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NEW ZEALAND QUALIFICATIONS AUTHORITY
MANA TOHU MĀTAURANGA O AOTEAROA

Scholarship 2006
Accounting

2.00 pm Tuesday 5 December 2006
Time allowed: Three hours
Total marks: 48

QUESTION BOOKLET

You should write ALL your answers in the Answer Booklet.

Show ALL working. Start each question on a NEW page. Number each question carefully.

Check that this booklet has pages 2–11 in the correct order.

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

You have three hours to complete this examination.

QUESTION ONE: COMPANY ACCOUNTING (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

The following supporting note (Note 26) appears in the Annual Report of *Waste Management NZ Limited* for the year ended 31 December 2005.

> ***26 International Financial Reporting Standards***
>
> The Accounting Standards Review Board announced in December 2002 that New Zealand equivalents to International Financial Reporting Standards (NZIFRS) will apply to New Zealand reporting entities for periods commencing from 1 January 2007. With the option of transitioning early, Waste Management is planning to adopt NZIFRS in 2006 and will prepare its first set of financial statements under NZIFRS for the six months ending 30 June 2006.
>
> ***Disclosure requirements***
>
> NZIFRS requires a large number of additional disclosures and will result in a number of changes to the way the financial information is presented. For example, the income statement under NZIFRS is required to include expenses classified by either nature or function, whichever is the more relevant.

Study the information above and answer the following questions:

(a) Explain the importance to a potential investor of Note 26 in the 2005 Annual Report in relation to the adoption of New Zealand equivalents to International Financial Reporting Standards. Your answer could include consideration of the *New Zealand Equivalent to the Framework for the Preparation and Presentation of Financial Statements* (NZ Framework), the *Financial Reporting Act 1993* and the requirements of FRS 41, *'Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards'.*

(b) NZ IAS 1 'Presentation of Financial Statements' permits reporting entities to prepare income statements by **function** or by **nature**. This is confirmed by Note 26 *Disclosure requirements* (above).

Explain fully the characteristics of each type of income statement and the circumstances in which each is likely to provide information that is more useful to users. You are **NOT** required to prepare an income statement.

QUESTION TWO: INCOME STATEMENT AND ACCOMPANYING NOTES PREPARED FOR EXTERNAL REPORTING PURPOSES (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

The following trial balance has been extracted from the accounting records of *Red Shirt Limited* for the year ended 31 March 2006. **Ignore** GST in this question.

	Dr	**Cr**
Advertising expenses	1450	
Auditors' remuneration	2450	
Bad debts	1640	
Depreciation	4330	
Dividends received		9440
Interest paid	2560	
Interest received		4660
Inventory at 1 April 2005	11500	
Loss on sale of equipment	990	
Other expenses	5670	
Purchases	54900	
Sales		88650
Staff salaries	12600	
Tax expense	1100	
Net assets	3560	
	102750	102750

The following additional information is available

- Auditors' remuneration comprises $1900 for the annual audit while the balance was paid for taxation services.
- A debtor who owed *Red Shirt Limited* $1400 on 31 March 2006 was declared bankrupt on 23 April 2006. The auditors have advised the directors that under New Zealand equivalents to International Financial Reporting Standard, this amount should be written off at balance sheet date.
- Interest of $620 is owed by *Red Shirt Limited* at balance sheet date. This amount has not been provided for.
- Inventory on hand at 31 March 2006 was $9540.
- The loss on the sale of equipment arose from the disposal of manufacturing equipment.
- In the 'Other expenses' account, an amount of $950 is included for donations made to a political party. 'Other expenses' should be allocated to administrative expenses.
- Management has advised that 60 per cent of staff salaries are for distribution purposes, while 25 per cent of the staff salaries should be allocated to cost of sales.
- Of the depreciation expense, $1250 must be allocated to distribution, while $1890 should be allocated to cost of sales.
- The tax charge has been correctly calculated.

Study the information above and:
Prepare the income statement classified by **function** and provide the relevant accompanying notes for *Red Shirt Limited* for the year ended 31 March 2006 in a manner suitable for external financial reporting purposes. You are **NOT** required to provide a tax note. Clearly show and label your workings.

QUESTION THREE: BALANCE SHEET AND ACCOMPANYING NOTES PREPARED FOR EXTERNAL REPORTING PURPOSES (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

The following ledger accounts have been extracted from the accounting records of *Raid Limited*, a company whose balance sheet date is 30 June 2006.

Land

Date	Description	Dr	Cr	Balance
31 December 2003	Cash	2 356 000		2 356 000 Dr

Buildings

Date	Description	Dr	Cr	Balance
31 December 2003	Cash	1 567 900		1 567 900 Dr

Accumulated Depreciation – Buildings

Date	Description	Dr	Cr	Balance
30 June 2004	Depreciation		78 395	78 395 Cr
30 June 2005	Depreciation		156 790	235 185 Cr

Manufacturing Plant

Date	Description	Dr	Cr	Balance
1 July 2002	Cash	1 789 000		1 789 000 Dr
1 October 2005	Cash	450 000		2 239 000 Dr

Accumulated Depreciation – Manufacturing Plant

Date	Description	Dr	Cr	Balance
30 June 2003	Depreciation		357 800	357 800 Cr
30 June 2004	Depreciation		357 800	715 600 Cr
30 June 2005	Depreciation		357 800	1 073 400 Cr

The following additional information is available

- On acquisition, *Raid Limited* initially records items of property, plant and equipment at cost. In addition to the purchase price, cost includes all costs directly attributable to bringing the asset to the location and condition necessary for its intended use. Examples of these costs include installation and delivery costs.
- On 1 July 2005, Mr H. Tufuga, an independent valuer, revalued the land and buildings originally purchased on 31 December 2003. The valuation was based on the market value of surrounding properties. Mr H. Tufuga valued the land at $3 350 000 and the buildings at $1 642 800.
- On 30 June 2006, *Raid Limited* purchased additional land and buildings at a cost of $2 695 400. Of this amount, $1 789 400 was allocated to the cost of the land. These amounts have not yet been recorded in the general ledger.
- 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

Study the information above and answer the following question:

Prepare the full disclosure note for property, plant and equipment that would appear in the notes to the financial statements of *Raid Limited* for the year ending 30 June 2006.

SHOW YOUR WORKING

QUESTION FOUR: NEW ZEALAND FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS AND ACCOUNTING POLICIES (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

In October 2002 the Accounting Standards Review Board (ASRB) recommended to the New Zealand Government and other affected bodies that from 2007 listed issuers should comply with International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board (IASB). Issuers could however adopt IFRSs from 2005.

A number of claims have been made regarding the potential benefits that may accrue to New Zealand reporting entities from the international harmonisation process.

(a) **Identify** and **explain** the potential benefits that may accrue to New Zealand reporting entities from adopting IFRS.

(b) The following accounting policy has been extracted from the 2005 Annual Report of *Waste Management NZ Limited*.

BASIS OF PREPARATION

The financial statements comprise the statement of significant accounting policies, statement of financial performance, statement of movements in equity, statement of financial position and statement of cash flows, as well as the notes to these statements. The financial statements have been prepared in accordance with generally accepted accounting practice in New Zealand.

Where no financial reporting standard exists in New Zealand in relation to a particular issue, the accounting policies and disclosures adopted have been determined having regard to authoritative support.

The financial statements are prepared on the basis of historical cost with the exception of certain items for which specific accounting policies are identified.

Study the above extract and answer the following:

Explain why *Waste Management NZ Limited* or any other reporting entity points out to users of their annual report that the financial statements are prepared in accordance with "generally accepted accounting practice in New Zealand".

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Please turn over for QUESTION FIVE

QUESTION FIVE: ANALYSIS AND INTERPRETATION OF FINANCIAL REPORTS (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

The following information has been extracted from the 2005 Annual Reports of *Waste Management NZ Limited*. The last five years of the financial results and position have been extracted from the Five Year Trend Statement.

Waste Management NZ Limited
Five Year Trend Statement

	2005	**2004**	**2003**	**2002**	**2001**
	\$000	**\$000**	**\$000**	**\$000**	**\$000**
FINANCIAL PERFORMANCE					
Sales	250 314	212 676	181 316	163 293	153 448
Other revenue	1 634	679	607	641	1 023
Operating revenue	251 948	213 355	181 923	163 934	154 471
Operating surplus before taxation	49 261	42 680	31 484	25 587	21 726
Net surplus for the year	30 712	25 609	18 509	15 050	13 079
FINANCIAL POSITION					
Share capital	140 034	136 779	133 874	133 319	132 991
Reserves (including retained earnings)	51 379	52 523	45 600	41 940	35 460
Total equity	191 413	189 302	179 474	175 259	168 451
OTHER INFORMATION					
Earnings per share	30.7c	25.8c	18.8c	15.3c	13.4c
Dividends					
Dividends per share approved for year	30.8c	26.6c	15.8c	10.8c	7.5c
Financial					
Return on average shareholders' funds	16.1%	13.9%	10.4%	8.8%	8.1%
Shareholders' equity in total assets	53.7%	58.2%	62.8%	64.1%	61.2%
Earnings before interest and tax to interest expense (times cover)	10.8	13.6	11.9	7.5	6.8
Dividend cover	1.00	0.97	1.19	1.42	1.78
Number of shares issued during the year					
Options exercised	955 543	924 836	271 662	231 992	158 360
Shares issued	–	–	–	–	301 997
Total shares on issue	100 386 429	99 430 886	98 506 050	98 234 388	98 002 396

The following headlines and additional reporting on *Waste Management NZ Limited* have been extracted from the financial pages of various publications.

Profits up but Waste's share price drops

Waste collection and landfill company Waste Management posted a 29 per cent increase in half-year profit and predicted a 23 per cent rise in full-year profit.

However, Waste Management's shares fell as much as 30 cents yesterday before recovering slightly to close down 19c at $6.59.

Waste Management said net profit for the six months to June 30 rose 29 per cent before non-recurring items, to $14.81 million and revenue climbed 17.7 per cent to $119.9 million.

Last year, Waste Management made eight acquisitions, including the A$16 million (NZ$18 million) purchase of properties for a landfill and transfer station in Adelaide. These opened on January 1. However, chief financial officer Ken Bugden attributed most of the profit rise to organic growth.

Gareth Vaughn in *The Dominion Post*, Business, 9 August 2005

Waste Management gets rating boost

First NZ Capital this week lifted its rating on the stock of *Waste Management NZ* (WAM) to "outperform" from neutral because of relative share price movements in the past month. "Since August 23, 2005, Waste Management's share price has fallen 7.9%, while the NZSX50 has fallen only 0.2%," First NZ Capital analyst Murray Brown said in a report.

"First NZ Capital's current 12-month total projected return for WAM of 17.7% implies a projected rate of return relative to the market of 9.5%. This now leads to an outperform rating."

An outperform rating is when a stock's total return is expected to exceed the industry average by at least 10–15% over the next 12 months, according to First NZ Capital. A neutral rating is when the stock's total return is expected to be in line with the industry average range of plus or minus 10% over the next 12 months.

Sineva Toevai in *The National Business Review*, 16 September 2005

(a) One of your classmates has recently inherited 10 000 shares in *Waste Management NZ Limited*. At the date of inheritance the shares were valued at $65 000. Your classmate is uncertain what to do with the shares. Of particular concern is the article by Gareth Vaughn in *The Dominion Post*, dated 9 August 2005 'Profits up but Waste's share price drops'. Your classmate's choice is narrowed down to three options:

OPTION ONE – hold on to the shares

OPTION TWO – sell them and invest the proceeds in a 5% fixed deposit

OPTION THREE – sell them and buy a car for $65 000

Using the 2001 to 2005 information extracted from the 2005 Annual Report of Waste Management NZ Limited, as well as any other relevant information provided in this question, prepare a report to your classmate in which you make a *recommendation* on which one of the three options they should take. In supporting your position your report should:

(i) provide an analysis of the return on average shareholders' funds;
(ii) provide an analysis of the financial stability;
(iii) provide an analysis of the dividends and earnings returns;
(iv) provide a recommendation on which of the three options your classmate should choose.

Note: For the purposes of this question you may assume that your classmate can sell the shares for $65 000. Ignore any tax considerations.

(b) The following simplified, consolidated Statement of Cash Flows has been extracted from the 2005 Annual Report of *Waste Management NZ Limited*.

Waste Management NZ Limited

Statement of Cash Flows
for the year ended 31 December 2005

	2005	**2004**
	$000	**$000**
OPERATING ACTIVITIES		
Receipts from customers	244 382	220 829
Dividends from associate companies	650	345
Interest received	86	70
Payments to suppliers and employees	(163 536)	(149 358)
Taxes paid	(18 448)	(15 770)
Interest paid	(4 916)	(3 490)
Net cash flows from operating activities	58 218	52 626
INVESTING ACTIVITIES		
Disposal of property, plant and equipment	1 538	8 585
Loan repaid by associate company	322	–
Refund relating to prior year acquisition	–	339
Purchase of property, plant and equipment	(44 406)	(36 478)
Investment in associate company	–	(822)
Business purchases including goodwill	(6 427)	(30 031)
Interest paid and capitalised	(109)	(498)
Loans to associate companies	(2 600)	(267)
Net cash flows from investing activities	(51 682)	(59 172)
FINANCING ACTIVITIES		
Issue of shares	3 255	2 905
Term loans advanced	20 979	38 661
Dividends paid	(31 743)	(18 022)
Term loan repaid	–	(15 600)
Net cash flows from financing activities	(7 509)	7 944
MOVEMENTS IN CASH AND BANK OVERDRAFT		
Cash at 1 January	830	(577)
Cash at 31 December	(151)	830

The consolidated statement of cash flows shows that for the year ending 31 December 2005, *Waste Management NZ Limited* has decreased its cash position from a positive $830 000 to a negative balance of $151 000.

Study the cash flow statement above and **evaluate** the three areas of operating, investing and financing activities to assess how well *Waste Management NZ Limited* has managed its cash flows.

QUESTION SIX: PREPARATION AND INTERPRETATION OF ACCOUNTING INFORMATION FOR MANAGEMENT DECISIONS (8 marks)

*YOU SHOULD SPEND NO MORE THAN **30 MINUTES** ANSWERING THIS QUESTION.*

Margaret has just completed the Level 2 Certificate in Hairdressing at the local polytechnic. She hopes to open her own salon, and has been offered the following:

> She has found premises in Bayfair Shopping Centre at Mount Maunganui. She is able to rent a small shop in the premises for $1 200 per month. In addition, she has negotiated the lease of hairdressing equipment for $897 per month. She has decided to specialise in providing children's haircuts and plans to charge $10 per haircut. As part of her lease agreement with the shopping centre, she is required to open every day of the month between the hours of 9.00 am and 6.00 pm.

Variable Costs	Variable Costs per Unit
Direct labour	$2.50
Direct materials	$1.40
Variable overheads	$1.60

Fixed Costs	Total Fixed Costs per Month
Fixed overheads	$2 097

For the purposes of this question, assume that there are 30 days in a month.

Study the above information and answer the following questions:

(a) Explain what is meant by fixed and variable costs. Use examples from the hairdressing venture to illustrate your explanation.

(b) Explain to Margaret the importance of the break-even concept for the evaluation of this business venture.

(c) Calculate the break-even number of haircuts per month in units and in sales dollars. Show your workings.

(d) If the venture has a profit expectation of $6 003 per month, discuss fully whether this profit target is feasible. Include relevant calculations in your answer.

(e) Explain fully how the position in (d) would change if an additional hairdresser was employed at $2 996 per month, and the price per haircut was increased to $15.