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91174



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.

Low Merit

TOTAL

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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
Assets	
Accounts receivable	1 600
Prepayments	250
Property, plant and equipment (Note)	37 300
Goodwill	8 000
Total assets	47 150
Liabilities	
Accounts payable	2 100
Income in advance (hire fees)	90
Bank loan	7 000
Total liabilities	9 190

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 described the purpose of the statement of financial position and described understandability in relation to Jessica and described a limitation of the statement of financial position in context.

- (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 the financial statement of financial position for *Fancy Pants* is to show *Fancy Pants*' financial position and to allow to calculate the total net assets and closing capital for the business. Jessica may have used *Fancy Pants*' statement of financial position when purchasing the business as it gives her an idea of how well the business assets are performing when compared to liabilities (return on total assets) so she can assess total net assets. The financial statement also shows faithful representation as the dollar figures have come from an independent external 3rd party and can be verified through some documents. The qualitative characteristic of understandability is important as Jessica must have some knowledge of accounting to be able to comprehend and understand the statement of financial position for *Fancy Pants* thoroughly, as well as a willingness to learn about the business. A limitation of the statement of financial position is that it does not provide any non-financial information about *Fancy Pants* such as customer base or how long *Fancy Pants* has been operating for what may influence the economic decisions of Jessica when making a business decision.

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.

Income in advance 90
~~hire fees~~ 90
 Hire fees

All transactions are reported when recorded when they occur and reported into periods of which they relate to. The \$90 received in advance would be subtracted from the hire fees income in the Income Statement for Fancy Pants as it relates to ~~this~~ next period as the costume has been pre-ordered and will be rented next period, and been paid for. //

The \$90 received in advance would be recorded as income in advance, a current liability in the Statement of Financial Position for Fancy Pants as it relates to next period as the costume has already been paid for but will be rented to the customer during the next accounting period. //

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 The examination continues on the following page.

The student has given a full definition of accrual basis and linked to context

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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**.

The fees on credit are an income for *Fancy Pants* as it is an inflow of economic benefit which increases assets (accounts receivable) which increases equity, resulting in more profit, not as a result of contributions by the owner, Jessica. It is probable (more than likely) that future economic benefit will flow from the hire fees on credit as customers will pay for costumes which they hire in order to use the costumes. The cost of the hire fees show faithful representation as the cost of the hire fees are verifiable due to source documents ^(invoices) which prove that a transaction ~~took~~ place. The invoice has been checked by an independent neutral 3rd party (the customer) and has a ~~value~~ which monetary value issued to it to show that the cost of the hire fees are verifiable therefore making the cost of hire fees ~~be~~ a free from bias as they have been checked by an independent neutral 3rd party.

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 reporting of accessory sales meets the qualitative characteristic of **relevance** as information is up to date ^(timely) and complete meaning it is still able to influence Jessica's decisions when making a business decision. The qualitative characteristic of **materiality** has been applied in reporting accessory sales separately from hire fees as compared to the \$80,000 of hire fees, the \$5,700 of accessory sales is significant enough in size (large enough) in order to influence the economic decisions of *Fancy Pants* for Jessica. The \$5,700 of accessory sales is large enough in size compared to the \$80,000 of ~~the~~ hire fees if she wants to make an economic decision for *Fancy Pants*, e.g. if the sales of accessory fees profitable for the business, ^{to continue selling accessories.} this is large enough to influence Jessica's business decisions.

The student has correctly explained why hire fees is income by using all three parts and referring to profit and accounts receivable increasing

The student has explained the invoice that provides the reliable _{pro}.

The student has explained how accessory sales are material in terms of separation due to size and described how accessory sales are relevant in terms of 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.

We use diminishing value depreciation as it best reflects the decrease in economic benefit when using the office computer. The decrease in economic benefit when using the office computer occurs most at the beginning of its lifetime and then decreases in value throughout its lifetime of using the office computer. We use units of use depreciation as it best reflects the decrease in economic benefit when using the costumes. The decrease in economic benefit when using the costumes occurs ~~as~~ as the costumes are used rather than the physical age of costumes, e.g. depreciates each time the costume is worn. The correct uses of depreciation method have been used for the office computer and costumes as the depreciation methods used best reflect the decrease in ~~using~~ economic benefits when using the office computer and the costumes, due to wear and tear and obsolescence.

- (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**.

Cleaning equipment is a non-current asset as it is not expected to be realised in Fancy Pants' normal operating cycle. Cleaning equipment is an asset as it is a resource controlled meaning Fancy Pants has exclusive right to using the cleaning equipment which prevents others from using it. The first event of the cleaning equipment is when cash was paid when an invoice was received for the purchase of the cleaning equipment as it was purchased on credit. Future economic benefit is expected to flow from the cleaning equipment as it will be used to clean and launder costumes before they are hired ^{to customers} which brings in cash to the net income to Fancy Pants in the form of cash to ~~pay~~ ~~equ~~. The cost of the cleaning equipment shows the qualitative characteristic of verifiability as the cost of the cleaning equipment can be measured with reliability as source documents (invoices) have come from an independent neutral 3rd party (the supplier) which shows that it is free from bias. The purchase of the cleaning equipment is capital expenditure as it creates an asset which is not expected to be realised within Fancy Pants' normal operating cycle and will benefit Fancy Pants beyond the accounting period.

The student has correctly described the units of use depreciation method and briefly explained why the units of use method is suitable

The student has correctly explained why the cleaning equipment meets the past, present control, and future economic benefit of an asset and how the invoice meets verifiability.

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High Merit

TOTAL

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ASSESSOR'S USE ONLY

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
Assets	
Accounts receivable	1600
Prepayments	250
Property, plant and equipment (Note)	37300
Goodwill	8000
Total assets	47150
Liabilities	
Accounts payable	2100
Income in advance (hire fees)	90
Bank loan	7000
Total liabilities	9190

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 explained the purpose of the Statement of Financial Position including how Jessica uses the information and described understandability and a limitation of the statement of Financial Position

- (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.

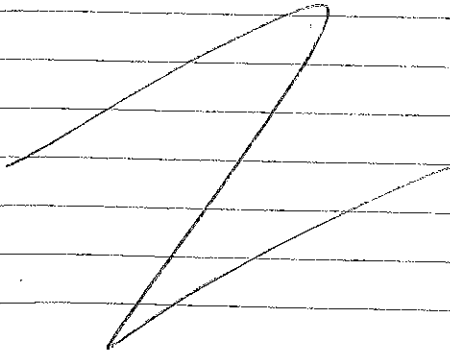
The purpose of financial statement for *Fancy Pants* is to show asset liabilities and equity at a point in time. Jessica would have used the statement of financial position to example see if how much debt the business owes this would have helped her as if the business had a huge amount of ~~cash~~ ~~pending~~ she would have decided that *Fancy Pant* is not a secure investment. The statement of financial position would also show her how much asset the business own. The qualitative characteristic of understandability would have helped Jessica use statement of financial position as it would have ~~she~~ clarified what asset to enty own and liabilities. The ~~character~~ of understandability is important as it would help users of financial information like Jessica to be able to understand and interpret the business and position it hold to enable her to decide if this is a workable purchase. One limitation of the statement of financial position is the current ~~value~~ ~~depreciation~~ of asset are based on estimates and may not be accurate one other limitation may be that the asset are recorded at the historical cost price as does not show the current market value therefore is outdated.

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.

The accrual basis concept states that all transactions and events must be recognised at the time they occur and recorded in the financial statement to which they relate to. The \$90 received in advance for hire fees is reported in the statement of financial fees as "income in advance" as it is still a current liability for the business because the fees do not belong to this time period meaning fancy pants is still obliged to pay the customer. So an income in advance account is reported as a current asset liability in the statement of financial position. The current account is hire fee which is reported in the income statement where \$90 is subtracted because the \$90 does not belong to this time period therefore fancy pants does not ~~is~~ is not entitled to receive ~~it~~ ~~owning~~ earning the (income) hire fees yet.



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The examination continues on the following page.

The student has explained accrual basis to ^{both} the statement of financial position and income statement for income in advance.

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.

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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 is an income for fancy pants because when fancy pants lets customers hire costumes, customers will pay for the hiring of costume and this is a flow of future economic benefits. Hire fees on credit increase the equity for fancy pants therefore increase profit. The hire fee is not a contribution by Jessica into the business. It is probable that the entity will continue to operate into the foreseeable future as there is not evidence of de-liquidation hence customers when fancy pants lets customers hire costumes, the customer will pay for hire fees and inflow of cash will occur (future economic benefit) as fancy pants has a legal right to receive cash owing from credit customers. Fancy pants can reliably measure this as there will have an invoice/receipt which shows a market transaction between fancy pants and customers which is complete, neutral and free from error.

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 information has the qualitative characteristics of relevance when it is capable of making a difference in the decision of users. We see that accessory sales is a new advancement to fancy pants. Accessory sales has the qualitative characteristic of relevance as owners and users can make decisions based on example. Jessica will be able to see if this has increased (other) income for the entity or if it has caused more expense she can use this to decide if she wants to continue selling accessories. The qualitative characteristics for materiality mean information that is misstated or omits material information on the nature of it will build influence decisions made by users.

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

The student has given a definition of income with a link to net profit increasing equity and not contributions by Jessica and explained that it is probable cash will flow to Fancy Pents with a valid reason why and explains that an invoice/receipt provides a reliable measure

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.

Diminishing value method of depreciation is applied when the economic benefit consumed of the asset is generally high at the early stages of its life, and decreases as it is utilised more in Fancy pants.

The units of use method is applied when the economic benefit consumed of asset are dependent on the usage of the asset in its life.

The office computer is depreciated using the diminishing value method because the use of the computer is high at early stage of its life. The economic benefit consumed when using computer is most effective when first involved/used for the diminishing value is correct to depreciate the office computer. This is because computers can slowly become of no use as its economic benefits are consumed. The units of use method is used to depreciate costumes this is because the economic benefit consumed of costumes will be different & changing during its life. Example some years of use might be high and usage would be high & some years not so high usage (so sales low) therefore is depreciated with units of use method as the economic benefit consumed is dependent on usage of its life.

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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**.

Cleaning equipment is an asset for Fancy pants because it was purchased in the past. Fancy pants controls the usage of the cleaning equipment and only Fancy pants has exclusive right to use cleaning equipment to generate future economic benefits. When Fancy pants uses cleaning equipment to clean and launder bank costumes it will mean that the costumes will be more appealing to customers and customers will hire costumes thus generate future economic benefits. Fancy pants will report cleaning equipment as a noncurrent asset because Fancy pants has no intention to turn the asset into cash as the business will use cleaning equipment into foreseeable future, and continue to generate future economic benefits to Fancy pants. The qualitative characteristics would mean that two individual people/parties can reach a consensus that an event or transaction has occurred. This would be possible as when Fancy pants purchased cleaning equipment there would be an invoice showing the purchase of cleaning equipment which is complete neutral & free from error as it shows a consensus/agreement between Fancy pants and purchase store of cleaning equipment.

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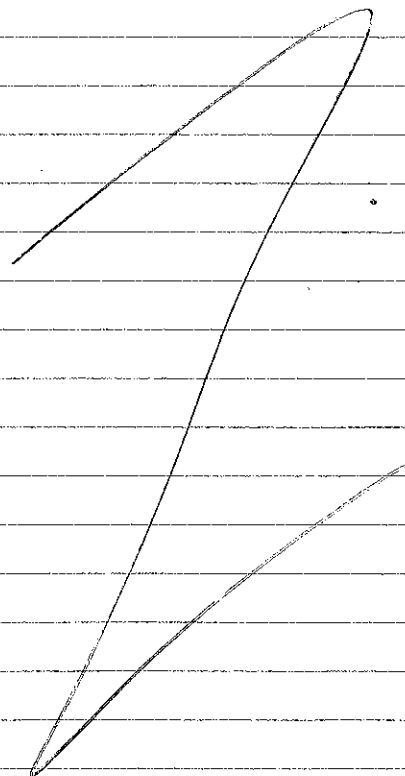
The student has described both methods of depreciation

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

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

QUESTION
NUMBER

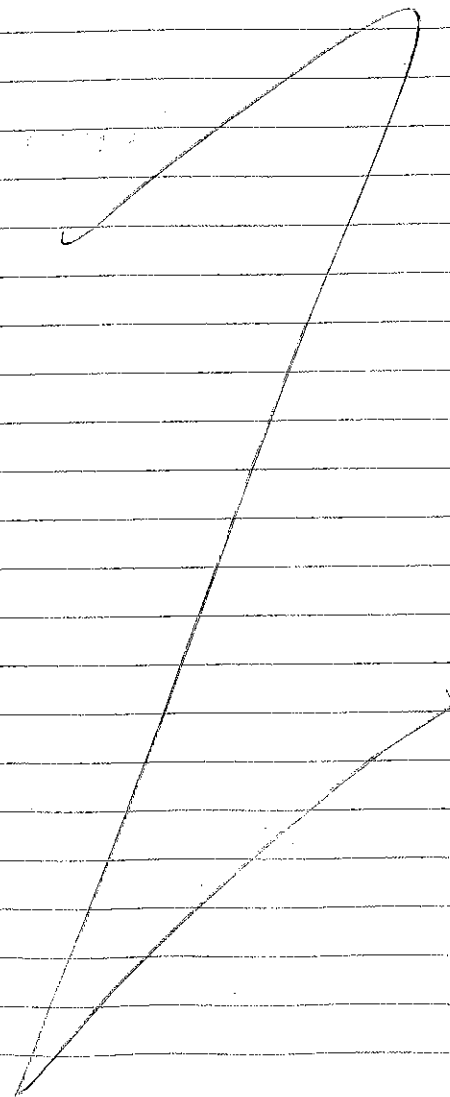
The purchase of cleaning equipment meets the definition of capital expenditure because the purchase of cleaning equipment is a one off purchase and creates a non current asset that Fanny pants will continue to use in the foreseeable future to clean their ballroom and generate future economic benefits.



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

QUESTION
NUMBER



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