

Achievement Standard 91174

Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems

ACCOUNTING

2.1

Externally assessed 4 credits

Concepts, notions and characteristics of accounting

Functions of accounting

Accounting is the processing of financial information for the users of that information in order to aid their business decision making.

Users of accounting information

Financial statements are prepared for users, in order to satisfy different needs. The users of financial statements and their needs include the following.

1. **Owners/Investors** – require information about the risk involved and their return from their investment in a business. Financial statements enable them to determine whether they should buy, hold or sell their investment in a business.
2. **Lenders** – are interested in seeing whether their loans and interest owing will be paid when these fall due, and need to assess the security over loan applications.
3. **Suppliers** – like lenders, are interested in seeing if amounts that the business owes them will be paid when due. They also use financial statements in order to help them make decisions about credit limits and terms of credit.
4. **Government** and its agencies (e.g. IRD) – the government is interested in resource use, therefore the activities of businesses. It also requires information for taxation purposes, for regulation and to determine national income and other statistics.

The following three users also desire access to the financial statements; however, it is unlikely they will have access if the business is a sole proprietorship. Therefore avoid using them in the examination if you can.

5. **Employees** – are concerned about the financial stability and the profitability of a business. Financial statements help them assess the business's ability to provide remuneration, retirement benefits, employment opportunities and stability. They do not often obtain access to the information.
6. **Customers** – are interested in the continuance of a business, especially if they feel the good or service provided by that business is of importance to them. They do not often get this information.
7. **Public** – the general public may require information on the contribution a business makes to the local economy. Details of interest include the number of people the business employs, and its patronage of local suppliers. Financial statements provide information to the public on the prosperity of a business and on its range of activities.

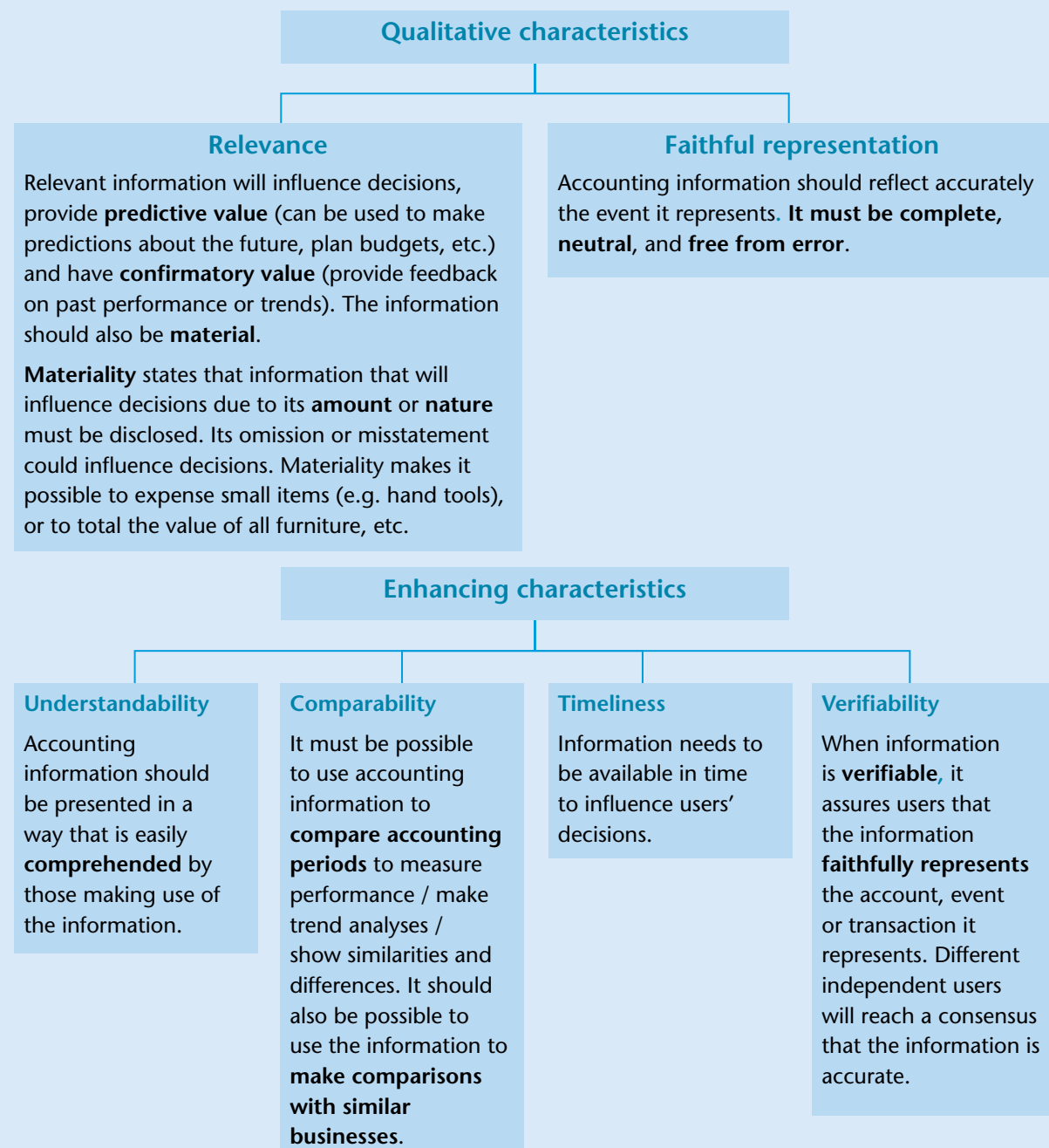
Accounting concepts

At NCEA Level 2, 'accounting concepts' refers to: qualitative characteristics and their enhancements; financial elements; measurement base; assumptions and notions.

Qualitative characteristics

The New Zealand Institute of Chartered Accountants (NZICA) **New Zealand Framework** explains the nature of the rules that accountants should follow (ask your teacher, he or she should have a copy) and acts as an introduction to the **International Financial Reporting Standards (IFRS)** that accountants must follow in order to reach a true and fair view of the financial performance and position of the accounting entity they are reporting on.

Qualitative characteristics (the *minimum* requirements in terms of *quality* that accounting information must possess in order to be considered useful for the decision-making process) must be followed.



Question One

Year 2019
Ans. p. 109

Emma particularly enjoys photographing weddings and plans to continue operating the business in the same way over the next few years. Some clients have booked *Okupu Photography* for weddings that will take place during the next wedding season, starting in October 2019. Clients are required to pay a deposit in advance to secure Emma's photography services at their wedding.

Okupu Photography Trial Balance (extract) as at 31 March 2019			
	\$		\$
		Wedding photo income	77 400

- Wedding photo income received in advance: \$9 000, excluding GST.

- a. Explain how the 'going concern' concept is applied to *Okupu Photography* as at 31 March 2019. In your answer, refer to Emma's plans and explain why wedding clients will be prepared to pay a deposit six or more months in advance of their wedding.

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- b. Justify how wedding photo income and the related adjustment will be reported in *Okupu Photography's* Income Statement for the year ended 31 March 2019, and the Statement of Financial Position as at 31 March 2019.

In your answer, refer to each of the following:

- the purpose of the Income Statement
- period reporting
- accrual basis
- relevant dollar figures.

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Achievement Standard 91176

Prepare financial information for an entity that operates accounting subsystems

ACCOUNTING

2.3

Externally assessed 5 credits

To gain the credits in Achievement Standard 91176 (Accounting 2.3), you will be required to have a full understanding of the financial statements that a sole proprietor, registered for GST on the invoice basis, would have prepared at the end of the financial year. The nature of the business conducted by the sole trader could be either:

- a service firm; *or*
- a trading firm (using a perpetual inventory system).

In addition to this, you need to be able to record any relevant balance-date adjustments, closing entries, and reversal entries in both the General Journal and General Ledger.

Balance-date adjustments

The life of a business is broken into periods of equal length, and as a result of the existence of differing accounting periods, some transactions occur during one period, but relate to a different accounting period – thus, balance-date adjustments must be prepared to ensure that transactions are accurately reported in the period to which they relate. Adjustments required at balance day include the following.

1. Accrued expenses

These are expenses incurred by the business (the service/goods have been received or used) but as at balance day they have not been recorded in the financial records of the business. The General Journal entry will *always* be:

Current liability in the Statement of Financial Position	DR 'Expense name' (e.g. wages)	xx	
	CR Accrued expenses		xx

2. Accrued income

These are income items that have been earned by the business (the service/goods have been provided) but as at balance day they have not been recorded in the financial records of the business.

The General Journal entry will *always* be:

Current asset in the Statement of Financial Position	DR Accrued income	xx	
	CR 'Income name' (e.g. dividends)		xx

3. Prepayments

These are expenses that have been paid for by the business (always GST-exclusive amount) but as at balance day they have not been incurred (used) by the business. The General Journal entry will *always* be:

Current asset in the Statement of Financial Position	DR Prepayments	xx	
	CR 'Expense name' (e.g. insurance)		xx

Questions: Putting it all together

Question One

Resource A

Year 2019
Ans. p. 116

The following Trial Balance and additional information relate to *Okupu Photography*, which is registered for GST on the invoice basis.

Okupu Photography Trial Balance as at 31 March 2019			
	\$		\$
Accounts receivable	12 700	Accounts payable	1 600
Bad debts	1 000	Accumulated depreciation: Photography equipment	8 400
Drawings	37 000	Accumulated depreciation: Printing equipment	800
Depreciation on photography equipment	5 600	Allowance for doubtful debts	500
Framing expenses	7 700	Bank	700
GST	1 200	Capital	42 000
Goodwill	18 200	Family photo income	34 300
Insurance – photography	1 900	Loan	7 000
Interest on loan	700	Wedding photo income	77 400
Loss on sale of camera lens	100		
Office expenses	5 600		
Photography equipment	30 000		
Photo supplies on hand	2 400		
Photo supplies used	11 700		
Printing equipment	4 000		
Second shoot wages	6 000		
Software licence fees	2 100		
Travel expenses	7 500		
Website expenses	8 400		
Wedding expo expenses	8 900		
	\$172 700		\$172 700

Resource A (continued)

Additional information

- Wedding photo income received in advance: \$9 000, excluding GST.
- The second shoot (Emma's photography assistant) attended four weddings in March, for which he has not yet been paid. He receives \$450 per wedding.
- Wedding expo expenses paid in advance: \$4 025, including GST.
- Invoices on hand for family photo income: \$4 600, including GST, not yet recorded.
- Write off additional bad debts: \$2 300, including GST.
- Adjust the allowance for doubtful debts to 2% of accounts receivable.
- Depreciation on printing equipment is 25%, straight line.
- Depreciation on photography equipment has been recorded.
- Invoice on hand for new camera lens: \$3 450, including GST, not yet recorded. Camera lenses are included in photography equipment.
- During the year, Emma sold an old camera lens. The lens originally cost \$2 000, excluding GST, and had a carrying amount of \$600 when it was sold for \$575 cash, including GST. The related loss on sale has been included in the Trial Balance.
- The carrying amount of photography equipment on 1 April 2018 was \$27 800.

Resource B

When Emma receives a request for *Okupu Photography's* wedding services, she provides a quote that includes a non-refundable deposit for her clients to secure Emma as their wedding photographer. When she receives the deposit in *Okupu Photography's* bank account, she invoices the clients for the remainder of the wedding photo fee. This is payable just before the clients' weddings.

- During April 2019, Emma provided quotes for four weddings scheduled for November and December 2019. Each quote total was \$4 600, with a 25% non-refundable deposit payable immediately. All four clients paid the non-refundable deposit directly to *Okupu Photography's* bank account during April 2019. Emma then sent an invoice to each client for the remainder of their wedding photo fee before 30 April 2019.
- On 25 April 2019, Emma invoiced a family \$575 for their Anzac Day family photo shoot.
- At the end of April 2019, Emma wrote off one wedding that was cancelled. This wedding was quoted during 2018 for \$2 300 in total. The non-refundable 25% deposit was received and banked in 2018.
- On 30 April 2019, the balance of accounts receivable was \$15 650.

Age of accounts receivable

$$\frac{\text{Average Accounts Receivable}}{\text{Net Credit Sales (incl. GST)}} \times 365$$

$$\text{Net Credit Sales} = \text{Credit Sales} \times 1.15$$

This formula will produce a figure that represents the length of time, in days – on average – which it takes for accounts receivable to repay the debts they owe to the business. An acceptable level is generally considered to be 30–45 days.

An 'age of accounts receivable' figure that is too high is an issue for a business. The reason is that money owed by customers is usually required by a business to pay suppliers and other expenses. If the 'age of accounts receivable' is too high, the business may find it is short of cash (that is, it will have a liquidity problem). On the other hand, this figure can never be too low, since the faster debtors pay what they owe the business, the better. To improve: tighten credit policy; offer discounts for prompt payment.

Dealing with the theory of analysis and interpretation**Calculations**

Formulae will be provided for analysis measures. Understanding the *meaning* of the numbers you calculate and/or are provided with is paramount – you must *interpret* the data.

Interpretation and evaluation

Interpretation means explaining the meaning of analysis undertaken and also identifying trends in the data, and making recommendations.

This includes the following.

- Describing / explaining / justifying analysis measures.
- Describing / explaining / justifying possible reasons for trends.
- Justifying consequences of a continued trend.
- Linking (calculated) analysis measures to other financial information.
- Making links between related (calculated) analysis measures.
- Using comparative figures and the results of their analysis to comment on an entity's financial performance and financial position.
- Making a recommendation to an entity and explaining / justifying the recommendation by explaining how it will improve:
 - profitability
 - financial stability
 - liquidity
 - management effectiveness.

A good activity to complete is to 'mind-map' each analysis measure, highlighting what it means and what influences it. This will enable you to see clear similarities/linkages between measures.

Note: Achieved = describing

Merit = explaining

Excellence = justifying

Questions: Analysis and interpretation

You will be supplied with a formula resource containing the formulae to calculate the analysis measures. In the following questions, please use the formulae on pages 79–82.

Question One

Year 2019
Ans. p. 118

Resource A

Whangamatā is a popular summer holiday destination in the Coromandel. The permanent local population of Whangamatā is approximately 3 500. During the summer months, the population swells considerably, sometimes to more than 25 000.

Three of the small businesses located in the town are:

- *Surfeze*, a surf shop
- *Bella Marine*, a marine services business
- *Whangawave*, a kayak hire business.

Resource B

Nami is the owner of *Surfeze*, a shop selling surfboards, surfwear and accessories. In summer, Nami opens *Surfeze* for longer hours on weekends and weekday evenings when visitors are out and about enjoying the local cafés and shops. Nami's permanent staff currently work overtime to cover the extra summer opening hours. The permanent staff would prefer to spend this time with their families. Nami is therefore considering employing students as part-time staff to cover the extra summer opening hours.

The following analysis measures were extracted from *Surfeze's* financial statements relating to the year ended 31 March 2019.

Analysis measure	Surfeze 2019	Industry average
Mark-up %	200%	150%
Inventory turnover	2.5 times p.a.	4 times p.a.
Distribution cost %	33%	25%
Profit for the year %	14%	15%

Resource C

Bella owns *Bella Marine*, a marine services business for local boaties in Whangamatā. Many summer customers are from out of town and one off, only getting their boats serviced once at *Bella Marine*. Bella offers all customers 20-day credit terms for their service fees.

Bella's accountant is concerned that her credit management is making it harder for Bella to make payments to *Bella Marine's* creditors on time.

Bella thinks she should offer her customers a discount for prompt payment, as her electricity company does. She always pays the electricity bill first, to claim the discount. However, her accountant has recommended that Bella requires full payment in cash on delivery for all first time or one-off customers and that she should charge an additional fee to any creditworthy local customers who do not pay within the 20-day credit terms.

Answers and explanations

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

2.1 Conceptual basis of accounting

p. 8

Question One

Part A

- a. The concept of going concern makes the assumption that the financial statements are prepared with the knowledge that the business, *Okupu Photography*, will continue to operate into the foreseeable future. This is very true in this case, as Emma has indicated that she intends to keep operating over the next few years because she is really enjoying her work. She definitely intends to continue for the next financial year as she has accepted bookings and deposits for events next summer, over six months away. Her clients are prepared to pay the deposit six months in advance to ensure they secure her services and because they are confident she will continue in business for at least that length of time. She currently has \$9 000 excluding GST of deposits for weddings that she will photograph at the end of the next financial year. This will be shown as a liability as Emma is obliged to fulfil the services.

(A = definition for going concern linked to *Okupu Photography*, M = in addition to Achieved, explaining how clients are confident in the going concern, paying deposits over six months in advance)

- b. The wedding photo income in the Trial Balance represents the amount of cash received for the photography services in the financial year ended 31 March 2019. Period reporting concept requires the life of *Okupu Photography* to be broken up into time periods of equal length for reporting purposes. In this case, *Okupu Photography* breaks its life into financial years ending 31 March each year. This way Emma can make comparisons and decisions between periods based on a consistent time period. The Income Statement is prepared for the year ended 31 March each year to report the incomes earned and expenses incurred in this period, in order to calculate the profit or loss for the period. In order for the profit to be accurate for the period, Emma must apply the accrual basis concept. This requires *Okupu Photography* to recognise transactions when they occur (e.g. \$77 400 has been received for wedding photos) and reported in the financial statements in the period they relate to. This means the \$9 000 deposits received for photography that has not yet happened does not belong in this year's Income Statement. As a result, the \$9 000 is deducted and \$68 400 is reported as income in the Income Statement ended 31 March 2019. The \$9 000 received in advance will be reported as income in the 2020 Income Statement once the photography has been completed. On balance date, *Okupu Photography* must recognise the liability of the \$9 000 Income Received

in Advance because Emma has to carry out the services or refund the deposit in the next financial period, making this a current liability in the Statement of Financial Position.

(A = two of: purpose of income statement, definition of period reporting, definition of accrual basis, linked to *Okupu Photography*, M = in addition to Achieved, explains why/how *Okupu Photography* meets 2 of the 3 using figures/data from the resource, E = in addition to Merit, justifies why and how the figures in the Income Statement and Statement of Financial Position are reported this way on 31 March 2019 using the period reporting and accrual basis concepts)

Part B

Okupu Photography reports the software licence fees as a photography expense in the Income Statement each year. *Okupu Photography* purchases a range of software licences from overseas, paying for them monthly. As *Okupu Photography* is a New Zealand business, all financial elements must be measured and reported in the financial statements and must be prepared in New Zealand dollars in accordance with the monetary measurement concept. This requires Emma to convert the amount paid into New Zealand dollars before recording the payment in the journals and preparing the financial statements. For example, even though the Adobe licence is \$11.99 Australian dollars for November, Emma will convert this to New Zealand dollars and report this as \$13.43 in her financial accounts as this is the New Zealand dollar equivalent.

All of the licence fees are quite small each month; however, they total \$2 100 for the year ended 31 March 2019. Materiality concept ensures that the treatment of items does not limit the usefulness for decision making, whether by omission or how it is disclosed. It is irrelevant to the users how much each individual software licence is, but how much Emma pays in total is the important information. This is why the software fees are reported as one total in the Income Statement, as grouping them together is more useful for users and makes the statement less cluttered. It is the total \$2 100 which will influence Emma's decisions, not the individual costs, hence they can be added together. In addition to this, the cents are rounded to the nearest dollar and the cents will not influence the decisions as they are not large enough in size.

The software licence fees are revenue expenditure for *Okupu Photography* because they are an operating expense which must be paid regularly (in this case monthly), and are a cost against this year's income, and will not affect future years. In order to use the software, Emma will need to keep paying these fees every year, therefore meeting the criteria of revenue expenditure. For the software licence fee to be capital expenditure, it would have needed to be a one-off licence payment for more than one year's use.

(A = explains the definition of monetary measurement and revenue expenditure in relation to the software licence fees and *Okupu Photography*, M = in addition to Achieved, explains with examples, and states how materiality is followed, E = justifies how the software licence fees are reported in the income statement in accordance with materiality, monetary measure and revenue expenditure as opposed to capital expenditure, with specific examples from the resource for *Okupu Photography*)

Part C

The new camera lens will be reported as part of the non-current assets Property, plant and equipment in *Okupu Photography's* Statement of Financial Position, making the photography equipment figure now \$33 000. The lens is reported at its original cost price of \$3 000 which is the GST-exclusive amount payable