

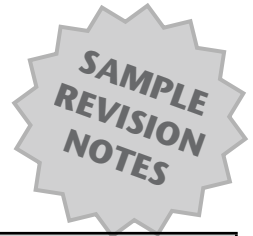
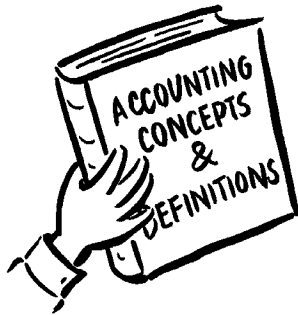
Chapter 4

NZ Framework

NCEA Level 3 Accounting material in this chapter includes material for Achievement Standard 90500 (Accounting 3.1) 'Describe and apply the conceptual basis of accounting in context'. The chapter deals with the following concepts covered in the NZ Framework:

- Qualitative characteristics of financial statements.
- Constraints on relevant and reliable information.
- Underlying assumptions.
- Elements of the financial statements.
- Recognition of the elements of the financial statements.
- Measurements of the elements of the financial statements.

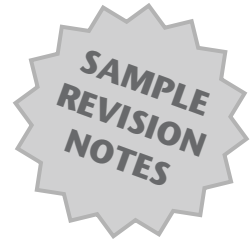
Accounting concepts and definitions



Notions	Definition	Application
Accounting Entity notion	The financial affairs of an entity (business) must be kept separate and distinct from the financial affairs of the owner and other entities.	When accounting records of a business are prepared, only include business transactions. Transactions relating to the owner are recorded as drawings or are excluded.
Monetary Measurement notion	All transactions are recorded in the common unit of measure (eg \$NZ).	If a transaction cannot be expressed in money values, it will not be recorded or reported in the accounting reports, and all transactions for a business will be reported in the same currency (ie financial reports in NZ will use NZ\$).
Reporting period	Assumes life of a business may be divided up into regular time periods, usually one year.	Provides timely information about the business's profitability and Balance Sheet for decision making.



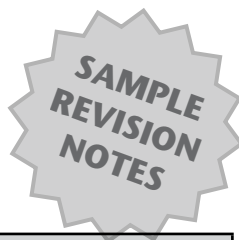
Assumptions when preparing financial statements



Assumption	Definition	Application
Going concern	Financial reports are prepared on the assumption that the entity will continue in operation for the foreseeable future.	Expected selling price is not relevant when valuing assets in the Balance Sheet, as they are not planned to be sold now, the business is not closing down in the foreseeable future, and the assets are expected to provide future economic benefits as they are used. Therefore, the assets are recorded at historical cost. This is shown by reporting non-current assets and non-current liabilities – these will be used or repaid over more than one accounting period, so the business must be expected to continue in operation into the future.

Accrual basis	The effects of transactions and other events are recognised when they occur. The transactions are <i>reported</i> in the financial statements of the periods to which they relate.	Effects of transactions recorded when they occur and reported in the accounting period to which they relate, shown by reporting accounts receivable, accounts payable, and other balance day adjustments.
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Elements of the financial statements



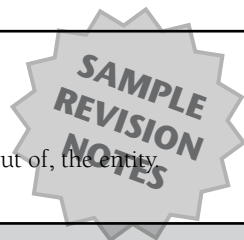
Elements	Definition	Application
Assets	A resource controlled by an entity as a result of past events from which future economic benefits are expected to flow to the entity.	The assets (eg equipment) will be used by the business to provide a service to customers or to assist in selling inventory that will create income (future economic benefit from accounts receivable increasing). The business has exclusive rights to the equipment and restricts anyone else from using the equipment. This is shown by the fact that the business controls how, when, and who uses the equipment. The past event was when the equipment was purchased.
Liabilities	Present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits.	The entity owes another entity the amount of the debt (eg a loan is owed to a bank). There will be a payment of cash, which is an outflow of resources. The past event was when the loan was first borrowed.
Equity	The residual interest in assets of the entity after deducting its liabilities.	

Income	An increase in economic benefits during the period – in the form of inflows, enhancements of assets or decreases in liabilities – that result in increases in equity, other than those relating to contributions from equity participants.	Sales, fees, and interest received are inflows that will either increase bank or accounts receivable. Discount received is a decrease in a liability. These transactions increase equity as they increase profit for the year. They are <i>not</i> a contribution from the owners.
Expenses	A decrease in economic benefits during the period – in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.	Depreciation is an expense as it is a depletion of property, plant and equipment assets. Other expenses, like wages and electricity, are outflows or increase liabilities (eg accrued expenses). All of the examples decrease economic benefits, as the value of assets will decrease through depreciation or when the bank balance decreases. These transactions decrease equity as they decrease profit for the year. They are <i>not</i> a distribution to the owners.
Capital Maintenance Adjustments	The revaluation or restatements of assets or liabilities that change equity – not included in the Income Statement, but is included in the Statement of Changes in Equity.	<ul style="list-style-type: none"> • A change in Land or Buildings Revaluation Surplus. • A change in the Fair Value Surplus of Available for Sale Investments.

Recognition of Elements

Elements should be recognised in the financial statements if:

- It is probable that any future economic benefit will flow to, or out of, the entity.
- The item can be measured with reliability.

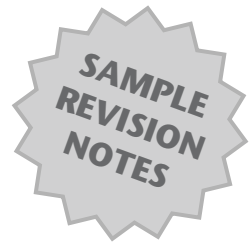
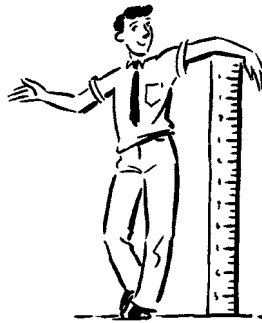


Recognition of Elements	Definition	Application
Assets	Assets are recognised if it is probable that future economic benefits will flow to the entity <i>and</i> the assets can be measured reliably.	Research costs are <i>not</i> an asset since future economic benefits may not eventuate. Internally generated goodwill is not an asset, since it cannot be measured reliably.
Liabilities	Liabilities are recognised if it is probable that an outflow of resources embodying future economic benefits will result from settlement of a present obligation <i>and</i> the liability can be measured reliably.	Being sued in a court case is not a liability, since the debt is uncertain or may not eventuate. A lost court case, where the amount of damages has <i>not</i> been determined, is not a liability, since the debt cannot be measured reliably.

Income	Income is recognised if it is probable that an increase in future economic benefits relating to an increase in assets or a decrease in liabilities will occur <i>and</i> the income can be measured reliably.	There is no income if there is no increase in assets or decrease in liabilities.
Expenses	Expenses are recognised if it is probable that a decrease in future economic benefits relating to a decrease in assets or an increase in liabilities will occur <i>and</i> the expenses can be measured reliably.	There is no expense if there is no decrease in assets or increase in liabilities.

Measurement of Elements

The measurement of elements involves determining, by selection of a particular basis of measurement, the monetary amounts for which the elements of the financial statements will be recognised and reported in the financial statements.



Measurement of Elements	Definition	Application
Historical Cost	Assets are recorded at the amount of cash paid or payable at time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.	Assets are recorded at their original price when first purchased. Liabilities are recorded at the amount borrowed or the cost of the asset/expense bought on credit.
Current Cost	Assets are reported at the amount of cash that would be required to purchase the asset currently. Liabilities are reported at the undiscounted amount of cash that would be required to settle the obligation currently.	Specialised equipment may be reported at the cost of buying that particular asset at balance date. Liabilities would be reported at the amount required to repay the debt at balance date.

Realisable Value	Assets are reported at the amount of cash that would currently be received by selling the asset, in an orderly disposal. Liabilities are reported at their settlement values, the undiscounted amount of cash expected to be paid to satisfy the debt in the normal course of business.	Assets would be revalued to the current market price. Liabilities would be reported at the amount required to repay the debt as it falls due.
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Current Cost or Realisable Value

Assets are initially valued at their historical cost to the company. This value may be changed at regular intervals by someone qualified to revalue the asset.

- A registered valuer would be needed for land and buildings revaluations.
- For specialised equipment, a professional involved in that industry would be required to provide the valuation.

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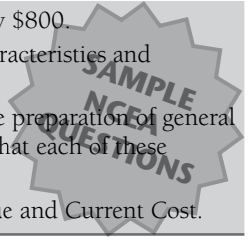
The reasons for the different methods of valuation are that while *historical cost* is a reliable method of measurement, it may not be relevant in providing effective predictive value. To change from the *historical cost* basis, the new basis should be reliable (ie free from bias and represent the actual value of future economic benefit of the asset).

Activity 4A: NZ Framework Assumptions, Financial Elements and Measurement of Elements

1. a. For the following, decide if an income or expense exists, explaining whether or not it should be recognised, and why.
 - i. A credit sale of \$2 000.
 - ii. Employees have not been paid \$5 000 which they earned last week.
 - iii. A reduction in mortgage instalments due to falling interest rates.
 - iv. A bad debt of \$500 is written off.
 - v. A bad debt of \$250 is recovered.

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- vi. The allowance for doubtful debts has been increased by \$800.
- b. Does a revaluation of land and building assets meet the characteristics and recognition criteria for income? Explain.
2. The NZ Framework sets out two underlying assumptions in the preparation of general purpose accounts – *Going Concern* and *Accrual Basis*. Explain what each of these assumptions means.
3. Explain the differences between Historical Cost, Realisable Value and Current Cost.

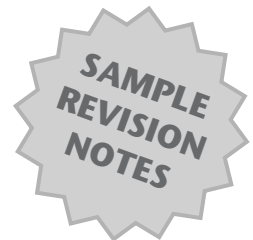


Qualitative Characteristics

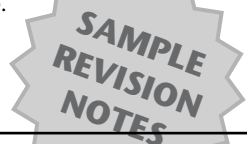
The usefulness of financial reports to users depends upon the quality of the information provided. There are four characteristics of accounting information which help to measure the quality of the information – understandability, relevance, reliability and comparability.

Reliability includes faithful representation, substance over form, neutrality, prudence and completeness; relevance includes materiality.

Qualitative characteristic	Definition	Application
Understandability	Information in financial statements needs to be readily understandable by users. Users are assumed to have a reasonable knowledge of business, economic activities and accounting, and will study the information with reasonable diligence.	The reports are presented in a manner that follows Generally Accepted Accounting Practice and communicates information in such a manner that users are likely to be able to comprehend the financial statements and can make decisions from them.
Relevance	Information is <i>relevant</i> when it influences the economic decisions of users by helping them evaluate past, present or future events. <ul style="list-style-type: none"> • Has confirmatory role – in that it must inform the user about the accuracy of past predictions. • Has predictive value – information must be helpful in making predictions about future financial position and performance. 	<ul style="list-style-type: none"> • The financial statements are compared with the budget, a confirmatory role. • The financial statements are used to prepare next year's budget, a predictive value role.



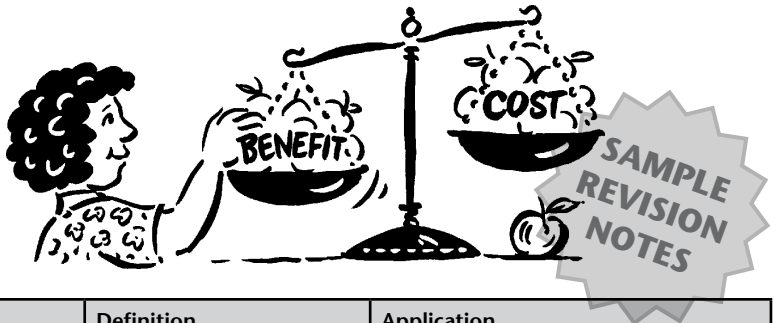
	<p>Materiality Information is <i>material</i> if the effect of it being omitted or mis-stated could influence the economic decision making of users of the financial statements. An item can be material by nature or by size.</p>	<p>Some expenses are combined in Administrative Expenses in the Income Statement, as they are not material by nature or size. Some low-value assets (eg rubbish bins), are recorded as an expense rather than recorded as assets. Some expenses are reported separately in the Income Statement as they are material by nature (eg Directors' Fees – shareholders would want to know how much remuneration the directors are receiving).</p>
Reliability	<p>Information is <i>reliable</i> when it is free from material error or bias and can be depended upon to represent faithfully what it purports to represent.</p>	<p>The information is:</p> <ul style="list-style-type: none"> • Neutral. • Transactions are recorded in a manner that conveys the effect or actual substance of the transaction rather than its mere legal form.
	<p>Faithful Representation Information must <i>represent faithfully</i> the transactions and other events that have occurred.</p>	<p>Report all assets, liabilities, income and expenses in the financial statements that meet the recognition criteria of probability and measured reliably.</p>
	<p>Substance over Form Information needs to be accounted for in accordance with the <i>substance</i> and economic reality of the transaction rather than the mere legality of the transaction (<i>form</i>).</p>	<p>Transactions are recorded in a manner that conveys their actual substance.</p>
	<p>Neutrality Information in the financial statements needs to be free from bias.</p>	<p>Statements <i>are not</i> prepared in a manner that will influence decision making to achieve a predetermined result.</p>
	<p>Prudence Accountants need to be cautious when exercising judgements in making estimates. This means that accountants <i>will not</i> overstate income or assets and <i>will not</i> understate liabilities or expenses.</p>	<p>An example is shown by the recording of allowance for doubtful debts, reducing the asset, accounts receivable's value, and recording an expense, doubtful debts.</p>
	<p>Completeness The information needs to be complete, as an omission could lead to the information being false or misleading.</p>	<p>All relevant information, within the bounds of materiality and cost, is included, which makes the financial statements more reliable.</p>



Comparability	<ul style="list-style-type: none"> • Users must be able to compare the financial statements of an entity over time, to identify trends in the financial position and performance. • Users must be able to compare the financial statements of different entities to evaluate their relative financial position and performance. 	<ul style="list-style-type: none"> • Comparative figures make it possible to compare financial statements of an entity over time. • Financial statements are prepared in a consistent manner, and if there are any changes to the methods of measurement, then these changes and their effects are disclosed in the financial statements. • Financial statements are prepared following GAAP and the NZIFRSs, so that this entity's financial statements can be compared with the financial statements of other entities.
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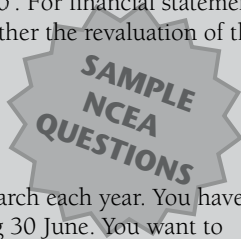
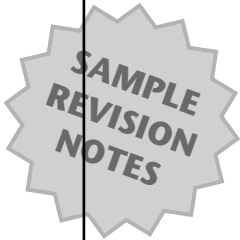
Constraints on Relevant and Reliable Information

There are constraints on the qualitative characteristics of relevant and reliable information that affect the usefulness of the information.



Constraints on Relevant and Reliable Information	Definition	Application
Timeliness	Undue delay in reporting information means the information may lose its relevance. Information may not be reliable if it is reported before all aspects of the transaction are known. Achieving a balance means deciding how to best satisfy the economic decision making needs of users.	Financial statements are prepared within a few months of balance date, to make the information more relevant.

<p>Balance between benefits and costs</p>	<p>Benefits derived from information should exceed the cost in providing it.</p>	<p>Deciding on the benefits and costs of providing information involves a judgement by the accountant. This is applied to the financial statements prepared for an exempt company or for a company that qualifies for differential reporting.</p>
<p>Balance between Qualitative Characteristics</p>	<p>A balancing or trade-off between qualitative characteristics is necessary.</p>	<p>A judgement is made of the relative importance of the characteristics.</p> <p>Example A _____</p> <p>By revaluing land, the qualitative characteristic of reliable information is given up as the revaluation is an estimate; however, it is considered to be more important in meeting the needs of users of the financial statements to provide up-to-date information – so, the land is revalued to the up-to-date market value, which means the land value meets the qualitative characteristic of providing relevant information.</p>
<p>True and Fair View or Fair Presentation</p>	<p>Financial statements are described as showing a true and fair view or presenting fairly the financial position and performance.</p>	<p>By applying the qualitative characteristics and accounting standards, the financial statements will usually convey a true and fair view.</p>



Activity 4B: NZ Framework Qualitative Characteristics and Constraints on Qualitative Characteristics

1. Explain why accountants use the historical cost basis for the measurement and reporting of Balance Sheet assets in terms of the accounting characteristics of reliability and comparability.
2. ‘The Land has been revalued up from \$200 000 to \$400 000’. For financial statements to be useful, they should be reliable and relevant. State whether the revaluation of the Land would make the financial statements more or less:
 - Reliable.
 - Relevant.

Give a reason for your answer.
3. You own a dairy which has a financial year ending on 31 March each year. You have recently purchased a shop which has a financial year ending 30 June. You want to change the financial year of this second business to 31 March so that it will be the same as your existing business. You propose to do this in the current year. Explain the effect this change would have on the comparability of the accounts for the next financial year. Is this change permissible in terms of the characteristics of good accounting information? Explain.

4. A reporting entity is being sued for damages, with the amount of the claim being disputed. Discuss how the characteristics of relevance and reliability are in conflict.
5. Complicated depreciation schedules are recorded in the Property, Plant and Equipment Register, yet are shown as one amount in the financial statements. Discuss how the characteristics of understandability and reliability are in conflict.
6. A business has taken two years to gather information on developing a new product line. Discuss how the characteristics of relevance and reliability are in conflict.
7. A business's records are destroyed by fire. Discuss the difficulty of satisfying the characteristic of comparability in this situation.
8. It can be said that 'information which is relevant is not always reliable and information which is reliable is not always relevant'. (For example, budgets may be relevant but are not reliable and financial statements for past periods may not be relevant.)

Explain why budgets are prepared although they are not reliable, and explain why past financial statements are used although they may not be relevant.

Activity 4C: Applications of NZ Framework

A number of independent situations follow. You are required to answer the question(s) that follow each independent situation.

Situation A

Jill Kingsley operates a florist business in central Wellington. She has taken out a bank loan to expand her shop and has recorded the loan as a liability in the Balance Sheet.

1. Using the NZ Framework and criteria for liability recognition, explain whether or not this is the correct treatment.

Situation B

Jacks Car Parts Ltd has been in business for ten years. Jack, the owner, is concerned that the land and buildings are still valued at their original cost price of \$175 000. Jack has just recently had the land and buildings valued. Three independent valuers believed the land and buildings are worth \$400 000. Jack informs you that the land and buildings current Government valuation is \$380 000.

The NZ Framework identifies qualitative characteristics and measurement bases to measure the quality of information.

2.
 - a. In the past, Jack has reported Land and Buildings as \$175 000. What is the name of this method of valuation?
 - b. State an alternative method that Jack could have used to determine the value of his land and buildings.
 - c. What qualitative characteristic would back up Jack's belief that his land and buildings need to be revalued? Explain your answer.
 - d. Which qualitative characteristic would be breached if Jack revalued his land and buildings? Explain your answer.
 - e. If Jack revalued the land and buildings, where would he disclose the change in asset valuation in his financial statements?

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Situation C

Joe Bloggs, a small business operator, has recently purchased a computer. He has recorded the computer as an asset in the company's Balance Sheet. Joe informs you that the computer was given to his daughter, who has nothing to do with his company.

3. a. Explain, in terms of generally accepted accounting practice, why Joe's treatment of the computer, as an asset to the business, is incorrect.
- b. Explain how Joe should have treated the computer purchase.

Situation D

Bill Smith, operating as *Mr Fixit*, has been in business for 20 years. This year, for the very first time in the business's history, he has created a \$20 000 account called Goodwill. *Mr Fixit* has classified Goodwill as an asset in his Balance Sheet.

4. a. Is *Mr Fixit's* treatment of Goodwill as an asset correct? (Simply answer 'Yes' or 'No'.)
- b. Using the NZ Framework and criteria for asset recognition, explain your answer to a.

Situation E

Clare Fashions Limited is a large company which has a chain of retail outlets in a number of shopping malls throughout New Zealand. At the end of the financial year, it prepares an annual report, which includes the financial statements. It also prepares monthly reports, which include financial statements, budgets and projected cash flows.

Clare Fashions Limited has two subsidiary companies, which are operated separately. One operates as a wholesale distributor/mail order outlet, and the other to make deliveries. The business uses the following policies and practices in reporting transactions and in preparing the annual financial statements.

Accrual Accounting

Accrual accounting has been used to report the effects of transactions in the period to which they relate.

Accounts Receivable

Accounts Receivable are stated at their estimated net realisable value.

Depreciation

Depreciation has been calculated using a systematic basis over the economic life of the assets. Buildings 50 years, Plant 25 years, Furniture 10 years.

Assets with a cost of less than \$500 are recorded as an expense in the year of acquisition.

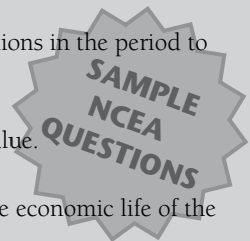
Inventories

Inventories have been valued at the lower of cost or net realisable value.

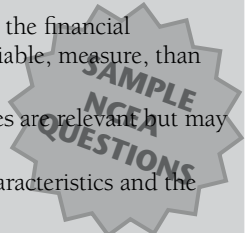
Non-current Assets

Non-current assets have been stated at cost or valuation less aggregate depreciation or amortisation.

Land has been revalued on a yearly basis and the increase in value has been transferred to the Land Revaluation Reserve.



5. a. Explain how the accounting entity concept is applied to *Clare Fashions Limited*.
- b. The Statement of Accounting Policies states that the reports have been prepared on the basis of going concern, and that Property, Plant and Equipment assets have been stated at cost. Explain how the going concern assumption has been applied to the measurement of Property, Plant and Equipment in the financial statements of *Clare Fashions Limited*.
- c. Explain how the accrual basis would have been applied to the financial statements of *Clare Fashions Limited*.
- d. *Clare Fashions Limited* uses realisable value to report land in the financial statements. Explain why this is a more relevant, but less reliable, measure, than historical cost.
- e. Explain how the budgets that *Clare Fashions Limited* prepares are relevant but may not be reliable.
- f. Explain how the plant owned by the business meets the characteristics and the recognition criteria of an asset.
- g. Explain how the depreciation on the plant and equipment owned by the business meets the characteristics and the recognition criteria of an expense.
- h. Explain how the income earned from selling clothes meets the characteristics and the recognition criteria of income.
- i. Explain how the loan used to purchase the buildings meets the characteristics and the recognition criteria of a liability.
- j. Provide an example and explain how the accountant has applied prudence.
- k. Provide an example and explain how the accountant has applied materiality.



Activity 4A: NZ Framework Assumptions, Financial Elements and Measurement of Elements (p. 40)

1. a. i. Income is recognised, as a sale has occurred which increases assets (accounts receivable), increases equity through larger profits, and it is not a contribution from the owners. Also, the amount can be measured reliably, as the amount due from accounts receivable is recorded on the invoice. (A/M)
 - ii. Expense is recognised, as the cost has been incurred, which increases liabilities (accrued expenses), decreases equity through lower profits, and it is not a distribution to the owners. Also, the amount can be measured reliably, as the amount owing to staff is recorded on time sheets. (A/M)
 - iii. There is *no* income or expense, as the decrease in interest rates does not meet the criteria of an income or expense. It will result in a decrease in expense cost in the future, but cannot be recognised at the moment, as there has been no transaction. (A/M)
 - iv. An expense is recognised, as there is a reduction in assets (accounts receivable), a reduction in equity through lower profits which is not a distribution to the owners and the bad debt can be measured reliably as the amount of the debt written off. (A/M)
 - v. This is a negative expense, a reduction in expenses, as the money has been received for a debt previously written off. There has been an increase in assets (Bank account), an increase in equity through higher profits and it is not a contribution from the owners. Also, the amount received can be measured reliably with the receipt issued. (A)
 - vi. An expense is recognised, as there is a reduction in assets (accounts receivable through an increase in the allowance for doubtful debts), a reduction in equity through lower profits which is not a distribution to the owners and the doubtful debt expense can be measured reliably as the increase in the allowance for doubtful debts based on accounts receivable statement totals. (A)
 - b. A revaluation of land or buildings does meet the characteristics and recognition criteria for income. The increase in value increases an asset (land or buildings), increases equity (Land or Buildings Revaluation Surplus), and is not a contribution from the owners; therefore, it is a income. The amount of the increase is measured reliably if an independent valuer completes the valuation. The only difference is that this income, the increase in value of the land or buildings, is reported in the Statement of Changes in Equity, as it is not a regular source of income. (A)
2. The *Going Concern* assumption means that it is assumed that the business will continue to operate into the foreseeable future. This is reflected in the way assets are measured. The majority of assets will be measured using historical cost (the amount paid to acquire the asset), rather than realisable value (the expected selling price). This is appropriate, as the assets will be consumed over several accounting periods rather than being sold soon (eg Motor Vehicles).
The *Accrual Basis* assumption means that effects of transactions are reported in the accounting period to which they relate. This is shown by reporting balance day adjustments, eg Prepayments. (A; E – answer refers to examples)
 3. Historical Cost measures transactions at the amount paid/payable or received/receivable at the time of the transaction. It is a reliable basis for measuring transactions, as there are source documents that ensure that the amount recorded is neutral.

Realisable Value measures assets at the amount that would be received if an asset was sold. It also measures liabilities at the amount required to settle a debt. This is a relevant basis of measuring assets and liabilities, as the amounts provide a more accurate predictive value, as the values are more up to date or timely.

Current Cost measures assets at the amount of cash required to purchase the asset at the present moment. It also measures liabilities at the amount required to settle the debt. This is a relevant basis of measuring assets, as the amounts provide a more accurate predictive value, than the historical cost of an asset, as the value of an asset reflects the cost required to replace the asset if it was destroyed. (M)

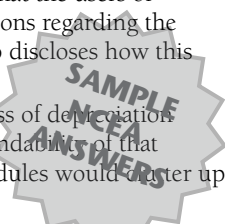
Activity 4B: NZ Framework Qualitative Characteristics and Constraints on Qualitative Characteristics (p. 44)

1. Accountants use historical cost as a basis for measuring balance sheet assets because these transactions can be measured reliably, as there are source documents which would prove the amount of the transaction. This ensures that the transaction value is neutral or free from bias. These amounts can then be compared easily over time, as they are representationally faithful, reflecting the actual transaction. (M; E – answer includes both reliability, comparability, and refers to neutrality or representationally faithful)
2. The revaluation of land is *less reliable*, because it is *not verifiable* until the land is sold; or there is a possible bias from the person who provided the valuation; or lacks representational faithfulness. The revaluation is *more relevant*, because it provides a better indication of shareholders' equity for decision-making purposes. It is more timely, gives greater predictive value of the future economic benefit of that particular asset. (M; E – answer discusses both relevance and reliability and refers to particular aspects of relevance and reliability, bias or predictive value)
3. The change of balance date would mean that the financial statements of the new shop could not be compared with those of previous years or with those of the original shop, because they would be for a nine-month period only. In the following year, the accounts would show the results of both businesses for a full year, so they would become comparable with each other.

The change is permissible, providing that it is disclosed in the financial statements of the new business. If the accounts of the two dairies are to be combined, then the change must be disclosed in the combined statements. This enables users of the statements to take the change of balance date into account in making any decisions. (A)

4. Being sued for damages is relevant information to users for decision-making purposes. It is unreliable to record the amount of the claim in the accounts, as the outcome of the court case is unknown. The amount should be disclosed in the Notes to the financial statements as a Contingent Liability, as it is relevant information that the users of the financial statements would need to know when making decisions regarding the business. (A – discusses relevance and reliability; M – answer also discloses how this information is reported)
5. Showing one amount for depreciation avoids the recording process of depreciation being included in the financial statements. This aids the understandability of that accounting information for users. Reporting all depreciation schedules would clutter up the accounts and may confuse users.

Thus, by simplifying the reporting process for depreciation, the accountant is sacrificing reliability. (A; M – answer discusses understandability)



6. Taking two years to gather accurate information ensures the information is truthful (representationally faithful) and therefore reliable (eg market surveys, pricing strategies). Given the time to collate the data (two years), the information may no longer be relevant, as it may be out of date. (**M; E** – answer discusses both relevance and reliability and refers to particular aspects of relevance and reliability)
7. This extraordinary event has a dramatic effect on comparability, as there are no past records to compare this year's statements with. The accountant can still make comparisons of this year's trading results with other entities' results in the same industry. (**A**)
8. Relevant information may not always be reliable because it cannot be verified – particularly true for budgets which are numerical plans for the future (until the time has passed, it is not possible to verify them). Budgets may also be prepared with some bias, depending on who is preparing them and whether or not that person is honest or wishes to make his/her performance appear better than it really is. The budgets involve estimates of income, expenses, receipts and payments.

Reliable information, on the other hand, is not always relevant. Financial statements based on historical cost accounts are neutral, but may not always be helpful for prediction, especially if there have been major changes in either the firm's activities or external factors such as interest rates and the economic climate. Financial statements are often not timely, as it is often several months after the end of the financial year before users receive published financial statements. (**A; M** – answer discusses both relevance and reliability)

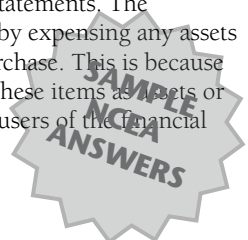
Activity 4C: Applications of NZ Framework (p. 45)

1. This is the correct treatment. There is a past transaction relating to taking out a loan, Jill Kingsley has a current obligation to repay the loan and repayment will require sacrifice of future economic benefit, in the form of paying cash. Repayment is probable; if the debt is not repaid, the bank will take Jill Kingsley to court. Also, the debt can be measured reliably, as there would be a loan agreement stating the amount of the loan. (**M**)
2.
 - a. Historical cost. It was the amount paid to purchase the land and buildings. (**A**)
 - b. Realisable value. This would be the amount that the land and buildings could be sold for. (**A**)
 - c. Relevance – the information related to the land and buildings is more timely and up to date. Provides better predictive value or indication of value of shareholders' equity for decision making. (**M; E** – if the answer refers to land and buildings and particular aspects of relevance, timely or predictive value)
 - d. Reliability – the valuation of the land and buildings may not be neutral, as there may be bias from the person who provided the valuation. (**M; E** – answer refers to land and buildings and particular aspects of reliability and neutrality)
 - e. The increased value of land and buildings would be reported in the Balance Sheet, also the Land and Buildings Revaluation Surplus would be reported in the Balance Sheet. The increase in the Land and Buildings Revaluation Surplus would be reported in the Statement of Changes in Equity. The changes in the accounting policy would be noted in the Statement of Accounting Policies. (**A**)

3. a. The recording of the computer as an asset breaches the entity concept and the definition of an asset. This is because the computer is a personal asset, which should not be recorded in business records. Joe Bloggs's business must have control of the computer and a future economic benefit must be expected from the use of the computer, for it to be reported as a business asset. (M)
- b. The cost of the computer, including GST, should have been recorded as drawings or dividends. This is because the cost of the computer is a distribution to the owner, as a personal cost rather than a business acquiring another asset. (M)
4. a. *Mr Fixit's* treatment of recording goodwill is incorrect. (A)
- b. The goodwill cannot be recorded or reported as an asset, as there has not been a past transaction, it is not a faithful representation of the events that have occurred. Also, the goodwill cannot be measured reliably until the business is sold. The \$20 000 is not neutral, as the amount is subject to bias from the owner. (M)
5. a. The entity concept is applied to *Clare Fashions Limited* by separate financial statements being prepared for *Clare Fashions Limited* and each of its subsidiaries. (A)
- b. The Property, Plant and Equipment assets have been reported at historical cost in the financial statements of *Clare Fashions Limited*, as this is a reliable basis of measurement. This assumes that the business will continue to operate into the foreseeable future, so that the future economic benefit of those assets can be obtained over their useful life (eg Office Equipment). Therefore, there is no need to measure the property, plant and equipment assets at realisable value, as there is no intention to sell these assets in the immediate future. (A; M – answer refers to a particular asset)
- c. By *Clare Fashions Limited* reporting the effects of transactions in the accounting period to which they relate – seen by the inclusion of accounts receivable in the financial statements, as well as other balance day adjustment accounts (eg accrued expenses). (A; M – answer refers to a particular asset)
- d. The reporting of land at realisable value in the financial statements of *Clare Fashions Limited* is a more relevant basis of measurement than historical cost, as the land value is up to date and provides a better predictive value of the asset, land. However, it is a less reliable basis of measurement than historical cost, as historical cost has a Sale and Purchase Agreement contract detailing the purchase price of the land – whereas the realisable value method uses someone's (usually an independent valuer's) opinion as the basis of valuation. The valuer's opinion could be biased or inaccurate. The true value of the land can only be determined when the land is sold. (M; E – answer refers to both relevance and reliability, and aspects of them)
- e. Relevant – they are timely and have predictive value in estimating how *Clare Fashions Limited* will perform in the future; not reliable – they may not be representationally faithful and may be biased, as the person preparing the budgets may want to make their performance appear better than it is in reality. (M; E – answer refers to both relevance and reliability, and aspects of them)
- f. There was a past event when the plant was purchased; *Clare Fashions Limited* has exclusive rights to determine when, how, and by whom, the plant is operated, which illustrates the plant is controlled by *Clare Fashions Limited*. The plant will be used to provide services for customers that will earn income for *Clare Fashions Limited* – shows that the plant has future economic benefit to *Clare Fashions Limited*.

Also, the plant can be measured reliably, from an invoice when the plant was purchased; and, it is probable that the plant can be used to provide services from which income will be obtained – the plant meets the recognition criteria for an asset. (**M; E** – answer refers to both the characteristics and the recognition criteria)

- g.** There has been a depletion in the future economic benefit of the plant and equipment assets, as the plant and equipment assets have been used by *Clare Fashions Limited* in this accounting period to earn income and some of its economic life has been used. The depreciation decreases equity of *Clare Fashions Limited* by reducing profits, as it is an expense and is not a distribution to the owners. The depreciation on plant also meets the recognition criteria, as there has been a reduction in the future economic benefit of the asset and it can be measured reliably by using the appropriate depreciation rates. (**M; E** – answer refers to both the characteristics and the recognition criteria)
- h.** There is an inflow into the business, as cash will flow into *Clare Fashions Limited* from the sale – either as a cash sale, or from money received from accounts receivable from a credit sale. This will increase the bank account balance, an asset. The income also increases equity by increasing the profits of *Clare Fashions Limited*, and it is not a contribution from the owners. The income from selling clothes also meets the recognition criteria for income, as the increase in future economic benefits is probable, as cash has been received, and it can be measured reliably, as the amount of cash received or the invoice amount for credit sales. (**M; E** – answer refers to both the characteristics and the recognition criteria)
- i.** There has been a past event, when the loan was first obtained. *Clare Fashions Limited* has an obligation to repay the debt, otherwise the lending organisation (bank) will take *Clare Fashions Limited* to court to recover the amount of the debt. *Clare Fashions Limited* will need to use cash to settle the debt, which represents an outflow of resources embodying future economic benefits. The loan also meets the recognition criteria for a liability, as it is probable that there will be an outflow of economic resources (cash will flow out of *Clare Fashions Limited*) and the amount of the loan can be measured reliably from the initial loan agreement document. (**M; E** – answer refers to both the characteristics and the recognition criteria)
- j.** Prudence occurs when accountants take a conservative approach involving estimates in the measuring of financial elements. The main idea is to *not to overstate assets or income*, or to *not understate liabilities or expenses*. The Notes to the financial statements of *Clare Fashions Limited* indicate that the accountant has used prudence twice – the first by reporting an amount for allowance for doubtful debts, so that accounts receivable is not overstated; secondly, since some inventory items are reported at net realisable value – if the inventory item's expected selling price is less than the cost price of the inventory item due to obsolescence, the total inventory amount is not overstated. (**M**)
- k.** An item is material, by nature or dollar amount, if its reporting is likely to influence the economic decision making of the users of the financial statements. The accountant of *Clare Fashions Limited* has applied materiality by expensing any assets with a dollar value of less than \$500, in the year of their purchase. This is because the dollar amount of these assets is low, so the reporting of these items as assets or as an expense will not influence the decision making of the users of the financial statements of *Clare Fashions Limited*. (**M**)



Glossary/Index

accounting entity (35): the financial affairs of the owner and the business are kept separate and distinct.

Accounting Standards Review Board (ASRB) (17): an organisation that reviews and approves new financial reporting standards in New Zealand.

accounts payable (139): individuals or businesses that the entity owes money to; also known as creditors.

accounts receivable (139): individuals or businesses that owe the entity money; also known as debtors.

accrual basis (37): transactions are reported in the financial statements of the periods to which they relate.

accrued expenses (138): expenses that have been incurred at balance date but have not been paid for yet (eg Wages, Interest).

accrued income (138): income that has been earned at balance date but has not been received yet (eg Dividends, Interest).

accumulated depreciation (144): the total amount of annual depreciation expense for a particular asset, deducted from the asset in the Balance Sheet.

Administrative Expenses (154): an expense category in the Income Statement, includes expenses related to management or office organisation.

allowance for doubtful debts (139): an amount of money due from accounts receivable that is not expected to be collected, deducted from accounts receivable in the Balance Sheet.

analysis (217): calculation of percentages and ratios to assist the understanding of financial statements.

analysis – cash management (218): calculation of percentage change and ratios to assist the understanding of the Cash Flow Statement.

analysis – financial stability (218): calculation of percentages and ratios to assist the understanding of the Balance Sheet.

analysis – liquidity (218): calculation of percentages and ratios to assist the understanding of Balance Sheet.

analysis – market analysis (218): calculation of ratios using the current market value of shares to assist the understanding of financial statements.

analysis – profitability (217): calculation of percentages and ratios to assist the understanding of the Income Statement.

Annual Report (11): the report of a company that includes all of the financial statements, non-financial statements and supplementary information.

assets (37): a resource controlled by an entity as a result of past events from which future economic benefits are expected to flow.

available for sale investments (38): An investment that is classified as a non-current asset (eg Government Bonds).

