Assessment Schedule – 2007

Scholarship Accounting (93203)

Evidence Statement

QUESTION ONE

Wall Fruit Limited
Income Statement for the year ended 31 March 2007

	Notes	$NZ
Revenue	**1**	114 150
Less: Cost of sales		67 890
Gross profit		46 260
Add: Other income	**2**	31 950
		78 210
Less:		
Distribution costs		11 130
Administrative expenses		42 750
Operating profit	**3 and 4**	24 330
Less: Finance costs	**5**	5 600
Profit before tax		18 730
Income tax expense		5 730
Profit for the period		13 000

Notes on the Income Statement

1. Revenue

Sales	114 150

2. Other Income

Consulting revenue	24 950
Interest received	7 000
	31 950

3. Operating Profit

Operating profit has been determined after taking into account the following:

Auditors' Remuneration	
- Fees for audit	8 400
- Consulting services	4 900
	13 300
Donations	1 870
Directors' remuneration	24 800

4. Classification of expenses by nature

Changes in inventories	(1 300)
Raw materials and consumables used	38 100
Depreciation expense	15 300
Employment benefit expenses	10 000
Write-down of inventory	2 900
Rent paid	12 400
Discount on sales	1 400
Other expenses	3 000

5. Finance costs

Interest on loan	5 600

Workings

Calculation of cost of sales	
Opening inventory	9 800
Purchases	38 100
Closing inventory	8 200
Cost of sales	39 700

Allocation of expenses

	Cost of sales	**Administration expenses**	**Distribution expenses**
	55%	10%	35%
Cost of sales	39 700		
Auditors' remuneration		13 300	
Depreciation – Plant and machinery	12 900		
Depreciation – Fixtures and fittings ($2 400)	1 320	240	840
Directors' fees	–	24 800	–
Discount on sales			1 400
Other expenses – donation		1 870	
Other expenses ($4 870 – $1 870)	1 650	300	1 050
Rent paid ($12 400)	6 820	1 240	4 340
Staff wages ($10 000)	5 500	1 000	3 500
	67 890	42 750	11 130

Alternative allocation of expenses

	Cost of sales	**Administration expenses**	**Distribution expenses**
	55%	10%	35%
Cost of sales	36 800		
Write-down of inventory	2 900		
Auditors' remuneration		13 300	
Depreciation – Plant and machinery	12 900		
Depreciation – Fixtures and fittings ($2 400)	1 320	240	840
Directors' fees	–	24 800	–
Discount on sales			1 400
Other expenses – donation		1 870	
Other expenses ($4 870 – $1 870)	1 650	300	1 050
Rent paid ($12 400)	6 820	1 240	4 340
Staff wages ($10 000)	5 500	1 000	3 500
	67 890	42 750	11 130

QUESTION TWO

(a)

The solution should explain that *Contact Energy Limited* adopted NZIFRS from 1 July 2005, while NZ reporting entities have until 2007 to adopt NZIFRS. During the transition period, users of NZ financial statements will need a frame of reference when comparing financial statements of different entities. Remember, the objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity. The NZ Framework also considers qualitative characteristics of comparability, ie users of financial statements must be able to compare financial statements of an entity through time to identify trends in financial position and performance. Users must be able to compare the financial statements of different entities to evaluate their relative financial position, performance and changes in financial position. Users must be able compare *Contact Energy Limited* financial statements with other power generating companies that may not have adopted NZIFRS early.

The Statement of Compliance emphasises the importance of *Contact Energy Limited* complying with IFRS when preparing financial statements. NZ IAS 1, paragraph 14, requires entities to make an "explicit and unreserved statement" that they comply with IFRS requirements. Financial statements cannot be described as being in compliance with IFRS unless **all** IFRS requirements are met, which can be incompatible with presenting a true and fair view (see the FRA).
Note 30 explains how the transition from NZGAAP to NZIFRS affects *Contact Energy Limited'*s reported financial position, financial performance and cash flows. This is shown in the form of a reconciliation of *Contact Energy Limited*'s equity reported under NZGAAP to its equity under NZIFRS at 1 October 2004 (the date of transition), and details the impact of the restatement as at 30 June 2005 on the Consolidated Balance Sheet, and also the impact on the Consolidated Income Statement for the nine months ended 30 June 2005.

This translates to accounting policies employed in the preparation of the financial statements. *Note 30* indicates that as a result of adopting NZIFRS, changes to the accounting policies for deferred tax, property, plant and equipment, foreign currency translations, employee benefits' goodwill and investment in associates have taken place.

(b)

Sections 11 and 14 of the FRA require *Contact Energy Limited* to prepare financial statements that comply with generally accepted accounting practice. Generally accepted accounting practice describes the basis on which general purpose financial reports are normally prepared. According to the NZ Preface, commentary paragraph 10, the term encompasses the specific rules, practices and procedures relating to particular circumstances, and broad concepts and principles of general application.

Section 3 of the FRA says that financial statements will comply with generally accepted accounting practice only if those statements meet applicable financial reporting standards. Where there are no applicable financial reporting standards or rule of law, statements shall comply with accounting policies that are appropriate to the circumstances of the reporting entity, and have authoritative support within the accounting profession in New Zealand.

Accounting standards are the primary indicators of generally accepted accounting practice. Where no applicable accounting standard or applicable rule of law exists, entities must adopt accounting policies that are appropriate and have authoritative support within the accounting profession.

Compliance with generally accepted accounting practice usually means that financial statements give a true and fair view of an entity's financial position, performance and cash flows. In circumstances where compliance with generally accepted accounting practice does not result in a true and fair view, s. 11 of the FRA and NZ IAS 1 'Presentation of Financial Statements' require that the directors of the entity provide additional information and explanations to ensure that a 'true and fair' view of the general purpose financial reports is given.

Section 11 of the FRA, and NZ IAS 1 'Presentation of Financial Statements', paragraph 13, contain a true and fair override. NZ IAS 1 requires financial statements to present fairly the financial position, financial performance and cash flows of an entity. In this context, fair presentation requires the faithful representation of the effects of transactions, other events and conditions according to the definitions and recognition criteria for assets, liabilities, income and expenses set out in the NZ Framework.

Thus, general purpose financial statements prepared by New Zealand entities will only achieve fair presentation in circumstances where they comply with the New Zealand equivalents to IFRS, as well as giving any additional disclosures necessary to ensure fair presentation. This is achieved according to NZ IAS 1, paragraph 15, by the selection and application of accounting policies of NZ IAS 8. Information, including accounting policies, shall be presented so that it is relevant, reliable, comparable and understandable. The information shall give sufficient additional disclosures when there is inadequate compliance with the New Zealand equivalents to IFRS to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position, and financial performance.

QUESTION THREE

(a)

Calculation of contribution margin per unit	
Break-even point in units	If changes take place
\$460 – \$260 = \$200	\$437 – \$260 = \$177
Break-even point in units	If changes take place
$460x = 260x + 680\ 000$	$437x = 260x + 769\ 950$
$200x = 680\ 000$	$177x = 769\ 950$
$x = 3\ 400$ units	$x = 4\ 350$ units

Contribution margin is the amount of revenue that remains after the deduction of variable costs. For every model ship sold under the current situation, there will be \$200 to cover fixed costs and to contribute to profit. As fixed costs are \$680 000, *Blue Oceans Limited* must sell 3 400 units before there is any profit. If the firm adopted William's proposal, *Blue Oceans Limited* would need to sell 4 350 units before there was any profit.

Calculate margin of safety
Actual (expected) sales – Break-even sales = Margin of safety
3 750 × \$460 – 3 400 × \$460 = \$161 000
(9.33%)

If changes take place
4 820 × \$437 – 4 350 × \$437 = \$205 390
(9.75%)

The margin of safety is the difference between the actual (or expected sales), and sales at break-even point. This relationship measures the 'breathing space' or cushion that management has to break even if expected sales don't occur. The adequacy of the margin of safety must be assessed by management. Factors they should consider include vulnerability of product to competitive pressure, and downturns in the economy.

	Before Changes	**After Changes**
Sales	1 725 000	2 106 340
Variable costs		
Gross profit	975 000	1 253 200
Contribution margin	750 000	853 140
Fixed costs		
Display costs	680 000	769 950
Net profit	70 000	83 190

Required sales = (fixed costs + target profit) ÷ contribution margin

\$1 794 341 = (\$680 000 + \$100 000) ÷ 0.4348	\$2 148 024 = (\$680 000 + \$89 950 + \$100 000) ÷ 0.4050
At \$460, 3 901 units should be sold.	At \$437, 4 915 units should be sold.

(b)

The overall increase in contribution margin is \$1 034 140. This covers the additional fixed costs of \$89 950 and overall profit by \$13 190. The decrease in sales price proposed to increase sales volume may have affected the overall increase in profit as variable costs remained constant, but fixed costs increased. So it is tempting to undertake expansion for additional profit. However, the additional profit of \$13 190 does not outweigh the additional \$89 950 costs incurred.

Consider:
- feasibility of additional number of units sold
- marketing of Viaduct Basin as tourist resort
- foot traffic through basin
- cruise ships in harbour.

QUESTION FOUR

The underlying substance and economic reality of the loyalty scheme is that it gives rise to a liability. The liability arises because:

- The scheme is a present obligation of the entity. Fred has an obligation to provide a free song download or a CD of the customer's choice based on the amount of money spent in the shop. The obligation may not necessarily be legally binding but must arise through normal business practice of custom. The loyalty scheme fits into this category.

- The liability must have arisen as a result of a past event. The past event here is the purchase by the customers of products from *Forge Music*

- The settlement of the liability is expected to result in an outflow from the entity of resources embodying economic benefits. *Forge Music* will have to pay the supplier of the music for the free song given to customers, while providing the free CD results in an outflow of an inventory resource paid for by *Forge Music*.

- For accounting purposes, before a liability is recognised in the balance sheet, it must meet the recognition criteria. For a liability to be recognised:

  - It is probable that any future economic benefits associated with the item will flow from the entity. The growth and popularity of loyalty schemes means that customers probably will make use of loyalty schemes. Experience suggests that economic benefits (in the form of cash or inventory) will flow from *Forge Music*.

  - The item has a cost or value that can be measured reliably. Thus, the cost of the music download and inventory can be measured reliably.

  - The liability must be recognised if it is material, ie could the omission of the liability from the loyalty scheme individually or collectively influence the economic decisions of users?

A question facing Fred is whether the liability should be disclosed as a current or non-current liability in the balance sheet. If Fred is to recognise the liability as current, it must satisfy any of the following:

- it is expected to be settled in the entity's normal operating cycle
- it is held primarily for the purpose of being traded
- it is due to be settled within 12 months after the balance sheet date.

Whether the liability is considered to be current or non-current will depend on the terms of the loyalty scheme. If the loyalty scheme has conditions, eg it must be taken up within three months of being earned, then it is likely to be disclosed as a current liability.

The amount to be disclosed also needs to be considered. It is unlikely that all prizes will be taken up, and this needs to be part of the calculation of liability to enter in the balance sheet.

QUESTION FIVE

Shaw Publishers Limited
Balance sheet at 31 March 2007

	Notes	NZ$
LIABILITIES		
Non-current Liabilities		
Long-term loan ($840 000 – $84 000)	**1**	756 000
Debentures	**2**	1 900 000
		2 656 000
Current Liabilities		
Bank overdraft ($2 100 + $207 000*)		209 100
Trade and other payables	**3**	204 500
Tax payable		5 500
Current portion of long-term loan		84 000
		503 100
Total liabilities		3 159 100
Net assets		3 827 700
EQUITY		
Contributed equity	**4**	2 878 500
Retained earnings ($669 900 + $275 000 – $67 200 – $69 750)	**5**	807 200
Revaluation surplus	**6**	142 000
Total Equity		3 827 700

NOTES TO THE 2007 FINANCIAL STATEMENTS

1 Long-term loan

Mortgage bond	840 000
Less: Current portion of mortgage	84 000
	756 000

The mortgage bond, which is repayable in equal instalments of $84 000, is secured over the company's land. The interest rate is 8% per annum.

2 Debentures

Debentures	1 900 000

The debentures are due for redemption on 18 September 2018. 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 9%.

3 Trade and other payables

Accounts payable	137 300
Interest accrued	67 200
	204 500

4 Contributed equity

	No. of shares	
Balance at beginning of year	1 050 000	2 520 000
Additional shares issued during the year	150 000	510 000
Shares bought back during the year	60 000	151 500
Balance at end of year	1 140 000	2 878 500

5 Retained earnings

Balance at beginning of year	669 900
Profit for the year ($275 000 – $67 200)	207 800
Share buy-back	70 500
	807 200

6 Revaluation surplus

Balance at beginning and end of year	142 000

* ($222 000 – $15 000 cash on hand)
Note: The equity section shown in the narrative format was also marked correct.

QUESTION SIX

The letter should contain at least the following discussion:

An advantage of segment information is that it details how well management has performed. It is more difficult for management to hide their failures behind their successes if disaggregated information is disclosed. Management must also be more careful in making investment decisions and more decisive in correcting mistakes. As a result, segment reporting may result in improved managerial performance.

A business segment is a group of assets and operations engaged in providing products or services that are subject to differing risk characteristics, and returns that are different from those of other business segments. Segment reporting provides investors with additional relevant information on which they can base their investment decisions. *Contact Energy Limited* comprises two main business segments, viz. retail and wholesale electricity. Without segment reporting, the characteristics of each segment will be obscured. An analyst can work on segmental data calculating various ratios and using them to compare performance between classes of business and between geographical areas.

Segment reporting, then, is useful for decision-making by financial report users. It allows managers to inform shareholders of the outcomes of financial decisions.

The disadvantages of segment reporting are that it makes additional costs to a reporting entity. Management may be less inclined to take business risks in particular business segments if the results of each segment's operations are made available. Disclosure of segment data may result in competitors having access to information about the profitability of particular segments of an organisation.

Evaluation of performance and position of *Contact Energy Limited* for a potential shareholder:

(i) Return on shareholders' equity and return on assets

The return on 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 shareholders' funds is a function of profitability (after interest and taxes) which 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.

In percentage terms the return on shareholders' equity has increased from 4.3 percent in 2002 to 9.5 percent in 2006. Over the last four year period this return has shown an increasing trend, showing a year-on-year increase as follows.

Year	2006	2005	2004	2003
Year-on-year return on shareholders' equity	53.23	29.17	2.13	9.30

The return on assets indicates a company's overall profitability. The ratio expresses income as a percentage of the assets available to generate income. As assets are generally financed partially by debt and partly by equity, this is an inclusive way of measuring earning power that ignores specific sources of financing. *Contact Energy Limited*'s return on assets is related to both profit margin and asset turnover.

The return on assets is in the generally low range of 3.0 percent in 2003 to 3.4 percent in 2005. There was a significant increase in 2006 to 5.3 percent. However, it must be remembered that in 2002 and 2004 *Contact Energy Limited* did revalue its property, plant and equipment, which would have had an impact on the ratios of those years.

(ii) Financial stability

Equity to total assets. This ratio has trended downwards over the last six years although there was an increase to a high of 74.52 percent in 2002. There is a decrease to 54.35 percent in 2005, but it must be remembered that adjustments have been made to the equity figure as a result of the adoption of IFRS requirements. As such, care needs to be taken when comparing the equity to total assets figure for 2005 and 2006 against previous years. Overall, the trend suggests that *Contact Energy Limited* has increasing debt levels. While a 50 percent debt to assets ratio is usually considered normal, industry averages would provide a more accurate indication of appropriate debt to asset ratio. The equity to total asset ratio shows that in 2006 *Contact Energy Limited* is geared by 55.72 percent through debt. This could not be considered too risky in light of increasing profitability.

EBITDAF is what the business really generates. It is a figure referred to by investors as a reality-check, as it is a figure separate from loan payments, tax situation, asset history, etc, items over which companies have some control or deal with differently (eg, entering into different forms of financing arrangements leading to differing interest charges which impact on taxation). EBITDA is used to compare the profitability between companies and industries, because it eliminates the effects of financing and accounting decisions. Although this figure is subject to some fluctuation, the overall trend is positive.

(iii) Dividends per share

Dividends per share show an increasing trend from 20.9 cents in 2002 to 26.0 cents in 2006. This is an overall increase during this period of 24.4 per cent. During this period the return on shareholders' equity has increased by 120.93 per cent. Candidates could consider some possible reasons for this. The increasing dividends per share is in line with generally increasing profit for the period. (The decrease in dividends to 18 cents per share in 2005 could be discussed.) However, the profit increase of 89.86 percent from 2005 to 2006 is not matched in the 44.44 percent increase in dividends over the same period. It should be noted that there was a 28 percent decrease in dividends from 2004 to 2005.

Discussion and recommendation

It is important that investors assess the comparative attractiveness of the various alternatives. Should your grandmother invest in *Contact Energy Limited* or should she invest in other securities? Your grandmother should note with caution that there was to be an expected squeeze on earnings; this did not eventuate in 2006 where both profit and EBITDAF showed an increase over the previous year.

Other factors such as drought and the increased costs of gas can have an impact on generating capacity, which results in higher costs to Contact Energy; this is generally countered by an increase in the price of electricity to consumers.

The increasing trend in return in shareholders' funds, sound equity to total assets, EBIT to interest expense ratios, and dividend and earnings returns suggest that this is a safe investment. There is also good potential for an increase in the share price, which may result in a greater return.