CHAPTER 3

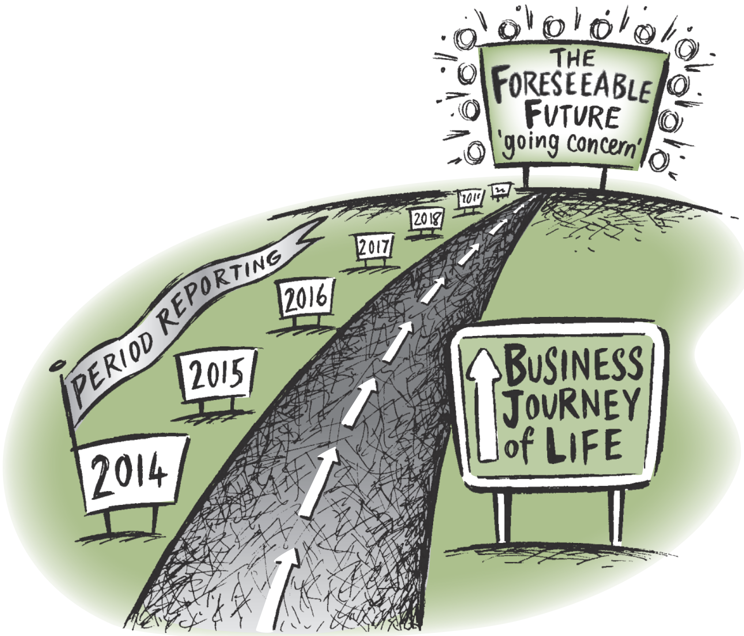
Accounting concepts relating to the timing of events

NCEA Level 2 Accounting material covered in this chapter helps students to meet the requirements for Achievement Standard 91174 (Accounting 2.1) 'Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems'. The focus of this chapter is 'concepts used in the preparation of financial statements'. Concepts used in the preparation of financial statements covered in this chapter are:

- reporting period
- accrual basis of accounting
- going concern
- depreciation methods, including straight line, diminishing value and units of use.

Reporting period

The financial life of a business is divided into accounting periods in order to report performance (profit/loss) and position (assets, liabilities and equity). These are called **reporting periods** or accounting periods. An accounting period of one year is a legal requirement of the Inland Revenue Department. In addition, a true picture of how a business is doing financially can only be found over a period of time. However, a business may want to produce statements at the end of each month as well, so that there is time to implement any changes that might be necessary.



Application

A year is a good time span for an accounting period, especially if a business is seasonal and has a busy period in the course of a year – for example, a toy shop at Christmas or a ski shop in winter. Period reporting also allows a business to compare each year's results with that of the preceding or earlier years.

If the accounting year runs from 1 April to 31 March, all expenses and income are totalled for the year, and profit is calculated. On 1 April of the following year the business's expenses and income start from zero again, and the process is repeated the next year.

In order to produce accounting information that is consistent from entity to entity and from year to year it is essential to have a set of guiding principles. The guiding principles discussed in this chapter relate to the timing of events.

Activity 3A: Reporting period

Ans p. 234

A business called *Dino's Pizzas* produces financial statements at the end of each year. Why does Dino produce these statements?

Accrual basis of accounting

Level 2 NCEA Accounting assumes that businesses account for their activities using the accrual basis. This means that transactions are reported in the periods to which they relate.

Under the **accrual basis**, the effects of transactions and other events are recognised when they occur and are then recorded in the accounting records. They are reported in the financial reports of the periods to which they relate. The time at which each event or transaction occurs may or may not coincide with the time that cash is received or paid. Using the accrual basis, however, an accurate picture of transactions for a particular period can be prepared.

Application

Using the accrual basis of accounting means that when transactions have occurred, amounts that have not yet been received or paid are nevertheless still accounted for. Income is regarded as being earned even though the money may not yet have been received.

Example A

A credit sale is recorded as income, although the customer has yet to pay for the good or service provided.

Activity 3B: Accrual basis of accounting

Ans p. 234

At the end of the year, Dino owes the chefs in his pizza shop two weeks' wages ($800), that relate to the last two weeks of the year but that won't be paid until three days after the end of the financial year.

Using the concept of accrual accounting, explain how these wages will be reported in the financial statements.

Going concern

The going-concern concept states that the business is ongoing and will continue to operate for the foreseeable future. It is assumed that assets will be used for operating the business rather than being sold off to wind down the business, therefore it is acceptable to use the historical cost method in the Statement of Financial Position. If it is known that a business will not be continuing to operate, this must be stated in the financial reports.

Application

If a business is not a **going concern** – i.e. it is known that the business will be wound up in the coming year – the assets are to be valued at their market value rather than using historical cost.

The reason for this is that the assets will be sold off in the coming year so they should be recorded at the amount of cash that will actually be received rather than at what they originally cost to purchase. Accounting for them in this way will ensure that the owner and other users of the Statement of Financial Position will be able to make more accurate decisions.

Activity 3C: Going concern

Ans p. 234

Dino prepares statements at the end of the financial year and states that he views the business as a 'going concern'. What aspects of the financial statement would show that the business is actually a going concern, and that there is no intention to wind the business up?

Depreciation

Depreciation is defined as the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount is how much the asset will lose in value. The depreciable amount is the original cost of the asset less what the asset will be sold for (also known as residual, scrap or salvage value) when it reaches the end of its useful life.

The purchase price of an asset is a definite amount backed up by an invoice, whereas the amount that the asset will be sold for is an estimated future amount. Depreciation acts as a reduction in the value of an asset that will over time reduce the value of the asset to its residual value. This reduced value (or carrying amount) should be close to its market value.

Assets help the business generate future economic benefit as the assets are used to generate sales. Over time and through usage, the amount of sales they will be able to generate into the future will reduce. Therefore the amount of depreciation should match the amount of loss of future economic benefit. As different assets lose future economic benefit at faster or slower rates, there are different methods that can be used to record depreciation.

The numerical side of depreciation is covered in your study of financial statements. As part of the concepts section of your studies, you may have to justify why one depreciation method is best for a certain type of asset.

Depreciation methods

There are three depreciation methods, as set out in the table below.

Method	Description	Loss of future economic benefit (loss of value)
Straight line	Depreciation of the asset is the same amount each year.	Best when the loss of future economic benefit is equal and consistent each year.
Diminishing value	Depreciation of the asset is high in the early years, then decreases to a smaller value in later years.	Best when the loss of economic value is greatest in the early years.
Units of use	The amount of depreciation of the asset varies due to usage and is directly related to how much the asset is used. The units are the main item that drives costs such as kilometres driven for a van, or machine hours for a piece of equipment.	Best when the loss of economic value is nil when the asset is not used but high when the asset is being used to produce a good or service.

Chapter 3

Example B

Dino's Pizzas has three major assets, each of which is depreciated according to a different depreciation method.

- Straight-line depreciation is used for the shop, since the shop building loses its future economic benefit evenly over the lifetime of the building. This is because there is a gradual deterioration in the condition of the building that doesn't change from year to year.
- The diminishing-value method is used for the pizza oven because in the first year after it was purchased, it was heated and cooled a lot and that caused cracks. Therefore, there was a greater loss of future economic benefit in the first year compared with the loss in later years when the structure had stabilised and suffered less damage.
- The method of depreciation used in the case of the pizza delivery van is units of use. The reason for this is that the van consumes future economic benefit each time that it is driven to make a pizza delivery. When the van isn't being used to deliver pizzas, it is parked behind the shop so loses no future economic benefit.

Activity 3D: Depreciation

Ans p. 234

1. Define depreciation.
2. Explain what the depreciable amount consists of.
3. Explain why units of use would be an appropriate method of depreciating a copier machine in a photocopying business.
4. For the same photocopy business, explain why diminishing value would be an appropriate method of calculating depreciation for a new delivery van that has been purchased.

CHAPTER 4

Elements and components of the Statement of Financial Position

NCEA Level 2 Accounting material covered in this chapter helps students to meet the requirements for Achievement Standard 91174 (Accounting 2.1) 'Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems'. Concepts used in the preparation of financial statements covered in this chapter are:

- purposes, components and limitations of the financial statements
- financial elements, characteristics and recognition criteria.

Dividing up the Statement of Financial Position

The purpose of a Statement of Financial Position

The purpose of the **Statement of Financial Position** is to disclose the entity's assets, liabilities and equity and to show the relationship of these elements to one another at a point in time.

Statement of Financial Position explained

This statement is like a photo taken of the business assets, liabilities and equity on the very **last day** of the financial year. This is different from the Income Statement that includes all income and expenses over the **whole year.**

The Statement of Financial Position is like an equation, in that assets less liabilities equal equity.

Assets – Liabilities = Equity

The names 'Statement of Financial Position' and 'Balance Sheet'

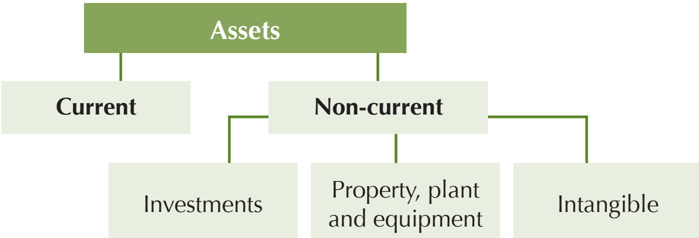
A checking subtotal called 'net assets' is included in the statement after liabilities are subtracted from assets. This should equal – or 'balance' with – the final equity figure. For this reason the Statement of Financial Position can also be called a 'Balance Sheet'. The title 'Balance Sheet' is an approved name for use in textbooks and in the classroom. However, in examinations the title used for this statement is 'Statement of Financial Position', and consequently this name is used here.

You can think of the Statement of Financial Position as being an answer to the question: 'What sort of financial position is the business in as at the very end of the financial year?'

Accounting is an information process. The more information that can be provided to users, the more useful the information becomes for decision making; for this reason, assets and liabilities are divided into further sub-categories.

The components of the Statement of Financial Position

Assets



Current assets

Current assets are assets that are cash or will be turned into cash or will be consumed (used up) within 12 months after the reporting period.

Non-current assets

All assets that are not current assets are called non-current assets.

Investments are funds placed in government bonds, long-term bank deposits or shares in other businesses, with the intention of earning interest or dividends (returns from shares). For an asset to be included in the category 'investments', it is anticipated that the investment will be held for longer than one accounting period (otherwise it would be a current asset).

Property, plant and equipment are assets purchased to help the business earn income and not for the purpose of reselling them at a profit. They benefit the business over a number of accounting periods. They include physical (tangible) assets such as equipment, land and buildings. In this category, only the total of all those assets is shown and it is called the 'total carrying amount'.

Intangible assets such as goodwill, patents and trademarks are assets that are not physical in nature. Although they cannot be seen or 'touched', intangible assets can be very valuable. Goodwill is the amount paid on purchase of a business, over and above the value of equity (net assets). It is the amount the buyer is prepared to pay for a firm's reputation, the loyalty of its current customers and its location.

Liabilities

Current liabilities are liabilities that are expected to be settled or extinguished within the year, e.g. bank overdraft, accounts payable, GST payable and short-term loans.

Non-current liabilities are liabilities that the business is able to repay over a period longer than a year; mortgages and long-term loans come under this heading. Such liabilities can also be called long-term liabilities.

Qualitative characteristics of useful information

CHAPTER 6

NCEA Level 2 Accounting material covered in this chapter helps students to meet the requirements for Achievement Standard 91174 (Accounting 2.1) 'Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems'. The focus of this chapter is 'qualitative characteristics of accounting information', and the following topics are covered:

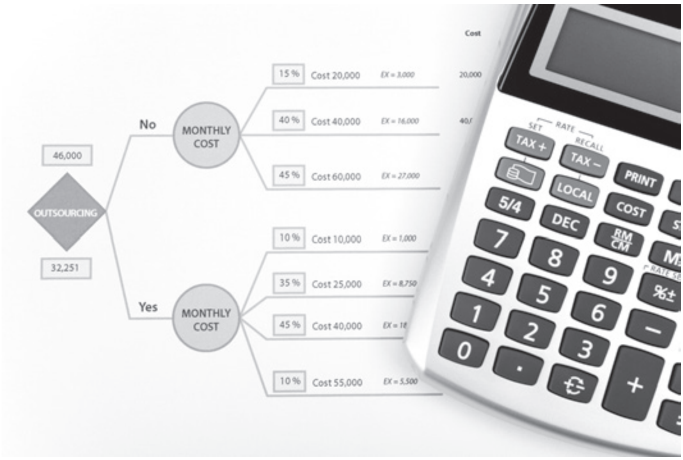
- relevance, including materiality
- faithful representation
- comparability
- verifiability
- timeliness
- understandability.

Introduction

For accounting information to be useful for decision-making purposes, it needs to be:

- faithfully represented
- relevant
- understandable and
- comparable.

For accounting information to have these characteristics, there must be consistency in the value of the financial elements shown. In accounting, the method used to value assets or any financial elements is called a **measurement base**. A document called the *New Zealand Framework* contains guidance to help people who prepare and use financial statements to apply standards to such financial statements.



Characteristics of useful information

Fundamental qualitative characteristics

Essential aspects of information needed to ensure that sound decisions can be made

Relevance

Information that is important enough to make a difference in a decision

Subsections

- Materiality
- Predictive value
- Confirmatory value

Faithful representation

(Formerly 'reliability')

Information is useful when it represents what it says it represents

Subsections

- Neutral
- Complete

Enhancing qualitative characteristics

Information may be already relevant and faithfully represented but these enhancing characteristics assist further in deciding how best to present information

Subsections

- Comparability
- Verifiability
- Timeliness
- Understandability

Fundamental characteristics of accounting information

Accounting information must have the two characteristics discussed below in order to be of sufficient quality.

1 Relevance

Characteristic	Definition	Application
Relevance	**Relevant** information is capable of making a difference when decisions are taken.	The recording of buildings at their market value rather than at historic cost (market value is usually higher than historic cost) could have a large impact on the value of assets and assist in the business's application for a loan.
Subsets of relevance		
Materiality	Information is **material** if its size or nature is significant enough to influence decisions.	Small items – such as a desk lamp costing $59 – should be recorded as a stationery expense rather than an asset, even though the lamp would last for more than 12 months. Recording it as an asset will have no influence on decision making as its value is not great enough.

Predictive value	Information is used as a guide as to what is likely to happen in the future – that is, the information is used to make **predictions**.	An Income Statement shows the amount of sales for a company for the last two years. This can be used as a trend in order to predict sales for the coming year.
Confirmatory value	Information provides feedback that may confirm previous decisions – that is, the information is used as **confirmation**.	Comparing actual sales achieved to what has been budgeted.

Activity 6A: Relevance Ans p. 237

1. Explain how the Statement of Financial Position for *Jayne's Jeans* could have predictive value if it was being used for preparing a cash budget for a future period.
2. *Jayne's Jeans* owns land with a current market value of $120 000. Why would this be viewed as a material item in terms of both size and nature?

2 Faithful representation

Characteristic	Definition	Application
Faithful representation	Financial information must be a fair representation.	To achieve faithful representation, information should be complete, neutral and free from error as well as representing a true and fair view.
Subsets of faithful representation		
Neutral	Presenting information without bias or manipulation.	Not attempting to hide a decrease in income but stating it in the same manner as previous years to allow users to make their own decisions.
Complete	All necessary information should be included.	A Statement of Financial Position should include a description of property, plant and equipment assets and their values in a note.

Chapter 6

Activity 6B: Faithful representation Ans p. 237

1. *Jayne's Jeans* shows its property at historical cost in its Statement of Financial Position. Explain why this policy could be described as being neutral.
2. Describe an estimate that *Jayne's Jeans* is likely to use in its financial statements and how Jayne would ensure that the estimate is close to the actual figure to make sure there is no error material enough to have a negative impact on decisions.

ANSWERS

Achievement Standard 91174 (Accounting 2.1) 'Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems'

Chapter 1 – Introduction to accounting

Activity 1A (page 7)

1. **a.** Financial information: cost of renting/leasing premises to house the new shop, cost of shop refurbishment and fittings, cost of inventory for the new shop, and what additional borrowings if any he would need to make in order to get the new store started. He should then consider the probable cash flow and profit or loss generated by the new shop in the first year of trading.
   Non-financial information: what other boot shops already exist in Palmerston North, availability of a good location and staff for his new shop.

   b. Susan would be interested in the estimated sales figures for the new branch to see if these would be greater than those in the current shop, as this would enable her to earn a higher commission amount. Susan would also want to make sure that the business will be stable in the long term to ensure job stability for her.

   c. The IRD needs information on the business's sales and expenses that include GST, obtainable from the Income Statement or cash journals. The IRD would check the amount of GST received from sales and deduct the amount of GST on expenses to work out whether the final amount of GST payable as submitted by the business accountant is correct.

   d. The suppliers would want to check that the business can pay their invoices by looking at the financial information of *The Work Boot Shop* – such as its Statement of Cash Flows – to ensure there is enough cash coming in to allow for payment of the supplier invoices.

2. **a.** Members, people in the local community, volunteers at the SPCA shelter, potential lenders and potential building contractors.

   b. Potential lenders would want to know what other assets the branch owns as security for any loan. They would be interested in any other liabilities and the probable cash flow. Lenders will want to try to establish how risky lending to the SPCA would be.

Activity 1B (page 10)

1.

Assets	Expenses	Liabilities	Equity	Income
Bank	wages	loan	Sue's investment	sales
inventory	interest on loan	accounts payable		discount received
shop equipment	shop rent	GST payable		

2.

Assets	Expenses	Liabilities	Equity	Income
bait on hand	insurance	bank overdraft	Fred's investment	bait sales
shop fittings	interest on overdraft	hire purchase	Fred's drawings	rent received

Chapter 2 – General accounting concepts

Activity 2A: Accounting entity (page 12)

1. As the cost of this holiday is a personal expense, Alison will have to record the air fares purchased as drawings in order to keep the business transactions separate from her personal transactions. This will ensure her equity is properly stated and that only business expenses will appear in *Ad Design*'s Income Statement, thus allowing for an accurate profit figure. This will enable Alison to make good business decisions.
2. Alison will not be able to see the true value of the business assets as her personal assets are included in the Statement of Financial Position. Therefore the asset figure will be overstated, which will consequently lead to overstated equity. This will make it hard for Alison to make business decisions as she does not have a clear picture of the business's actual financial position.

Activity 2B: Monetary measurement (page 13)

The money earned from sales made in China should be converted to New Zealand dollars using the exchange rate. This means the business's stakeholders will be able to see all sales in a common currency and the Income Statement will be clear and understandable. The business's owners and managers will be able to make good decisions about how it should use its sales resources.

Activity 2C: Historical cost (page 14)

1. Historical cost is a reliable figure as there is an invoice which shows the purchase amount which can be used with confidence in statements. This verifiable figure gives a faithful representation of the amount paid to buy the asset and helps users make informed decisions based on accurate information.

2. Historical cost is reliable and verifiable as there is an invoice which shows the purchase amount, but in some cases the asset may increase or decrease substantially in value over time, meaning the historical cost figure gives a distorted view of the current value of the asset.
3. It is likely that the value of the property has increased dramatically, so the $40 000 will not be a relevant figure for decision making. If the building was to be sold today it is likely that it wouldn't sell for $40 000 but for a lot more as land tends to increase in value over time.

Activity 2D: Capital expenditure (page 17)

1.

Capital expenditure	Revenue expenditure
delivery vehicle purchase	weekly petrol for delivery vehicle
sign-writing for the side of delivery vehicle	replacement tools for those that have been broken
new shelving for workshop	monthly interest payments on work vehicle
new showroom extension	annual insurance premium
	new tyres for delivery vehicle after vehicle failed a warrant of fitness due to having worn tyres
tools to assist in sewing machine repairs	monthly electricity

2.

Capital	Revenue
2 300	310
	490
3 600	200
940	17
$6 840	$1 017

3. a. Expense.

b. Materiality concept – because $8 is a small amount that would make little difference to the total assets in the Statement of Financial Position, therefore it wouldn't have any impact on decisions. For this reason, it could be treated as an administrative expense as there would be no value in including it in Property, plant and equipment.

4. A $900 iPhone™ purchased for business use by *Matt Mataia Plumbing* is an item of capital expenditure because it is an asset that will be used for business purposes – to receive new plumbing jobs and co-ordinate Matt's work – for a period of longer than one year. It will be reported in the property, plant and equipment section of the Statement of Financial Position. While the payment of $39 for a monthly cellphone plan is still expenditure of money, like the purchase of the phone (*comparing*), the $39 will be used up every month so won't last more than one year (*contrasting*). In addition, the cellphone plan is an ongoing cost that needs to be paid each month. Matt will incur the $39 revenue expenditure monthly in order to help him generate plumbing fees from receiving calls for new jobs.

Chapter 3 – Accounting concepts relating to the timing of events

Activity 3A: Reporting period (page 20)

The annual financial statements for his business will enable Dino to:

- see how much profit or loss is being made by his business in each period
- compare the results of one period with those of another
- look at positive and negative trends
- make decisions each month on how to improve the business; for example, whether to increase the price of the pizzas he sells
- view the assets and liabilities at the end of each period when looking at the business's Statement of Financial Position.

Activity 3B: Accrual basis of accounting (page 20)

Accrual accounting requires that transactions should be reported in the financial statements in the period to which they relate, regardless of when the cash changes hands.

The hours the pizza chefs worked were during the financial year that is being reported, therefore the amount of $800 should be included in the wages amount for the year, which would appear in the Income Statement as an expense.

As the amount is owing at the end of the year, it also needs to be reported as a liability in the Statement of Financial Position of *Dino's Pizzas*. This should be a current liability as the $800 of wages owing will be paid soon after the new financial year starts.

Activity 3C: Going concern (page 21)

Dino would record his assets – as ovens, accounts receivable and delivery van – at historical cost rather than showing them at a market value or net realisable value, which would be the case if the business was known to be winding up soon after balance day.

Activity 3D: Depreciation (page 22)

1. The systematic allocation of the depreciable amount of an asset over its useful life.
2. The cost of an asset less the salvage value of that asset. This means that the purchase price paid is not the amount that is used as the basis when depreciation calculations are done. This is because the residual value – i.e. what the asset can be sold for when the business decides it doesn't want to use the asset any more – is not the

Answers

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