shareholders
- 80.8 per cent of capital employed is provided by ordinary equity shareholders.

An equity shareholder is paid after both debenture interest and preference dividends have been paid. The higher the proportion of total capital that comprises these, the lower the amount of profit available for equity shareholders.

Therefore, it is not in the interest of equity shareholders to invest in a low-geared business, especially when profits are low. However, in times of high profits the amount paid to debenture holders and preference shareholders remains fixed, so ordinary shareholders will receive a greater return.

Investment in a low-geared business has less risk than that in a high-geared business. If a business is high-geared and becomes unable to pay its long-term debts, it is likely to be forced into liquidation by those long-term capital providers.

Also, a high-geared business may find it difficult to borrow further funds because of this risk. Banks may also be reluctant to lend further to such a business as they may feel that finance should be provided by the ordinary shareholders themselves.

Plus, the higher the gearing, the greater the likelihood of high interest payments, which will further reduce the profit available to be used for dividend payments to the ordinary shareholders.

Gearing ratio	Description	Borrowing	Debt	Risk
Greater than 50%	High gearing	High borrowing	High debt	High risk
Less than 50%	Low gearing	Low borrowing	Low debt	Low risk
50%	Neutral	Medium	Medium	Medium

To reduce gearing, a business can:

- issue new ordinary shares
- redeem debentures
- retain profits.

To increase gearing, a business can:

- issue debentures
- buy back ordinary shares in issue
- issue new preference shares.

Investment ratios

There are various ratios, particularly used by equity shareholders, which indicate how well a business is doing in relation to its shares.

Earnings per share ratio

This is the most frequently used investment ratio as it generally gives the best view of performance. Earnings per share (EPS) indicates how much of the company's profit can be attributed to each issued equity share.

It is used to compare:

- the results of one particular company over a number of years
- the performance of one company's equity shares against the performance of another company's equity shares

- the earnings against a return available from alternative investments.

Earnings are calculated as the profit after tax and after the deduction of preference share dividends. That is the earnings relevant to equity shareholders.

The ratio is calculated as:

$$\frac{\text{Profit after tax and preference dividends in cents}}{\text{Number of ordinary shares}}$$

From the results for Assessment Ltd:

$$\frac{3\,430\,000¢}{50\,000} = 68.6¢ \text{ (i.e. \$0.686)}$$

This means that each equity share earns 68.6¢ during the year. This does not represent actual cash in the form of dividends but the profit attributable to equity shareholders.

Price/earnings (P/E) ratio

The price earnings (P/E) ratio compares the market price of the shares to the earnings per share. It puts price into context as a multiple of earnings. It represents the number of years' earnings that investors are prepared to pay to purchase one of the company's shares.

The higher the ratio, the greater the demand for shares and so the greater the confidence investors have in the future of the business. A low P/E means that there is little demand for the shares. The ratio enables potential investors to assess whether the expected future earnings make the share a worthwhile investment.

The ratio is calculated as:

$$\frac{\text{Market price per ordinary share in cents}}{\text{Earnings per share in cents}}$$

For Assessment Ltd, if the market price of one equity share is \$3.43, then the P/E ratio is:

$$\frac{343}{68.6} = 5$$

This means that it takes five years to recover the market price of the shares with earnings. Buyers are paying five times the earnings to acquire shares in Assessment Ltd.

Any increase in the market price of an equity share will increase the ratio. Usually, an increase in the market price of shares is in response to an increase in the demand for the shares. Demand increases as confidence increases:

- a high P/E ratio indicates expected growth in the future
- a low P/E ratio indicates expected poor performance in the future.

Dividend yield ratio

Shareholders invest in businesses for two reasons:

- to gain an annual return on their investment in the form of dividends
- to make a capital gain when selling the shares with an increase in their market value.

Dividend yield measures the real rate of return of an ordinary share by comparing the dividend paid to the market price of a share. It shows the actual percentage return an investor can expect based on the current market price and so expresses the actual dividend as a percentage of the current market price of the share.

The ratio is calculated as:

$$\frac{\text{Total ordinary dividend paid}}{\text{Market price of all equity shares}} \times 100$$

For Assessment Ltd the market price was $3.43 per equity share. There are 50 000 shares, so the market price of all equity shares is:

$3.43 \times 50\,000 = \$171\,500$

The ratio is, therefore: $\frac{\$5600}{\$171\,500} \times 100 = 3.27\%$

This yield is low, especially given the high earnings per share. It appears that the earnings are not being passed on to the equity shareholders.

Another approach to calculate this ratio is:

$$\frac{\text{Declared rate of dividend} \times \text{Nominal value of equity shares}}{\text{Market price of ordinary shares}}$$

The dividend per share is $\frac{\$5600}{50\,000} = 0.112¢$

$0.112 \times (1/3.43) \times 100 = 3.27\%$

Dividend cover ratio

As ordinary dividends vary with the level of profit, an investor is often concerned as to whether a company will be able to continue to pay its current rate of ordinary share dividend in the future. Dividend cover gives this indication by comparing the amount of profit earned by an ordinary share with the amount of dividend paid, thereby giving the shareholder some idea as to the proportion that the ordinary dividends bear compared to the amount available for distribution to ordinary shareholders.

The ratio is calculated as:

$$\frac{\text{Profits available for ordinary dividends}}{\text{Ordinary dividend paid}}$$

For Assessment Ltd, the ratio will be: $\frac{34\,300}{5600} = 6.125$ times

This is quite high. A high figure is favourable as it suggests that the company will be able to continue to pay the current level of ordinary dividends even if profits fall. This may also be an indication that the directors operate a conservative approach to dividend payment as much of the profits are being reinvested back into the company.

This further confirms the results from the dividend yield, which showed that despite a high earnings per share, the dividend yield was low and, therefore, the earnings were not being passed on to the ordinary shareholder.

If the ratio had been low, this may be due to a more reckless dividend policy. A small reduction in company profits may then have an adverse effect on dividends in the future.

Dividend per share ratio

The dividend per share ratio indicates how much each ordinary share actually received as a dividend.

It is calculated as:

$$\frac{\text{Ordinary dividend paid}}{\text{Number of issued ordinary shares}}$$

For Assessment Ltd, the ratio will be: $\frac{5600}{50\,000} = 11.2¢$

Each ordinary shareholder, therefore, received 11.2¢ per share held. This should be compared to previous years to see if there was an improvement or decline in the rate paid out per share.

Working capital cycle ratio

The working capital cycle shows the length of time taken between making a payment for goods taken into inventory and the receipt of cash from the sale of inventory to the customers. Obviously the shorter the time the better! If there is a long delay between buying the inventory and then selling the goods and receiving the money from the customers, this can cause cash flow problems both within and outside the working capital.

There would be a lack of cash available to pay for everyday trading within the working capital (for example the purchase of inventory from suppliers) but also outside working capital (for example the purchase of non-current assets, the repayment of a loan, the payment of tax and significantly to an investor, the payment of dividends).

If the cycle is short, then the value of working capital to be financed from other sources will be lower.

The cycle can be shortened by the business:

- reducing inventory levels held
- speeding up trade receivables collection period
- delaying payment to trade payables.

The main reason that the cycle gets longer is that there is a quicker payment of trade payables.

The working capital cycle (in days) is calculated as either:

Trade receivables turnover (in days) + Inventory turnover (in days) – Trade payables turnover (in days)

or:

Average collection period + Inventory turnover (in days) – Average payment period

For Assessment Ltd, these individual ratios were calculated in AS Level Chapter 1.5.1 Analysis and communication of accounting information to stakeholders:

- Trade receivables in days = 32 days
- Trade payables in days = 109 days
- Inventory turnover in days = 52 days

The working capital cycle is, therefore:

$$32 + 52 - 109 = -25 \text{ days}$$

This means that the business is selling its inventory and collecting its money in from the trade receivables within 84 days but then delays payment to trade payables by a further 25 days.

The net working assets/revenue ratio

The net working assets/revenue ratio calculates the percentage of revenue that is net working assets, where net working assets are inventories + trade receivables – trade payables.

The ratio is calculated as:

$$\frac{\text{Net working assets}}{\text{Revenue}} \times 100$$

For Assessment Ltd, the ratio would be:

$$\frac{12\,500 + 16\,800 - 25\,500}{192\,000} \times 100 = 1.98\%$$

This shows that for every dollar of revenue, there are nearly two cents of net working assets, which appears to be low. In other words, the value of net assets is 1.98 per cent of each $1 of revenue. This could be improved upon.

The role of auditors

The law requires that limited companies have their accounts audited annually. (It should be noted that usually smaller companies are exempt from this requirement.) It is the shareholders who appoint the auditors, not the directors; it is to the shareholders that the auditors report every year. This legal requirement is designed to ensure that shareholders can have confidence that the stewards of the company (the directors) are giving them a true and fair view of the company's affairs, so that they are in a good position to make valid decisions about their investment.

The law requires auditors to do the following:

- Provide an independent check of the company's accounting records. In order for this to happen, it is important that auditors are not influenced in any way by the directors of the company.
- Carry out their duties objectively, so that their opinions and judgments are based on evidence that they have been able to verify during the course of their work.
- Ensure that the accounts comply with current accounting standards and the requirements of the Companies Acts.
- Ensure that the accounts provide shareholders with a true and fair view of the company's financial position.
- Ensure that the accounts are free from significant errors.

In order to carry out their responsibilities, the law requires auditors to be suitably qualified and to be given reasonable access to the company's accounting records and to have questions answered within a reasonable time.

Internal and external audits

The independent audit described above is sometimes referred to as an *external audit*. It is also usual for large-scale organisations to carry out *internal audits*. Internal audits are conducted by the organisation's own

The auditors' report

A company's annual report must contain a report from the auditors. Usually this is quite a short statement. The most important part of the report is the auditors' opinion that the financial statements:

- give a true and fair view of the company's affairs
- have been properly prepared in accordance with international accounting standards

IAS36 states that non-current asset should not be stated more than the higher value of fair value less cost to sell or value in use. This is known as recoverable amount. In this case Equipment has become obselete & his caring amount is 180,000 which is also it's recoverable amount. The value of 180,000 should be written off in the SOFP & should be shown as loss in Income statement.

IAS 2 & IAS8. Inventory should be valued at lower of cost or NRV according to Prudence cost. A business should consistencyly show the value of inventory so that comparisons can be made. The business should decrease it's profit by 42,000 because it has overvalued it's invantory by changing method & overvalued it's profit.

IAS10- Adjusting Event. The business should make an adjustment of 60,750 (81,000×75%) as bad debt recovered and adjust this as an Income in the Income Statement.

~~Opa~~ Profit for the Year	174,000
Less Impairment Loss	(180,000)
Less Inventory	(42,000)
Add Bad debt recovered	60,750
	12,750

The Qualified auditor report ~~mean~~ indicates that auditor is not satisfied by financial statemat giving true & fair view and it signals the financial statements are incorrect in the opinion of the extenal auditor. It may also put away potential investment of shareholders.

- comply with the requirements of the Companies Acts.

A statement like this, where there are no reservations, is called an unqualified report.

The report will also include the following:

- a note that clarifies the roles of the auditors and directors
- a statement about the scope of the audit which explains how it was conducted and confirming that the audit provides a sound basis for the auditors' opinion.

Where applicable the report will include any reservations the auditors may have, for example:

- if there are significant inconsistencies and/or errors in the financial statements
- if the financial statements are misleading in any way
- if the directors' report contains statements which are inconsistent with the auditors' view of the company's affairs.

Where a report contains reservations, it is referred to as a qualified report.

The role of the directors

Directors are appointed by the shareholders. Their main responsibilities to shareholders include the following:

- The maintenance of proper accounting records which enable financial statements to be prepared in accordance with the requirements of the Companies Acts and international accounting standards.
- Preparing annual financial statements, i.e.:
  - income statement
  - statement of changes in equity
  - statement of financial position
  - statement of cash flows.
- Taking care of the company's resources.
- Deciding the company's accounting policies.
- Implementing suitable accounting controls.
- Confirming that accounting standards have been followed.
- Supporting the work of auditors by providing reasonable access to accounting records and responding to questions raised.
- Preparing an annual report to shareholders on the way in which they have managed the company, i.e. how they have discharged their stewardship role (the directors' report).

The directors' report

The Companies Act 2006 requires that the directors of the company prepare a report at the end of the financial year for submission to the shareholders. The main contents of the directors' report are as follows:

- A statement of the affairs of the company, which may include non-monetary issues not highlighted by the financial statements.
- The principal activities of the company and any significant changes made during the year.
- Details of significant events that have occurred since the financial year end.
- Details of significant future events.
- A statement of employees' involvement in:
  - information
  - consultation
  - common awareness.
- Details of own shares purchased or charged.
- Non-current assets:
  - significant changes
  - any difference between book value and market value of land.
- Proposed dividends.
- Transfers to reserves.
- A statement of policy on:
  - the health and safety of employees
  - disabled persons.
- Details of political and charitable donations.
- Details of any directors serving during the year, including:
  - name
  - interests in the shares of the company
  - share options granted or exercised during the year.
- Details of the company's policy on the payment of suppliers.
- Information on research and development being carried out.

The role and duties of shareholders

Shareholders delegate the responsibility for running a company to the directors. It follows that the main duty of a shareholder is to elect directors. Through their voting powers shareholders can re-elect directors or remove them when not satisfied. In some situations shareholders may be asked at the annual general meeting to give consent to directors' actions (e.g. changing the name of the company).

It is important to note that shareholders do not normally have the right to interfere in the day-to-day management of the company, or have access to the company's accounting records (other than the annual report).

Shareholders are also required by law to appoint auditors except where the law gives exemption to small companies.

It is important to remember that directors may also be shareholders in a company.

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Shareholders are also required by law to appoint auditors except where the law gives exemption to small companies.

It is important to remember that directors may also be shareholders in a company.

Stewardship is the responsibility given to directors to allocate resources or manage resources on behalf of the shareholders.

Audit provides confidence of true and fair value of the financial statements to the shareholders which are prepared by directors.

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