Assessment Schedule – 2006

Scholarship Accounting (93203)

Evidence Statement

QUESTION ONE

(a) This solution should consider adoption of NZ IFRSs in New Zealand, the NZ Framework, the *Financial Reporting Act 1993* and FRS 41, 'Disclosing the impact of Adopting New Zealand Equivalents to International Financial Reporting Standards'.

The introduction should consider justifications of the ASRB to adopt IFRSs in New Zealand. These include New Zealand's close economic ties with Australia, and the tendency for international investors to group New Zealand and Australia together. Also, should New Zealand fail to follow the Australian lead, the credibility of New Zealand's financial reporting could be placed at risk.

Consider the NZ Framework
The NZ Framework (para. 12) explains that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Consider the Financial Reporting Act 1993
Under section 3 of the FRA, financial statements and group financial statements comply with generally accepted accounting practice only if they comply with all applicable financial reporting standards. Reporting entities must therefore comply with FRS 41 'Disclosing the impact of Adopting New Zealand Equivalents to International Financial Reporting Standards', which applies to reporting periods ending on or after 30 June 2005. FRS 41 requires issues to disclose the impact of adopting NZ equivalents to IFRS.

In order to provide users (in this case potential investors in *Waste Management NZ Limited*) with information regarding the possible impact of the company adopting NZ IFRSs, FRS 41 requires entities to:

- provide an explanation how the transition to NZ IFRSs is being managed
- explain the key differences in accounting policies that are expected to arise from adopting NZ IFRSs, or provide a statement that the differences are not known
- explain any known or reliably estimatable information about the impacts on the financial report had it been prepared using NZ IFRSs, or provide a statement indicating the impacts are unknown; and
- provide a cautionary note to the effect that the actual impact of adopting NZ IFRSs may vary from the information provided and that the variations may be material.

(b) The answer to this question will depend on the approach taken by a candidate. They should recognise that the choice an entity takes in selecting an income statement by function or nature of expense method will depend on historical and industry factors and the nature of the entity.

Under the **nature of expense** method, expenses are aggregated in the income statement according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and are not reallocated among various functions within the entity. As this method is simple to apply (no allocations of expenses to functional classifications are necessary), it is possibly more suitable for smaller reporting entities and entities in the service industry.

Under the **function of expense** method, expenses are classified according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. A possible criticism of an income statement prepared by function is that the allocation of the individual expenses between cost of sales, selling and distribution expenses, and administration expenses, maybe arbitrary and involves considerable judgement on the part of management. Different managers may allocate the expenses on a different basis, resulting in a different gross profit for external reporting purposes. Preparing an income statement according to the function method may provide more relevant information to users, as users will be able to calculate the gross profit percentage, something that is perhaps more difficult using the nature of expenses classification method. When the income statement is prepared according to the function of expenses method, additional costs are involved as information relating to the nature of expenses must be disclosed, as this information is necessary to enable users to predict future cash flows. Ultimately, management must select the method they consider will provide the most relevant and reliable information on the financial performance of the reporting entity.

QUESTION TWO

Red Shirt Limited

Income statement for the year ended 31 March 2006

	Notes	$
Revenue	**1**	88 650
Cost of sales		62 890
Gross profit		25 760
Other income	**2**	14 100
Distribution costs		10 260
Administrative expenses		14 240
Operating profit	**3**	15 360
Finance costs	**4**	3 180
Profit before tax		12 180
Tax expense		1 100
Profit for the year		11 080

***Red Shirt Limited* – Notes to the Financial Statement**

1 Revenue

Sales	88 650

2 Other income

Interest received	4 660
Dividends received	9 440
	14 100

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	1 960
Raw materials and consumables used	54 900
Depreciation expense	4 330
Employee benefits costs	12 600
Other expenses	
Auditor's remuneration	
Audit fee	1 900
Taxation services	550
	2 450
Bad debts	3 040
Donations	950
Loss on disposal of property, plant, and equipment	990

4 Finance costs

Interest paid	3 180

Journal Entries and Workings

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

Dr		Donations	950	
	Cr	Other expenses		950
		Record donations' expense for the year		
Dr		Interest expense	620	
	Cr	Accrued interest		620
		Record interest owing at balance sheet date		
Dr		Bad debts	1 400	
	Cr	Accounts receivable		1 400
		Write off debt owed by bankrupt debtor at balance sheet date		

Calculation of cost of sales

Opening inventory	11 500
+ Purchases	54 900
– Closing inventory	9 540
	56 860

Allocation of expenses

	Cost of sales	Selling and distribution expenses	Administration expenses
Cost of sales	56 860		
Advertising expenses	–	1 450	–
Auditors' remuneration	–	–	2 450
Bad debts			3 040
Depreciation	1 890	1 250	1 190
Loss on disposal of PPE	990		
Other expenses			5 670
Staff salaries	3 150	7 560	1 890
	62 890	10 260	14 240

QUESTION THREE

These journal entries are not required and are provided merely for the purposes of completeness.

30 June 2006	Dr		Land	994 000	
		Cr	Revaluation surplus		994 000
			Revaluation of land to fair value		
	Dr		Accumulated depreciation	235 185	
		Cr	Buildings		235 185
			Reversal of accumulated depreciation		
	Dr		Buildings	310 085	
		Cr	Revaluation surplus – buildings		310 085
			Revaluation of land to fair value		
	Dr		Depreciation	589 580	
		Cr	Accumulated depreciation – buildings		164 280
		Cr	Accumulated depreciation – manufacturing plant		425 300
			Depreciation on property plant and equipment for year		

Raid Limited
Notes to the 2006 financial statements

5 Property, plant, and equipment (Balance at 1 July 2005 included for completeness)

	Land	Buildings	Manufacturing equipment	Total
Balance at 1 July 2005				
At cost or valuation	2 356 000	1 567 900	1 789 000	5 712 900
Accumulated depreciation	–	235 185	1 073 400	1 308 585
Net book value	2 356 000	1 332 715	715 600	4 404 315
Year ending 30 June 2006				
Opening net book value	2 356 000	1 332 715	715 600	4 404 315
Additions	1 789 400	906 000	450 000	3 145 400
Revaluation surplus	994 000	310 085	–	1 304 085
Depreciation	–	(164 280)	(425 300)	(589 580)
Closing net book amount	5 139 400	2 384 520	740 300	8 264 220
Balance at 1 July 2006				
At cost or valuation	5 139 400	2 548 800	2 239 000	9 927 200
Accumulated depreciation	–	164 280	1 498 700	1 662 980
Net book value	5 139 400	2 384 520	740 300	8 264 220

Depreciation is calculated on the straight-line basis at the following rates:
Buildings – 10 per cent per annum
Manufacturing plant – 20 per cent per annum

The company's land and building were revalued on 1 July 2005 by Mr H. Tufuga, an independent valuer. The valuation was based on the market value of surrounding properties. The revaluation surplus was credited to revaluation surplus in equity (see note 7).

If the land and buildings were stated on the historical cost basis, the carrying amounts would be as follows:

	2006
Land – carrying amount	4 145 400
Buildings	2 473 900
Accumulated depreciation	391 975
Net carrying amount – buildings	2 081 925
Total carrying amount	6 227 325

Acceptable alternative note disclosure:
Had land not been revalued, the carrying amount under the cost model would be $4 145 400. Had buildings not been revalued, the carrying amount under the cost model would be $2 081 925.

QUESTION FOUR

(a) Potential benefits that may accrue to New Zealand reporting entities from adopting IFRSs include:

- an improved quality of financial reporting in New Zealand
- in a competitive market the comparability of financial reports prepared in different countries can be increased, and by being able to compare the reporting entity's performance with competitors globally, participants in international capital markets (potential investors) can be provided with better quality information on which to base investment and credit decisions
- barriers to international capital flows will be reduced by reducing differences in financial reporting requirements for participants in international capital markets
- financial reporting costs for New Zealand multinational companies and foreign companies operating in New Zealand and reporting elsewhere will be reduced and
- more meaningful comparisons of the financial performance and financial position of New Zealand and foreign public sector reporting entities can be facilitated.

Markers should carefully consider the arguments put forward by individual candidates in their explanation of the potential benefits of harmonisation. However, candidates could say that empirical evidence is not yet available on the benefits of adopting IRFS.

(b) Generally accepted accounting practice (GAAP) is described in the 'New Zealand Preface' (Preface), paragraph 8, as 'the term used to describe the basis on which general purpose financial statements are prepared'. This includes the specific rules, practices, and procedures relating to particular circumstances, together with the broad concepts and principles of general application. The importance of GAAP in the preparation of financial reports is recognised by the legislative requirements contained in the FRA. In terms of section 3 of the FRA, financial statements and group financial statements comply with GAAP only if they comply with applicable financial reporting standards.

Accounting standards are the primary indicators of GAAP. For an entity to comply with GAAP, it must adhere to all applicable financial reporting standards. If a particular situation is not covered by an accounting standard (or where there is no applicable rule or law), the accounting policies of the entity should be appropriate to the circumstances and have authoritative support within the accounting profession in New Zealand.

Under the FRA, compliance with GAAP usually means that financial statements should provide a true and fair view of an entity's financial position, performance and cash flows. Where compliance with GAAP does not result in a true and fair view, section 11 of the FRA requires that the directors provide additional information and explanations to ensure that the financial statements provide a 'true and fair' view. In addition, NZ IAS 1, paragraph 21, requires management to provide additional information in those rare circumstances where the management conclude that compliance with an IFRS requirement is misleading.

QUESTION FIVE

(a) Evaluation of performance and position of *Waste Management NZ Limited* for an existing shareholder.

(i) Return on shareholders' funds

Return on the 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 the shareholders' funds is a function of profitability (after interest and taxes) that belongs to ordinary shareholders. It measures the return on the owners' investment in the reporting entity. As a rule, the higher the return, the better off the owners.

Over the five-year-period, this return has shown an increasing trend, increasing from 8.1 per cent to 16.1 per cent. The year-on-year increase is shown below.

	2005	2004	2003	2002
Return on shareholders' funds	15.83	33.65	18.18	8.64

Candidates may discuss the number of shares issued through options. They may calculate the average issue price of options and the impact this would have had on the return on shareholders' funds had the shares been issued at full price.

(ii) Financial stability

Equity to total assets. This ratio has trended downwards over the five years, although the ratio did increase to 64.1 per cent in 2002. Overall, the trend suggests that *Waste Management NZ Limited* has increasing debt levels. While a 50 per cent debt to assets 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 2005, *Waste Management NZ Limited* is geared by 46.3 per cent through debt. This could not be considered too risky in light of increasing profitability.

Earnings before interest and tax to interest expense. This ratio has fluctuated over the five-year-period, although it has remained in a fairly narrow 6.8 to 13.6 $\times$ range. In 2005, *Waste Management NZ Limited* still has 10.8 times profits to cover interest repayments. However, the fluctuating ratio should be monitored, although it does not appear to be a cause for concern.

(iii) Dividends and earnings returns

Earnings per shares (cents). This ratio shows an increasing trend over the five-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 and dropping off to 19 per cent in 2005. This is a steady and acceptable increase in earnings.

Dividends per ordinary shares (cents) show an increasing trend in line with earnings per share. The only possible concern here is that in 2004 and 2005, dividends per share approved per year were slightly higher than earnings. This may indicate a return to surplus capital (retained earnings) being returned to shareholders.

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 has shown a decline. Although this could be of concern at present, there is no evidence of impending problems.

(iv) Discussion and recommendation

It is important that investors assess the comparative attractiveness of the various alternatives. Is it better for the investors to sell the shares and invest the proceeds elsewhere? At this stage, the evidence would suggest that your classmate should retain the investment in *Waste Management NZ Limited*.

If he or she had adequate savings (unlikely in a student), then buying 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 return in the 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. Also, NZ Capital recently lifted its rating on the stock of *Waste Management NZ Limited* to "outperform", showing its confidence in the shares. Business is growing as evidenced by previous acquisitions. The last dividend declared by *Waste Management NZ Limited* was 30.8 cents, which translates to total dividends of $3 080. As can be seen from the 2005 Annual Report of *Waste Management NZ Limited*, the amount of dividends paid each year varies. However, there is the possibility of an increase in the share price, which may result in a greater return.

(b) The Consolidated statement of cash flows indicates the cash movements that took place in the organisation over a particular period of time and are summarised into operating, investing, and financing activities. Overall, the net cash position has decreased from a favourable $830 000 in 2004 to an unfavourable $151 000 in 2005.

Waste Management NZ Limited is generating positive and increasing cash flows from operating activities ($52 626 000 in 2004 and $58 218 000 in 2005). There are cash outflows from investing activities in 2004 and 2005, with the amount decreasing from $59 172 000 in 2004 to $51 682 000 in 2005. Purchases of property, plant and equipment are significant for both years ($36 478 000 in 2004 and $44 406 000 in 2005), which suggests increased growth / expansion. Evidence of this expansion is supported by the business purchases of $30 031 000 in 2004 and $6 427 000 in 2005. Cash flows from financing activities were positive in 2004 ($7 944 000). The main contribution here was a term loan of $38 661 000 advanced, although dividends and repayment of term loans amounted to $33 622 000. In 2005, cash loans from financing activities were negative $7 509 000. Although term loans of $20 979 000 were received, dividends of $31 743 000 were paid.

It appears that *Waste Management NZ Limited* does not have any solvency problems, although the overall cash position has decreased by $981 000. In addition, the increased levels of dividend payments may warrant monitoring. However, the cash flows from operating activities have increased by $5 592 000, which suggests that overall the investing activities are having a positive impact on the operations of the company.

QUESTION SIX

(a) **Explanation of fixed and variable costs**

Fixed costs are those costs that do not vary over a wide range of outputs of final product. These costs are paid regardless of how much capacity has been utilised to produce units of output. Such costs can include rates, rent, and depreciation, which are incurred each period whether or not production has occurred. These costs are fixed in total over a range of outputs but are usually variable per unit. For example, if there is an increase in the number of haircuts, then, while the total fixed costs remain constant, the fixed cost per haircut will decrease. Fixed costs do not change with changes in the level of activity.

Examples relating to Margaret's hairdressing salon include:

rent for premises
lease expenses for hairdressing equipment.

Variable costs are those costs that increase in total as the volume of production increases. These costs are usually variable in total but constant per unit. Variable costs can include direct materials, direct labour, variable overheads like lighting and heating, repairs and maintenance, and variable selling costs. Variable costs are costs that vary proportionately with changes in the level of activity.

Examples relating to Margaret's hairdressing salon include:

direct labour – the person being paid to cut the hair
direct materials – the cost of shampoo, conditioner, and other consumables, etc,
variable overheads – electricity or gas for heating, electricity for hairdryers, water for washing hair, cleaning of salon, telephone expenses for confirming appointments.

(b) **Break-even concept**

The break-even concept is the starting point for cost-volume-profit analysis. The cost-volume-profit analysis model is used by management to evaluate the interrelationship of sales volume, selling price, variable costs, and fixed costs in order to plan an acceptable level of profit. The break-even analysis is a tool that can be used to indicate the possible impact of alternative courses of action on the break-even point. The break-even point indicates the sales volume (or sales dollars) at which total revenues are equal to the total costs of making and selling that product. This can be depicted by the formula:

$$\text{Break-even sales in units} = \frac{\text{Fixed costs}}{\text{(Sales price per unit) – (Variable cost per unit)}}$$

It is important that Margaret understands the break-even point related to the running of the hairdressing salon. It is only above the break-even that Margaret will start to make profits. If the monthly number of haircuts is below the break-even, then losses will be incurred. The break-even point indicates to Margaret the target minimum number of haircuts that should be charged for, just to cover total costs. Margaret should ensure that she cuts above the break-even level. The break-even is not a desired level of performance for the salon because it would mean that a profit is not being made.

(c) **Calculate the break-even number of haircuts per month in units and in sales dollars**

$$\text{Break-even (units)} = \frac{\text{Fixed costs}}{\text{Unit contribution margin}}$$

$$= \frac{\$2\,097}{\$10 - (\$2.50 + \$1.40 + \$1.60)}$$

$$= \frac{\$2\,097}{\$4.50}$$

$$= 466$$

$$\text{Break-even sales dollars} = \text{Break-even units} \times \text{sales price}$$
$$= 466 \times \$10$$
$$= \$4\,660$$

(d) **Profit target feasibility**

$$\text{Desired monthly sales volume (units)} = \frac{\text{Fixed costs + Profit}}{\text{Unit contribution margin}}$$

$$= \frac{\$2\,097 + \$6\,003}{\$10 - (\$2.50 + \$1.40 + \$1.60)}$$

$$= \frac{\$8\,100}{\$4.50}$$

$$= 1\,800$$

Average daily number of haircuts = 1 800 ÷ 30
= 60

As can be seen from the calculations, if a profit figure of $6 003 per month is expected, a total of 1 800 haircuts would have to be done. This amounts to 60 per day or 6.67 per hour. This leaves no time for meals or breaks, holidays, sick days, or time off, and as such is an unrealistic expectation. Even for children's haircuts, the time that could be taken to perform such a service could vary from 15 minutes to half an hour. This means a possible 4 haircuts an hour is the maximum that could be expected. It is unlikely that 7 haircuts per hour could be managed. Candidates could also mention that school time would affect the number of haircuts that could be done during school hours.

(e) **Position with changes**

If an additional hairdresser was employed at $2 996 per month and the price per haircut increased to $15, the average number of haircuts would change to 38.93 per day between two hairdressers. This would amount to 2.1 per hour per hairdresser over the course of the day. This is a more realistic expectation.

$$\text{Desired monthly sales volume (units)} = \frac{\text{Fixed costs + Profit}}{\text{Unit contribution margin}}$$

$$= \frac{\$2\,097 + 2\,996 + \$6\,003}{\$15 - (\$2.50 + \$1.40 + \$1.60)}$$

$$= \frac{\$11\,096}{\$9.50}$$

$$= 1\,168$$

Average daily number of haircuts = 1 168 ÷ 30
= 38.93 daily, shared between 2 workers