

CHAPTER 2

Conceptual basis of Accounting (Part 1)

In this chapter and in Chapter 3, we deal with the requirements for Achievement Standard 91174 (Accounting 2.1). Chapter 3 focuses on Accounting concepts, while in this chapter we look at all the other requirements for AS91174, including users, types of information, depreciation, and financial statement components and limitations. Chapter 4 reinforces this learning in preparation for the examination.

Functions of Accounting

Accounting is the communication of financial information to interested parties to help aid decision making. Thus it has the following two main functions.

- Means of communication – a way to communicate information, usually in the form of financial statements, following common conventions and concepts so that comparisons can be made.
- Aid to decision making – the information must be useful and accurate, so that it can be used to help make financial decisions by those parties interested in the information.

Users of accounting information

Many different individuals and groups use accounting information, to help them make a variety of different decisions. What information each group requires will vary depending on the decision they are making.

User	Decision / Use	Information required
Owner	<ul style="list-style-type: none">• Is my money safe?• What is the return I am receiving on the money I have invested?• Should I expand my business?• What profit is my business making?	<ul style="list-style-type: none">• Assets and liabilities (equity ratio)• Return on equity• Existing competition?• Profit in the Income Statement
Manager	<ul style="list-style-type: none">• Have the sales increased from last year?• What inventory should be discounted this week?• What expenses can be cut back on?	<ul style="list-style-type: none">• Income Statement / Sales figure from this year and last year• Inventory turnover• Expenses this year and last year
Government (IRD)	<ul style="list-style-type: none">• Is the business paying the correct amount of tax?	<ul style="list-style-type: none">• GST returns• Income Statement
Bank manager / Lender	<ul style="list-style-type: none">• Should we lend them more money?• What term should the loan be for?	<ul style="list-style-type: none">• Equity ratio• Other existing liabilities• Current cash flow• Profit (Income Statement)• Security (Statement of Financial Position)
Creditors / Suppliers	<ul style="list-style-type: none">• Should we extend credit?• Should we allow credit?	<ul style="list-style-type: none">• Credit rating• Current and liquid ratios• Existing liabilities

Users do not rely solely on financial information to make their decisions. Non-financial information is also important.

- **Financial information** – information that has to do with money (has a monetary value) (e.g. purchase price, interest).
- **Non-financial information** – information that does not have to do with money (e.g. location, competition, age of assets).

Activity 2A: Accounting information

Answers
p. 41

These questions relate to *Daisy's Garden Store*, a sole proprietorship which specialises in selling garden plants and accessories.

1. Define the purpose of accounting.

2. Daisy wants to expand her garden store by opening a café attached to it. She has gone to her bank manager to borrow \$30 000 to complete this expansion.

- a. List three pieces of financial information the bank manager would want before deciding whether or not to lend the money.

- b. List three pieces of non-financial information the bank manager would be interested in before deciding whether or not to lend the money.

- c. The bank manager has asked Daisy about her 'security' for her loan. Describe what *security* refers to.

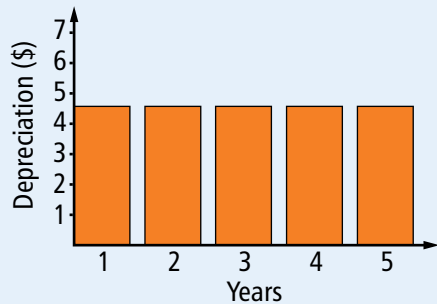
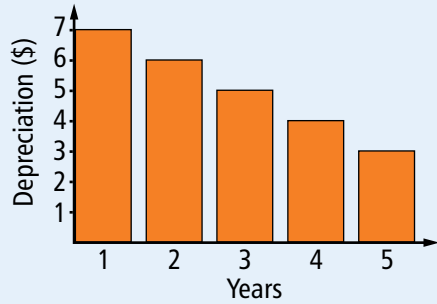
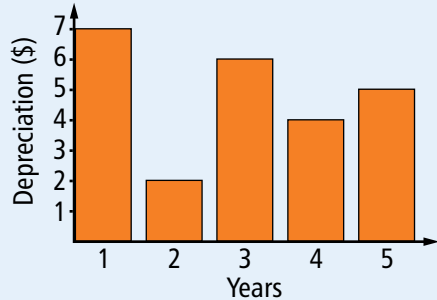
3. Daisy wants to set up credit accounts with her new café suppliers for the food and other supplies. She has approached *Coffee Beans Co.*, and it has asked her for the name and phone number of an existing creditor.

- a. Is the name and phone number financial or non-financial information? Justify your answer.

8. Explain the purpose of the Statement of Accounting Policies for *Daisy's Garden Store* and how that statement and the Cash Flow Statement can help *Daisy's Garden Store's* bank manager.

Depreciation

Depreciation is the systematic allocation of the depreciable amount of the asset over its useful life. This, in effect, is the writing off of the cost of the asset in a set way every year. Level 2 has three depreciation methods.

Method	Description	Justification	Graph												
Straight line	The amount of depreciation is the same every year.	Best when the consumption of future economic benefit of the asset is consistent over time.	 <p>A bar chart showing depreciation in dollars over 5 years. The y-axis is labeled 'Depreciation (\$)' and ranges from 1 to 7. The x-axis is labeled 'Years' and ranges from 1 to 5. Five bars of equal height (4.5) represent the depreciation for each year.</p> <table><thead><tr><th>Years</th><th>Depreciation (\$)</th></tr></thead><tbody><tr><td>1</td><td>4.5</td></tr><tr><td>2</td><td>4.5</td></tr><tr><td>3</td><td>4.5</td></tr><tr><td>4</td><td>4.5</td></tr><tr><td>5</td><td>4.5</td></tr></tbody></table>	Years	Depreciation (\$)	1	4.5	2	4.5	3	4.5	4	4.5	5	4.5
Years	Depreciation (\$)														
1	4.5														
2	4.5														
3	4.5														
4	4.5														
5	4.5														
Diminishing value	The amount of depreciation decreases every year.	Best when the consumption of future economic benefit of the asset is greatest in its earlier years.	 <p>A bar chart showing depreciation in dollars over 5 years. The y-axis is labeled 'Depreciation (\$)' and ranges from 1 to 7. The x-axis is labeled 'Years' and ranges from 1 to 5. The bars decrease in height from 7 in year 1 to 3 in year 5.</p> <table><thead><tr><th>Years</th><th>Depreciation (\$)</th></tr></thead><tbody><tr><td>1</td><td>7</td></tr><tr><td>2</td><td>6</td></tr><tr><td>3</td><td>5</td></tr><tr><td>4</td><td>4</td></tr><tr><td>5</td><td>3</td></tr></tbody></table>	Years	Depreciation (\$)	1	7	2	6	3	5	4	4	5	3
Years	Depreciation (\$)														
1	7														
2	6														
3	5														
4	4														
5	3														
Units of use	The amount of depreciation has a direct relationship to the amount the asset has been used.	Best when the consumption of future economic benefit of the asset is in relation to how much it is used.	 <p>A bar chart showing depreciation in dollars over 5 years. The y-axis is labeled 'Depreciation (\$)' and ranges from 1 to 7. The x-axis is labeled 'Years' and ranges from 1 to 5. The bars represent varying usage: 7 in year 1, 2 in year 2, 6 in year 3, 4 in year 4, and 5 in year 5.</p> <table><thead><tr><th>Years</th><th>Depreciation (\$)</th></tr></thead><tbody><tr><td>1</td><td>7</td></tr><tr><td>2</td><td>2</td></tr><tr><td>3</td><td>6</td></tr><tr><td>4</td><td>4</td></tr><tr><td>5</td><td>5</td></tr></tbody></table>	Years	Depreciation (\$)	1	7	2	2	3	6	4	4	5	5
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1	7														
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Activity 2C: DepreciationAnswers
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1. Define depreciation.

2. Justify the use of the diminishing-value method of depreciation by a business to depreciate its equipment.

3. Justify the use of the straight-line method of depreciation by a business to depreciate its office furniture.

4. Justify the use of the units-of-use method by a business of depreciation to depreciate its vehicles.

CHAPTER 3

Conceptual basis of Accounting (Part 2)

Accounting concepts

'Accounting concepts' is an encompassing term used to describe the rules and assumptions that guide accountants when they prepare financial statements. There are six main categories, listed in the table below.

Accounting concepts					
Notions of Accounting	Underlying assumptions	Qualitative characteristics	Enhancing qualitative characteristics	Elements of financial statements	Measurement base
<ul style="list-style-type: none">Accounting entityPeriod reportingMonetary measurement	<ul style="list-style-type: none">Going concernAccrual basis	<ul style="list-style-type: none">RelevanceMaterialityFaithful representation	<ul style="list-style-type: none">TimelinessComparabilityVerifiabilityUnderstandability	<ul style="list-style-type: none">AssetsLiabilitiesEquityExpensesIncome	<ul style="list-style-type: none">Historical cost

Notions of Accounting

It is taken for granted that these are present when preparing financial statements.

- Accounting entity** – the financial affairs of the entity must be kept separate and distinct from the financial affairs of the owner. The Income Statement and Statement of Financial Position of a business show expenses, incomes, assets and liabilities only of the business entity, not those of the owner personally, or those of any other business. Any of the owner's personal expenses that have been paid for by the business will be recorded as drawings.
- Period reporting** – the life of the business is divided up into time periods of equal length for reporting purposes. This is done so the owners and other users can (for example) measure the profit for the year and compare it with that of previous years. This helps users of the reports make decisions.
- Monetary measurement** – all transactions, assets, liabilities, incomes and expenses in the financial statements are reported in New Zealand dollars. This means that if there is no dollar amount, the item cannot be reported in the financial statements. If an item was purchased from overseas, it is recorded at the equivalent New Zealand dollar amount to ensure a common currency unit is used. For New Zealand-owned entities this will be \$NZ.

Underlying assumptions

These are assumptions that users of financial statements make when using the financial statements to assist with their decision making.

- Going concern** – the entity is going to continue to operate into the foreseeable future. This means that the Statement of Financial Position values are at their historical cost, not at the current market value, because there is no intention to sell/liquidate/downscale the entity.

- **Accrual basis** – Accrual Accounting requires that the effects of transactions and other events on the entity's resources and claims be reported in the period those effects occur, even if cash receipts or payments occur in a different period. In essence this means transactions are recognised when they occur and *reported in the financial statements* of the accounting period to which they relate (i.e. when the income is earned, or the expenses incurred), regardless of whether cash has changed hands yet. This is one of the reasons for 'balance-date adjustments'.

Measurement base

Although there are several asset valuation methods available, we need to know only one at NCEA Level 2 Accounting. This is historical cost.

- **Historical cost** – assets and liabilities are recorded at the amount of cash or cash equivalent paid at the time of acquisition, i.e. the original purchase cost to the entity.

Activity 3A: Accounting notions and assumptions

Answers
p. 41

The following questions relate to *Ruth's Records and Relics*, a sole-trader business.

1. Explain, using an accounting concept, why it is important for *Ruth's Records and Relics* to prepare its Income Statement for the year ending on the same date each year.
2. Explain, using an accounting concept, why it is important for *Ruth's Records and Relics* to report its Statement of Financial Position on the same date each year.
3. Ruth, the owner of *Ruth's Records and Relics*, has used one cheque to pay for her personal insurance \$600 and the insurance for the business \$840. Explain, using an accounting concept, how this transaction would be recorded.

CHAPTER 4

Practice tests

This chapter consists of examination-type questions. Often they are longer, paragraph-type answers, but the content knowledge required is the same.

Activity 4

Answers
p. 43

1. Mark Henare owns *PhotoCentre*, a local photographic supply shop that also provides a photo developing service.

The demand for the photo developing service has increased, and Mark has decided to purchase a digital photo printer so he can better meet his customers' needs. He wishes to borrow \$40 000 from the bank to help finance the new equipment.

The bank's lending officer requires *PhotoCentre*'s latest Income Statement and Statement of Financial Position as part of the application for the loan.

- a. The bank's lending officer wants to see *PhotoCentre*'s current profit for the year and the business's assets and liabilities in the **Statement of Financial Position**.

Explain *why* the bank's lending officer would like to see *PhotoCentre*'s **current liabilities and non-current liabilities** as reported in the Statement of Financial Position, before deciding whether to approve the loan.

- b. Explain, using the **accrual basis assumption**, how and why insurance paid in advance would be reported in *PhotoCentre*'s Statement of Financial Position.

- c. *PhotoCentre's* Income Statement is prepared based upon the idea of **period reporting**. Define **period reporting**, and **explain** how *PhotoCentre's* Income Statement for the year ended 31 March 2022 would illustrate this assumption.

- d. Mark depreciates *PhotoCentre's* current photo developing equipment based on the number of prints made each year.

- i. State the depreciation method used by Mark. _____
- ii. Justify Mark's choice of this method of depreciation for the developing equipment.

- iii. Explain why **depreciation on photo developing equipment** is recorded as an **expense** in *PhotoCentre's* financial statements.

- e. On 31 March 2022, Mark identified some photo albums and frames on hand that cost \$2 000. Mark estimates that their net realisable value is \$500. Explain the **conflict between faithful representation and relevance** that Mark must consider when recording the closing inventory.

ANSWERS

Activity 2A: Accounting information (page 4)

- To communicate financial information to interested parties in order to help with decision making.
- Examples include:* value of existing liabilities; liquid ratio; equity ratio; current value of inventory; value of security; expected profit of café.
 - Examples include:* existing customer base; existing café competition in the area; length of time Daisy will have to close the garden store to build the café; how long it will take to build the café.
 - 'Security' refers to the assets the business has, in relation to existing liabilities. This information is required in case the bank needs to secure the loan so that it will have the right to sell Daisy's assets if she doesn't repay her loan on time.
- Non-financial information – the names and phone numbers of existing suppliers have nothing to do with money.
 - This information will enable *Coffee Beans Co.* to find out whether or not *Daisy's Garden Store* has a good credit history and repays its debts on time. This will help it decide whether or not to give Daisy credit and what her credit limit will be.
 - Examples include:* value of existing liabilities; how much profit the business made last year; current ratio.

Activity 2B: Financial statements (page 7)

- | Transaction | Capital | Revenue |
|--|---------|---------|
| Purchased new oven | ✓ | |
| Paid for installation of oven | ✓ | |
| Paid café assistants' wages | | ✓ |
| Paid for advertising of the new café | | ✓ |
| Paid for the ingredients and food for the café | | ✓ |
- The purchase of the fridge is a 'one-off' type expenditure, and the fridge is expected to be of benefit to the café for more than the current accounting period, because *Daisy's Garden Store* will use the fridge for several years to store drinks which will be sold to customers.
 - Insurance is an ongoing expense that the café will need to pay every year, which does not create an asset. The benefit of the insurance premium is for the current year only.
- Current liabilities are those liabilities which *Daisy's Garden Store* will have to repay in the next financial year (12 months). Non-current liabilities are those liabilities that will still be outstanding beyond the next accounting period (it will take longer than the next accounting year to repay them).
- To calculate the profit (deficit) of *Daisy's Garden Store* for the accounting period – Daisy can then compare this figure with that of last year to see if the profit improved or not.
 - The depreciation / doubtful debts is an estimate, and therefore the profit for the period may not be accurate; or the Income Statement does not include non-financial information (e.g. quality of staff, customer base).
- To calculate the assets, liabilities, and equity of *Daisy's Garden Store* on the balance date.

- The accumulated depreciation / allowance for doubtful debts is an estimate, and therefore the carrying amounts of the assets may not be accurate; or the age of the assets is not included, therefore the decision being made may not be accurate; or the values of the assets are based on historical cost, which might be out of date and not reflect the current market value of the assets.
- To report the sources of money received, and what money was spent on during the period; the Cash Flow Statement also shows how the change in bank balance occurred during the period, and what the balance is on balance date.
 - The Cash Flow Statement does not show credit transactions (e.g. credit purchases) or include non-cash items (e.g. depreciation); or the Cash Flow Statement is based on past cash receipts and payments and does not show current cash obligations.
- Café wages are a 'distribution cost' because they are paid to staff who are involved in the promotion and selling of the inventory of *Daisy's Garden Store/Café*, whereas office salaries are an administrative cost because they are paid to the employees who work in the office and perform the administrative tasks of the business.
- The purpose of the Statement of Accounting Policies is to inform the users of the financial statements how the statements have been prepared and what measurement basis and assumptions have been used. The bank manager will use this information to (for example) know that the assets are based on historical cost, not market value, and the Cash Flow Statement will help the bank manager to decide whether to lend more money to *Daisy's Garden Store*.

Activity 2C: Depreciation (page 10)

- The systematic allocation of the depreciable amount of the asset over its useful life.
- The diminishing-value method is used when the loss of the 'future economic benefit' / economic benefit of the equipment is greater in the earlier years of its life and reduces as it ages; that is, the depreciation amount is biggest in the early years and gets progressively smaller.
- The straight-line method is used when the loss of future economic benefit of the furniture is consistent (the same) each year over the life of the furniture; that is, the depreciation amount is the same each year.
- The units-of-use method is used when the loss of future economic benefit of the vehicles varies in direct proportion to how often the vehicles are used. The more they are used, the more they depreciate, which reflects the greater loss in economic benefit of the vehicles in the future.

Activity 3A: Accounting notions and assumptions (page 12)

- The period reporting concept requires a business, such as *Ruth's Records and Relics*, to divide its trading 'life' into equal periods. This means that the profit for the year for *Ruth's Records and Relics* can be calculated and compared with that of previous years. This information will indicate, for example, whether the business's performance has improved.
- The period reporting concept requires a business, such as *Ruth's Records and Relics*, to divide its trading 'life' into equal periods. By reporting the business's Statement of Financial Position on the same day each year,

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