case study 1.1

Corporation of New Zealand Limited Auditors' Report 2013

The following extract is taken from the Telecom Corporation of New Zealand Limited (Telecom NZ) Annual Report for the year ended 30 June 2013 (p. 69).

KPMG

Independent auditor's report

To the shareholders of Telecom Corporation of New Zealand Limited

Report on the company and group financial statements

We have audited the accompanying financial statements of Telecom Corporation of New Zealand Limited and the group, comprising the company and its subsidiaries, on pages 71 to 132. The financial statements comprise the statements of financial position as at 30 June 2013, the income statements and statements of comprehensive income, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, for both the company and the group.

Directors' responsibility for the company and group financial statements

The directors are responsible for the preparation of company and group financial statements in accordance with generally accepted accounting practice in New Zealand and International Financial Reporting Standards that give a true and fair view of the matters to which they relate, and for such internal control as the directors determine is necessary to enable the preparation of company and group financial statements that are free from material misstatement whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these company and group financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (New Zealand) and International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the company and group financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the company and group financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company and group's preparation of the financial statements that give a true and fair view of the matters to which they relate in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company and group's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, as well as evaluating the presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

We carry out other assignments on behalf of the company and group in the areas of other audit and assurance related services and advisory services. The firm, partners and employees of our firm also deal with the company and group on normal terms within the ordinary course of trading activities of the business of the company and group. These matters have not impaired our independence as auditors of the company and group. The firm has no other relationship with, or interest in, the company and group.

Opinion

In our opinion the financial statements on pages 71 to 132:

- comply with generally accepted accounting practice in New Zealand;
- comply with International Financial Reporting Standards;
- give a true and fair view of the financial position of the company and the group as at 30 June 2013 and of the financial performance and cash flows of the company and the group for the year then ended.

Report on other legal and regulatory requirements

In accordance with the requirements of sections 16(1)(d) and 16(1)(e) of the Financial Reporting Act 1993, we report that:

- we have obtained all the information and explanations that we have required; and
- in our opinion, proper accounting records have been kept by Telecom Corporation of New Zealand Limited as far as appears from our examination of those records.

KPMG

22 August 2013

Auckland, New Zealand

Questions

1 Does Telecom NZ provide a complete set of financial statements as required by NZ IAS 1?
2 The auditors state that the financial statements provide information about the financial performance and financial position of the company and group. What is the difference between 'company' and 'group'?
3 The directors of Telecom Corporation of New Zealand Limited are responsible for the preparation of financial statements that give a true and fair view of the financial position of the company and group. How can 'true' and 'fair' be assessed in this context?
4 Give examples of the 'estimates' and 'judgements' directors have to assume in the preparation of the financial statements.
5 The auditors seek reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error. How can materiality be reasonably defined in this context?
6 What is the 'New Zealand generally accepted accounting practice' the auditors refer to in their unqualified opinion?
7 Why does New Zealand legislation require the independent audit of financial statements?
8 Discuss whether the justification the auditors provide for their independence is sufficient.
9 What are the 'New Zealand Auditing Standards' the auditors' reports are based on, and who is responsible for setting such standards?
10 The auditors examined the amounts and disclosures in the financial statements only 'on a test basis'. Do you believe that this method is sufficient?

case study 1.1 solution

Telecom Corporation of New Zealand Limited Auditors' Report 2013

The following extract is taken from the Telecom Corporation of New Zealand Limited (Telecom NZ) Annual Report for the year ended 30 June 2013 (p. 69).

Independent auditor's report

To the shareholders of Telecom Corporation of New Zealand Limited

Report on the company and group financial statements

We have audited the accompanying financial statements of Telecom Corporation of New Zealand Limited and the group, comprising the company and its subsidiaries, on pages 71 to 132. The financial statements comprise the statements of financial position as at 30 June 2013, the income statements and statements of comprehensive income, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, for both the company and the group.

Directors' responsibility for the company and group financial statements

The directors are responsible for the preparation of company and group financial statements in accordance with generally accepted accounting practice in New Zealand and International Financial Reporting Standards that give a true and fair view of the matters to which they relate, and for such internal control as the directors determine is necessary to enable the preparation of company and group financial statements that are free from material misstatement whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these company and group financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (New Zealand) and International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the company and group financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the company and group financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company and group's preparation of the financial statements that give a true and fair view of the matters to which they relate in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company and group's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, as well as evaluating the presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

We carry out other assignments on behalf of the company and group in the areas of other audit and assurance related services and advisory services. The firm, partners and employees of our firm also deal with the company and group on normal terms within the ordinary course of trading activities of the business of the company and group. These matters have not impaired our independence as auditors of the company and group. The firm has no other relationship with, or interest in, the company and group.

Opinion

In our opinion the financial statements on pages 71 to 132:

- comply with generally accepted accounting practice in New Zealand;
- comply with International Financial Reporting Standards;
- give a true and fair view of the financial position of the company and the group as at 30 June 2013 and of the financial performance and cash flows of the company and the group for the year then ended.

Report on other legal and regulatory requirements

In accordance with the requirements of sections 16(1)(d) and 16(1)(e) of the Financial Reporting Act 1993, we report that:

- we have obtained all the information and explanations that we have required; and
- in our opinion, proper accounting records have been kept by Telecom Corporation of New Zealand Limited as far as appears from our examination of those records.

KPMG

22 August 2013

Auckland, New Zealand

Questions

1 Does Telecom NZ provide a complete set of financial statements as required by NZ IAS 1?
NZ IAS 1.10: A complete set of financial statements comprises:
(a) a statement of financial position (Balance Sheet) as at the end of the period
(b) a statement of comprehensive income (Income Statement) for the period
(c) a statement of changes in equity for the period
(d) a statement of cash flows (Cash Flow Statement) for the period

(e) notes, comprising a summary of significant accounting policies and other explanatory information
(f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively, or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity may use titles for the statements other than those used in this standard.

The auditors assure that Telecom NZ provided:

- an income statement (fulfils (b) in the above list)
- a statement of changes in equity (fulfils (c) in the above list)
- a balance sheet (fulfils (a) in the above list)
- a cash flow statement (fulfils (d) in the above list)
- the notes (fulfils (e) in the above list).

We do not know from the information provided if Telecom NZ has applied an accounting policy retrospectively, or has made a retrospective restatement of items in its financial statements, or has reclassified items in its financial statements, hence is required to provide a comparative statement of financial position (balance sheet) as stipulated in NZ IAS 1.10 (f). We can therefore assume that they provide a complete set of financial statements as required by NZ IAS 1.

2 The auditors state that the financial statements provide information about the financial performance and financial position of the company and group. What is the difference between 'company' and 'group'?

The group (here, Telecom NZ) refers to the aggregate (or consolidated) financial reports for the economic entity, being comprised of the parent or holding company, and all the subsidiary companies to which it is directly or indirectly connected. Subsidiary companies are those companies over which it has management control (normally through the ownership of the majority of voting shares). The company (here, Telecom Corporation of New Zealand Limited), refers to the legal accounts of the parent or holding company as a single entity.

3 The directors of Telecom Corporation of New Zealand Limited are responsible for the preparation of financial statements that give a true and fair view of the financial position of the company and group. How can 'true' and 'fair' be assessed in this context?

'True' and 'fair' have not been clearly defined, nor have these terms been tested in court. True and fair are normally closely linked with the provision of all material financial information that is necessary to facilitate the decision's usefulness (in the allocation of scarce resources) and the accountability (stewardship) roles of accounting. It can also be linked with preparing financial statements to conform with the accounting standards and other generally accepted accounting principles. Today, these other accepted accounting principles are largely represented by the *New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements (NZ Framework)*.

4 Give examples of the 'estimates' and 'judgements' directors have to assume in the preparation of the financial statements.

There are a multitude of incomplete transactions at the arbitrary end of each accounting period. The majority of these relate to:

- revenues and assets (uncollected credit sales, sales returns and allowances, constructions in progress)
- revenues and liabilities (unearned revenues, deposits received in advance)
- expenses and assets (depreciable assets, deferred expenses, prepayments, impaired assets, amortisation of identifiable intangibles)
- expenses and liabilities (accrued expenses, provisions for warranty).

Management are required to make estimates and judgements in relation to many incomplete transactions. Examples are:

- accounts receivable – the estimated amount for sales returns, early settlement discounts, warranty claims and bad debts
- inventory – the estimated losses through theft, damage and economic obsolescence
- Plant and equipment – the estimated fair value, useful life, pattern of consumption and residual value
- investments – the estimated fair value
- identifiable intangibles – the estimated recoverable amount, pattern of consumption, useful life and residual value
- goodwill – the estimated recoverable amount
- provision accounts (warranty, long-service leave, holiday pay) – the estimated amount and timing of the outlays.

5 The auditors seek reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error. How can materiality be reasonably defined in this context?

Materiality is largely defined in terms of whether the information would impact on decision making related to the allocation of scarce resources, or the assessment of compliance with professional, industry and statutory requirements. If the inclusion or exclusion, misstatement, or non-disclosure will impact on the users' assessment of the above, then it is said to be material.

6 What is the 'New Zealand generally accepted accounting practice' the auditors refer to in their unqualified opinion?

Accounting pronouncements issued by the New Zealand Institute of Chartered Accountants (NZICA) consist of:

- financial reporting standards
- statements of standard accounting practice
- guidance notes
- technical practice aids.

These accounting pronouncements represent Generally Accepted Accounting Practice (GAAP). In New Zealand, companies, issuers, most categories of public sector entities, and producer boards are required under legislation to comply with GAAP in the presentation of their external financial reports. In addition, NZICA requires members who are involved in preparing or reporting on the financial reports of entities to make best efforts to ensure that such financial reports comply with GAAP and to report any non-compliance if they do not.

Financial reporting standards are accounting pronouncements which have the greatest authority. Statements of standard accounting practice are older accounting standards that are yet to be revised to become financial reporting standards. Other accounting pronouncements have lower authority but are still authoritative as they will either provide interpretative guidance in applying the requirements of a financial reporting standard or will cover an area of financial reporting not covered by a financial reporting standard.

7 Why does New Zealand legislation require the independent audit of financial statements?

The New Zealand *Companies Act 1993* requires an independent financial audit to ensure an enhanced accuracy of the financial reporting process. An audit of financial statements is the review of the financial statements of a company or any other legal entity (including governments), resulting in the publication of an independent opinion on whether those financial statements are relevant, accurate, complete and fairly presented. Financial audits are typically performed by firms of practicing accountants due to the specialist financial reporting knowledge they require. The financial audit is one of many assurance or attestation functions provided by accounting and auditing firms, whereby the firm provides an independent opinion on published information.

Financial audits exist to add credibility to the implied assertion by an organisation's management that its financial statements fairly represent the organisation's position and performance to the firm's stakeholders. The principal stakeholders of a company are typically its shareholders, but other parties such as the Inland Revenue Department (IRD), banks, regulatory agencies, suppliers, customers, and employees may also have an interest in ensuring that the financial statements are accurate.

8 Discuss whether the justification the auditors provide for their independence is sufficient.
KPMG, Telecom NZ's elected auditor, has made the statement that 'other than in our capacity as auditors we have no relationship with nor interest in the company. Partners and employees of our firm may also deal with the company and group on normal terms within the ordinary course of trading activities of the business of the company and group. These matters have not impaired our independence as auditors of the company and group.' This has been a point of contention as proving audit independence can be difficult as there, as stated, may be relations between auditors and the organisation given the service Telecom provides. Students should critique the value of this independence in the light of recent corporate collapses (both within and external to New Zealand) and the role that the auditor had in relation to this.

9 What are the 'New Zealand Auditing Standards' the auditors' reports are based on, and who is responsible for setting such standards?
New Zealand Auditing Standards refer to the International Standards on Auditing (New Zealand) (ISAs (NZ)), which are adapted from the International Standards on Auditing and house a set of standards that guide the audit process. This is coupled with a professional code of ethics. The New Zealand Institute of Chartered Accountants, through the Professional Standards Board, take responsibility for the implementation, review and development of these standards.

10 The auditors examined the amounts and disclosures in the financial statements only 'on a test basis'. Do you believe that this method is sufficient?
It is important that the independent audit team collects sufficient and appropriate audit evidence to provide a valid audit opinion of the organisation. Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the ISAs (NZ):

(a) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

(b) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgement, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

case study 1.2

How sustainable is Telecom NZ's financial performance?

Telecom Corporation of New Zealand Limited (Telecom NZ) is listed on the New York Stock Exchange. One of many obligations under United States legislation arising from this listing is the disclosure of the nature of forward-looking statements made in the financial statements (Telecom NZ Annual Report 2013, pp. 169–170). Forward-looking statements provide investors with the management's stance on future developments that might have an effect on the financial performance and position of the company. See the next pages for this document.

Question

A SWOT analysis is a tool to visualise the strengths, weaknesses, opportunities and threats of a business on a matrix. It is often used as a management planning tool. However, it can also be used to analyse a company's potential to generate sustainable performance from an investor's perspective.

Develop a SWOT matrix for Telecom NZ based on the disclosure on forward-looking statements and any other information you may find about Telecom NZ. Based on your findings, discuss how sustainable Telecom NZ's financial performance is.

Forward-looking statements

This Report contains forward-looking statements within the meaning of Section 27A of the United States Securities Act of 1933 and Section 21E of the United States Securities Exchange Act of 1934. Such forward-looking statements are based on the beliefs of Telecom's management, as well as on assumptions made by, and information currently available to, Telecom at the time such statements were made.

These forward-looking statements include statements of Telecom's present expectations, beliefs, future plans, strategies, other anticipated developments and matters that are not historical facts. Forward-looking statements can generally be identified by the use of forward-looking words such as 'may', 'could', 'anticipate', 'estimate', 'expect', 'opportunity', 'plan', 'continue', 'objectives', 'outlook', 'guidance', 'intend', 'aim', 'seek', 'believe', 'should', 'will' and similar expressions.

These forward-looking statements include, without limitation, statements relating to:

- Telecom's operations and business prospects;
- Capital expenditure and investment plans;
- Telecom's business and operating strategies, including reducing costs, simplifying Telecom's business and improving customer experiences and operational performance;
- Telecom's expectations for its future financial performance generally;
- The regulatory environment and the impact of regulatory initiatives on Telecom;
- Future dividend payout levels;
- The performance of AAPT and its ability to achieve earnings growth;
- Cash flow from operations and existing cash and available borrowings sufficient to fund Telecom's expected capital expenditure, working capital and investment requirements;
- The performance of investments, including dividends from Southern Cross;
- Growth of, and opportunities available in, the communications and IT services markets and Telecom's positioning to take advantage of such opportunities;
- The convergence of technologies, growth and opportunities to offer new products and services;
- Plans for the launch of new products and services;
- Telecom's network and infrastructure development plans, including 4G LTE;
- Network performance, resilience and quality;
- The impact of legal proceedings, investigations and inquiries involving Telecom;
- Competition, market share, prices and growth; and
- The operating environment and overall market conditions and trends.

Such forward-looking statements are not guarantees of future performance. Actual results, performance or achievements could differ materially from those projected in, or implied by, the forward-looking statements as a result of various assumptions, risks and uncertainties. In addition to the risks described elsewhere in the Report under Risk factors, other factors and risks could cause actual results to differ materially from those described in the forward-looking statements. These factors and risks include, but are not limited to:

- Telecom's ability to successfully implement its strategy to shift from a traditional fixed and mobile infrastructure company to a future-orientated, competitive provider of communication entertainment and IT services;
- Telecom's ability to comply with regulatory requirements;
- Competition in the markets in which Telecom operates and the entrance of new competitors to these markets, particularly in the New Zealand market for mobile phone services;
- Uncertainties regarding fibre uptake;
- Rapid technological changes and convergence of telecommunications, information services and media markets and technologies;
- Degree of reliance on legacy fixed line revenues (including wholesale revenues;
- Uncertainties regarding operating new systems and technologies;
- Uncertainties regarding Telecom's ability to secure spectrum for it's 4G LTE network;
- Uncertainties about the degree of growth in the number of markets in which Telecom operates;
- Decreasing revenues from traditional services due to mobile and other substitution and competitive pressures;
- Technological innovations, including the cost of developing new products, networks and solutions and the need to increase expenditure to improve the quality of service;
- The anticipated benefits and advantages of new technologies, products and services, including broadband and other new-wave initiatives not being realised;
- Significant changes in market shares for Telecom and its principal products and services;
- Network or system interruptions;
- Use of third-party suppliers and the resources available in the New Zealand labour market for delivery of important services and projects;
- Uncertainties around acquisitions, divestments and investments;
- Future regulatory actions and conditions;
- General economic conditions within the countries in which Telecom operates; and
- Other factors or trends affecting the telecommunications industry generally, the economies in which Telecom operates and Telecom's financial condition in particular.

Given the risks, uncertainties and other factors, undue reliance should not be placed on any forward-looking statement, which speaks only as of the date made. Telecom does not undertake any obligation to review or confirm analysts' expectations or estimates or to release publicly any revisions to any forward-looking statements to reflect events or circumstances after the date of this Report or to reflect the occurrence of unanticipated events. Further, the information contained in this document is a statement of Telecom's intention as of the date of this filing and is based upon, among other things, the existing regulatory environment, industry conditions, market conditions and prices, the economy in general and Telecom management's assumptions. Telecom's management may change its intentions at any time and without notice based upon any changes in such factors, assumptions or otherwise.

case study 1.2 solution

How sustainable is Telecom NZ's financial performance?

Telecom Corporation of New Zealand Limited (Telecom NZ) is listed on the New York Stock Exchange. One of many obligations under United States legislation arising from this listing is the disclosure of the nature of forward-looking statements made in the financial statements (Telecom NZ Annual Report 2013, pp. 169–170). Forward-looking statements provide investors with the management's stance of future developments that might have an effect on the financial performance and position of the company. See the next pages for this document.

Question

A SWOT analysis is a tool to visualise the strengths, weaknesses, opportunities and threats of a business on a matrix. It is often used as a management planning tool. However, it can also be used to analyse a company's potential to generate sustainable performance from an investor's perspective.

Develop a SWOT matrix for Telecom NZ based on the disclosure on forward-looking statements and any other information you may find on Telecom NZ. Based on your findings, discuss how sustainable Telecom NZ's financial performance is. The model answer for this begins on p. 3, after the Telecom document.

Forward-looking statements

This Report contains forward-looking statements within the meaning of Section 27A of the United States Securities Act of 1933 and Section 21E of the United States Securities Exchange Act of 1934. Such forward-looking statements are based on the beliefs of Telecom's management, as well as on assumptions made by, and information currently available to, Telecom at the time such statements were made.

These forward-looking statements include statements of Telecom's present expectations, beliefs, future plans, strategies, other anticipated developments and matters that are not historical facts. Forward-looking statements can generally be identified by the use of forward-looking words such as 'may', 'could', 'anticipate', 'estimate', 'expect', 'opportunity', 'plan', 'continue', 'objectives', 'outlook', 'guidance', 'intend', 'aim', 'seek', 'believe', 'should', 'will' and similar expressions.

These forward-looking statements include, without limitation, statements relating to:

- Telecom's operations and business prospects;
- Capital expenditure and investment plans;
- Telecom's business and operating strategies, including reducing costs, simplifying Telecom's business and improving customer experiences and operational performance;
- Telecom's expectations for its future financial performance generally;
- The regulatory environment and the impact of regulatory initiatives on Telecom;
- Future dividend payout levels;
- The performance of AAPT and its ability to achieve earnings growth;
- Cash flow from operations and existing cash and available borrowings sufficient to fund Telecom's expected capital expenditure, working capital and investment requirements;
- The performance of investments, including dividends from Southern Cross;
- Growth of, and opportunities available in, the communications and IT services markets and Telecom's positioning to take advantage of such opportunities;
- The convergence of technologies, growth and opportunities to offer new products and services;
- Plans for the launch of new products and services;
- Telecom's network and infrastructure development plans, including 4G LTE;
- Network performance, resilience and quality;
- The impact of legal proceedings, investigations and inquiries involving Telecom;
- Competition, market share, prices and growth; and
- The operating environment and overall market conditions and trends.

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- Telecom's ability to successfully implement its strategy to shift from a traditional fixed and mobile infrastructure company to a future-orientated, competitive provider of communication entertainment and IT services;
- Telecom's ability to comply with regulatory requirements;
- Competition in the markets in which Telecom operates and the entrance of new competitors to these markets, particularly in the New Zealand market for mobile phone services;
- Uncertainties regarding fibre uptake;
- Rapid technological changes and convergence of telecommunications, information services and media markets and technologies;
- Degree of reliance on legacy fixed line revenues (including wholesale revenues;
- Uncertainties regarding operating new systems and technologies;
- Uncertainties regarding Telecom's ability to secure spectrum for it's 4G LTE network;
- Uncertainties about the degree of growth in the number of markets in which Telecom operates;
- Decreasing revenues from traditional services due to mobile and other substitution and competitive pressures;
- Technological innovations, including the cost of developing new products, networks and solutions and the need to increase expenditure to improve the quality of service;
- The anticipated benefits and advantages of new technologies, products and services, including broadband and other new-wave initiatives not being realised;
- Significant changes in market shares for Telecom and its principal products and services;
- Network or system interruptions;
- Use of third-party suppliers and the resources available in the New Zealand labour market for delivery of important services and projects;
- Uncertainties around acquisitions, divestments and investments;
- Future regulatory actions and conditions;
- General economic conditions within the countries in which Telecom operates; and
- Other factors or trends affecting the telecommunications industry generally, the economies in which Telecom operates and Telecom's financial condition in particular.

Given the risks, uncertainties and other factors, undue reliance should not be placed on any forward-looking statement, which speaks only as of the date made. Telecom does not undertake any obligation to review or confirm analysts' expectations or estimates or to release publicly any revisions to any forward-looking statements to reflect events or circumstances after the date of this Report or to reflect the occurrence of unanticipated events. Further, the information contained in this document is a statement of Telecom's intention as of the date of this filing and is based upon, among other things, the existing regulatory environment, industry conditions, market conditions and prices, the economy in general and Telecom management's assumptions. Telecom's management may change its intentions at any time and without notice based upon any changes in such factors, assumptions or otherwise.

Strengths

- The efficiency of Telecom's transformation strategy and Telecom's ability to successfully implement such strategy – from a traditional fixed and mobile infrastructure company to a future-orientated, competitive provider of communication entertainment and IT services.
- Telecom's network and infrastructure development.
- Telecom's 2014 outlook for the group's adjusted EBITDA, depreciation and amortisation and adjusted net earnings after tax, and expectations for Telecom's future performance generally.
- The target dividend payout.
- Cash flow from operations.
- Performance of investments, including dividends from Southern Cross.
- Telecom's ability to comply with regulations.
- Network performance and quality.

Weaknesses

- The impact of legal proceedings and investigations involving Telecom.
- Uncertainties regarding operating new systems and technologies.
- Uncertainties regarding fibre uptake.
- Uncertainties regarding Telecom's ability to secure spectrum for its 4G LTE network.
- Technological innovations, including the cost of developing new products, networks and solutions and the need to increase expenditures for improving the quality of service.
- Significant changes in market shares for Telecom and its principal products and services.

Opportunities

- Capital expenditure and investment plans.
- The performance of the Australian subsidiary AAPT and its ability to achieve sustainable and profitable revenue growth and reduction in operating costs.
- Cash flow from operations and existing cash and available borrowings are sufficient to fund Telecom's expected capital expenditure, working capital and investment requirements.
- The performance of investments, joint ventures and acquired businesses; growth of, and opportunities available in, the communications, IT services, information and entertainment sectors and Telecom's positioning to take advantage of those opportunities.
- The convergence of technologies and growth and opportunities to offer new wave products and services revenues.

- Plans for the launch of new products and services and Telecom's ability to grow its products, including traditional products and services revenue and core and new wholesale products.
- Telecom's network and infrastructure development plans, including 4G LTE.

Threats

- Competition in the markets in which Telecom operates and the entrance of new competitors to these markets, particularly in the New Zealand market for mobile phone services.
- The impact of the Undertakings and the government's national broadband initiative.
- The impact of further regulation regarding Telecom's telecommunications service obligations (TSO) under New Zealand law.
- Rapid technological changes and convergence of telecommunications, information services, and media markets and technologies.
- Decreasing revenues from traditional services owing to mobile and other substitution and competitive pressures.
- Network or system interruptions owing to natural disasters and other events such as fire, terrorism or sabotage, affecting key facilities, software faults, viruses, and power supply loss or overloading.
- Uncertainties around acquisitions and investments.
- General economic conditions within the countries in which Telecom operates.

Based on the above SWOT analysis a student should come to the realisation that Telecom is in a good financial position and its performance is relatively strong. A student's SWOT analysis will differ depending on the extent of research and analysis undertaken and information available on the Telecom New Zealand website: www.telecom.co.nz.

case study 1.3

Dispelling the 'Bean Counter' Image

While accountancy conjures up the image of someone stuck in an office number crunching, nothing could be further from the truth, says Megan Alexander.

Rather than simply being 'bean counters', the general manager of leading recruitment firm Robert Half New Zealand says today's accountants work in a variety of dynamic roles that are frequently at the very heart of the business.

Ms Alexander is urging teenagers returning to school and university study to put aside any ideas of accountants as people who just sit in front of computers manipulating spreadsheets. She wants them to consider accounting and finance as a career that offers excitement, variety and a world of opportunity.

'They work with every organisation, from large multinationals to small accounting practices, from government departments to charities, sports clubs and schools,' says Ms Alexander.

'Finance and accounting is a crucial part of every organisation, no matter what its core focus, which offers possibly the widest choice of working environments.

'There are still some of those "dry" roles around, but they're becoming few and far between. In the past accountants may have sat in the back office and not got involved, but in today's world that just can't happen.

'It's all about adding value and that means they've got to be at the forefront, helping to drive the business; accountants can be very influential these days.'

There are many different avenues to pursue, from the business analyst route, to management accounting through to the chartered accountancy side.

And while finance and accounting professionals obviously do need technical skill, Ms Alexander, herself a chartered accountant, says employers are increasingly looking for employees who are also 'people people'.

'Accounting and finance professionals often have to work with everyone in the organisation, from the CEO to the receptionist. They need to be able to explain financial issues in everyday language, to explain the impact of certain decisions on the business, to work in multi-disciplinary teams on crucial projects.

'Few other professions can match the variety of work available, or the number of career options. It is, quite honestly, a cool career.'

One example of a young accountant who says he has chosen an exciting and interesting career is Ash Matuschka, a 23-year-old senior auditor with Ernst & Young.

Mr Matuschka, whose hobbies outside work include racing inflatable rescue boats and surf-lifesaving ('that's my other, unpaid, job'), never considered accounting as a career when he was a child or a young teen.

But at university he chose to do a business degree 'because I thought I wanted to go into business'.

He decided to major in marketing and accounting and, by his second year, had become increasingly interested in becoming a chartered accountant.

He went straight from Auckland University to Ernst & Young, where he has been for three years, and has just completed his final professional exam to become a chartered accountant.

Now, he says, he has a fascinating job that takes him into a wide variety of organisations – all the way from listed companies to small charities – and involves working with 'all the different people in all the different roles' as he gets to understand each business.

Though most people understand his job involves checking financial statements and providing opinions on whether they are correct, Mr Matuschka says to do that auditors really need to understand every aspect of the business.

And that involves talking to people all the time.

'If you were not a people person in this job, you just wouldn't be able to do it,' he says.

'A chartered accountant is expected to be more than just someone who can look at numbers. There's an emphasis on problem-solving and communication.'

Ms Alexander says Mr Matuschka's situation isn't unusual – these days most new young accountants find a world of opportunities opening up to them.

'It is a great qualification to travel on – good finance and accounting professionals are always in demand throughout the world.'

Ms Alexander herself worked in London in a number of different roles within one company, from finance manager through to being a project accountant setting up systems.

'I got a lot of exposure to people around the business, it was good being able to talk to lots of different people, and it was one of those times when I thought, yes, accounting really is a cool career.'

With many professionals wanting to travel with their career, Robert Half has set up a website to help those wanting to work in other countries.

SOURCE: Robert Half New Zealand, 'Dispelling the Bean Counter Image', *The Dominion Post*, 22 March 2010, p. G3.

This newspaper article highlights many stereotypes currently held about accountants and the accounting profession. Using this article as a base, try to construct answers to the following questions.

Questions

1 Why did you choose to study accounting?
2 What are your own perceptions of accounting? (Perceptions are defined as a way of regarding, understanding or interpreting something.)
3 Identify the range of preconceptions that others possess about accounting. This could be done through an Internet search using key words, such as 'accountants', 'accounting', 'accounting profession', 'bean counters', 'chartered accountants', or by talking to your friends, family or teaching support.
4 Critically assess the implications of these preconceptions for accountants, accounting, and users of accounting information.

case study 1.3 solution

Dispelling the 'Bean Counter' Image

While accountancy conjures up the image of someone stuck in an office number crunching, nothing could be further from the truth, says Megan Alexander.

Rather than simply being 'bean counters', the general manager of leading recruitment firm Robert Half New Zealand says today's accountants work in a variety of dynamic roles that are frequently at the very heart of the business.

Ms Alexander is urging teenagers returning to school and university study to put aside any ideas of accountants as people who just sit in front of computers manipulating spreadsheets. She wants them to consider accounting and finance as a career that offers excitement, variety and a world of opportunity.

'They work with every organisation, from large multinationals to small accounting practices, from government departments to charities, sports clubs and schools,' says Ms Alexander.

'Finance and accounting is a crucial part of every organisation, no matter what its core focus, which offers possibly the widest choice of working environments.

'There are still some of those "dry" roles around, but they're becoming few and far between. In the past accountants may have sat in the back office and not got involved, but in today's world that just can't happen.

'It's all about adding value and that means they've got to be at the forefront, helping to drive the business; accountants can be very influential these days.'

There are many different avenues to pursue, from the business analyst route, to management accounting through to the chartered accountancy side.

And while finance and accounting professionals obviously do need technical skill, Ms Alexander, herself a chartered accountant, says employers are increasingly looking for employees who are also 'people people'.

'Accounting and finance professionals often have to work with everyone in the organisation, from the CEO to the receptionist. They need to be able to explain financial issues in everyday language, to explain the impact of certain decisions on the business, to work in multi-disciplinary teams on crucial projects.

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This newspaper article highlights many stereotypes currently held about accountants and the accounting profession. Using this article as a base, try to construct answers to the following questions.

Questions

This case study aims to address students' negative preconceptions of accounting by allowing them the opportunity to articulate their thought processes and address the impact of such preconceptions on the accounting profession.

1 Why did you choose to study accounting?
No set answer – this will depend on the student. The aim of this question is to allow a student to articulate themselves in their own language exactly why they chose to study accounting.

2 What are your own perceptions of accounting? (Perceptions are defined as a way of regarding, understanding or interpreting something.)
No set answer – this will depend on the student. The aim of this question is to allow a student the space and time to be able to document what it is they currently perceive accounting to be. This will often be based on current misconceptions, popular media, everyday life experience, and so on. It is a useful exercise to enable a student to articulate how they currently perceive the discipline of accounting and then once they have been exposed to a course on accounting to ask them again so they are able to see a difference in their perceptions.

3 Identify the range of preconceptions that others possess about accounting. This could be done through an Internet search using key words, such as 'accountants', 'accounting', 'accounting

profession', 'bean counters', 'chartered accountants', or by talking to your friends, family or teaching support.

There is no set answer for this question – without representing an exhaustive list, key findings may include:

- boring
- uninteresting
- mathematical
- objective
- a fear associated with an accountant, such as the auditor – may lead to budget cuts, restructuring, and so on
- cheap and tight with money
- lack of personality
- quantification – excluding all other matters of a social and environmental nature
- corporate collapse, with blame being placed on the accountant and the accounting profession.

4 Critically assess the implications of these preconceptions for accountants, accounting, and users of accounting information.

Students should arrive at the social costs associated with these preconceptions, including:

- negative social stigma of an individual's professional career – that they have little personality and are only interested in the bottom line
- critical shortage of accountants
- lack of understanding of the accounting profession can lead to a misconception of the role the accountant plays within society to ensure accountability, and so on
- narrow view by users of accounting information to include only information of a financial nature.

case study 2.1

Fonterra Co-Operative Group Limited shareholders' rights in a liquidation

47. LIQUIDATION

47.1 Distribution of assets: If the Company is liquidated the liquidator may, with the approval of Shareholders by Special Resolution and any other sanction required by the Act:

(a) divide among the Shareholders in kind the whole or any part of the assets of the Company (whether they consist of property of the same kind or not) and may for that purpose fix such value as the liquidator deems fair in respect of any property to be so divided, and may determine how the division shall be carried out as between Shareholders or between different Classes; and

(b) for the avoidance of doubt, all Co-operative Shares are Shares of the same Class and rank pari-passu and without priority or preference among themselves on liquidation notwithstanding that they may have been issued for different Fair Values; and

(c) vest the whole or any part of any such assets in trustees upon such trusts for the benefit of the persons so entitled as the liquidator thinks fit, but so that no Shareholder is compelled to accept any shares or other securities on which there is any liability.

SOURCE: Constitution of Fonterra Co-Operative Group Limited, 30 June 2010, Information on the Company, last accessed 02 September 2013: http://www.fonterra.com/wps/wcm/connect/ad590c8040a009d694d5f63dece10957/2154056+Consolidated+constitution+- +30+June+2010+-+v1.pdf?MOD=AJPERES

Questions

1 Briefly describe what is meant by a 'company liquidation'.
2 What does the word 'limited' refer to in the company name 'Fonterra Co-Operative Group Limited'?
3 If a company goes into liquidation, resources are normally distributed to creditors first. Who are the creditors?
4 Why would the creditors have priority over other stakeholders in the distribution of assets?
5 What is meant by a 'co-operative' form of business ownership?
6 What does the term 'pari-passu' mean in this context?
7 Explain how the surplus after the payment of all amounts owing to creditors and preference shareholders is to be distributed.

case study 2.1 solution

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Questions

1 Briefly describe what is meant by a 'company liquidation'.

Company liquidation is the process by which companies are terminated, assets are disposed of, shareholders may be called upon to contribute amounts uncalled or unpaid on their shares, creditors are fully or partly paid out in accordance with a strict set of priorities, and shareholders may or may not receive a distribution based on their rights and the residual asset (cash) balance remaining. At the end of the process there are no balances left in any accounts and the company ceases to exist (deregistered).

2 What does the word 'limited' refer to in the company name 'Fonterra Co-Operative Group Limited'?

The term 'limited' refers to the liability of the shareholders to contribute funds to the company. Companies can be classified as 'unlimited', 'limited', or 'no liability'. Limited means that the shareholders' liability to the company issuing the shares is limited to the prescribed or registered or issue value of the shares acquired. At any point in time the shareholder can only be asked to pay to the company on any shares owned the amount that has been called but not paid, plus the amount that has not previously been called. So if Mr Smith acquired 100 shares in Fonterra Co-Operative Group Limited at an issue price of $10, but which were called to $8 and he has only paid $7, then the maximum liability of Mr Smith being 100 shares times $3 ($1 called but not paid, plus $2 uncalled).

3 If a company goes into liquidation, resources are normally distributed to creditors first. Who are the creditors?

‘Creditor’ is a general term for a liability account where a specific individual and amount can be identified (as contrasted with provisions). It will include those providing funds (banks, loans, advances), those providing goods and contractual services (trade and other payables), and those providing labour (wages, sick leave, annual leave, long service leave, and so on).

4 Why would the creditors have priority over other stakeholders in the distribution of assets?
Shareholders are the residual owners of the business and they benefit from any gains and suffer losses. Creditors by their very nature have priority over the owners, but sometimes they will enter contracts also giving them preferential treatment over other creditors (a specific or general claim on certain assets, i.e. a mortgage), or the corporations law may give them priority (the amount owing to the tax office, the claims of the liquidator, the claims of employees).

5 What is meant by a ‘co-operative’ form of business ownership?
A co-operative is a business organisation owned and operated by a group of individuals for their mutual benefit. Co-operatives are defined by the International Co-operative Alliance’s Statement on the Co-operative Identity as autonomous associations of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through jointly owned and democratically controlled enterprises.

A co-operative is a legal entity owned and democratically controlled by its members. Members often have a close association with the enterprise as producers or consumers of its products or services, or as its employees. Co-operatives often share their earnings with the membership as dividends, which are divided among the members according to their participation in the enterprise, such as patronage, instead of according to the value of their capital shareholdings (as is done by a traditional company form of ownership).

Fonterra Co-operative Group Limited is a New Zealand multinational dairy co-operative owned by over 10 500 New Zealand farmers. The company controls about 30% of the world’s dairy exports. It is New Zealand’s largest company with revenue exceeding NZ$16 billion.

6 What does the term ‘pari-passu’ mean in this context?
The term ‘pari-passu’ is from the Latin meaning equal footstep or equal footing. In this context the term is referring to two or more classes of shares having equal rights of payment or level of preference.

7 Explain how the surplus after the payment of all amounts owing to creditors and preference shareholders is to be distributed.
The surplus will be distributed equally to the holders of Fonterra Co-Operative Group Limited shareholders on the basis of the issued and paid-up value of those shares.

case study 2.2

Telecom Corporation of New Zealand Limited's Approach to Corporate Governance

Governance at Telecom

The board and management are committed to ensuring that Telecom maintains international best practice governance structures and adheres to the highest ethical standards. The board regularly reviews and assesses Telecom's governance structures and processes to ensure that they are consistent with international best practice, in both form and substance.

Telecom's approach to corporate governance

Framework
Telecom has a dual listing of its shares on the New Zealand Stock Market (NZSX) and on the Australian Securities Exchange (ASX). Telecom is required to comply with the full listing rules of the NZSX and ASX. American Depositary Shares (ADSs), each representing five ordinary shares and evidenced by American Depositary Receipts (ADRs), are listed on the New York Stock Exchange (NYSE). The Bank of New York Mellon is Telecom's ADR Depositary.

As a result of Telecom's stock exchange listings in New Zealand, Australia and New York, it is subject to the governance requirements of each of these jurisdictions. This includes: the NZSX Listing Rules and Corporate Governance Best Practice Code; the New Zealand Securities Commission's report titled 'Corporate Governance in New Zealand Principles and Guidelines' (Securities Commission Principles and Guidelines); the ASX Listing Rules and ASX Corporate Governance Council's Principles and Recommendations; the United States Sarbanes-Oxley Act of 2002 and United States Securities and Exchange Commission (SEC) rules and the NYSE corporate governance rules.

Where there are conflicts between the requirements or best practice recommendations of New Zealand, Australia and the United States, the board has adopted practices and policies consistent with the requirements across these jurisdictions. The board will continue to monitor developments in the governance area and review and update its governance practices to ensure the most appropriate standards of governance for Telecom are maintained.

SOURCE: *Telecom Corporation of New Zealand Limited Annual Report 2013,* Governance at Telecom, p. 133.

Questions

The financial statements of Telecom Corporation of New Zealand Group are prepared in accordance with International Financial Reporting Standards (IFRS), which differ in certain aspects from US Generally Accepted Accounting Principles (GAAP).

1 Describe what is meant by the term GAAP.
2 Describe what is meant by the term IFRS.

3 Outline the difference between ‘Telecom Corporation of New Zealand Group’ and ‘Telecom Corporation of New Zealand Limited’.
4 Telecom Corporation of New Zealand Group is required to file an annual report with the United States Securities and Exchange Commission on Form 20-F. Describe the process that is required.
5 How does this differ from previous practice?
6 Outline jurisdictional governance requirements that Telecom Corporation of New Zealand Group is subject to. How might the organisation comply with such requirements?

case study 2.2 solution

Telecom Corporation of New Zealand Limited's Approach to Corporate Governance

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1 Describe what is meant by the term GAAP.
GAAP refers to 'Generally Accepted Accounting Principles/Practices'. Essentially it incorporates all of the statutory and professional reporting requirements and guidelines, together with the residual of historical accounting conventions or doctrines.

2 Describe what is meant by the term IFRS.

IFRS stands for 'International Financial Reporting Standards', which are produced by the International Accounting Standards Board.

3 Outline the difference between 'Telecom Corporation of New Zealand Group' and 'Telecom Corporation of New Zealand Limited'.
Telecom Corporation of New Zealand Group refers to the economic entity and the aggregated accounts being composed of the parent or holding company and all of the subsidiary companies controlled directly or indirectly by the holding company. Telecom Corporation of New Zealand Ltd represents the legal entity as the parent (holding) company on its own.

4 Telecom Corporation of New Zealand Group is required to file an annual report with the United States Securities and Exchange Commission on Form 20-F. Describe the process that is required.
A foreign private issuer of securities, such as Telecom Corporation of New Zealand Group, which is publically listed in the US, is required to file form 20-F with the United States Securities and Exchange Commission (SEC) in order to issue its annual report. This is a requirement of the United States *Securities and Exchange Act of 1934*.

The Form 20-F enables financial users to obtain a once-a-year overview of the business: financial results, business risks, management governance, and so on. The form also enables investors to learn more about the unique factors that affect the returns of foreign shares, from currency fluctuations to political pressures.

The United States Securities and Exchange Commission has recently changed its rules to accept from foreign private issuers in their filings with the Commission financial statements prepared in accordance with International Financial Reporting Standards ('IFRS') as issued by the International Accounting Standards Board ('IASB') without reconciliation to generally accepted accounting principles ('GAAP') as used in the United States. Current requirements regarding the reconciliation to US GAAP do not change for a foreign private issuer that files its financial statements with the Commission using a basis of accounting other than IFRS as issued by the IASB.

5 How does this differ from previous practice?
Telecom Corporation of New Zealand Limited shares are listed on the Australian, New Zealand and US Stock Markets. In the past (prior to early 2008), the International accounting standards satisfied listing on the Australian and New Zealand exchanges, but for the US listing US GAAP regulations had to be complied with, therefore Telecom Corporation of New Zealand Limited would have had to undertake a reconciliation of its financial statements between IFRS and US GAAP. This would then have needed to be disclosed to the United States Securities and Exchange Commission on Form 20-F.

6 Outline jurisdictional governance requirements that Telecom Corporation of New Zealand Group is subject to. How might the organisation comply with such requirements?
Jurisdictional Governance Requirements include:

- New Zealand – the NZSX Listing Rules and Corporate Governance Best Practice Code; the New Zealand Securities Commission's report titled 'Corporate Governance in New Zealand Principles and Guidelines' (Securities Commission Principles and Guidelines)
- Australia – the ASX Listing Rules and ASX Corporate Governance Council's Principles and Recommendations
- United States of America – the United States *Sarbanes-Oxley Act of 2002* and United States Securities and Exchange Commission (SEC) rules and the NYSE corporate governance rules.

Compliance with NZSX Best Practice Code, Securities Commission Principles and Guidelines and ASX Corporate Governance Council Recommendations:

- The NZSX Listing Rules require Telecom to include a statement in its annual report disclosing the extent to which it has followed the NZSX Corporate Governance Best Practice Code for the reporting period. Telecom considers its governance practices comply with the Code in its entirety for the year ended 30 June 2013. Telecom also considers that its governance practices comply with the Securities Commission Principles and Guidelines in their entirety for the year ended 30 June 2013.

This includes adhering to the principles of the Statement of Corporate Governance:

- observe and foster high ethical standards
- balance of independence, skills, knowledge and experience among directors so the board works effectively
- board uses committees to enhance effective decision making
- gain integrity in financial reporting and in the timeliness and disclosure of information
- remuneration of directors should be fair, transparent and reasonable
- risk management process and policy is in place
- ensure quality and independence of external audit
- foster constructive relationships with shareholders encouraging them to engage with the company
- respect the interests of stakeholders.

In addition, the ASX Listing Rules require Telecom to include a statement in its annual report disclosing the extent to which Telecom's governance practices comply with the ASX Corporate Governance Council Principles and Recommendations set out in the second edition of the Corporate Governance Principles and Recommendations during the reporting period, identifying the recommendations that have not been followed and providing reasons for that variance.

The ASX Corporate Governance Council released changes to the Corporate Governance Principles and Recommendations on 30 June 2010. Listed companies are expected to disclose the extent to which their governance practices comply with these changes in respect of financial years beginning on or after 1 January 2011.

Compliance with NYSE listing standards:

- As a 'foreign private issuer' registered with the SEC with securities listed on the NYSE, Telecom has a 'home country' exemption from most of the NYSE corporate governance requirements. However, Telecom is still required to comply with certain corporate governance requirements contained in United States securities laws, including applicable portions of the *Sarbanes-Oxley Act 2002* and applicable NYSE listing standards. As required under the NYSE listing standards and SEC rules, Telecom must provide a concise summary of any significant ways in which its corporate governance practices differ from those followed by United States domestic companies under the NYSE listing standards.

Telecom has reviewed the NYSE's corporate governance requirements and believes its practices are broadly consistent with the NYSE corporate governance requirements, with the following material exceptions:

- Under sections 303A.04 and 303A.05 of the NYSE corporate governance rules, United States domestic-listed companies are required to have a corporate governance committee and a compensation committee comprised entirely of independent directors. The Telecom committee charters of the Nominations and Corporate Governance Committee and the Human Resources and Compensation Committee require that only a majority of members be independent (as that term is defined in the board charter) directors, as permitted by New Zealand and Australian corporate governance requirements. In addition to the independence test contained in section 303A.02 of the NYSE corporate governance rules, the independence test contained in the board charter also contains the broader NZSX and ASX recommended independence standards.
- Under section 303A.08 of the NYSE corporate governance requirements, shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions of these plans. Telecom considers that its share plans all come within the definition of 'discretionary plan' as set out in the explanatory note to section 303A.08, which also states

that additional grants under discretionary plans may not be made without further shareholder approval. Since 2003, when the requirement came into effect, shareholder approval has been sought at the time each equity-compensation plan was established. However, Telecom will not be seeking further shareholder approval in relation to allocations under its share plans.

case study 2.3

New Zealand Farming and its Form of Business Ownership

Tenders for the Crafar family farms have closed with the receivers reporting 'significant' interest, but just how strong the buyer competition was, is for now anyone's guess.

The only two certainties at the 4 pm deadline were state-owned enterprise Landcorp, which today announced its bid would be a joint venture with its Wairakei Pastoral farming partners, businessmen Trevor Farmer, Mark Wyborn and Ross Green, and Chinese company Natural Dairy.

The Hong Kong-registered company had a purchase agreement for the 16, mainly dairy, farms conditional on getting Overseas Investment Office consent, and providing the receivers got no offer that suited them better.

Receivers Brendan Gibson and Michael Stiassny said in a statement today they expected 'a number' of other tenders before 4 pm. Assessing the offers would take some time and no further comment would be made until a decision had been made.

The Crafar farms, totalling 8,000 ha in the southern and central North Island, were put into receivership in October by their financiers, owed $200 million. Family spokesman Allan Crafar was reported today as saying he hoped to raise $200 million to settle the debts by 4pm. He declined to comment a short time ago.

Natural Dairy only applied for OIO consent yesterday after a drawn-out process that has included court action to try to get around the OIO obligation, and return of the company's first application for want of detail and the correct fee. The company has lodged an appeal over a High Court dismissal of its case to circumvent OIO approval.

Landcorp chief executive Chris Kelly said the joint venture bid with the Wairakei partners was for 'all 16 farms or nothing'.

The Wairakei farming partnership was formed six years ago after the three businessmen bought the former 25,000 ha Fletcher Forests. Landcorp has developed 9,000 ha into dairy farms and leases them from the partnership under a 40-year agreement, Mr Kelly said.

He said Landcorp's prospective partners in the Crafar farms bid were 'New Zealanders and long-term farm owners and investors'.

A new 50:50 company would be formed if the bid was successful.

'This would be a long-term partnership. We are no strangers to one another, and they are sound reputable businessmen.'

The new company could sell some of the Crafar farms on, but that was a decision for later, Mr Kelly said.

The joint venture offer would be conditional on vacant possession of three farm houses the Crafar family has so far resisted leaving.

SOURCE: Andrea Fox, 'Tenders Close for Crafar Farms', 7 July 2010, *Business Day*. Last accessed, 27 August 2010: http://www.stuff.co.nz/business/farming/3893313/Tenders-close-for-Crafar-farms.

Questions

1 Provide a brief synopsis of the article, outlining the key parties involved.
2 What is meant by the term ‘tender’?
3 Landcorp announced its bid for the Crafar Farms would be a joint venture with its Wairakei Pastoral farming partners. What is meant by the term ‘joint venture’?
4 The Wairakei farming partnership constitutes three partners and was established in 2004 after a land purchase of 25 000 hectares of Fletcher Forests. Explain what is meant by ‘mutual agency’ and how this would affect these partners.
5 Landcorp states that it developed 9000 hectares of land into dairy farms and leases them back from the partnership. Outline the advantages and disadvantages for Landcorp in this arrangement.
6 If this bid were successful a new company would be formed. Outline the potential advantages for the owners in forming a new company. What are the potential disadvantages to the company’s suppliers and how can they minimise their risk?
7 Landcorp chief executive Chris Kelly states that if the bid were successful a new company would be formed. He then comments, ‘This would be a long-term partnership’. Critically discuss what is meant by this phrase.

case study 2.3 solution

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Receivers Brendan Gibson and Michael Stiassny said in a statement today they expected 'a number' of other tenders before 4 pm. Assessing the offers would take some time and no further comment would be made until a decision had been made.

The Crafar farms, totalling 8,000 ha in the southern and central North Island, were put into receivership in October by their financiers, owed $200 million. Family spokesman Allan Crafar was reported today as saying he hoped to raise $200 million to settle the debts by 4pm. He declined to comment a short time ago.

Natural Dairy only applied for OIO consent yesterday after a drawn-out process that has included court action to try to get around the OIO obligation, and return of the company's first application for want of detail and the correct fee. The company has lodged an appeal over a High Court dismissal of its case to circumvent OIO approval.

Landcorp chief executive Chris Kelly said the joint venture bid with the Wairakei partners was for 'all 16 farms or nothing'.

The Wairakei farming partnership was formed six years ago after the three businessmen bought the former 25,000 ha Fletcher Forests. Landcorp has developed 9,000 ha into dairy farms and leases them from the partnership under a 40-year agreement, Mr Kelly said.

He said Landcorp's prospective partners in the Crafar farms bid were 'New Zealanders and long-term farm owners and investors'.

A new 50:50 company would be formed if the bid was successful.

'This would be a long-term partnership. We are no strangers to one another, and they are sound reputable businessmen.'

The new company could sell some of the Crafar farms on, but that was a decision for later, Mr Kelly said.

The joint venture offer would be conditional on vacant possession of three farm houses the Crafar family has so far resisted leaving.

SOURCE: Andrea Fox, 'Tenders Close for Crafar Farms', 7 July 2010, *Business Day*. Last accessed, 27 August 2010: http://www.stuff.co.nz/business/farming/3893313/Tenders-close-for-Crafar-farms.

Questions

1 Provide a brief synopsis of the article, outlining the key parties involved.
A family-owned farming enterprise, Crafar Farms, has been placed into receivership by its financiers, owing $200 million debt. The receivers have placed a tender for the 8000 hectares of land.

A leading bid has been placed by a joint venture between Landcorp, Wairakei Pastoral farming partners and a Chinese company, Natural Dairy. The tender being placed is for all 16 farms and is conditional on the vacation of the Crafar family from all residential lodging.

If the bid were successful it is planned to form a new company in which to control the newly acquired assets.

2 What is meant by the term 'tender'?
A tender is an open offer or invitation to the public (usually announced in a newspaper advertisement) to tender a purchase price for a business for sale by a specified time. In this case a tender was put out by the receivers of Crafar Farms to settle prior debt.

3 Landcorp announced its bid for the Crafar Farms would be a joint venture with its Wairakei Pastoral farming partners. What is meant by the term 'joint venture'?
A joint venture is defined by 'NZ IAS 31: Interests in Joint Ventures' as:

> A *joint venture* is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Joint ventures take many different forms and structures. This Standard identifies three broad types – jointly controlled operations, jointly controlled assets, and jointly controlled entities – that are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

(a) two or more venturers are bound by a contractual arrangement; and
(b) the contractual arrangement establishes joint control.

In this case the joint venture is in the form of a jointly controlled entity bearing a contractual arrangement (in the form of a company as per the end of the article) between Landcorp, Wairakei Pastoral farming partners and a Chinese company, Natural Dairy, to take over the operations of the farms.

4 The Wairakei farming partnership constitutes three partners and was established in 2004 after a land purchase of 25 000 hectares of Fletcher Forests. Explain what is meant by 'mutual agency' and how this would affect these partners.
'Mutual agency' essentially means that partners will be responsible jointly and separately for the actions of other partners in relation to the business operations.

In this case, if one of the partners misappropriated funds, all other partners could be held jointly liable.

5 Landcorp states that it developed 9000 hectares of land into dairy farms and leases them back from the partnership. Outline the advantages and disadvantages for Landcorp in this arrangement.

Potential advantages of leasing

- Leasing is less capital-intensive than purchasing, so if a business has constraints on its capital, it can grow more rapidly by leasing property than it could by purchasing the property outright.
- Capital assets may fluctuate in value. Leasing shifts risks to the lessor, but if the property market has shown steady growth over time, a business that depends on leased property is sacrificing capital gains.
- Leasing may provide more flexibility to a business, which expects to grow or move in the relatively short term, because a lessee is not usually obliged to renew a lease at the end of its term.

- In some cases a lease may be the only practical option.
- Depreciation of capital assets has different tax and financial reporting treatment from ordinary business expenses. Lease payments are considered expenses, which can be set off against revenue when calculating taxable profit at the end of the relevant tax accounting period.

Potential disadvantages of leasing

- A lease may shift some or all of the maintenance costs onto the lessee.
- If circumstances dictate that a business must change its operations significantly, it may be expensive or otherwise difficult to terminate a lease before the end of the term. In some cases, a business may be able to sublet property no longer required, but this may not recoup the costs of the original lease, and, in any event, usually requires the consent of the original lessor. Tactical legal considerations usually make it expedient for lessees to default on their leases.
- If the business is successful, lessors may demand higher rental payments when leases come up for renewal. If the value of the business is tied to the use of that particular property, the lessor has a significant advantage over the lessee in negotiations.

6 If this bid were successful a new company would be formed. Outline the potential advantages for the owners in forming a new company. What are the potential disadvantages to the company's suppliers and how can they minimise their risk?

Possible benefits to the owner:

- limited liability
- unlimited life
- possible taxation benefits (lower maximum tax rate)
- possible access to funds from additional owners
- potentially the ability to transfer or sell part of the ownership interest without selling the entire business
- possible separation of ownership and management.

Possible disadvantages to the suppliers:

The major disadvantage to suppliers is that of the limited liability of the owners in relation to business debts.

Obviously not all suppliers of goods and services are protected, as we read regularly that they lose all or part of what is owed to them when companies are liquidated (for example, Ansett, Feltex, Enron, HIH insurance, and so on). However, a number of factors, requirements or actions are designed to provide protection including:

- the legal requirement for companies to prepare financial reports in conformity with statutory accounting standards
- suppliers require payments to be made in advance
- creditors require personal guarantees by the owners or management
- lenders take out a specific claim against tangible assets of the company (mortgage, bill of sale)
- creditors will rank before the shareholders in the distribution of assets in the event of liquidation of the company
- lending agreements restrict the financial practices
    - maximum level of debt to assets
    - minimum required return on assets
    - limitations on profit distributions

- restrictions on asset sales
- specification of accounting methods that can be used.

7 Landcorp chief executive Chris Kelly states that if the bid were successful a new company would be formed. He then comments, 'This would be a long-term partnership'. Critically discuss what is meant by this phrase.

Landcorp chief executive Chris Kelly stated in the article that if the bid was successful it is likely that a joint venture will proceed in the form of a jointly controlled entity in the establishment of a new company. This company would constitute the legal entity and can consume and provide assets just like an individual.

He has then commented that this would be a 'long-term partnership. We are no strangers to one another, and they are sound reputable businessmen.' The context in which this phrase is used is within the everyday use of the word partnership in terms of the businessmen working together. It is not meant in the context of a legal form of ownership.

case study 3.1

Telecom Corporation of New Zealand Limited
Balance Sheet

Statement of financial position

As at 30 June 2013 and 2012

AS AT 30 JUNE (DOLLARS IN MILLIONS)	NOTES	GROUP 2013 NZ$M	GROUP 2012 NZ$M	PARENT 2013 NZ$M	PARENT 2012 NZ$M
Current assets:					
Cash		118	185	–	–
Short-term derivative assets	12	5	1	–	–
Receivables and prepayments	13	658	684	1	1
Taxation recoverable		4	53	99	84
Inventories	14	53	49	–	–
Total current assets		838	972	100	85
Non-current assets:					
Long-term investments	15	77	57	7,155	8,129
Long-term receivables and prepayments	13	159	222	–	–
Long-term derivative assets	12	1	1	–	–
Intangible assets	16	1,071	900	–	–
Property, plant and equipment	17	1,347	1,515	–	–
Total non-current assets		2,655	2,695	7,155	8,129
Total assets		3,493	3,667	7,255	8,214
Current liabilities:					
Accounts payable and accruals	18	819	775	37	69
Taxation payable		6	6	–	–
Short-term derivative liabilities	12	1	3	–	–
Short-term provisions	19	35	13	–	–
Debt due within one year	20	225	407	3,715	4,241
Total current liabilities		1,086	1,204	3,752	4,310
Non-current liabilities:					
Deferred tax liabilities	21	146	159	–	–
Long-term derivative liabilities	12	22	23	–	–
Long-term payables and accruals	18	30	30	–	–
Long-term provisions	19	45	20	2,052	1,897
Long-term debt	22	751	605	–	–
Total non-current liabilities		994	837	2,052	1,897
Total liabilities		2,080	2,041	5,804	6,207
Equity:					
Share capital	23	899	990	899	990
Reserves	23	(504)	(495)	2	7
Retained earnings		1,012	1,126	550	1,010
Total equity attributable to equity holders of the Company		1,407	1,621	1,451	2,007
Non-controlling interests		6	5	–	–
Total equity		1,413	1,626	1,451	2,007
Total liabilities and equity		3,493	3,667	7,255	8,214

See accompanying notes to the financial statements.

On behalf of the Board

Mark Verbiest, Chairman

Authorised for issue on 22 August 2013

Simon Moutter, Chief Executive Officer

SOURCE: *Telecom Corporation of New Zealand Limited Annual Report 2013*, p. 77.

Questions

1 Figures are provided for both ‘Telecom Corporation of New Zealand Group’ and ‘Telecom Corporation of New Zealand Parent’.
  (a) What is the difference between these two entities?
  (b) Why are the two sets of figures provided?
2 The assets are classified as ‘current’ and ‘non-current’.
  (a) What is the difference between these two categories?
  (b) How else could the assets be classified?
3 What sort of items would be included in the inventory of ‘Telecom Corporation of New Zealand Group’?
4 Both the current and non-current liability categories include an account labelled ‘Provisions’.
  (a) What does the term ‘provision’ mean?
  (b) Provide possible examples of liability provision accounts.
  (c) Discuss how a provision can be both a ‘current liability’ and a ‘non-current liability’.
5 Intangible assets make up 40.3% of Telecom Corporation of New Zealand Group’s 2013 total non-current assets.
  (a) What is meant by the term ‘intangible assets’?
  (b) What are some likely examples of intangible assets that Telecom Corporation of New Zealand may hold?
6 Does this report represent an ‘entity’ or ‘proprietary’ approach to the accounting equation?
7 Outline what is meant by ‘long-term derivative assets’. You should also illustrate your answer with examples.
8 Provide possible examples of ‘Reserve’ accounts for Telecom Corporation of New Zealand.
9 Why would accounts payable and accruals of the Telecom Corporation of New Zealand Group be greater than accounts payable and accruals of Telecom Corporation of New Zealand Parent?

case study 3.1 solution

Telecom Corporation of New Zealand Limited
Balance Sheet

Statement of financial position

As at 30 June 2013 and 2012

AS AT 30 JUNE		GROUP		PARENT	
		2013	2012	2013	2012
(DOLLARS IN MILLIONS)	NOTES	NZ$M	NZ$M	NZ$M	NZ$M
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See accompanying notes to the financial statements.

On behalf of the Board

Mark Verbiest, Chairman
Authorised for issue on 22 August 2013

Simon Moutter, Chief Executive Officer

SOURCE: *Telecom Corporation of New Zealand Limited Annual Report 2013*, p. 77.

Questions

1 Figures are provided for both 'Telecom Corporation of New Zealand Group' and 'Telecom Corporation of New Zealand Parent'.

(a) What is the difference between these two entities?

Telecom Corporation of New Zealand Parent represents the parent, holding or controlling company's report. It is the report of a single legal entity that has controlling interests in a number of other companies within the group.

Telecom Corporation of New Zealand Group represents the financial position of the economic entity comprising the holding or parent company and all other subsidiary entities within the group (those where the holding or parent company has direct or indirect control).

(b) Why are the two sets of figures provided?

Two sets of figures are provided to show the balance sheet of the holding company Telecom Corporation of New Zealand Parent as a separate entity and subsequently the balance sheet for the overall Telecom Corporation of New Zealand Group to include all interests of subsidiaries.

2 The assets are classified as 'current' and 'non-current'.

(a) What is the difference between these two categories?

Current assets represent those assets that are in the form of cash, or will be converted to cash or fully used up or realised within either the next accounting cycle period or 12 months. Non-current assets are those that will not be converted to cash or fully used up or realised within the next 12 months or operating cycle period.

(b) How else could the assets be classified?

An acceptable alternative, providing it provides more relevant information, is to classify the assets in order of liquidity (the speed with which non-cash assets can be converted to cash).

3 What sort of items would be included in the inventory of 'Telecom Corporation of New Zealand Group'?

Inventory refers to raw material used in the production process, work or goods in process (partly produced), finished goods for sale (merchandise) or use, and consumable stores.

In the case of Telecom you could identify possible items within each class:

- maintenance materials and consumables
- goods held for resale
- work in progress.

4 Both the current and non-current liability categories include an account labelled 'Provisions'.

(a) What does the term 'provision' mean?

According to *NZ IAS 37: Provisions, Contingent Liabilities and Contingent Assets*, a provision is a liability of uncertain timing or amount.

A provision shall be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event
- it is probable that outflow of resources embodying economic benefits will be required to settle obligation, and
- a reliable estimate can be made of the amount of the obligation.

(b) Provide possible examples of liability provision accounts.

The liability provisions relate to expected future outlays of economic benefits related to existing contractual claims against the entity, but normally where the amount of the claim has not been previously determined (for example, insurance, warranty, long service leave, holiday pay, taxation).

Specific examples include:

- Commercial – these provisions principally relate to the cost of rectifying several billing application configuration issues, and covers the cost of investigating and resolving these issues.
- Property – property provisions relate primarily to make good requirements under property leases.
- Other – other provisions include legal provisions.

(c) Discuss how a provision can be both a 'current liability' and a 'non-current liability'.

The expected future outflow of goods or services may be within one year or within the normal operating cycle (classified as 'current'), or beyond that time frame (classified as 'non-current').

5 Intangible assets make up 40.3% of Telecom Corporation of New Zealand Group's 2013 total non-current assets.

(a) What is meant by the term 'intangible assets'?

NZ IAS 38: Intangible Assets defines an intangible asset as '[a]n identifiable non-monetary asset without physical substance'.

> '... Physical form is not essential to the existence of an asset ... [intangible assets exist] if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.' (NZ Framework, para 56)

Three conditions need to be established before an item can be recognised as an intangible asset. The item must be non-monetary, identifiable, and lack physical substance.

An asset meets the identifiability criterion in the definition when it:

- is separable, that is, is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability, or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

(b) What are some likely examples of intangible assets that Telecom Corporation of New Zealand may hold?

Examples include patents, goodwill, research and development, mastheads, brand names, copyrights, and trademarks.

Examples specific to Telecom include software, capacity, spectrum licences, other intangibles, and goodwill.

6 Does this report represent an 'entity' or 'proprietary' approach to the accounting equation?

The report uses the proprietary approach (OE = A – L).

7 Outline what is meant by 'long-term derivative assets'. You should also illustrate your answer with examples.

A long-term derivative asset is a type of financial instrument governed by *NZ IAS 39: Financial instruments: Recognition and Measurement*. NZ IAS 39 defines a derivative in para 9 as:

Definition of a derivative

A *derivative* is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying')

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

(c) it is settled at a future date.

Examples include:

- currency options
- electricity price hedges
- foreign exchange contracts
- interest rate swaps
- cross-currency interest rate swaps.

8 Provide possible examples of 'Reserve' accounts for Telecom Corporation of New Zealand.

Examples of reserve accounts are:

- asset revaluation reserve
- capital reduction reserve
- capital profits reserve
- asset replacement reserve
- forfeited shares reserve
- foreign currency translation reserve
- dividend equalisation reserve.

9 Why would accounts payable and accruals of the Telecom Corporation of New Zealand Group be greater than accounts payable and accruals of Telecom Corporation of New Zealand Parent?

The accounts payable and accruals of Telecom Corporation of New Zealand Parent will only include the accounts payable and accruals of that company. The accounts payable and accruals of the Telecom Corporation of New Zealand Group will represent an aggregation of all of the accounts payable and accruals of the parent company and all subsidiary companies.

case study 3.2

Enron Boss to Turn Himself In

ENRON: THE KEY PLAYERS

To be indicted

Kenneth Lay

To be indicted overnight on charges relating to accounting fraud that drove Enron into bankruptcy.

Guilty pleas

Andrew Fastow

Pleaded guilty in January to two counts of wire fraud and conspiracy to commit wire and securities fraud. His wife Lea, a one-time director and assistant treasurer of corporate finance at Enron, faces one year in jail after pleading guilty to a single count of filing a false income tax return.

Awaiting trial

Jeffrey Skilling

Former CEO was indicted on 35 counts of securities fraud, insider trading, wire fraud and conspiracy in February. He pleaded not guilty and is free on bond.

Richard Causey

Former chief accountant was indicted in January. He faces 31 counts of fraud, conspiracy and insider trading.

The company

Enron could emerge from Chapter 11 bankruptcy protection by July 15, the deadline for when a bankruptcy judge may issue his approval of the company's reorganisation plan. Under the plan, creditors stand to receive 20c for every dollar owed – 92 per cent in cash and the rest in equity in Prisma Energy International, which owns Enron's foreign assets. Enron's other assets have been sold, or are in the process of being sold.

Thirty months after the collapse of Enron shook US market capitalism to its core, former boss Ken Lay will turn himself in to the FBI today and appear in court to face criminal charges that he conspired to defraud investors.

A friend of President George W Bush and a member of Houston society, Mr Lay, 62, is expected to suffer the indignity of wearing handcuffs as he is paraded like the catch of the day for the media on his way into the courtroom.

He will plead not guilty to the long-awaited charges, which are yet to be specified but were said to include fraud and insider trading.

‘I have been advised that I have been indicted,’ Mr Lay said last night. ‘I will surrender in the morning. I have done nothing wrong and the indictment is not justified.’

Mr Lay became the public face of corporate greed after Enron – the energy trader he built into the seventh-largest US company by sales – filed for bankruptcy in December 2001.

Thousands lost their jobs and billions of dollars of shareholder wealth evaporated in what was then the largest bankruptcy filing in US history.

The collapse of telecommunications giant WorldCom almost two years ago dwarfed Enron in terms of assets destroyed but the Enron disaster dented America’s faith in the capital markets by revealing that some companies’ balance sheets were garbage wrapped in glossy paper.

As rumours that the indictment was imminent drew stronger in past weeks, Mr Lay broke his silence to profess his innocence, blaming underlings such as former chief financial officer Andrew Fastow for cooking up the off-balance-sheet schemes that hid Enron’s ballooning debt.

The Enron collapse brought down accounting giant Arthur Andersen and prompted Washington to enact corporate governance reforms.

Mr Lay, whose wealth was largely tied up in Enron stock, suffered along with investors. Worth more than $US400 million at the start of 2001, Mr Lay told *The New York Times* recently that of his remaining $US20 million, about $US19 million would be used for legal fees and to pay off debt.

The indictment is a huge step in a two-year investigation by the Justice Department, which has so far yielded criminal charges against 30 individuals, including Fastow and Jeffrey Skilling, who resigned as Enron chief executive in August 2001 after only six months in charge.

Skilling’s departure ended Mr Lay’s thoughts of moving on from Enron, ensuring the Texas titan, who was once rumoured to be in line for a cabinet post in the Bush administration, was at the helm when the ship went down.

Enron investigators are believed to have focused on this period, when Mr Lay made numerous public announcements expressing confidence in Enron while he was selling the stock and while whistleblowers such as Sherron Watkins – later named one of *Time* magazine’s Persons of the Year in 2002 – were sending him warning emails.

Federal prosecutors scored a coup in January when Fastow pleaded guilty to two counts of conspiracy and agreed to assist the investigation.

A similar strategy was used in the WorldCom investigation, with prosecutors waiting for CFO Scott Sullivan to agree to co-operate before they charged CEO Bernie Ebbers.

SOURCE: Rodney Dalton, New York Correspondent, ‘Enron boss to turn himself in’, *The Australian*, 9 July 2004, p. 17.

Questions

1 Briefly highlight key aspects of the Enron financial disaster.

2 Mr Lay, the CEO of Enron, is to be charged with fraud and insider trading.
   (a) What is ‘insider trading’?
   (b) Why does company law view ‘insider trading’ so severely?

3 The article said ‘that some companies’ balance sheets were garbage wrapped in glossy paper’.
   (a) What is a balance sheet supposed to reveal about a reporting entity?

(b) What is the balance sheet equation?
(c) Why might any of the assets, liability or owners' equity, or their balances, be incorrect?

4 What is 'off-balance-sheet' debt?
5 How did the collapse of Enron bring down the giant auditing firm of Arthur Andersen?
6 Is it ethical for the CEO to sell shares in the company while at the same time making 'numerous announcements expressing confidence in Enron'?

case study 3.2 solution

Enron Boss to Turn Himself In

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Kenneth Lay

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SOURCE: Rodney Dalton, New York Correspondent, 'Enron boss to turn himself in', *The Australian*, 9 July 2004, p. 17.

Questions

1 Briefly highlight key aspects of the Enron financial disaster.
A student is expected to complete a web search in order to outline, in chronological order, key events in the Enron timeline and corporate collapse.

However, the key accounting issues revealed in nearly every recent corporate crash are:

(a) Revenues have been overstated. They have been recognised before they have been realised (in advance of receiving the cash or having an unavoidable claim to a certain amount of cash).
(b) Expenses have been understated. Expenditure has been deferred as an asset in situations

where there are going to be no future economic benefits related to that expenditure. This has been particularly evident in relation to intangible items (research and expenditure, advertising, goodwill, other identifiable intangibles, set-up costs). It also relates to management errors in under-estimating the economic benefits of tangible assets used up during the period (for example, inventory obsolescence, depreciation, amortisation, impairment). The expense understatement also relates to inadequate provisions for transactions arising during those periods (for example, employee benefits, restoration of the environment, warranty claims, taxation).

(c) Assets have been overstated for reasons already identified above (receivables that will not be collected, intangibles that will generate no future benefits, inventory that is obsolete, property, plant and equipment with values that cannot be recovered).

(d) Liabilities that have been understated through omission, misstatements, or reliance on the legal form, rather that the underlying substance of the financial arrangement. Liabilities in relation to stakeholder claims are understated (for example, employee benefits, restoration of the environment, warranty claims). Liabilities related to executory costs are not shown (for example, operating leases, construction contracts, purchase contracts, employment contracts). Liabilities in relation to future contingencies are excluded, and those contingencies are no longer remote or immaterial (for example, legal suits, guarantees). Liabilities have been labelled as owners' equity (for example, preference shares that are secured and redeemable).

(e) The parties responsible for oversight have failed. This includes the management, directors and the auditors.

2 Mr Lay, the CEO of Enron, is to be charged with fraud and insider trading.

(a) What is 'insider trading'?
Insider trading is using private information gained in your employment position, and which is not available publicly to other investors or stakeholders, to make a financial gain in the market.

(b) Why does company law view 'insider trading' so severely?
The company law is concerned not just that such behaviour is immoral, but that it will severely impact on market confidence. The regulations under corporations law, and its enforcement, is aimed at providing equity for all stakeholders related to the operations of companies and maintaining the confidence of the general public in the equities market.

3 The article said 'that some companies' balance sheets were garbage wrapped in glossy paper'.

(a) What is a balance sheet supposed to reveal about a reporting entity?
A balance sheet is a statement of financial position at a point in time identifying the monetary balances in the assets and the claims against those assets (inside − owners' equity, and outside – liabilities).

(b) What is the balance sheet equation?
The balance sheet equation: A = L + OE or OE = A − L.

(c) Why might any of the assets, liability or owners' equity, or their balances, be incorrect?
Different interpretations could be made of the term 'incorrect'. Does it mean that they were inconsistent with the economic reality, yet consistent with the regulations, or does it mean they were inconsistent with the regulations, or inconsistent with particular critics' interpretations of those regulations?

In answering the following should be considered:

- Element definition – conflict may have arisen in terms of what represents an asset, a liability, and owners' equity. The definitions are subject to different interpretations.
- Element recognition – conflict may have arisen in terms of the recognition criterion (probability and reliability of measurement), which are subjective in nature.

- Transaction measurement – accounting uses a range of different measures for assets and liabilities including historical cost, residual historical cost, fair value, market value, recoverable amount, value in use, value in exchange, net realisable value, deprival value and net present value. The assessment of what each term means is not always clear, and objective determination of the stated figures may be even more difficult.
- Estimation – many of the accounting measures used require management or expert estimation of future variables. This estimation process by its very nature will lead to differences in outcomes (examples of estimates include asset lives, residual values, pattern of use, expected collection, future claims, changes in wage level, interest rates, exchange rates, regulations, technological changes, economic growth, and so on).
- Accounting method choice – within existing regulations management is given considerable choice (for example, to capitalise or expense certain outlays, to use accelerated or straight line depreciation, to use FIFO or weighted average inventory, to use the direct or indirect approach for bad debts, to revalue assets or use the cost method, and so on).
- Disclosure methods – information can be revealed directly in the accounts, or in the notes to the accounts, or by other disclosures (directors' statement, news release).
- Intentional or unintentional material errors or omissions in terms of accounts and account balances.

4 What is 'off-balance-sheet' debt?
Off-balance-sheet financing refers to obligations of the entity that are not included in the balance sheet as a liability. This arises from intentional or unintentional error, or in relation to what has been known as 'executory contracts'. Executory contracts are those contracts that are either equally performed or unperformed at a given point in time. Common examples might be building contracts, future sales contracts, employment contracts or lease agreements. Given that there has not been performance by the other party (builder, customer, employee, lessor) there is no need to recognise either the asset or the liability. However, in these cases there is often a legal contractual obligation in place that the entity cannot avoid and yet no record of this appears on the balance sheet.

5 How did the collapse of Enron bring down the giant auditing firm of Arthur Andersen?
The collapse of Enron brought down the giant accounting firm of Arthur Andersen in at least two ways:
- First, because there were massive claims against Arthur Andersen and its partners, the liquidation of the business was really the only option.
- Second, the business would have been unlikely to have survived, as clients would have left en masse for other accounting service providers.

6 Is it ethical for the CEO to sell shares in the company while at the same time making 'numerous announcements expressing confidence in Enron'?
It is not necessarily legally or morally wrong for the CEO to provide advice to others to acquire shares in a company while at the same time selling shares in that company. The CEO may have a particular need for cash at that time, or may wish to diversify risk, or be aware of better alternative investments. However, it is not just a matter of doing what is right, but being seen to be doing what is right. It would, therefore, seem inappropriate ethically for a CEO to provide positive advice to others to invest in the company while he himself is selling off his/her shares in that same company. A debate on managerial ethics is encouraged with perhaps the introduction of agency theory.

case study 3.3

Telecom Assets Overvalued in First Report

Telecom, New Zealand's biggest phone company, overvalued its fixed assets in its first regulatory report to the Commerce Commission.

The regulator says Telecom overstated the value of its fixed assets by $711 million using current cost accounting (CCA) methodology, which takes into account current values then depreciated, in the 12 months ended 30 June 2009.

The commission prefers use of historical cost accounting (HCA), which takes the value of an asset at the time of purchase before considering depreciation.

The majority of this so-called 'uplift' in value came in Telecom's passive network, which is essential for all fixed-line services such as voice and broadband.

Under HCA, the passive network is worth $4.2 billion or 33 percent of the company's total fixed assets, compared to $5.4 billion, or 62 percent of total assets, under CCA.

'The valuation methodologies of Telecom's network can have an impact on the estimated cost of providing access and backhaul services to other providers,' the Commission said.

'To the extent that the CCA statement of financial performance is impacted by the increase in the value of fixed assets through net revaluation gains and the resulting increase in depreciation expense, this will flow through to product statements in the 2010 financial year.'

Telecom is required to provide financial statements to the Commerce Commission under part 2B of the Telecommunications Act 2001, providing financial information about its network, wholesale and retail activities as though they operated as independent entities in what's known as accounting separation.

Telecommunications Commission Ross Patterson said the first year of regulatory reporting was always a transition year.

It 'has highlighted areas where a reworking of the reporting requirements, particularly in relation to the attribution of income and expenses and valuation of Telecom's fixed assets, is likely to be necessary,' he said in a statement.

The Commerce Commission report questioned the non-financial data used as the basis for attributing costs and assets as not being independently verified.

It also flagged the lack of transparency in Telecom's internal transfer charges between services groups as a hindrance to its report.

The regulator is seeking submissions on a discussion document it's released in response to Telecom's first report until 28 April.

Shares of Telecom rose 0.5 percent to $2.25 on Thursday and have fallen 13 percent in the past three months.

SOURCE: 'Telecom Assets Overvalued in First Report', *Business Day*, 15 April 2010. Last accessed 05 September 2013: http://www.stuff.co.nz/business/industries/3585746/Telecom-assets-overvalued-in-first-report

Questions

1 Historical cost accounting is an asset measurement method, which underpins conventional accounting practice. Write a memo to Telecom's senior management advising of three additional methods for reporting non-current assets, explaining each of your selected methods. Your memo needs to include an explanation as to why 'historical cost' accounting may be preferred by the Commerce Commission.
2 Differentiate between 'current cost' and 'historical cost' accounting.
3 Critically discuss what is meant by the following phrase:
'To the extent that the CCA statement of financial performance is impacted by the increase in the value of fixed assets through net revaluation gains and the resulting increase in depreciation expense, this will flow through to product statements in the 2010 financial year.'
4 Describe what is meant by the term 'accounting separation'.
5 Why would it be important to provide an independent verification of the non-financial data used as the basis for attributing Telecom costs and assets? How might this be achieved?
6 What is meant by the term 'transfer charges'?
7 Why is transparency in financial reporting important?

case study 3.3 solution

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Memo

Date: 14 March 2014
To: Telecom Senior Management
Re: Telecom Corporation of New Zealand Ltd Asset Valuation Update
From: Accounting 101 Student
CC: Accounting Lecturer

NZ Framework, discusses the measurement basis of non-current assets. NZ Framework states that the measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and statement of comprehensive income.
NZ Framework outlines different bases of measurement.
Historical cost – assets are recorded at the amount of cash or cash equivalents paid, or the fair value of the consideration given to acquire them at the time of the acquisition.
Current cost – assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or equivalent asset was acquired currently.
Realisable (settlement) value – assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.
Present value – assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.
'Historical cost' accounting may be preferred by the Commerce Commission as it may be seen as a more reliable means of asset valuation, in that very little assumption and professional judgement needs to be made when using the historical value of an asset, as it is objective in that cash exchanged hands in a business transaction for the stated amount and a receipt is obtained as proof. This, however, needs to be balanced by the fact that the use of historical data may not prove relevant in that the information may be out of date and no longer relevant to today's market value of assets.

There is a growing tendency for many non-current assets to be valued on the basis of market values in order to provide more-relevant information. Examples of such valuations are:

- Property, plant and equipment can be revalued to 'fair value', which is commonly defined as an exchange price between an independent, knowledgeable, and willing buyer and seller.
- Assets of a life insurer (for example, investments) must be measured at net market value, which is the amount that could be expected to be received from disposal after deducting the expected costs of disposal.
- Leased assets and other assets subject to deferred settlement should be valued on the basis

of the present value of expected future settlement payments, using an appropriate discount rate.
- Biological assets are to be recorded at fair value. ▫

These bases of measurement are permitted by either the NZ Framework or specific accounting standards, such as NZ IAS 16, 'Property, Plant and Equipment'. This is a much contested area of accounting judgement and consensus has not yet been achievable – illustrated at a global level where professional accounting bodies from various jurisdictions fail to agree on this issue.

2 Differentiate between 'current cost' and 'historical cost' accounting.
Current cost accounting (CCA) attempts to provide more realistic book values by valuing assets at current replacement cost, rather than the amount actually paid for them. The current cost is usually calculated by adjusting the historical cost for inflation, in addition to the usual adjustments such as depreciation.

CCA is more complex than historical cost accounting (HCA), and attempts to implement it tend to create controversy over what adjustments are appropriate (requires the use of professional judgement).

HCA is an approach to accounting using asset values based on the actual amount on money paid for assets with no inflation adjustment.

Although the use of HCA excludes routine adjustments for inflation, the cost still needs several adjustments when calculating the book value. The most important of these are depreciation, depletion (depreciation for assets that are used up in a directly measurable way), and impairment. (Impairment is when the value of an asset, as shown in the balance sheet, exceeds its actual value to a company, which means the amount shown in the balance sheet needs to be reduced. This reduction is shown as a cost in the statement of comprehensive income.)

In addition, although current accounting standards are largely based on HCA, there are exceptions such as the use of fair value, net realisable value and other revaluations.

In this example, under HCA, the passive network is worth $4.2 billion or 33% of the company's total fixed assets, compared to $5.4 billion, or 62% of total assets, under CCA.

3 Critically discuss what is meant by the following phrase:
'To the extent that the CCA statement of financial performance is impacted by the increase in the value of fixed assets through net revaluation gains and the resulting increase in depreciation expense, this will flow through to product statements in the 2010 financial year.'
Telecom has reported using current cost accounting, which means their non-current assets have been overvalued by $1.2 billion. This increase in assets would lead to an increase in the assets revaluation reserve and the asset increase itself as reported in the balance sheet. This increase in assets would also have the effect of increasing the depreciation amount charged in the statement of comprehensive income, resulting in a lower net profit and therefore a reduction in tax expense.

4 Describe what is meant by the term 'accounting separation'.
Accounting separation requires a de-consolidation of a holding company's financial statements so that the costs and revenues associated with each subsidiary or unit can be individually identified and allocated.

In this case, Telecom would provide information under its different entities including network, wholesale, and retail activities as though they operated as independent entities.

5 Why would it be important to provide an independent verification of the non-financial data used as the basis for attributing Telecom costs and assets? How might this be achieved?

Often when measuring assets and determining their value for inclusion in the balance sheet, professional judgement is required from senior management, accountants, and so on.

Management will often make decisions based on information collated, both of a financial and non-financial nature. An independent verification may often be required as non-financial information, by its very nature, is often subjective, suitable only for a certain specific situation and less reliable than financial information.

This might be achieved through:

- the use of an independent valuation company and their expert advice
- consultancy advice from an accounting firm
- official statistics
- competitor analysis
- statistics provided from Inland Revenue Department.

6 What is meant by the term ‘transfer charges’?

Transfer charges refer to transfer pricing, which is a price charged by individual entities for goods or services supplied to one another in multi-department, multi-office or multinational firms. Tax authorities usually insist that each internal part of the firm deals with the other on ‘arm’s length’ (market price) basis.

7 Why is transparency in financial reporting important?

Transparency in financial reporting is important, as the financial statements prepared by the accountant are often the main form of communication between Telecom’s directors (senior management) and the shareholders.

A heightened level of disclosure in the financial statements will lead to increased transparency so that shareholders are able to see exactly what has occurred in terms of financial performance and position for that year.

This maximum degree of disclosure to which agreements, dealings, practices and transactions are open to all for verification, enables an increased degree of collaboration, cooperation and collective decision making among interested parties.