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# 2

91174



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NEW ZEALAND QUALIFICATIONS AUTHORITY  
MANA TOHU MĀTAURANGA O AOTEAROA

SUPERVISOR'S USE ONLY

## Level 2 Accounting, 2014

### 91174 Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems

2.00 pm Wednesday 26 November 2014  
Credits: Four

Achievement	Achievement with Merit	Achievement with Excellence
Demonstrate understanding of accounting concepts for an entity that operates accounting subsystems.	Demonstrate in-depth understanding of accounting concepts for an entity that operates accounting subsystems.	Demonstrate comprehensive understanding of accounting concepts for an entity that operates accounting subsystems.

Check that the National Student Number (NSN) on your admission slip is the same as the number at the top of this page.

**You should attempt ALL the questions in this booklet.**

If you need more room for any answer, use the extra space provided at the back of this booklet.

Check that this booklet has pages 2–11 in the correct order and that none of these pages is blank.

**YOU MUST HAND THIS BOOKLET TO THE SUPERVISOR AT THE END OF THE EXAMINATION.**

**Achievement**

**TOTAL**

**8**

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## QUESTION ONE

On 10 April 2013, Jessica purchased a small business called *Fancy Pants*, a fancy dress and costume hire shop. Jessica made this decision after careful consideration of the financial statements and consultation with her bank manager.

Below is an extract of the Statement of Financial Position for *Fancy Pants* used by Jessica in her decision to buy the business.

Fancy Pants Statement of Financial Position (extract) as at 31 March 2013	
	\$NZ
<b>Assets</b>	
Accounts receivable	1600
Prepayments	250
Property, plant and equipment (Note)	37300
Goodwill	8000
<b>Total assets</b>	<b>47150</b>
<b>Liabilities</b>	
Accounts payable	2100
Income in advance (hire fees)	90
Bank loan	7000
<b>Total liabilities</b>	<b>9190</b>

Note: Property, plant and equipment

As at 31 March 2013	Costumes	Office computer	Shop fittings	Total
	\$NZ	\$NZ	\$NZ	\$NZ
Cost	26000	5400	22000	53400
Accumulated depreciation	7300	2200	6600	16100
Carrying amount	18700	3200	15400	37300

The student has described the purpose of the statement of Financial Position and described understandability in relation to Jessica and explained a limitation of the statement of Financial Position as it relates to *Fancy Pants*.

- (a) With reference to the extract on the previous page, justify how the Statement of Financial Position was useful to Jessica when she made her decision to purchase the business *Fancy Pants*.

Include in your answer:

- the **purpose** of *Fancy Pants*' Statement of Financial Position
- an explanation of how Jessica may have used information in *Fancy Pants*' Statement of Financial Position when making her decision
- an explanation of how the qualitative characteristic of **understandability** was important to Jessica's use of *Fancy Pants*' Statement of Financial Position in her decision
- a limitation of *Fancy Pants*' Statement of Financial Position and the importance of Jessica being aware of the limitation when making her decision.

The purpose of *Fancy Pants*' statement of financial position is to give information about the entity's position and about the elements such as assets, liabilities and equity.

Jessica will have been able to use *Fancy Pants*' statement of financial position to find out information such as the liquidity of the business and what kind of position the business is in.

The qualitative characteristic of understandability states that information must be easy for the user to comprehend, the user being expected to have some knowledge. Assuming *Fancy Pants*' Statement of financial position shows understandability, Jessica should be able to understand it. If Jessica does not understand it properly, she may have a false interpretation of the business.

One limitation of *Fancy Pants*' statement of financial position is that it does not include non-financial information such as, number of loyal customers, advantages or disadvantages of location etc. This is important to Jessica because where the business is located could be in the right or wrong place for their target audience.

At the end of the financial year (31 March 2013), *Fancy Pants* had received \$90 from a customer for a pre-ordered costume that was to be hired in May 2013.

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- (b) Using the **accrual basis**, fully explain **how** and **why** the hire fee of \$90 received in advance was reported in both the Statement of Financial Position and the Income Statement for *Fancy Pants*.

Accrual basis states that the transaction must be reported in the financial statements to the period with it relates. //

The fee of \$90 has been paid in advance to *Fancy Pants*. This creates the current asset 'Prepayment' with a figure of \$90. The \$90 is reported as an asset as it will provide future economic benefit (to the period with it relates). //

When the fee of \$90 period to which it occurs arrives, the fee of \$90 will be taken out of <sup>the</sup> prepayment account and put back into *Fancy Pants* Income statement in an income account such as hire fees. The fee of \$90 is now income as it provide economic benefit (now). //

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The examination continues on the following page.

The student has given a full definition of accrual basis and attempted to link to context, however

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## QUESTION TWO

The main source of income for *Fancy Pants* is hire fees from costume hire. During her first year of operating, Jessica introduces the sale of accessories such as make-up to match the Dracula costume and masks for Halloween. Below is an extract from the Income Statement for *Fancy Pants* for 2013 and 2014.

Fancy Pants Income Statement (extract) for the period ended 31 March		
	\$NZ 2013	\$NZ 2014
Revenue		
Hire fees	75 000	80 000
Other income		
Accessory sales	0	5 700
Total income	75 000	85 700

In 2014, hire fees for *Fancy Pants* are \$70 000 cash and \$10 000 credit transactions.

- (a) Justify why hire fees on **credit** are an income for *Fancy Pants*. Include in your answer:
- the **definition** of an **income** to explain why the hire fees on **credit** are an income
  - an explanation of the **recognition criteria** of an income as related to hire fees on **credit**.

Income provides economic benefit usually in the form of cash. It is the increase of the credit account. Income is a credit account. Therefore when hire fees are paid by a credit transaction, rather than cash, they are still included as income. //

The student has not been able to define income or give a definition of the recognition criteria

Following one year of trading, Jessica is not sure if she is reporting the Revenue and Other Income for *Fancy Pants* correctly.

- (b) With reference to the Income Statement extract on the previous page, justify in terms of **relevance** and **materiality** why accessory sales are reported separately from the hire fees income. Include in your answer:
- an explanation of how the qualitative characteristic of **relevance** has been applied in the reporting of **accessory sales**
  - an explanation of how the qualitative characteristic of **materiality** has been applied in reporting **accessory sales** separately from **hire fees income**.

The qualitative characteristic of relevance states that information must show the characteristic of being relevant to a transaction or event. Accessory sales meet this qualitative characteristic as they show relevance as they go with the costume / enhance the costume. Therefore the accessory sales have correctly been reported as other income. //

The qualitative characteristic of materiality states that its misstatement or omission must be large enough to have an influence on the decision. The hire fees are recorded as revenue (the main source of income) as it is larger. //

The student has not described how accessory sales are relevant or material.

## QUESTION THREE

Fancy Pants currently uses different methods for the depreciation of its non-current assets. However, Jessica is not sure that she is using the correct methods. The office computer is depreciated using the **diminishing value** depreciation method, and the costumes are depreciated using the **units of use** depreciation method.

- (a) Justify to Jessica the methods of depreciation chosen for reporting both the office computer and the costumes in the financial statements of Fancy Pants. Include in your answer:
- a description of the **diminishing value** method of depreciation
  - a description of the **units of use** method of depreciation
  - explanations for whether the correct depreciation method is being used for the office computer and the costumes.

The diminishing value method depreciates by the equation

$$\text{Carrying amount} \times \frac{\text{Cost Price} - \text{Residual Value}}{\text{Estimated Total Units}} \times \text{Units Used}$$

This method is appropriate when the greatest consumption of ~~the~~ economic benefit is at the start of its useful lifetime. These include products such as phones, TVs, etc.

The units of use method depreciates by the equation

$$\frac{\text{Cost Price} - \text{Residual Value}}{\text{Estimated Total Units}} \times \text{Units Used}$$

This method is appropriate when the consumption of economic benefit is determined by usage e.g. a truck or delivery van.

Jessica is using the correct method to depreciate both the computer and costumes. A computer's consumption of economic benefit is greatest at the start of its life therefore the diminishing value method is appropriate. The more hours the costume are worn the more consumption of economic benefit there will be as the costumes too old from usage. Therefore Jessica depreciates the costumes by hours used.

- (b) Jessica has recently expanded the business into providing formal wear for hire at weddings and school balls. A consequence of expanding the business is that Jessica had to purchase on credit more **cleaning equipment**, at a cost of \$2800, to clean and launder the various costumes, dresses, and suits available for hire.

Justify why Fancy Pants will report the **cleaning equipment** as a non-current asset in the Statement of Financial Position.

Include in your answer:

- the use of the **definition** of an **asset** to explain why the cleaning equipment is an asset
- an explanation of a cost for the cleaning equipment that meets the qualitative characteristic of **verifiability**
- an explanation of how the purchase of the cleaning equipment meets the definition of **capital expenditure**.

An asset provides future economic benefit due to a past transaction. A non-current asset will not be turned into cash in the next 6-12 months. The cleaning equipment reaches this criteria as it will be used to clean garments. Therefore it provides future economic benefit as Jessica will not have to pay <sup>externally</sup> monthly to get costumes cleaned. Jessica is also not thinking of selling the new cleaning equipment in the near future so it is a non-current asset.

The cost of the cleaning equipment meets verifiability as it meets the quantitative characteristic of faithful representation and can be proven with a receipt/invoice/agreement.

Capital expenditure is a one off payment which affects a number of accounting periods. It affects the statement of financial position. Cleaning equipment is recorded as a non-current asset in the statement of financial position.

The student has given a description of both methods of depreciation and explained why the units of use method is suitable for the costumes

The student has named a source document for the qualitative characteristic verifiability and and described capital expenditure in relation to cleaning equipment