Assessment Schedule – 2008

Scholarship Accounting (93203)

Evidence Statement

QUESTION ONE

(a) Transaction disclosure

Transactions between related parties occur in the normal course of business. Common examples of transactions with related parties include: sales; purchases; transfers of items of property, plant and equipment; services either provided or received (for example accounting, management, engineering and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns).

The special relationship inherent between involved parties creates potential conflicts of interest, which can result in actions that benefit the people involved, as opposed to shareholders. For example, in the infamous Enron scandal, related-party transactions with “special-purpose entities” were used to help the company misreport its accounting numbers.

There is potential for distorted or misleading financial statements in the absence of adequate disclosure.

There have also been instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party.

Related parties, such as controlled entities, principal shareholders or management, can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure. They can even defraud the company by transferring funds to conduit-related parties and ultimately to the perpetrators.

The nature of control relationships could result in operating results or financial positions significantly different from those that would have been achieved in the absence of such relationships, regardless of whether there were transactions between or among the related parties.

(b) Corporate governance

In theory, a listed company is owned by its shareholders. However, in reality, there are often too many shareholders to run a company efficiently themselves and they may not have the expertise or desire to run a company anyway. In that case, running the company is delegated to its directors. The duty of a director is to run the company in a manner that maximises long-term returns to shareholders.

Corporate governance provides an indication of whether directors are maximising returns to shareholders and that business risk is set at a reasonable level. A director on a board of directors should not become dominant to the detriment of shareholders. Remuneration of directors should be reasonable.

Good corporate governance is an important tool for promoting investor confidence and enhancing the transparency and accountability of listed companies.

Corporate governance practices are not designed to prevent corporate failures, but rather to assist in prudential and risk management, and give company boards a framework with which to make decisions.

A balance between regulation and cost of compliance must be met. This is achieved through disclosures made in the annual report.

Investor confidence in public companies is essential to the functioning of the global economy.

Full and fair disclosure of information to investors is fundamental to good corporate governance. Issuers should provide information, in periodic and annual reports, and by continuous disclosure, to enable investors to make informed decisions when raising capital. The information provided to investors should be relevant, reliable, complete, unbiased and timely.

QUESTION TWO

(a) Financial analysis

(i) Return on average shareholders' funds

The return on average shareholders' funds reflects the returns to the reporting entity's ordinary shareholders. It is calculated after deducting the returns paid to loan providers (interest) and other providers of equity capital (preference shareholders). The return on average shareholders' funds is a function of profitability (after interest and taxes) that belongs to ordinary shareholders. It measures the return on the owner's investment in the reporting entity. As a rule – the higher the return, the better off the owners are.
Over the six-year-period, this return has shown mixed results. The year-on-year changes are shown below.

Return on average shareholders' funds	2007	2006	2005	2004	2003
	–5.0%	–10.9%	18.6%	1.2%	5.6%

(ii) Financial stability

Equity to total assets has trended upwards during the six years to 51.79 per cent in 2007. Overall, the trend suggests that *Fletcher Building Limited* has increasing debt levels. While a 50 per cent debt to asset ratio is usually considered normal, industry averages would provide a more accurate indication of an appropriate debt to asset ratio. This would not be considered too risky in light of increasing profitability.

	2007	2006	2005	2004	2003	2002
Equity to total assets	51.79	43.91	39.02	37.60	35.13	36.12

EBIT to interest expense has increased over the period, although during the 2005 to 2007 period it has remained in a fairly narrow 7.94× to 8.08× range. In 2007, *Fletcher Building Limited* still had 7.08 times profits to cover interest repayments. This ratio does not appear to be cause for concern.

	2007	2006	2005	2004	2003	2002
EBIT to interest expense	8.08×	7.67×	7.94×	6.13×	5.61×	4.12×

(iii) Dividends and earnings returns

Earnings per shares (cents) shows an increasing trend over the six-year period. In the first period, earnings per share increased by 13.2 per cent, 22.8 per cent in 2003, peaking at 37.8 per cent in 2004 before dropping off to 19 per cent in 2005. This is a steady and acceptable increase in earnings. The year-on-year increase is shown below.

	2007	2006	2005	2004	2003
Earnings per share	25.3%	4.8%	39.3%	28.3%	60.7%

Dividends per ordinary shares (cents) shows an increasing trend in line with earnings per share. They have increased by 221.4 per cent from 2002, indicating good growth.

Dividend cover provides users with an indication of the cushion that exists to meet future dividends, should earnings deteriorate. Read in conjunction with the earnings per share and dividends per share, this ratio is consistent over the period. There is no concern here.

	2007	2006	2005	2004	2003	2002
Dividend cover	2.26	2.03	2.45	2.28	2.28	1.92

A ratio of 2 or higher is usually considered safe (in the sense that the company can well afford the dividend), but anything below 1.5 is risky. If the ratio is under 1, the company is using its retained earnings from a previous year to pay this year's dividend.

Discussion and recommendation

It is important that investors assess the comparative attractiveness of the various alternatives. Is it better for investors to sell their shares and invest the proceeds elsewhere? At this stage, the evidence would suggest retain the investment in *Fletcher Building Limited*. If they had adequate savings, then the acquisition of a motor vehicle may provide certain short-term "feel good" benefits. At a return of 5 per cent, a fixed deposit would

provide an interest return of $3 250 per annum. This is a safe return and can be expected each year of the fixed deposit.
The increasing trend in returns on shareholders' funds, sound equity to total assets, EBIT to interest expense ratios, and dividend and earnings returns, suggest that this is a safe investment. Note that there is insufficient information to adequately consider liquidity issues. Business is growing, as evidenced by previous and future acquisitions (see subsequent events). The ability to raise additional equity in the future would not seem to be a problem, given the $321 million raised in 2007 through additional shares. As can be seen from the 2007 annual report of *Fletcher Building Limited*, the amount of dividends paid each year has been steadily increasing. However, there is a possibility of an increase in the share price, which may result in a greater return. The growth of the company and its international profile, as well as a relative value of $6 billion, does, however, make it a takeover target.

(b) Consolidated Statement of Cash Flows

The Consolidated Statement of Cash Flows shows the cash movements that took place in the organisation over a particular period of time. They are summarised into operating, investing and financing activities. Overall, the net cash position has increased from a favourable $49 million in 2006 to $332 million in 2007. *Fletcher Building Limited* is generating positive cash flows from operating activities ($560 million in 2006 and $483 million in 2007). This decrease in operating activities has come about because of higher payments to suppliers and employees. There has been an increase in cash outflows from investing activities in 2007 compared with 2006, with the amount increasing from $266 million in 2006 to $346 million in 2007. Although the acquisition of property, plant and equipment is slightly higher in 2007 ($15 million) than 2006, the bulk of the increase can be attributed to the acquisition of subsidiaries. Net cash from operating investing activities was reduced through the sale of fixed assets / receipt of cash from insurance payout for Taupo plant. Cash inflows from financing activities amounted to $55 million in 2007, compared with cash outflows of $305 million in 2006. The inflows resulted from the issue of shares of $321 million, while $201 million worth of debt was repaid in 2006. Other significant outflows from financing activities in 2007 were the repurchase of capital notes for $50 million (2006, $14 million) and the payment of $169 million of dividends (2006, $128 million). *Fletcher Building Limited* does not have any immediate solvency problems as its overall cash position has increased by $287 million. However, this has been earmarked for the acquisition of *Formica Corporation*. In light of the acquisition of *Formica Corporation* for $US700 million, some shareholders may view the increased levels of dividend payments with some concern.

QUESTION THREE

(a) CVP Income Statement for 2008

Sales	5 208 000
Variable expenses	
Cost of goods sold ($1 505 000 + 1 147 400 + 902 000)	3 556 400
Selling expenses	241 600
Administration expenses	110 000
Total variable expenses	3 906 000
Contribution margin	1 302 000
Fixed expenses	
Cost of goods sold	749 000
Selling expenses	295 000
Administration expenses	156 000
Financial expenses	65 000
Total fixed expenses	1 265 000
Profit	37 000

(b) Break-even points

(i) In units

2.8X = 2.1X + 1 265 000
0.7X = 1 265 000
X = 1 807 143

(ii) In dollars

X = 0.75X + 1 265 000
0.25X = 1 265 000
X = 5 060 000

(c) Margins

(i) Contribution margin ratio per unit

Sales – variable costs = contribution margin
$5 208 000 – $3 906 000 = $1 302 900
$2.80 – $2.10 = $0.70

Contribution margin per unit
$0.70 ÷ $2.80 = 25% or 0.25

(ii) Margin of safety

Actual sales – break even sales = margin of safety
$5 208 000 – 5 060 000 = $148 000
$148 000 ÷ $5 208 000 = 2.84% or 0.028

(d) Decision-making

Contribution margin per unit informs management that for every bottle of juice sold, *Newage Fruit Juices Limited* will have $0.70 ($1 302 000) to cover fixed costs and contribute to profit. Since fixed costs are $1 265 000, *Newage Fruit Juices Limited* will have to sell 1 807 143 bottles of Naturally Wild before there is any profit. Above that volume, every bottle sold will contribute $0.70 to profit. This means that if 1 900 000 bottles are sold, profit will be [(1 900 000 – 1 807 143) × $0.70] = $65 000 ($64 999.90).

The contribution margin ratio means that for every $1 worth of sales, $0.25 is available to apply to fixed costs and to contribute to profit.

The contribution margin is helpful in determining the effects of changes in sales on profit. To illustrate, if the management of *Newage Fruit Juices Limited* want to know the effect of a $40 000 increase in sales, they could multiply $40 000 by 25 per cent to establish that profit will increase by $10 000.

The margin of safety is a financial ratio that informs businesses of the percentage of sales it can afford to lose before it cannot cover its overheads.
In this example, *Newage Fruit Juices Limited* can afford to lose only 2.84 per cent of its sales before it cannot afford to cover its expenses (before the owner's salary) and therefore is not making a profit, nor providing a return on effort to the owner through the payment of a salary. The higher the percentage, the better – 2.84 is a very low margin of safety.

The margin of safety is important as it enables businesses to plan actions to deal with the entry of new competition, as well as the pricing policies of the competition. By calculating the margin of safety, business owners can know immediately what percentage of sales they can afford to lose in sales to the competition. If the result is low (say anything less than 20 per cent), the business is at high risk from increased price competition or new players coming into the marketplace.

(e) Sales required to earn a profit of $350 000

Required sales = variable costs + fixed costs + target profit
0.75X + $1 265 000 + $350 000
0.25X = 1 615 000
= $6 460 000
Or 2 307 143 units

(f) Modernising production facilities

Modernising production facilities and reducing the number of employees changes the proportion of fixed and variable costs. Fixed costs will increase because of higher depreciation charges and perhaps higher finance costs if there were additional borrowings. Variable charges will decrease because of the reduction in the number of employees. Other variable costs, such as electricity, may also decrease if the new production facilities operate more efficiently.

QUESTION FOUR

Advertising expense capitalised

Candidates should consider the definition of assets and the three characteristics in the definition.

Definition of asset: a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Three key characteristics:
- there must be a future benefit
- the reporting entity must control the future economic benefits
- the transaction of another event giving rise to the reporting entity's control over the future economic benefits must have occurred.

The definition refers to the benefit, not the source. For example, cash is an asset because of the benefits that flow as a result of the purchasing power it generates.

Control refers to the capacity of a reporting entity to benefit from an asset and to deny or regulate the access of others to that benefit.

Has the transaction occurred?

The advertising will generate benefits, but does the entity control those benefits?

Based on the discussion, is advertising an asset? No.

Candidates should discuss the issue of expenses and consider the following definition: an expense is a decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to the distributions to equity participants.

Has there been a reduction in the assets or equity of the reporting entity? Is the advertising an expense? Yes.

Rent paid in advance

Consider the three characteristics of the definition of an asset as they apply to rent paid in advance. Based on the characteristics, does it constitute an asset? Yes.

Does the rent paid in advance constitute an expense? No.

QUESTION FIVE

Foamcannon Limited **Balance sheet at 31 March 2008**		
	Notes	**NZ$**
LIABILITIES		
Non-current Liabilities		
Long-term loan ($1 800 000 – $90 000)	**1**	1 710 000
Debentures	**2**	1 600 000
		3 310 000
Current Liabilities		
Bank overdraft ($4 700 + $580 000)		584 700
Trade and other payables	**3**	277 900
Tax payable		23 800
Current portion of long-term loan		90 000
		976 400
Total liabilities		4 286 400
Net assets		5 066 400
EQUITY		
Contributed equity	**4**	3 939 000
Retained earnings	**5**	(180 600)
Revaluation surplus	**6**	1 308 000
Total Equity		5 066 400

***Foamcannon Limited* – Notes to the Financial Statement**		
		NZ$
1. Long-term loan		
Mortgage bond		1 800 000
Less: Current portion of mortgage		90 000
		1 710 000
The mortgage bond, which is repayable in equal instalments of $90 000, is secured over the company's land. The interest rate is 9% per annum.		
2. Debentures		
Debentures		1 600 000
The debentures are due for redemption on 30 June 2020. They are secured by a floating charge over the remainder of the company's assets not covered by the mortgage bond (see Note 1). Interest is charged on the debentures at 7% per annum.		
3. Trade and other payables		
Accounts payable		234 900
Employee benefit expense payable		2 500
Interest accrued		40 500
		277 900
4. Contributed equity	**Number of shares**	
Balance at beginning-of-year	1 600 000	3 040 000
Additional shares issued during the year	550 000	1 303 000
Shares bought back during the year	(200 000)	(404 000)
Balance at end of year	1 950 000	3 939 000
5. Retained earnings		
Balance at beginning of year		(339 900)
Profit for the year ($375 800 – $40 500)		335 300
Share buy-back		(176 000)
Balance at end of year		180 600
6. Revaluation surplus		
Balance at beginning of year		708 000
Revaluation during the year		600 000
Balance at end of year		1 308 000
The equity section could also be shown in the columnar format.		

QUESTION SIX

Refugeone Limited **Income statement for the year ended 31 March 2008**		
	Notes	**NZ$**
Revenue	**1**	747 460
Cost of sales		529 840
Gross profit		217 620
Other income	**2**	26 910
Distribution costs		44 695
Administrative expenses		141 665
Operating profit	**3**	58 170
Finance costs (6 890 + 1 680)	**4**	8 570
Profit before tax		49 600
Tax expense		15 380
Profit for the year		34 220

***Refugeone Limited* – Notes to the Income Statement**	
1. Revenue	
Sales	747 460
2. Other income	
Interest received	14 410
Dividends received	12 500
	26 910
3. Operating profit	
Operating profit has been determined after taking into account the following:	
Classification of expenses by nature	
Changes in inventory of finished goods	6 260
Raw materials and consumables used	344 960
Depreciation expense	25 500
Employee benefits costs	134 100
Electricity	46 200
Rent expenses	94 200
Advertising	12 070
General expenses	22 620
Other expenses	
Auditors' remuneration	
Audit fee	9 440
Consulting services	4 340
Taxation services	1 890
	15 670
Bad debts	7 170
Donations	5 950
Loss on disposal of property, plant and equipment	1 500
4. Finance costs	
Interest paid	8 570

Journal entries and workings

Note: These entries are not required and are provided for completeness.

Dr		Donations	5 950	
	Cr	Other expenses		5 950
		Record donations expense for the year		
Dr		Interest Expense	1 680	
	Cr	Accrued Interest		1 680
		Record interest owing at balance sheet date		
Dr		Rent expense	3 800	
		Accrued expenses		3 800
		Accrual of rent owing at balance sheet date		
Dr		Bad Debts	3 610	
	Cr	Accounts Receivable		3 610
		Write-off debt owed by bankrupt debtor at balance sheet date		

Calculation of cost of sales

Opening Inventory	33 700
+ Purchases	344 960
– Closing Inventory	27 440
	351 220

Allocation of expenses

	Cost of sales	**Selling and distribution expenses**	**Administration expenses**
Cost of sales	351 220		
Advertising expenses	–	12 070	–
Auditors' remuneration	–	–	15 670
Bad debts			7 170
Depreciation	10 200	2 550	12 750
Electricity	4 620	9 240	32 340
Loss on disposal of PPE			1 500
General expenses			28 570
Rent	56 520	14 130	23 550
Staff salaries	107 280	6 705	20 115
	529 840	44 695	141 665