Assessment Schedule – 2009

Scholarship Accounting (93203)

Evidence Statement

The suggested solutions in the assessment schedule are only indicative of the sort of answers that were accepted.

QUESTION ONE

Suggested solutions

The solution should consider the following issues:

(a) **Purchase price**

(i) Asset defined

An asset is 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.

(ii) Recognition criteria

An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

An asset is not recognised in the balance sheet when expenditure has been incurred and when it is not probable that economic benefits will flow to the entity beyond the current accounting period. In this situation, an expense must be recognised.

Issues to consider here include:

(1) Could the economic benefits generated by the player be measured? Will the signing of the player result in increased spectators at matches, in turn providing increased gate takings, increased revenue from the sale of merchandise, and additional revenue from sponsors? Additionally, can this increase in revenue be reliably measured?

(2) Whether the club can control the player – that is, keep the player from being taken by other clubs. Although the contract may prevent the player from playing for other clubs, it is questionable whether the club can actually control the player.

Candidates were also given full credit where they used the expense recognition criteria to account for the purchase price of Ronaldo.

(b) **Salary**

Recognition

Expenses are recognised in the income statement when a reliable measure can be made of a decrease in future economic benefits related to a decrease in an asset or an increase of a liability. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or of a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment). The salary is paid, and that results in a decrease in the asset cash. Candidates should recognise that the large amount paid for the salary does not influence its recognition.

QUESTION TWO

(a) The first part is very wide but should consider what sustainability is from a corporate perspective.

Corporate social responsibility reporting is similar in concept to health, safety, environmental (HSE) reporting. Sustainability reporting by entities satisfies the legitimate social, economic and environmental and governance expectations of its stakeholders. As such, it emphasises social matters such as ethical labour practices, training, education and diversity of work force and corporate philanthropic initiatives. It is part of a dialogue between a reporting entity and its stakeholders that provide information on the reporting entity's activities that assists to legitimise its behaviour, educate and inform, and change perceptions and expectations.

Sustainability reporting provides information on an entity's environmental, social and economic performance and impacts and their initiatives for improving their performance in these areas. Note that the term "sustainability" does not mean that a company or other entity is "sustainable" or that it will continue in existence for any specified period of time.

(b) **Importance of reporting**

Non-financial issues

(i) Improving / maintaining reputation

The corporation's communicating its sustainability efforts to a wide audience enhances the corporation's reputation and brand as a good corporate citizen. This behaviour can contribute to attracting and retaining customers and employees and can build greater support among key stakeholders. If a reporting entity behaves as a good corporate citizen, sustainability reporting will increase reputation. Once a reporting entity has a good reputation, sustainability reporting preserves the reputation.

(ii) Third party

The corporation receives third-party authentication for its sustainability (social, economic, environmental, and governance efforts). There are benefits to the reporting entity if the programme is rated highly and included in indexes.

For investors interested in ethical investments, reporting entities such as Sanford may be able to access additional investment if Sanford is included on sustainability indexes.

Reporting may assist entities to understand their own strengths and weaknesses. This will assist in identifying potential opportunities for improvement, and benchmarking themselves against competition through the response process and research firm feedback. This, in turn, can lead to continuous improvement in efficiency and management, resulting in lower costs and potentially increased access to capital.

Reporting can reaffirm the company's "license to operate" within the communities in which it conducts business, as a stakeholder that contributes to the social, economic, and environmental aspects of that community. In addition, participation provides an avenue for third-party authentication of company efforts (including in relation to peers), providing outside legitimacy that can boost a company's reputation and brand recognition and that could potentially appeal to new clients, employees, and other stakeholders.

Reporting can improve stakeholder engagement and bolster the reputation of the reporting entity.

Financial benefits

Financial benefits can flow from many of the non-financial benefits. Better internal knowledge and the resulting innovation in management systems and metrics can provide the opportunity to increase operational efficiency and significantly lower costs. Higher-quality employees and a larger customer base may be attracted to the company, and as a result competitiveness and market position can be strengthened – ultimately leading to higher shareholder value. In addition, pursuing corporate sustainability allows companies to address a range of risks; and with improved risk management, the access to and cost of capital becomes more favourable.

Certain investors value corporate sustainability programmes that are linked to improved risk management when making investment decisions.

Being listed on a sustainability index can be a proxy for a company's ability to proficiently manage certain risks. In addition, by providing the financial, NGO, media, and other communities with access to corporate sustainability information, research firms and disclosure initiatives enable a broad array of stakeholders to make informed decisions about this aspect of companies' risk profiles.

QUESTION THREE

Classified by Nature	**Classified by Function**
• The classification of expenses by nature is the simpler of the two methods to apply, so is suitable for smaller reporting entities.	• Preparing an income statement according to the function of expenses requires the entity to allocate the costs according to their function as part of cost of sales, such as the costs of administration or distribution expenses. A problem associated with this method is that the allocation of the expenses may be arbitrary and involve considerable professional judgement.
• Expenses are simply aggregated in the income statement according to their nature. (This means that expenses such as depreciation, purchases of materials, transport costs, employee benefits, and advertising costs are combined and not reallocated among various functions of the entity such as administration expenses, cost of sales, distribution expenses, or marketing expenses).	• Classifying expenses by function requires them to be allocated according to their function (for example, as part of cost of sales, distribution or administration expenses). This method of disclosing expenses can provide more relevant information to users than the classification of expenses by nature.
• For certain entities, especially those in the service industry, it has been argued that the classification of expenses by nature provides more relevant and reliable information than classification by function.	• When the function of expenses method is used to prepare an income statement, the nature of expenses such as depreciation and amortisation expense and employee benefits expense must also be disclosed in the accompanying notes, as information on the nature of expenses is useful in predicting future cash flows.
• Compared to the classification ‘‘by function,’’ the format ‘‘by nature’’ is a disaggregated format, with more items disclosed, and the related risk of revealing potential inside information to competitors. The trade-offs between positive and negative aspects of disaggregation are an issue.	• In the “by function” income statement, some other useful balances may be reported, such as: gross margin, operating income, etc. Then, though, the gross margin figure may be distorted because of the allocation of expenses to cost of sales.
• The “by nature” format provides a higher degree of detail by disclosing more expense items and is, therefore, more useful for decision-making.	
• An advantage of preparing an income statement by nature is that it facilitates the calculation of figures useful in financial statement analysis, particularly when it comes to comparative analysis of company performance. It can assist with the calculation of balances such as: o **commercial margin**: the difference between the sales of merchandise and the cost of merchandise sold o **value added**: the increase in value resulting from the enterprise’s activities over and above that of goods and services provided by third parties and consumed by the firm. Value added represents the wealth created by the enterprise that will be distributed to various stakeholders, including employees, lenders, governments, and shareholders o **gross operating income**: The EBITDA, or gross operating income, measures the wealth created by the enterprise from its operations, independent of its financial income and expenses, and charges for depreciation and amortisation. This indicator helps in evaluating the firm’s short-term ability to create wealth since it is not affected by long-term strategic decisions regarding financing (ie capital structure) and capital investment policies. The ratio of EBITDA to sales (or accounting “production”) is often	

considered to be a measure of the "business profitability" of the firm, thereby allowing inter-company comparisons. EBITDA is also considered to be a proxy for cash flow generated by operations and operating income. (Operating income or profit represents the results of the firm's normal and current activity without taking into account financial and unusual elements).	

Neither format of income statement is necessarily superior to the other, and neither provides a complete understanding of the reporting entity. One element that arises in comparing income statements ‘‘by nature’’ with income statements ‘‘by function’’ is that the transformation of an income statement ‘‘by nature’’ to an income statement ‘‘by function’’ (and vice-versa) is a very difficult exercise because it requires knowledge of information (concerning inventory, detail of personnel expenses, etc.) typically not available to the analyst.

QUESTION FOUR

(a) EBITDA = earnings before interest, taxes, depreciation, and amortization. EBITDA provides an indication of earnings a company would have made if it didn't have to pay interest on its debt or taxes, or take depreciation and amortization charges. EBITDA is intended to be an indicator of a company's financial performance. However, EBITDA leaves out so many expenses that it cannot be used as a measure of profitability. Additionally, it is not a proxy for cash flow, as it does not measure actual cash flowing into a company. As a ratio, EBITDA neglects the following considerations: variations in accounting methods; cash required for working capital; debt payments and other fixed expenses; capital expenditures.

A better measure would be cash flow from operations. Alternatively, investors could consider free cash flow (FCF). In its simplest form, FCF is simply cash from operations, minus capital expenditures. This has the advantage of capturing at least three items EBITDA leaves out: receivables, inventory, and capital expenditures (property, plant, and equipment).

(b) This is a general and very broad question. A number of issues could be considered here, including consolidated financial statements report aggregated results. Certain eliminations and adjustments are made when preparing consolidated financial statements.

Restaurant Brands Limited comprises KFC, Pizza Hut, Starbucks and Pizza Hut Victoria. Each segment has different levels of performance that cannot be determined from consolidated financial statements.

The consolidated income statement provides an indication of the aggregated financial performance of these dissimilar entities, and the consolidated balance sheet is a combination of many balance sheets with different financial structures. There is a loss of information.

Unprofitable subsidiaries can be hidden in the consolidated financial statements.

Alternatively, candidates may structure along the lines of the advantages and disadvantages of using segment reporting.

Advantages	**Disadvantages**
• Highlights the performance of various parts of an organisation • Providers of segment information demonstrate greater accountability, and this could provide an effective way to attract additional funds. • Segment data enables users to better predict future profitability for the organisation. • Reporting segment data is often necessary if profit streams are very dissimilar	• Additional costs to the reporting entity of providing the information that may result in a reduction in distributions • Competitors have access to information on profitability of reporting entity. Competitors in the pizza business are primarily private companies so do not have to issue annual reports to the public. They are, however, able to access Restaurant Brands annual reports and get some ideas on profitability / returns of different segments. • Losses in segments can lead to pressure to dispose of loss making segments. Plenty of publicity in additional resources dealing with this. (From an investor's perspective, this is also an advantage.)

(c) The analysis could be split into three areas (Note that ratios shown below are indicative only of those that were acceptable. Reporting period end totals rather than average totals were used to provide three sets of comparative figures.)

Profitability analysis
Return on total assets (Net income / total assets)
Return on equity (Net income / Equity)
Profit margin (Net income / turnover)

Return on assets
The return on assets provides an indication of the profit a reporting entity generated for each $1 invested in assets. The ROA provides a gauge of the asset intensity of a business.

Return on assets measures a company's earnings in relation to all of the resources it had at its disposal (equity plus short- and long-term borrowed funds). Thus, it is the most stringent and excessive test of return to shareholders. If a company has no debt, the return on assets and return on equity figures will be the same.

Return on assets is normally calculated by (Net income + after tax interest costs) – average total assets. A variation is EBIT – average total assets

	2008	2007	2006
KFC	50.98	45.64	70.46
Pizza Hut	(7.46)	(3.77)	11.62
Starbucks	6.89	4.70	5.74

Issues to consider:
Impairment on PPE of Pizza Hut Victoria – also consider issues in additional resources provided.

Return on equity
Return on equity provides an indication of the profit a reporting entity earns in comparison to the total of assets disclosed on the statement of financial position.

A reporting entity that has a high return on equity is more likely to be one that is capable of generating cash internally. However, this needs to be compared to industry standards for confirmation. This is, however, difficult because the majority of local large takeaway firms are privately owned.

	2008	2007	2006
KFC	65.32	63.70	95.18
Pizza Hut	(8.14)	(4.32)	13.47
Starbucks	7.86	5.20	6.36

Profit margin
EDIT to sales provides an indication of whether fixed costs are too high for sales volume.

	2008	2007	2006
KFC	13.73	12.12	13.62
Pizza Hut	(4.52)	(2.32)	6.53
Starbucks	2.65	2.35	3.29

Could consider the increasing turnover of KFC, the decreasing turnover of Pizza Hut and increasing turnover of Starbucks over the period.

Activity ratios

Asset turnover (sales / total assets)

Asset turnover
The asset turnover ratio calculates the total revenue for every dollar of assets a company owns.

Asset turnover provides a measure of a reporting entity's efficiency in using its assets. As a general rule, the higher the ratio, the better the entity is in using its assets. Care should, however, be taken in comparing the same industry. The higher a company's asset turnover, the lower its profit margin tends to be [and vice versa].

	2008	**2007**	**2006**
KFC	3.70	3.76	5.18
Pizza Hut	1.65	1.63	1.78
Starbucks	2.60	2.00	1.74

Capital structure

Total debt to equity ratio (Total liabilities / total equity) (an alternative could have been total debt / asset)
Interest coverage ratio (EBIT / Interest) (only for the group)

Total debt to equity

It indicates what proportion of equity and debt the company is using to finance its assets. High debt to equity ratio suggests that company has been using debt to finance growth. Total debt to equity ratio should be examined in the light of industry the company operates in.

	2008	**2007**	**2006**
KFC	28.15	39.57	35.08
Pizza Hut	9.05	14.41	15.92
Starbucks	14.07	10.59	10.85

Interest coverage ratio
Indicates how easily the entity can repay interest on outstanding debt. The lower the ratio the more difficult it may be for the company to repay its debt. Ideally this should be above 1.5. Ratios of below 1 should be viewed with caution.

	2008	**2007**	**2006**
Restaurant Brands	3.44	(0.31)	4.94

All above ratios should be discussed in context as follows: trends, consideration of material provided in the resource book and any other relevant information.

	KFC			Pizza Hut NZ			Starbucks Coffee			Pizza Hut Victoria			Other			Consolidated		
	2008	2007	2006	2008	2007	2006	2008	2007	2006	2008	2007	2006	2008	2007	2006	2008	2007	2006
$NZ000's																		
Business segments																		
Store sales revenue	199 116	182 673	171 812	71 419	79 721	89 086	33 012	31 252	27 865	6 275	25 068	27 589				309 822	318 714	316 352
Other revenue													447	415	389	447	415	389
Total operating revenue	**199 116**	**182 673**	**171 812**	**71 419**	**79 721**	**89 086**	**33 012**	**31 252**	**27 865**	**6 275**	**25 068**	**27 589**	**447**	**415**	**389**	**310 269**	**319 129**	**316 741**
Concept EBITDA before general and administration expenses	36 602	31 216	29 630	4 676	5 060	11 812	3 852	3 645	3 946	–	(2 931)	(330)	–	–	–	45 130	36 990	45 058
Depreciation	(5 833)	(4 922)	(3 846)	(4 244)	(3 686)	(2 890)	(1 941)	(1 722)	(1 463)	–	–	(1 838)	(398)	(443)	(961)	(12 416)	(11 062)	(10 998)
Amortisation	(552)	(186)	(41)	(235)	(183)	(154)	(211)	(206)	(208)	–	–	(158)	(285)	(289)	-	(1 283)	(575)	(561)
Segment result (EBIT) before non-trading	**28 293**	**24 171**	**23 883**	**(1 149)**	**(417)**	**7 044**	**676**	**733**	**1 342**	–	**(3 921)**	**(3 548)**	**(6 680)**	**(7 264)**	**(8 130)**	**21 140**	**13 302**	**20 591**
Impairment on property, plant and equipment	(326)	(840)	(429)	(209)	(502)	(786)	–	–	(425)	–	(5 862)	(3 681)	–	–	–	(535)	(7 204)	(5 321)
Impairment on intangibles	–	–	–	(1 187)	(1 142)	–	–	–	–	–	(702)	(3 434)	–	–	–	(1 187)	(1 844)	(3 434)
Other non-trading	(507)	(1 188)	(105)	(686)	213	(436)	200	–	–	(681)	(3 371)	(167)	(689)	(965)	246	(2 363)	(5 311)	(462)
Segment result	**27 460**	**22 143**	**23 349**	**(3 231)**	**(1 848)**	**5 822**	**876**	**733**	**917**	**(681)**	**(13 856)**	**(10 830)**	**(7 369)**	**(8 229)**	**(7 884)**	**17 055**	**(1 057)**	**11 374**
Operating profit (loss) (EBIT)																17 055	(1 057)	11 374
Net financing costs																(4 953)	(3 409)	(2 310)
Net profit (loss) before taxation																12 102	(4 466)	9 064
Income tax (expense)																(3 087)	912	(3 867)
Net profit (loss) after taxation																9 015	(3 554)	5 197
Net profit after taxation excluding non-trading																**11 044**	**6 542**	**12 326**
Segment assets	53 868	48 516	33 136	43 312	48 990	50 085	12 707	15 595	15 972	22	437	8 387	1 298	1 770	331	111 207	115 308	107 911
Unallocated assets																1 762	2 426	1 379
Total assets																**112 969**	**117 734**	**109 290**
Segment liabilities	11 833	13 754	8 605	3 596	6 170	6 880	1 567	1 493	1 564	1 287	3 530	3 799	2 241	1 628	1 239	20 524	26 575	22 087
Unallocated liabilities																56 608	58 528	43 293
Total liabilities																**77 132**	**85 103**	**65 380**
Capital expenditure including intangibles	12 024	22 028	9 408	2 421	5 310	8 186	616	1 715	2 942	–	97	1 272	335	1 345	530	15 396	30 495	22 338
EQUITY (Calculated)	42 035	34 762	24 531	39 716	42 820	43 205	11 140	14 102	14 408							35 837	32 631	43 910
Ratios																		
Profitability ratios																		
Return on assets	50.98	45.64	70.46	(7.46)	(3.77)	11.62	6.89	4.70	5.74							15.10	(0.90)	10.40
Return on equity	65.32	63.70	95.18	(8.14)	(4.32)	13.47	7.86	5.20	6.36							47.59	(3.24)	25.90
Profit margin (EBIT/sales)	13.79	12.12	13.62	(4.52)	(2.32	6.53	2.65	2.35	3.29							5.50	(0.33)	3.59
Activity/efficiency ratio																		
Asset turnover	3.70	3.76	5.18	1.65	1.63	1.78	2.60	2.00	1.74							2.75	2.71	2.89
Capital structure																		
Total debt to equity	28.15	39.57	35.08	9.05	14.41	15.92	14.07	10.59	10.85							2.15	2.61	1.49
Times interest (EBIT/interest																3.44	(0.31)	4.94

QUESTION FIVE

Suggested solution

Clown Ltd Statement of financial position at 31 March 2009		
	Notes	**2009 NZ$**
ASSETS *Non-current assets*		
Property, plant & equipment	1	1 946 400
Current assets		
Cash		15 120
Trade and other receivables ($ 77 880 – $3 894)	2	73 986
Inventory	3	179 400
Total current assets		268 506
Total assets		2 214 906
LIABILITIES *Non-current liabilities*		
Long-term loan	4	648 000
Current liabilities		
Trade and other payables	5	20 160
Current portion of long-term loan	4	72 000
Income tax payable		18 720
Total current liabilities		110 880
Total liabilities		758 880
NET ASSETS		1 456 026
EQUITY		
Contributed equity		1 080 000
Retained earnings ($223 920 – $3 894)		220 026
Revaluation surplus		156 000
Total Equity		1 456 026

Clown Ltd – Notes to the 2009 Financial Statement

	Land NZ$	Buildings NZ$	Plant & Equip NZ$	Total NZ$
1. Property, plant and equipment Year ending 31 March 2009				
Opening book value	1 020 000	727 680	288 000	2 035 680
Additions	–	–	–	–
Disposals	–	–	–	–
Depreciation		17 280	72 000	89 280
Net closing book value	1 020 000	710 400	216 000	1 946 400
Balance at 31 March 2009				
Cost or valuation	1 020 000	864 000	480 000	2 364 000
Accumulated depreciation		153 600	264 000	417 600
Balance at 31 March 2009	1 020 000	710 400	216 000	1 946 400

Depreciation is calculated on the straight line basis at the following rates:
Plant and equipment 15% per annum
Buildings 2% per annum

The land is mortgaged as detailed in Note 4.

2. Trade and other receivables		
Accounts receivable		77 880
Allowance for doubtful debts (@5%)		(3 894)
		73 986
Fair value of accounts receivable		73 986
3. Inventory		
Inventory comprises:		
Raw materials		26 910
Work in progress		71 760
Finished goods		80 730
		179 400
4. Long-term loan		
Long-term loan		720 000
Less: current portion of long-term loan		(72 000)
		648 000
The long-term loan is secured over the company's land (see Note 1). Interest on loan is charged at 8% per annum.		
5. Trade and other payables		
Accounts payables		20 160

***Journal Entries**:*

Dr		Bad debts	3 894	
	Cr	Allowance for doubtful debts *(to provide for doubtful debts @ 5% of accounts receivable)*		3 894
Dr		Long-term loan	72 000	
	Cr	Current portion of long-term loan *(to record portion of loan due in next 12 months as a current liability)*		72 000

QUESTION SIX

(a) relevant range – the volume of output for which the fixed costs will not change. The fixed costs of $960 are fixed at this amount only over the output of 0 units to 4 500 units per month. If any more units are to be produced in a month, then the fixed costs would increase. This is due to the fact that the business's capacity would need to be extended – cooking space, cooking facilities, etc.

(b) direct materials – all the materials that can be specifically identified with the production of the product. The direct materials are the materials that are directly used in the baking of the biscuits, the biscuit ingredients (flour etc) and the (plastic) wrapping.

(c) To be drawn manually.

(d) (i) Margin of safety = total sales – Break-even sales (Break-even = (fixed costs ÷ contribution margin)
Contribution margin per unit: SP – VC [$1.50 – (0.22 + 0.63 + 0.12) = 53 cents]

($1.50 × 2 800) – ($1.50 × 2 170) = $945

Margin of safety is the excess of (budgeted) actual sales over the break-even volume of sales. The greater the margin of safety, the less sensitive the firm is to sudden falls in revenue. From Chris's perspective, the margin of safety is reasonably high for the type of product and the quantity produced. This is because the break-even point is below the maximum capacity.

(ii) Expected profit per month

Sales	4 200
Variable costs ($0.97 × 2 800 biscuits)	2 716
Contribution margin	1 484
Fixed costs	1 150
Profit for the month	334

(f) Required sales = $\dfrac{\text{(fixed costs + target profit)}}{\text{contribution margin}}$

$$\frac{1\,150 + 720}{0.53}$$

3 529 units of biscuits

(g) The increase in capacity; more facilities; could Chris still produce the biscuits at home or would there be a need to rent a commercial kitchen; ability to meet demand and work in the part-time job; should Chris leave the part-time job; would Chris sell enough biscuits to be able to leave the part-time job.