**QUESTION ONE: SOCIAL CONSTRUCTION IN FINANCIAL REPORTING**

You are asked to read the following article available on Talis: Hines, R. D. (1988). Financial accounting: In communicating reality, we construct reality. Accounting, Organizations and Society, 13(3), 251-261. In this article, Dr Ruth Hines (1988) states: “…people only think of you as communicating reality, but in communicating reality, you construct reality.” Required: In your own words:

Discuss this reality construction in financial accounting; AND

Accounting constructs reality by deciding what information users should know– Accountants use financial figures to express their understanding of the measurements provided by companies. through the analysis of this information accountants determine the best way to communicate a companies’ position to users.

There is a level of subjectivity in financial reporting as IFRS and IPSAS are principal based (no clear cut rules acts more like a guide) hence the way information is recognised and communicated is based on the professional judgement of accountants (subjective).

For example the way certain items are recognised within the financial statement depend on the level of relevance and the quality of faithful representation an item is deemed to have by an accountant. Which means that the figures reported for assets, liabilities, revenue and expenses may vary depending on the judgement of the accountant preparing the account. As a result there will be variations in the financial statements, accounting ratio and the financial analysis etc. which are made based on these figures.

As external users are not intimately involved in the operations of a company – their perception of a company’s position is based on the information that accountants communicate.

On this basis, by communicating reality through financial reports – accountants construct reality as they are able to control a user’s perception of a company’s’ position based on the way they choose to communicate financial information.

(b) provide an example of subjectivity in financial reporting from any of the topics covered in class.

An example of this can be observed in Accounting conservatism where if there is uncertainty about incurring a loss an accountant will likely record the loss whereas if there is uncertainty in a gain the accountant will likely omit the gain – the level of uncertainty of the loss/gain is determined by the accountant. Therefore based on the accountants judgement of a true and fair view of the account they will decide if they will include or omit certain accounts.

This means that an accountant is able to create and convey the reality of an organisation’s performance subjectively as the addition or omissions of certain accounts can influence the perception of user’s perception of a company’s’ financial performance .

**QUESTION TWO: INVENTORIES**

You have been hired as a graduate financial accountant for Poneke Sporting Goods Limited. One of your first tasks is to carry out a physical stocktake of the company’s inventory. After performing this stocktake, you find that a considerable portion of the inventory is out of date merchandise for which there is limited demand. The inventory is currently all valued at cost on the balance sheet.

Required:

1. Explain how the inventory should be valued on the balance sheet in response to the findings of the stocktake.

Inventory is valued at either cost of acquisition or net realisable based on whatever value is lower in accordance to accounting conservatism. This is to ensure that as accountants we are communicating a true and fair view of an organisation’s performance.

Therefore on the balance sheet the inventory should be valued at its current realisable value -value of which it could be expected to sell for in accordance to its current state (“out of date” with “limited demand”) less the incremental costs associated with creating the sale. in response to the stock take regardless of what it was acquired for.

(b) If Poneke Sporting Goods Limited was to apply the correct measurement basis for inventory, determine the effect of the adjustment on:

**i. profit**

Applying the correct measurement basis for inventory will have a negative effect on net profits as it will create the additional expense of ‘mark-down’ which is debited to the value of the recorded value of inventory before the stocktake less the recorded value of inventory after the stocktake.

**ii. assets**

Apply the correct measurement basis for inventory will have a negative effect on total assets as it will decrease the current asset of inventory as this account will be credited to the value of the recorded value of inventory before the stocktake less the recorded value of inventory after the stocktake.

**iii. inventory turnover ratio**

inventory turnover ratio indicates how many times in an accounting period Poneke Sporting Goods Limited has sold its inventory and is calculated using the formula (Cost of Goods Sold ÷ average inventory )

Because the value of inventory has decreased, the value of average inventory will decrease.

As a result, the inventory turnover ratio will increase as Cost of Goods sold will be greater proportionately to the lower average inventory value.

**QUESTION THREE: HERITAGE ASSETS**

On 11 April 2017, the IPSASB published a Consultation Paper (CP) “Financial Reporting for Heritage in the Public Sector” for comment. The matters discussed in the CP are relevant for Tier 1 and Tier 2 New Zealand Public Benefit Entities (PBEs). The CP defines heritage items as “items that are intended to be held indefinitely and preserved for the benefit of present and future generations because of their rarity and/or significance”. The CP proposes that: 1. heritage items’ special characteristics do not prevent them from being assets for the purposes of financial reporting; 2. heritage items should be recognised in the statement of financial position if they meet the recognition criteria in the IPSASB’s Conceptual Framework; and 3. in many cases, it will be possible to assign a monetary value to heritage assets. This CP is the first step towards developing an accounting standard for Heritage Assets. The IPSASB required submissions from stakeholders (and the wider public) to be made by September 2017. In total, 40 submissions were received from various individuals and organisations. In accordance with standard setting due process, these submissions are all publicly available online at: <https://www.ipsasb.org/publications/financial-reporting-heritage-publicsector-0>

(scroll down to the bottom of the page). Three of these submissions have been made by New Zealand organisations:

• Submission 5: Chartered Accountants Australia and New Zealand (CA ANZ)

• Submission 18: Council of Australasian Museum Directors (CAMD)

• Submission 27: New Zealand Accounting Standards Board (New Zealand)

Required:

1. Discuss TWO issues relating to accounting for heritage assets that the IPSASB will have considered when preparing the CP (and will still need to consider going forward in the development of an “Exposure Draft” (draft standard), and ultimately standard); AND (10 marks)

-Are heritage assets, assets according to the NZ/PBE framework:

The requirements for an item to be classified as an asset is that, the item must provide future economic benefits, an entity must control the asset, control must have occurred due to past events.

Typically heritage assets lead to cash outflows (e.g cost of maintenance) however they do provide benefits (e.g service potential) but these benefits are not quantifiable as economic benefits (e.g cashflows)

Additionally it is hard to determine who has control over heritage assets (especially in cases where multiple departments oversees the asset), regulate access to public heritage (e.g parks) and if control can be determine there are often restrictions to use of the asset by external entities (e.g museum collection control by te papa is regulated by government restrictions).

As a result many heritage assets may not meet the criteria to be classified as an asset under the NZ/PBE framework which may cause inconsistent reporting.

-Method of valuation;

Certain assets do not have an active market (e.g treaty of Waitangi), historical cost may not applicable for assets attained in the past (e.g first banknote issued in NZ) and replacement cost of certain assets (e.g treaty of Waitangi) will be immeasurable due to their cultural and historical significance. This means that the valuation made by an independent valuer may not be representative of the true value of a heritage asset.

Alternative methods of valuation are contingent valuation method, travel cost method etc. but the issue of reliability pertains to these methods as there is no consistent way to measure the various types of heritage assets under a singular method.

(b) Provide an example of each of these issues (TWO examples in total) from any of the New Zealand submissions listed above.

Example 1

In submission 5 and 27, the issue of defining a heritage asset as an asset using the NZ/PBE framework is raised. In the context of New Zealand it would be difficult to classify Maori heritage assets (e.g Hei tiki) as an asset under the NZ/PBE framework as the one-dimensional concept of control does not align with Maori perception of being custodians of these heritage assets. This means that for any Maori heritage assets which may reside in an entities possession (e.g a museum) , the rightful ownership of the Maori heritage asset still belongs to the Maori people. This conflicts with the NZ/PBE framework definition of an asset as it would difficult to determine who controls the heritage asset.

Example 2

In submission 18, the issue with the method of valuation for heritage asset is raised. There is a concern of inconsistent valuation of heritage assets as the values assigned to a heritage asset is subjective to the valuer, additionally this value may be inconsistent with the value an audit agency may place on the heritage asset. Without an unambiguous agreed standard to valuing a heritage asset, there is no way to consistently and reliably place a monetary value on a heritage asset.

**QUESTION FOUR: BASIC FINANCIAL STATEMENT ANALYSIS**

Xero Limited is a New Zealand domiciled public technology company, listed on the Australian Stock Exchange (see <https://www.asx.com.au/asx/share-price-research/company/XRO>).

Xero offers a cloud-based accounting software platform for small and medium-sized businesses. The company’s annual report for the year ended 31 March 2020 is available at: <https://www.xero.com/content/dam/xero/pdf/about-us/xero-limited-annual-report-fy20.pdf>.

The General Purpose Financial Reports are found on pages 36 to 39 (with the notes to the financial statements on the subsequent pages).

The company’s annual report for the year ended 31 March 2019 is available at: <https://www.xero.com/content/dam/xero/pdf/about-us/xero-limited-annual-report-fy19.pdf>.

These documents will also be available on blackboard.

Required:

1. For the period ending 31 March 2020, evaluate Xero’s financial performance by calculating: i. TWO profitability ratios; ii. TWO financial gearing ratios; iii. TWO liquidity ratios.

**TWO profitability ratios**

**Return on assets (ROA):**

Average total assets = (970 318 000 + 1 153 688 000) ÷ 2

Average total assets = 1 062 003 000

= PROFIT ÷ AVERAGE TOTAL ASSETS

= 3 336 000 ÷ 1 062 003 000

=0.00314

=0.00314:1 (for every $1 of average total assets we are generating $0.00314 of profit)

**Profit ratio**

= profit ÷ sales

=3 336 000 / 718 231 000

=0.00464

=0.00464:1 (for every $1 of sales we are generating $0.00464 of profit)

**TWO financial gearing ratios**

**Debt to assets ratio**

  = Total liabilities ÷ total assets

= 731 322 000 / 1 153 688 000

=0.634

=0.634:1 (for every $1 of total assets we have 0.634 of total liabilities)

**Debt to equity ratio**

= Total liabilities ÷ total owner’s equity

= 731 322 000 / 422 366 000

= 1.73

= 1.73:1 (for every $1 of owner’s equity we have $1.73 of total liabilities)

**TWO liquidity ratios.**

**Current ratio**

= current assets ÷ current liabilities

=718 510 000 / 116 132 000

=6.19

=6.19:1 (for every $1 of current liabilities we have $6.19 of current assets)

**Interest coverage ratio**

= (earnings before interest and taxes) ÷ (interest costs)

=32 682 000 / (36277000-13432000)

=1.43

=1.43:1 (for every $1 of owner’s equity we have $1.73 of total liabilities)

b) Based on these ratio calculations, provide a brief assessment of Xero’s financial performance for the accounting period ending 31 March 2020.

**Profitability ratio**

**Return on assets (ROA)** - 0.00314:1

**Profit ratio -** 0.00464:1

-The return on asset (ROA) for Xero is relatively low at $0.00314 of profit for every $1 of average assets – this may mean that Xero is not effectively using Assets to generate profit

-The profit ratio is 0.0046:1 this is also worrying as for every $1 of sales Xero is earning $0.0046 in profit – this indicates that Xero may not be effectively controlling cost

To improve both return on assets and profit ratio Xero may consider reducing expenses such as sales and marketing (highest expense) to increase Net profits – however they should be careful of this as it may affect the number of subscriptions which could in turn decrease revenue and thus profit

**financial gearing ratios**

**Debt to assets ratio -** 0.634:1

**Debt to equity ratio -** 1.73:1

-The debt to asset ratio measures the amount of assets that are funded by creditors/lenders. Xero’s debt to asset ratio is 0.634:1 which is relatively low at $0.634 of total liabilities for every $1 of total asset. This indicate that the company is relatively stable as it has enough assets to cover its financial obligations.

-The debt to equity ratio is an indication of the amount of liabilities per dollar of equity. Xero’s debt to equity ratio is 1.73:1 which is relatively high as for every $1 of owner’s equity there is $1.73 of total assets. This indicate that the company is relatively risky as it is mainly funded by creditors and does not have enough equity to cover its financial obligations.

To improve the debt to equity ratio, Xero’s shareholder’s may chose to invest more funds into Xero – resulting in a lower amount of liabilities to owner equity ratio.

**Liquidity ratio**

**Current ratio -** 6.19:1

**Interest coverage ratio -** 1.43:1

-The current ratio measures an organisation’s ability to pay its debt when they fall due. Xero’s Current ratio is 6.19:1 which is relatively high at $6.19 of current assets for every $1 of current liabilities. This indicate that the company should be able to easily meet its short term obligations.

- Interest coverage ratio measures an organisation’s ability to meet its debt paying requirements ( finance expenses such as interest) when they fall due. Xero’s Interest coverage ratio is 1.43:1 which is relatively high at $1.43 of profit (before tax and finance expense) for every $1 of finance expense. This indicate that the company should be able to easily meet its debt paying requirements.

**QUESTION FIVE: CAPITAL INVESTMENT DECISIONS**

AlphaClave NZ Limited (ACL) produces sterile surgery kits for use in hospital operating theatres. Each kit contains a standard set of reusable operating equipment, such as scalpels and forceps, and of disposable items, such as swabs and gloves. Hospitals clean the reusable equipment before returning it to ACL, who then sterilise it before packing it into a new kit. Demand for ACL’s surgery kits has been steady over the last few years, but an opportunity for the company to expand has emerged with two large District Health Boards advertising tenders to supply them with sterile equipment. However, ACL’s production is nearing capacity and it would need to purchase a new sterilising machine to be able to meet the extra demand. Meg Matangi, ACL’s General Manager, has been investigating options and has proposed **purchasing a machine from the United States for $1,450,000**. However, it will cost a further **$40,000 to ship** it to New Zealand and **$20,000** to initially service and install it. If Meg’s proposal is approved by the directors at the next board meeting the project can begin immediately with the expectation that the new sterilising machine will start production at the beginning of the new financial year. **$10,000 has already been spent on research and trips to the United States to inspect the new machine and negotiate the purchase price <- sunk cost**



**Additional information:**

The **fixed costs include depreciation on the new machine of $304,000** a year. For the purposes of your calculations ignore taxation.

(a) Determine the **relevant** annual cash flows associated with establishing and operating the new sterilising machine.

>Initial cost= acquisition cost + shipping + installation

= 1450000+40000+20000

=1510000

>Contribution margin (Year 1-3)=sales price per kit -variable cost per kit

=75-60

=15

>Contribution margin (4-5)=sales price per kit -variable cost per kit

=80-65

=15

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Initial cost | (1510000) |  |  |  |  |  |
| CM (CM\*Sales volume) |  | 750 000 | 1 125 000 | 2 250 000 | 2 250 000 | 1 500 000 |
| Fixed cost - depreciation |  | (300000) | (300000) | (320 000) | (305 000) | (305 000) |
| Cashflow | (1 510 000) | 450 000 | 825 000 | 1 930 000 | 1 945 000 | 1 195 000 |

(b) Calculate the net present value (NPV) of the investment if the company uses a discount rate of 6 per cent.

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Cashflow (undiscounted) | Working (C/(1+r)^n) | PV of cashflow |
| 0 | (1 510 000) | (1 510 000)/(1.06)^0 | (1 510 000) |
| 1 | 450000 | 450000/(1.06)^1 | 424528.30 |
| 2 | 825 000 | 825000/(1.06)^2 | 734247.06 |
| 3 | 1 930 000 | 1930000/(1.06)^3 | 1620465.22 |
| 4 | 1 945 000 | 1945000/(1.06)^4 | 1540622.18 |
| 5 | 1 195 000 | 1195000/(1.06)^5 | 892973.52 |
| NPV |  |  | =$3 702 836.28 |

(c) Compared to the accounting rate of return and payback period methods of investment analysis, what are the benefits and risks of using the NPV approach?

**Benefits of using NPV:**

-Takes into consideration of timing of cashflow, inflation and risk whereas accounting rate of return and the payback period doesn’t take in time value of money into account (1$ today is worth less than $1 in the future)

-Reinforces long term thinking (emphasises contribution to wealth) by calculating return of investment after initial investment has been paid back whereas payback period methods reinforces short term thinking by only taking repayment time into account but not return of investment after its been paid back

-Uses cashflow over accounting profit which is more reliable than using the accounting rate of return analysis which depends on accounting profit as this can be manipulated depending on accounting policy used to calculate profit

- accounting rate of return counts depreciation twice (depreciation expense in average annual profit and expected residual value in average investment) – this means that the result of the accounting rate of return may be less reliable than the NPV approach which does not include depreciation

**Risk of Using NPV:**

-Unlike ARR, NPV only returns the cash return of the investment however it does not tell us the rate of return on our investment (when positive Rate of return is higher than time value of money but not how much it actually is)

-Unlike ARR and PP, NPV is difficult to calculate and harder to understand which may result in errors when using this method of analysis

-Unlike ARR and PP, the information for calculating NPV is not readily available as we need to calculate the cashflow for each period and know the discount rate

-Unlike ARR and PP, the analysis of NPV is dependent on discount rate – if we get this percentage wrong we may invest in a project which in analysis returns a positive net cashflow but in practice result in a negative net cashflow

-Unlike ARR and PP, NPV doesn’t take investment size into account, for example a smaller project may have a higher return but a lower NPV than a larger project, using NPV analysis the larger project will be more appealing regardless of rate of return due to its larger NPV

**QUESTION SIX: BUDGETS AND ACCOUNTING FOR SUSTAINABILITY**

EcoBags Limited produces a range of colourful reusable shopping bags made from ‘environmentally-friendly’ cotton fabric, which it buys directly from small producers in the developing world at prices that generally contain a premium above normal commercial rates. Janette McKenzie, EcoBags’ owner, believes that all organisations should operate sustainably and is wondering whether the company is doing enough to ensure good working conditions in its suppliers’ factories and for the farmers from which they purchase raw cotton. EcoBags’ production process involves the cutting of bag pieces from rolls of fabric and then sewing them into bags, with each bag using standard quantities of fabric. The budgeted and actual operating statement for May was as follows:



Additional information:

Cutting labour costs are fully variable, but 50% of sewing labour costs are considered to be fixed. There were no inventories of finished products or work in progress at the beginning or end of May

1. Prepare a flexed budget for May.

**EcoBags Limited**

**Flexed budget analysis for May 2020**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | $ | 800 bags | Activity variance |  | 850 bags | 850 bags | Revenue and spending Variance |  |
|  | Per bag | Planning Budget |  |  | Flex Budget | Actual  Results |  |  |
| Sales | 20 (16000/800) | 16000 | 1000 | F | 17000 | 16150 | 850 | U |
| Fabric | 2.5 (2000/800) | 2000 | 125 | U | 2125 | 3570 | 1445 | U |
| (V)Labour cutting | 3 (2400/800) | 2400 | 150 | U | 2550 | 2380 | 170 | F |
| (V) +(F) Labour sewing | 3.5(2800/800) | 5600 | 175 | U | 5775 | 5865 | 90 | U |
| Fixed overheads |  | 2300 | 0 | - | 2300 | 2150 | 150 | F |
| Net profit |  | 3700 | 550 | F | 4250 | 2185 | 1395 | U |

***Note: Labour sewing expense is a mixed cost (both fixed and variable) we assume that the fixed proportion of the expense remains constant at $2800 in both the flexed and actual budget.***

b) Prepare a reconciliation of the actual profit to the budgeted profit of the business for May.

**EcoBags Limited**

**Variance reconciliation for May 2020**

|  |  |  |
| --- | --- | --- |
| Planning budget profit |  | 3700 |
| Activity Variance | 550 F |  |
| Revenue variance | 850 U |  |
|  |  |  |
| **Spending variance** |  |  |
| Fabric | 1445 U |  |
| (V)Labour cutting | 170 F |  |
| (V) + (F) Labour sewing | 90 U |  |
| Fixed overheads | 150 F |  |
| **Total** | 1515 U | 2185 |
| **Actual profit** |  | **$2185** |

c) For each of the variances listed in the reconciliation in (b) above, suggest TWO possible causes.

Total variance between flexed budget net profit and planning budget net profit = $550 favourable

-mainly made up from the additional 50 bags of wool sold which generates a favourable $1000 variance in revenue

-however additional units of production means greater variable cost, the additional bags of wool generated a total of $450 in unfavourable variance

-overall this resulted in a $550 favourable activity variance

Total variance between flexed budget revenue and actual budget revenue = $850 unfavourable

Potential reasons:

-This may be caused by promotions EcoBags (e.g buy 2 get 1 free) may have offered during the month of May which would effect sales price per unit and thus actual budget revenue

-The additional 50 units sold over planned budget may be from a special order, Eco bag may have offered a discounted price for the bulk order which effect sales price per unit and thus actual budget revenue

Variance between flexed budget fabric variable expense and actual budget fabric variable expense=$1445 unfavourable

Potential reasons:

-This may be caused by a change in the amount of fabric needed per bag (e.g initial budget underestimated amount of fabric required to produce bag)

-This may be caused by a change in the price of the fabric roll purchased (e.g bad cotton season increasing price of cotton fabric)

Variance between flexed budget Labour cutting expense and actual budget Labour cutting expense=$170 favourable

Potential reasons:

-Employee’s may be more productive requiring less hours of work per bag (e.g new cutting technique making cutting more efficient)

-This may be caused by more skilled workers being hired (resulting in less overtime being required to cut a bag)

Variance between flexed budget Labour sewing expense and actual budget Labour sewing expense=$90 unfavourable

Labour sewing expense is a mixed cost (both fixed and variable) we assume that the fixed proportion of the expense remains constant at $2800 in both the flexed and actual budget.

However, if there are variances within the fixed proportion of this expense it is likely out of the department’s control and may be caused by outside influence (e.g new safety regulations, increased supervisor salary)

Potential reasons:

-More overtime being required due to increased number of bags being produced

-Increase in minimum wage

Variance between flexed budget fixed overheads and actual budget fixed overheads =$150 unfavourable

Fixed cost shouldn’t typically change – may be outside of department’s control

Potential reasons:

-increased hours of maintenance staff

-increased property rent

d) Janette McKenzie has asked for your help addressing her concerns over the working conditions in EcoBags’ suppliers’ factories and the farmers from whom they buy raw cotton. **She has heard about Sustainability Accounting and Integrated Reporting but is unsure what these terms mean or how they could help her persuade her suppliers to provide their workers with better work conditions**. **Write a short email to Janette** that includes the following:

i. An outline of what Sustainability Accounting involves;

ii. An outline of the Integrated Reporting Framework and its purpose;

iii. ONE reason why she may want to consider obtaining counter (or shadow) accounts as well as reports produced by the suppliers themselves.

To: EcoBags

From: Marina Suban Na Ayudtaya

Subject: Sustainability Reporting

Hello Janette,

In this email I will address your queries about what Sustainability Accounting involves, Integrated Reporting Framework involves and its purpose and why you may want to consider obtaining counter (or shadow) accounts as well as reports produced by the suppliers themselves.

Sustainability accounting involves disclosure of non-financial information about a firm’s performance in regards to their progress on the sustainability initiatives they have committed themselves to (goal’s companies set to mitigate the negative externality of their operation on society and the environment). From the sustainability report made by EcoBag’s suppliers, you will be able to observe if the company’s performance and actions align with their sustainability initiatives (better working environment for workers).

Sustainability accounting can be found in the Integrated Reporting Framework.

There are two frameworks to Integrated reporting (general and specific approach), both of which have the purpose of conveying the value a company generate over time (monetary, social and environmental). The information found in these reports will allow you to make an informed decision on how you want to progress with EcoBag’s relationship with EcoBag’s suppliers, as you will be able to determine if they are making appropriate progress towards sustainable/social initiatives and observe how they are allocating their resources. If they are not providing sufficient working conditions based on their integrated reports, as a stakeholder, you are able to hold the firm accountable and negotiate a solution with EcoBag’s suppliers.

You should be aware that in the integrated reports EcoBag’s suppliers have discretion in what they report. This means that they will likely make their company appear as appealing as possible in the eyes of a stakeholders by manipulating or omitting information. Counter Accounts are prepared by external stakeholders and often challenge the official reports of an organisation, by including accounts which may not be appealing to stakeholders but present a fairer and more representative view of a company’s activities. You may want to consider obtaining counter (or shadow) accounts as well as reports produced by EcoBag’s suppliers, as the reports made by the suppliers of Ecobag, may not reflect the realistic working conditions of their employees.

Regards,

Marina Suban Na Ayudtaya