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# 2

91174



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## 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.

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Excellence

TOTAL

19

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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.

<b>Fancy Pants</b> <b>Statement of Financial Position (extract)</b> <b>as at 31 March 2013</b>	
	\$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 in the context of buying the business justified how the information contained in the statement of financial position is used by Jessica and it is clear how Jessica is aware of a limitation and its importance in terms of how it could affect her decision to buy the business

- (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 ~~for~~ purpose of ~~extract~~ the Statement of financial position for *Fancy Pants* is to measure their assets, liabilities and equity at a point in time //
- Jessica used the information to help her make ~~the~~ the decision by ~~using~~ using the assets ~~for~~ determine whether or not the business has enough assets to create economic benefits in the future. The P.P.E assets show the amount of assets which will benefit ~~her~~ generate economic benefit for more than one financial year (12 months). Jessica would have used the liabilities to determine whether ~~she~~ see the amount of debt she would have to pay off. Together the assets ~~and~~ <sup>less</sup> liabilities will show ~~her~~ her the net assets which is \$37960 which clearly shows her ~~for~~ purchasing the business will benefit her economically in the future. Also goodwill shows her if she has enough ~~regular~~ regular customers to pay off regular expense
- ~~For~~ For information to be understandable it ~~is~~ needs to be classified characterised and presented clearly and ~~and~~ <sup>and</sup> concisely. Since the ~~the~~ Statement of financial position ~~is~~ characterised and classifies the assets and liabilities and presents the information clearly by using columns and tables the information easy to ~~understand~~ understand therefore it makes it easy for Jessica to make her ~~decision~~ decision.
- A limitation is that the Statement of financial position doesn't show non-financial information. e.g. Jessica ~~only~~ needs to factor in the age of her assets because if they're too old they may not benefit her business ~~for~~ for more than one period and she would have to purchase more assets. //

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.

- (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.

In accordance with the accrual basis concept all transactions are recognised when they occur and they are recorded and reported into the financial period in which they relate to regardless of whether ~~cash~~ ~~or~~ whether cash has been received ~~or~~ paid. //

The early income ~~is~~ creates the current liability 'income in advance' in the statement of financial position. The amount ~~received~~ received in advance is \$90 therefore the 'income in advance' account will be \$90. In the income statement ~~the \$90 received in advance would be taken~~ \$90 would be taken away from ~~the~~ 'sales' as Fancy Pants has not earned that \$90 yet as it belongs to the next accounting period. By removing \$90 from 'sales' and creating the current liability 'income in advance' of \$90 Fancy pants is following the accrual basis. They must do ~~this~~ ~~the~~ this ~~the~~ transaction in order to insure that the \$90 is ~~is~~ recognised when it occurs and to insure the \$90 is recorded and reported into the financial ~~period~~ period in which it relates to. //

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The student has given a full definition of accrual accounting and explained accrual basis to the income statement for income in advance (hire fees \$90)

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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
<b>Total income</b>	<b>75 000</b>	<b>85 700</b>

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 is an increase in economic benefits by increasing an asset or decreasing liability, which increases equity and is not a contribution by the owner Jessica.

Hire fees <sup>on credit</sup> increases economic benefits by increasing the asset accounts <sup>receivable</sup> ~~payable~~. This increases the profit for the year which increases equity. The hire fees <sup>on credit</sup> is not a contribution by Jessica.

Hire fees ~~paid~~ meets the ~~recognition~~ recognition criteria of an income when the hire fees have been sold on credit. Therefore the asset accounts receivable will <sup>increase</sup> ~~increase~~ for this financial period resulting in future economic benefit for *Fancy Pants*.

The value of the hire fees ~~is~~ sold on credit can be measured <sup>reliability</sup> as Jessica will have sent an invoice <sup>(source document)</sup> to the customer. The invoice will show evidence <sup>proof</sup> ~~(proof)~~ that the hire fees ~~is~~ sold on credit was \$10,000.

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**.

Relevant information is relevant if it influences the economic decisions of user by helping them evaluate present and future events and by helping users confirm or correct past evaluations. The accessory sales are relevant since it is the most up-to-date value of \$5700 therefore it will help users such as Jessica to decide whether or not the accessory sales will benefit the business in the future and see if it is benefiting the business currently.

Due to the nature of the accessory sales ~~is~~ it is reported under other income.

Materiality information is material if its omission/misstatement could influence the economic decision of users. The ~~value~~ size of accessory is ~~great~~ enough Accessory sales are material since its omission/misstatement would influence users decision making therefore it cannot be ignored and must be written under other income separately from hire fees due to the size and value of the accessory sales.

student has explained why hire fees is income and explained that the invoice is a reliable measure

The student has described how accessory sales are relevant in terms of predictive value and decision making.

## 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.

Depreciation is the systematic allocation of the ~~depreciated~~ depreciable amount of an asset over its useful life. Diminishing value method is used when an asset's value is greatest in its ~~early~~ earlier years and the diminishing value depreciates ~~fastest~~ greatest in the earlier year and the depreciation decrease ~~over~~ over the years. Therefore the diminishing value is the correct depreciation method to use for office computer. Since the value of the computer will be greatest in its early years and its value will decrease over time. By using the diminishing value method the asset will be depreciated greater in its early years which would give <sup>more</sup> an accurate estimate of the computer's life. //

Units of use method is used when you want to measure the value of the asset ~~directly~~ directly proportional to the amount its used. Units of use calculates the depreciation through the amount the asset is used therefore the costumes ~~are~~ units of use method is the correct method for the costumes as <sup>the costumes</sup> ~~its~~ value will decrease only when they ~~are~~ are being used. ~~in order for Jessica~~

Fancy Pants are using the ~~correct~~ correct depreciation methods for ~~the~~ the computer and costumes //

- (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**.

- The cleaning equipment was purchased in the past ~~and~~ by Fancy pants and they have ~~no~~ present control over the cleaning equipment and exclusive rights to use it. The cleaning equipment will generate income in the form of sales when the business ~~use~~ use the equipment to clean the clothes which will be sold for hire and this will ~~be~~ benefit ~~the~~ Fancy pants economically in the future.
- The cost of the cleaning equipment is verifiable as Fancy pants would have received a receipt at the time of purchase which will verify the cost of the equipment as different and knowledgeable people will reach a consensus (general agreement) that the cost of equipment is faithfully represented. //
- The purchase of the cleaning equipment is capital expenditure because it is a one off type expenditure and it is an ~~asset~~ ~~that~~ non-current asset since it will benefit ~~the~~ Fancy pants economically for more than one financial period. The equipment will be used to clean the ~~the~~ costumes which will be sold for hire and this will generate income in the form of sales and since the equipment will be used for more than one financial period it will generate future economic benefit for fancy pants for more than one financial period (12 months) //

The student has described both methods of depreciation

The student has justified why the cleaning equipment meets the past, present control and future economic benefit definition requirements of an asset and how the receipt provides a verifiable measure of the cost and how the cleaning equipment is capital expenditure

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2

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2.00 pm Wednesday 26 November 2014

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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)	37 300
Goodwill	8 000
<b>Total assets</b>	<b>47 150</b>
<b>Liabilities</b>	
Accounts payable	2 100
Income in advance (hire fees)	90
Bank loan	7 000
<b>Total liabilities</b>	<b>9 190</b>

Note: Property, plant and equipment

As at 31 March 2013	Costumes	Office computer	Shop fittings	Total
	\$NZ	\$NZ	\$NZ	\$NZ
Cost	26 000	5 400	22 000	53 400
Accumulated depreciation	7 300	2 200	6 600	16 100
Carrying amount	18 700	3 200	15 400	37 300

The student has justified in the context of buying the business, the understanding of how information contained in the statement is used by Jessica and it is clear how Jessica is aware of a limitation and its importance in terms of how it could affect her decision to buy the business.

(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 show users such as Jessica the financial position of Fancy Pants at any one point in time. It shows Fancy Pants assets, liabilities and equity and from this users such as Jessica can work out the liquidity and financial stability of the business.

Jessica may have used information from Fancy Pants' statement of financial position in order to work out the rate of return on average equity to see what sort of return on her investment she would get and what this would be, compared to interest rates at the bank. This would've helped Jessica in making her decision as she would be able to see what return she would get and whether this is worthwhile or not.

It is important that the qualitative characteristic of understandability has been used as it makes it so that the statements are formatted in such a way that is clear and concise and easily comprehended, this would've made it easier for Jessica to understand the statement of financial position for example having all the assets classified into a group and the liabilities classified into a group, it makes it easy for users such as Jessica to understand the 'total assets' figure and 'total liabilities' figure. By being easy to understand it helps Jessica make her decision as all the information is formatted so that if Jessica is uncertain about a certain figure in the statement of financial position such as the Property, Plant and Equipment she can see how this is calculated by looking at the note. A limitation of Fancy Pants' statement

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.

- (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.

The accrual basis concept states that the transactions are to be recognised when they occur and the effects of these transactions are to be reported into the financial statements to the period to which they relate. This means that the \$90 hire fee must be correctly reported into the financial statements.

Because the \$90 did not relate to the accounting period ending 31 March 2013, it must be recorded in Fancy Pants statements that end 31 March 2014.

This means that in <sup>Fancy Pants income statement</sup> \$90 must be deducted from Fancy Pants 'hire fees' account ~~asset~~, as this \$90 does not relate to that figure as the effect of this belongs in the accounting period ending 31 March 2014, as this is when the costume will be hired out, and the hire fees will be earned.

Because Fancy Pants are currently obliged to give this customer an outfit on hire, as he has paid the \$90 already, an account called 'income in advance' <sup>income</sup> which is a current liability must be created <sup>in Fancy Pants statement of financial position</sup>. Fancy Pants must add \$90 to this account as they are currently obliged to hire out a costume worth \$90 to the customer.

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The student has justified how the accrual basis is applied to the hire fees \$90 received in advance with clear explanation of how it is reported in the statement of

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Financial Position and Income Statement

ES

question 2(a)

Student has given a definition of income with a link to bank increasing and net profit increasing equity and not contributions by Jessica.

student has explained that it is probable that cash will flow to Fancy Pants with a valid reason why and explained a source document that provides a reliable measure.

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question 2(b)

The student has ~~justified~~ <sup>linked</sup> the definition of relevance and materiality and compared and contrasted why accessory sales are reported separately to hire fees.

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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
<b>Revenue</b>		
Hire fees	75 000	80 000
<b>Other income</b>		
Accessory sales	0	5 700
<b>Total income</b>	<b>75 000</b>	<b>85 700</b>

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**.

Hire fees on credit are an income for *Fancy Pants*, as when *Fancy Pants* credit customers pay for hiring their costumes, it results in an increase in economic benefit as cash comes into *Fancy Pants*, causing *Fancy Pants* 'bank' asset to increase. The hire fees are not a contribution from Jessica the owner as they are from customers paying for their hire of costumes, this means that they will cause *Fancy Pants* profit to increase and because profit is added to equity, Jessica's equity in *Fancy Pants* will also increase. It is probable that the hire fees on credit will be paid to *Fancy Pants*, as the customers hiring costumes are likely to hire costumes again and therefore if they do not pay for their costumes, which they purchased on credit, Jessica will no longer allow them to hire costumes from her store, so therefore there is a greater than 50% chance that the economic benefit will flow to the business and increase *Fancy Pants* asset bank. The hire fees on credit can also be reliably measured as when customers come in and hire a costume Jessica would issue them an invoice. This invoice is a faithful representation of what it is normally and therefore verifies the

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 has been applied in the reporting of accessory sales as the accessory sales have been reported separately in 2013 and 2014, Jessica has only just introduced the sale of accessories and therefore by classifying them separately to her main source of income she is following the qualitative characteristic of relevance as the accessory sales are able to influence decision made by Jessica such as whether it is worthwhile or not to keep continuing to sell these accessories. Because she made \$5 700 out of ~~selling~~ accessory sales in 2014 and reported this in her income statement she is following the qualitative characteristic of relevance as this amount is capable of influencing her decisions. //

By reporting the accessory sales separately to her hire fees, Jessica is applying the qualitative characteristic of materiality, because if she had grouped them with her hire fees it would mislead users and make them make inaccurate decisions as they would not be able to see how successful the accessories actually were in generating sales, and if she had completely left them out of her income statement it would also mislead users, so by correctly following the concept of materiality and grouping the two figures separately it has enabled users such as Jessica to compare her income for the previous years much easier. Jessica is able to see how much her main source of income 'hire fees' has grown over the past 2 years, ~~and she~~ ~~accountant~~, for if it had the accessory sales added to her 2014 hire fees it would make her statement harder to interpret. //

## 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 of depreciation is when the depreciation expense of the asset is highest in its earliest years and gradually decrease over time. This method best suits an asset which consumes its future economic benefit at a much higher rate during its early years which is why it has been used for the office computer. The office computer loses <sup>future economic benefit</sup> value rapidly in its earlier years and the loss in future economic benefit gradually decreases as it gets older so the ~~can~~ diminishing value method is definitely the correct method to use for the office computer as it is the method of depreciation that best fits the pattern of loss of future economic benefit of the office computer. //

The units of use method of depreciation is when the depreciation expense from the asset varies according to the usage of that asset, so this method of depreciation best fits an asset that loses its economic benefit based on how much it is used. //

This method of depreciation is definitely the <sup>most</sup> appropriate method of depreciation to use for the costumes, as depending on how much the costumes are used determines how much future economic benefit they lose. The more the costumes are worn the more they get ~~washed~~ and lose their future economic benefit which is why the ~~depreciated~~ units of use depreciation method is the correct method to use for the costumes, as it is the method that best fits the pattern of loss in future economic benefit of the costumes. //

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of the costumes //

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- (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**.

The cleaning equipment is a result of a past transaction between Jessica and a cleaning equipment shop. Jessica has exclusive rights to the cleaning equipment and it is under her control to decide what it is used for. It is only <sup>Fancy Pants</sup> Jessica that can use the cleaning equipment to clean and launder the various costumes, dresses and suits. The cleaning equipment will provide future economic benefit for Fancy Pants as Jessica will charge her customers a cleaning fee as part of the hire of their costumes, dresses and suits. When the customers pay their fee it will result in an inflow of cash to Fancy Pants and an increase in economic benefit. //

It is <sup>highly</sup> probable that Jessica will use the cleaning equipment to clean and launder her various costumes and therefore it is very likely that future economic benefit will flow into Fancy Pants as a result of this. //

When Fancy Pants purchased the cleaning equipment on credit they would receive an invoice from the company that they purchased this equipment from. The invoice would be faithfully represented and free from bias and would verify the amount at which the equipment cost <sup>\$2800</sup> Fancy Pants. Different independent users would be able to look at this information and come to an agreement that this information is correct which is why the cost of the cleaning equipment is verifiable and can be reliably measured. The purchase of the cleaning equipment is (continued on next

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The student has described both methods of depreciation and explained why the units of use method is suitable for the costumes.

The student has justified why the cleaning equipment meets the past, present control, and future economic benefit definition requirements of an asset and how an appropriate source

document provides a verifiable measure of the cost and how the cleaning equipment is capital expenditure.

Extra space if required.  
Write the question number(s) if applicable.

QUESTION  
NUMBER

1 a For example the location of Fancy Parts store. The location of Fancy Parts is a very critical piece of information that Jessica needs to know as it will help her to determine how many customers go past the fancy dress and costume hire shop. If the location is very inaccessible and is not near other shops it will influence Jessica's decision as it is a very relevant piece of information, as it means that Fancy Parts may not be making the most of these opportunities due to its poor location, and if it was in a better location, it could generate more sales, which is very important for Jessica.

3 b considered capital expenditure, as it is a one off expense of \$2800 that has resulted in the creation of a non-current asset which can be used beyond the current accounting period into future years to generate income for Fancy Parts. It is capital expenditure as it is not a day to day expense, therefore it is recorded with Fancy Parts Property, Plant and Equipment in Fancy Parts Statement of Financial Position.

Extra space if required.  
Write the question number(s) if applicable.

QUESTION  
NUMBER