93203Q

NEW ZEALAND QUALIFICATIONS AUTHORITY
MANA TOHU MĀTAURANGA O AOTEAROA

Scholarship 2005
Accounting

2.00 pm Tuesday 6 December 2005
Time allowed: Three hours
Total marks: 72

QUESTION BOOKLET

Answer ALL questions.

Write all your answers in the Answer Booklet 93203A.

Begin the answer to each new question (but not part of a question) on a NEW page.

Show ALL working.

Check that this booklet has pages 2–8 in the correct order and that none of these pages is blank.

YOU MAY KEEP THIS BOOKLET AT THE END OF THE EXAMINATION.

You are advised to spend three hours answering the questions from this booklet.

Ignore GST in this examination.

QUESTION ONE: ACCOUNTING INFORMATION FOR MANAGEMENT (24 marks)

Costing Concepts

David is considering retiring from playing football and has been reviewing business ventures. He is interested in starting a manufacturing business making soccer balls and branding the balls as Premier Soccer Balls. He approaches Spicer, an accountant, for advice and is given the following manufacturing costing information to consider:

Factory power and lighting
Rubber used in ball manufacturing
Depreciation of factory machinery
Factory rental
Paint colour for ball manufacturing
Assembly-line workers' wages
Factory manager's salary
Oil used in machinery
Factory cleaners' wages
Glue used in ball manufacturing

Study the above information and answer the following questions.

(a) The accountant informs David that there are direct and indirect manufacturing costs involved in the production of soccer balls.

(i) Classify the manufacturing costs provided in the list above into direct or indirect manufacturing costs.

(ii) David has no accounting knowledge and has requested your help to understand this process. Explain clearly why you have classified the costs as either direct or indirect manufacturing costs.

(iii) David has done a profit estimation for the Premier Soccer Balls. He has estimated that each ball would incur a manufacturing cost of $12 per unit. He also estimated that his profit % would be 50% if each soccer ball were to be sold at $24.

Spicer informs David that his estimation is inaccurate and that the overall profit % would indeed be lower, as David has ignored the fact that there are other non-manufacturing costs that must be considered in the operations of a manufacturing business.

Identify and explain to David what these important non-manufacturing costs might be for his soccer ball manufacturing business. (8 marks)

Cost–volume–profit analysis

David is unsure whether he wants to manufacture soccer balls or soccer uniforms. David's partner has become involved in reviewing possible business ventures. She is more excited about designing and manufacturing futuristic-type soccer uniforms than the manufacturing of 'boring' soccer balls. Spicer has simplified the costing information for David so that he can evaluate which business venture would be more feasible and profitable. The following information has been provided by Spicer.

	Soccer Ball	**Soccer Uniform**
		(The unit includes both the shirt and the shorts.)
Sales Price per unit:	$30.00	$100.00
Variable Costs per unit:		
Direct labour	$1.50	$11.50
Direct materials	$2.50	$15.50
Variable overheads	$5.00	$18.00
Total Annual Fixed Overhead Costs:	$210 000.00	$825 000.00

Study the above information and answer the following questions.

(b) (i) Use cost–volume–profit analysis to help David evaluate separately the two business ventures. Calculate the break-even point in units and sales dollars for both business ventures. Explain to David what the cost–volume–profit analysis indicates about the riskiness of the two business ventures.

(ii) A consumer market research survey has estimated that David would be able to sell 50 000 soccer balls or 40 000 soccer uniforms annually. Calculate the profit and profit % (Return on Sales %) for both business ventures using the estimated sales figures from the consumer market research survey. Make a recommendation to David about which business venture would be better, based on your profitability assessment of the two business ventures. (8 marks)

(c) David decided to go with the soccer uniform manufacturing business. He invested $200 000 cash at the commencement of this business. Sales price and variable costs per unit were as predicted in the table above. There were no accounts receivable or payable at the end of the year. For his first year of operation, he sold 16 000 soccer uniforms. The appropriate total annual fixed costs were also paid in cash during the year. The accountant had included annual depreciation on assets of $150 000 in the Fixed Overhead total of $825 000.

(i) Prepare a forecasted (based on 40 000 soccer uniforms) and actual (based on actual sales of 16 000 soccer uniforms) cash budget for David's soccer uniform manufacturing business. Indicate clearly the cash surplus or deficit for the first year of operations.

(ii) David thinks that he should close his soccer uniform business. The actual sales of 16 000 units were significantly lower than the 40 000 units estimated by the consumer market research survey. Should David close his manufacturing business? Use your knowledge of cost–volume–profit analysis, the cash budget, and short-term decision making issues to provide a recommendation to David. (8 marks)

QUESTION TWO: FINANCIAL REPORTING ISSUES (24 marks)

Extracted from The Warehouse 2004 Annual Report.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

1. STATEMENT OF ACCOUNTING POLICIES

Reporting entity

The Warehouse Group Limited is a company registered under the New Zealand Companies Act 1993 and is listed on the New Zealand and Australian stock exchanges. The Warehouse Group Limited is an issuer for the purposes of the New Zealand Financial Reporting Act 1993. The financial statements and group financial statements of The Warehouse Group Limited have been prepared in accordance with the New Zealand Companies Act 1993 and New Zealand Financial Reporting Act 1993.

Measurement base

The accounting principles recognised as appropriate for the measurement and reporting of financial performance and financial position on an historical cost basis are followed by the group.

Specific accounting policies

The following specific accounting policies which materially affect the measurement of financial performance and the financial position have been applied: …

Source: website: http://www.thewarehouse.co.nz/

Study the above information and answer the following questions.

(a) Financial Reporting Standard: FRS-1 requires a reporting entity to prepare a Statement of Accounting Policies.

(i) Discuss what this requirement means for a reporting entity.

(ii) Explain why it is important that a stakeholder of a reporting entity read the Statement of Accounting Policies in conjunction with the other financial statements provided in the financial reports, particularly when he / she is evaluating the performance and position of an organisation. (8 marks)

(b) (i) Explain why it is important that there are statutory regulations and reporting requirements.

(ii) Discuss the requirements of the New Zealand Companies Act 1993 and the New Zealand Financial Reporting Act 1993. (8 marks)

(c) Under the Specific accounting policies note, The Warehouse indicated that the company had applied specific accounting policies that *materially* affect the measurement of financial performance and the financial position.

Discuss the materiality concept as it is explained in the Statement of Concepts and explain why it is an important issue for companies measuring their performance and position. (8 marks)

Note: In this question:

- "FRS-1" refers to Financial Reporting Standard No. 1, "Disclosure of Accounting Policies"
- "Statements of Concepts" refers to document "SC – Statement of Concepts for General Purpose Financial Reporting".

These appear in *"New Zealand Accounting Standards January 2004"*, published by the Institute of Chartered Accountants of New Zealand.

QUESTION THREE: COMPANY REPORTS – INTERPRETATION AND ANALYSIS (24 marks)

The following headlines and information on The Warehouse Group have been extracted from various sources.

No home comfort for Warehouse

SHARES in the Warehouse Group took a hit after the group confirmed it was scaling back its Australian expansion amid widening losses there. … Losses in Australia tripled to A$32 million (NZ$33.6 million), from A$11 million in the previous financial year. … The Warehouse also confirmed that it did not expect to break even in Australia before 2006 or to be profitable before 2007. … The losses in Australia contributed to New Zealand's biggest retailer posting an 18.6 percent drop in net profit for the year ended August 1 to $61.5 million, compared with $75.6 million in the corresponding period. …

Anna Jaquiery in *The Dominion Post*, 11 September 2004, Edition 2, page 3

Warehouse shares fall as sales slip

SHARES in discount retailer The Warehouse tumbled to almost five-year lows after its New Zealand "Red Sheds" announced a 2.6 per cent fall in same-store sales for the October quarter. After yesterday's sales figures, the shares fell 19 cents, closing at $3.85, a long way from the July 2002 highs of $7.60. …

Sue Allen in *The Dominion Post*, 10 November 2004, Edition 2, page 1

Red alert

While retail sales have grown, The Warehouse is flagging. … The news shocked investors, who instead had been bracing themselves for more bad news from The Warehouse's struggling Australian "Yellow Sheds". The share price tumbled over the next couple of days to as low as $3.73, a five-year trough. It recovered yesterday to $3.79. … Problems linked to The Warehouse's years of rapid growth have come home to roost. The stores have grown haphazardly, making it hard for customers to find what they are looking for. …

Richard Richardson in *The New Zealand Herald*, 13 November 2004

The following information was extracted from The Warehouse 2004 Annual Report: Supplementary Information. The last five years of the financial results and position were extracted from the "Ten Year Review" supplementary information. (*Source:* http://www.thewarehouse.co.nz/)

The Warehouse Group Limited
Financial results ($000)

Trading ($000)	2004	2003	2002	2001	2000
Sales revenue	2 244 454	2 034 917	1 862 031	1 664 749	1 075 349
Operating profit	121 192	142 672	147 009	122 095	111 336
Interest	(17 188)	(11 962)	(12 250)	(14 927)	(4 786)
Goodwill and unusual items	(7 809)	(13 810)	(7 786)	(11 353)	1 502
Net surplus before taxation	96 195	116 900	126 973	95 815	108 052
Taxation expense	(34 692)	(41 310)	(44 369)	(35 062)	(37 593)
Net surplus after taxation	61 503	75 590	82 604	60 753	70 459
Minority interests	(324)	(191)	(398)	(348)	(406)
Net surplus attributable to shareholders	61 179	75 399	82 206	60 405	70 053
Ratios					
Operating margin %	5.4%	7.0%	7.9%	7.3%	10.4%
Tax paid return on average net assets %	17.4%	22.8%	28.6%	27.5%	40.1%
Net interest cover (times)	6.6 ×	10.8 ×	11.4 ×	7.4 ×	23.6 ×
Ordinary dividend per share (cents)	14.5 c	14.5 c	13.5 c	12.5 c	12.5 c
Earnings per share (cents)	20.0 c	24.7 c	27.0 c	20.3 c	24.3 c
Financial position ($000)					
Current assets	474 601	437 239	341 153	314 996	193 961
Current liabilities	323 631	185 900	140 442	193 218	185 153
Working capital	150 970	251 339	200 711	121 778	8 808
Non-current taxation	21 656	17 097	11 460	14 389	2 205
Fixed assets and investments	343 130	276 580	245 697	230 151	166 401
Intangible assets	40 621	48 277	59 349	72 709	11 881
Total assets	556 377	593 293	517 217	439 027	189 295
Term liabilities	198 895	246 553	201 744	179 785	10 000
Net assets	357 482	346 740	315 473	259 242	179 295
Ratios					
Current assets to current liabilities	1.47:1	2.35:1	2.43:1	1.63:1	1.05:1
Equity to total assets	40.6%	44.5%	48.0%	41.0%	47.9%

The following simplified Statement of Cash Flows has been taken from The Warehouse 2004 Annual Report.

The Warehouse Group Limited
Consolidated Statement of Cash Flows for the year ended 1 August

($000)	**2004**	**2003**
Cash flows from operating activities		
Cash received from customers	**2 255 825**	2 043 541
Interest income	**680**	1 494
Payments to suppliers and employees	**(2 095 021)**	(1 894 719)
Income tax paid	**(54 789)**	(54 431)
Interest paid	**(18 103)**	(12 740)
Net cash flows from operating activities	**88 592**	83 145
Cash flows from investing activities		
(Purchases) / proceeds of property, plant and equipment, net	**(119 458)**	(101 846)
(Purchases) / proceeds of investments, net	**8 774**	12 416
Net cash flows from investing activities	**(110 684)**	(89 430)
Cash flows from financing activities		
Proceeds from short term borrowings	**110 375**	12 920
(Repayment) / proceeds from term borrowings	**(46 122)**	52 163
Dividends paid	**(45 584)**	(45 753)
Net cash flows from financing activities	**18 669**	19 330
Net (decrease) / increase in cash held	**(3 423)**	13 045
Effect of exchange rate movements	**(34)**	(18)
Total movement in cash position	**(3 457)**	13 027
Opening cash position	**17 169**	4 142
Closing cash position	**13 712**	17 169

Study the information on pages 5–7 and answer the following questions.

(a) A shareholder in The Warehouse has approached you for advice regarding her shares in the company after reading the headlines (see page 5). Use the 2000 to 2004 information extracted from the "Ten Year Review" (see page 6) to evaluate the performance and position of the company for the shareholder. You do not need to carry out any further calculations to assist you in your evaluation. Your evaluation should :

(i) provide an analysis of the profitability
(ii) provide an analysis of the liquidity
(iii) provide an analysis of the financial stability
(iv) provide an analysis of the dividends and earnings returns
(v) make a recommendation to the shareholder about the riskiness of holding on to her shares in The Warehouse and whether she is receiving adequate dividend returns from her share investment in the public company. (8 marks)

(b) The Consolidated Statement of Cash Flows (see page 7) shows that The Warehouse has an operating net cash inflow of $88 592 000 at the end of the 2004 accounting period for the company. The 2004 net surplus attributable to shareholders in the "Ten Year Review" information was given as $61 179 000. The shareholder noted that there was a significant difference of $27 413 000 and was worried about where all the "cash" had gone from the net cash inflow from operating activities.

The shareholder was therefore very confused about the two different figures and wants to know why the 2004 net cash inflow from operating activities was not the same as the net surplus figure.

(i) Use your understanding of profit measurement to explain the situation to the shareholder.

(ii) Evaluate the solvency and cash position of the company for the shareholder by using the 2003 to 2004 information provided in the Consolidated Statement of Cash Flows. (8 marks)

(c) Your evaluation of The Warehouse in parts (a) and (b) focused on using financial information.

(i) Should you also have used other types of information in your evaluation of The Warehouse's performance and position? Discuss clearly the reason(s) for your answer.

(ii) Using appropriate information provided in this question and any relevant knowledge you may have about the Warehouse situation, explain why you think the share price of the company has not been doing so well in the New Zealand share market. (8 marks)