Achievement Standard 90220

External Exam – Credits: 3

Describe the Conceptual Basis of Accounting for a Sole Proprietor

For this topic there are a number of definitions and concepts that you need to be able to ***Recognise, Define and Apply***.

Recognise = to be able to identify/state the concept/definition used or given in an example. For example: a Delivery van is an asset/Property, Plant and Equipment.

Define = is stating the definition – you must commit these to memory. For example: Assets are resources ***controlled*** by the entity as a ***result of a past event***, from which ***future economic benefits*** are expected to flow to the entity.

Apply = using the example given in the answer. Always start you answer with the example given. For Example: *A Delivery Van* is an assets as it was ***purchased in the past*** (past transaction) ***that only the business*** (state business name) ***has the right to use it*** (present control) ***and it will be used to deliver goods to customers in order to earn an income when cash is received.***

Revising:

- On the following page are the topics/definitions/concepts that are covered in the standard.
- The starting point is to understand these and committing them to memory.
- Use the notes contained here.
- Use extra reading to help clarify them.
- There is a reference to pages in the 'Accounting for NCEA Level 2 – Book Two.
- The next stage is to practice answering questions
- There are revision questions from the Blue NCEA Level 2 Revision Guide.
- Completing the last two or three exams on this topic and…***marking*** them is also excellent revision.

Content studied in Standard		
Content	**Reading - 'Accounting for NCEA Level 2 BOOK ONE**	**Revision Questions (Pages of NCEA Revision Guide) Pages 9 – 20**
Functions of accounting	Page 1 – 2	
How interested parties make use of accounting information as a basis for decision making	Page 3	Q11(a), Q12(a), Q15(i)
Purpose, components and limitations of the financial statements selected from: Income Statement, Balance Sheet, Statement of Accounting Policies and Statement of Cash Flows	Page 20 – 22	Q2(d), Q6 (a – c)
Notion of an accounting entity	Page 13	Q2(c), Q3(b), Q9(i), Q11(h), Q15(b)
Notion of monetary measurement	Page 14	Q1(d), Q12(c)i-ii,
Notion of reporting period	Page 15	Q2(f), Q11(c), Q14(c)
Relevance (including materiality)	Page 7	Q2(a), Q3(d), Q3(e), Q4(b), Q5(b), Q5(c)ii, Q7(a – b), Q9(e), Q10 (a – b), Q12(d – e), Q14, Q15(d), Q15(g – h)
Reliability (including faithful representation and neutrality)	Page 7 – 8	
Understandability	Page 8	
Comparability	Page 9	
Constraints on relevant and reliable information (timeliness and balance between qualitative characteristics)	Page 10 – 11	
Going concern	Page 15	Q1(b), Q9(d)
Accrual basis	Page 14	Q1(a), Q2(e), Q5(c)i, Q9(j), Q10(c), Q11(b), Q15(e)
Assets (Including Recognition)	Page 19 – 20	Q1(e), Q2(g), Q3(c), Q9(g), Q13(a – b)
Liabilities (Including Recognition)		Q1(c), Q6(d), Q11(g), Q13(c)
Equity(Including Recognition)		
Income (Including Recognition)		Q2(h), Q15(f)
Expenses (Including Recognition)		Q2(b), Q3(a)i-ii, Q5(a), Q11(d)
Measurement base to be historical cost	Page 15 - 16	Q4(a), Q8(b – c), Q9(f), Q15(a)
Capital and revenue expenditure	Page 25	Q3(a)iii, Q5(d), Q8(a), Q11(f),
Depreciation with methods selected from: straight line, diminishing value and units of use	Page 27 – 28	Q9(h), Q12(f)
Financial and Non-Financial Information		Q9(a – c), Q12(b)

Overview

Recognise, define and apply the Conceptual Basis of Accounting

The function of Accounting is to provide both financial and non-financial information to users for decision making purposes.

The following table shows how interested parties make use of accounting information as a basis for decision making.

User	**Reason for Use**
Owner	Is my investment in the business secure and profitable?
Managers	Is the business making a profit?
Potential owners	Will the business provide a good return on investment?
Accounts payable	Can the business pay its immediate debts on time?
Government	Has the business GST been correctly calculated?
Customers	Can the business deliver the goods on time and are the goods of high quality?
Employees	Is my job secure in the long term?
Unions	Could we negotiate a pay rise since the business is making a profit?

Purpose of Financial Statements

Statement of Accounting Policies

To show the ***assumptions followed in preparing the statements and how financial elements have been measured***

Income Statement

To ***measure the profit/loss*** for the ***period***

Balance Sheet

To ***measure assets, liabilities and equity* at *one point in time***

Statement of Cash Flow

To show where ***cash has come from and how it has been spent over the period***

Components of Financial Statements

Statement of Accounting Policies

- identification of the reporting entity by name and nature, limited to a sole trader/proprietorship
- the measurement system adopted limited to historical cost
- accounting policies for depreciation, accounts receivable, GST, inventory, non-current assets
- a statement of changes (or no changes) in accounting policy since the date of the last financial report.

Income Statement

- calculation of Net Surplus/Deficit with classification of expenses appropriate to the business activities.

Balance Sheet

- classification of assets into current and non-current (investments, property, plant and equipment, intangibles)
- classification of liabilities into current and non-current.
- net surplus/deficit
- distributions to (or drawings by) the owner
- equity at the start of the period
- equity at the end of the period.

Statement of Cash Flow

- cash movements to be shown as cash receipts and cash payments
- the statement to be drawn up from a summary list of transactions and/or source documents and/or bank statement and/or reconstruction entries only for cash collection from customers (accounts receivable) and cash paid to suppliers (accounts payable)

Notion of Accounting Entity:

Is that ***the financial affairs of an entity must be kept separate and distinct from the financial affairs of the owner*** and other entities.

When preparing the accounting records of a business we ***only include the business' transactions and exclude those transactions of its owner.***

For Example: The **personal telephone expense** is not an expense of (give business name), so according to the notion **of Accounting Entity, it is**

reported as drawings to keep separate the personal and business transactions.

<u>Notion of Monetary Measurement:</u>

Is that ***all transactions are measured in dollar terms***. Therefore if a transaction cannot be expressed in money values, it will not be recorded in the accounting records.

<u>For Example:</u> The Balance Sheet (of business name) will record the business's transactions **(assets and liabilities)** ***<u>in New Zealand Dollars</u>*.**

Qualitative Characteristics of Accounting Information

<u>Relevance</u>

To be useful, information ***must be relevant to the decision-making*** needs of users. Information has the quality of relevance ***when it influences the economic decisions of users by:***

- helping the users to ***evaluate present or future events (predictive role)***

or

- helping the users to ***confirm or correct their past evaluations (confirmatory role)***

For Example: The current market value of the fixtures and fittings would have a **<u>more relevant value</u>**, which would be better to **<u>use to make decisions</u>** about the **<u>value of the store's assets as it is more up-to-date</u>** provides the **<u>best prediction of its future economic benefits</u>**.

<u>Materiality</u>

The ***relevance of information*** is ***affected*** by its nature and **materiality**. In some cases, the nature of information alone is sufficient to determine its relevance.

Information is ***material if its omission or misstatement could influence the economic decisions of users taken***. Materiality ***depends on the size*** of the item or error judged in the particular circumstances of its omissions or misstatement.

<u>For Example:</u> The **<u>amount paid for the footpath sign ($700)</u>** is **<u>not of a large enough</u>** amount ***compared with the ($50 000)*** billboard advertising **<u>to influence users' decisions</u>** so he has **<u>recorded it as an expense and not an asset.</u>**

<u>Reliability</u>

Information is reliable when it ***is free from bias*** and ***can be depended upon***

by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Reliability consists of the following components

- **<u>Faithful Representation</u>: Information must** *represent faithfully the transactions it claims to represent.* **For example: A source document provides faithful representation as it is evidence that a transaction has occurred.**

- **<u>Neutrality</u>: The information contained in financial statements** *must be free from bias.*

<u>For Example:</u> By recording the **<u>buildings at their original purchase price</u>**, the entity will have **<u>a source document (receipt)</u>** verifying the amount paid at purchase. This source document makes the value **<u>neutral and a faithful representation of the purchase price.</u>**

<u>Understandable</u>

The user has a ***reasonable knowledge of the business and has a willingness to study the information with reasonable diligence***.

<u>Comparability</u>

Users make comparisons or identify trends (similarities and differences) of financial statements from one period to another, and with different entities of the financial position and performance and changes in financial position.
Please Note:

- Measurement and display of the financial effect of like transactions must be carried out in a ***consistent*** manner for the entity and with other entities.
- Users are informed of Accounting Policies used in the preparation of the financial statements, and any changes in those policies.
- It is important that the financial statements show comparative figures for past periods.

<u>For Example:</u> <u>Comparative figures are shown so that trends</u> / differences can be identified **<u>which helps (owner's name) make decisions about (business name)</u>**

<u>The Assumption of Going Concern:</u>

Is that financial reports are prepared on the assumption that the ***life of a business is expected to continue into the foreseeable future***.

<u>For Example:</u> Property, Plant and Equipment are *<u>valued at Historical Cost in the Balance Sheet</u>*. The expected market value is not relevant as

we do not plan to sell the Property, Plant and Equipment in the foreseeable future as the business is not closing down.

The Assumption of Accrual Basis:

Is the ***effects of transactions and other events are recognised when they occur***. ***They are then reported in the financial reports of the periods to which they relate.***

Apply (Income Statement): The amount of the ***rent expenses prepaid relates to the following year and is reported in the rent expense in the income statement*** for the ***following year*** (subtracted from Rent in the current year) as it relates to the next year.

Apply (Balance Sheet): Prepaid rent is ***reported*** as a ***Current Asset (Prepayment) in the balance sheet*** (as it has the right to the continue using the rented premises for the amount of time repaid).

Constraints on Relevant and Reliable Information

Timeliness - If information is not up to date it may lose its relevance. Management may need to balance timely reporting and having reliable information. To achieve timely information it can be necessary to report before all parts of the transaction are known, which may weaken reliability. Or if information is not up to date it will be reliable but of little use to the users.

To achieve a balance between relevant and reliable information, consideration is given to how best it satisfies the users' decision making.

Balance between Qualitative Characteristics - Professional judgment is used for the balancing, or trade-off, between qualitative characteristics. The aim is to achieve a balance to meet objectives of financial statements.

Definition of the Elements

Assets (define):
Assets are resources ***controlled*** by the entity as a ***result of a past event***, from which ***future economic benefits*** are expected to flow to the entity.

Apply: A Delivery Vehicle is an asset for Pizza Hut because:
- The delivery vehicle was purchased in the ***past*** by pizza hut
- Pizza hut can use the vehicle to deliver pizzas *(controlled by pizza hut)*
- Pizza hut will ***benefit*** from the delivery vehicle by using it to deliver pizzas and ***earn an income (from cash)*** from it for the business ***in the future.***

<u>Liabilities (define):</u>
Liabilities are the ***present obligation*** of the entity ***arising from past events***, the settlement of which is expected to ***result in a future outflow*** from the entity of resources embodying economic benefits.

Apply: A bank loan is a liability for Pizza Hut because:

- The loan was taken out in the ***<u>past</u>***
- Pizza hut is ***<u>currently obliged</u>*** to pay the loan back
- In the ***<u>future</u>*** pizza hut will ***<u>use money</u>*** from the asset bank in order to ***<u>repay the loan</u>***

Owners Equity (Accumulated Fund for Community organisation)
Assets minus Liabilities (Equity is the residual interest in the assets of the entity after deducting all its liabilities).

<u>Income (define):</u>
Income is the ***increase in economic benefit*** in the form of ***inflows, or enhancements, of assets, or decreases in liabilities that result in increases in equity, other than contributions from the owner.***

Apply: Cash sales for Pizza Hut are income because:

- The *<u>asset bank increases</u>* when the sales money is received
- ***<u>Sales income</u>*** for pizza hut ***<u>increases net profit</u>*** which ***<u>increases equity</u>***
- The increase in equity is ***<u>not a contribution from the owner</u>***

<u>Expenses (define):</u>
Expenses are ***consumptions, or losses of service potentia***l or future economic benefits, ***in the form of reductions of assets or increases in liabilities***, ***other than those relating to distributions to the owner, that result in a decrease in equity***.

Apply: Paying the electricity bill for Pizza Hut is an expense because:

- The ***<u>bank asset decreases</u>*** when the bill is paid
- The electricity bill ***<u>decreases profit which decreases equity</u>***
- It is ***<u>not a distribution to the owner</u>***

Recognition of the Elements of the Financial Statements

<u>Note:</u> ***This applies for Assets, Expenses, Liabilities and Income***

An item that meets the definition of an element should be recognised if:

- it is **probable** that any future economic benefit associated with the item will flow to or from the entity **and**
- the item has a cost or value that can be **measured with reliability**.

For Example: ***It is probable (business name) will receive the money*** owing from accounts receivable from the credit sale ***as they have a legal right to the money so the accounts receivable will have to pay their account.***

For Example: The ***Loan*** has an ***amount that can be measured reliably*** as their will be a ***loan agreement which states the amount owed.***

HISTORICAL COST

Transactions are ***recorded at the amount of cash paid or payable at the time of the transaction.*** This means that assets are recorded at their original price when acquired.

For Example: *(**Business Name**) has* **recorded the buildings** at their **original purchase price of $50,000.**

The Distinction between CAPITAL and REVENUE EXPENDITURE

Capital Expenditure:

The purchase of items which will benefit the business beyond the current year –Includes:

- Purchasing ***Property Plant and Equipment***
- ***Improvements to Property, Plant and Equipment that increase their usefulness or extends their useful life***
- Any expenditure incurred in ***getting Property, Plant and Equipment into the place and condition where it can be used in*** business operations.
- It also includes ***repaying loans/mortgage***.

For Example: The (**name of expense**) has been **recorded as capital expenditure** because they have **benefited the store for more than one year**

Revenue expenditure:

Is items that **will benefit the firm for the current year** and are classified as expenses. They are recurring costs incurred to earn Income and will affect the current year's net profit calculation. These are recorded in the Income Statement.

For Example: The (**name of expense**) has been **recorded as revenue expenditure** because they have **benefited the store for less than one year**

Depreciation:

Depreciation is the ***systematic allocation of the depreciable amount of an asset over its useful life.***

The Purpose of Depreciation is to ***allocate the cost, less residual value*** *of* ***Property, Plant and Equipment*** to expenses in the income statement in the periods the asset will be used by the business.

Methods of Depreciation		
Method	**Description**	**Reason for Use**
Straight-line	This method assumes ***that the loss of future service potential of an asset occurs evenly throughout its useful economic life.*** **Answering a question:** *The straight line method has been* ***used for the desk because the loss of future service potential of the desk occurs evenly throughout its useful economic life.***	Used when the pattern of use of an asset's service potential is consistent each accounting period e.g., buildings
Diminishing Value	This method assumes ***that the loss of future service potential is highest in the earliest years of the asset's useful economic life.***	Used when obsolescence is a significant factor for an asset e.g., computer, or because the cost of repairs and maintenance is expected to increase later in the asset's life e.g., photocopying machine.
Units of Use	Assumes that ***the loss of future service potential of an asset is related to the amount of use the asset receives rather than its actual age***. Instead of measuring the useful economic life of an asset in time periods, the units-of-use method measures it in units of output. This may be kilometres travelled for a motor vehicle, of the number of hours a machine has been operating.	Used for assets whose future economic benefit or service potential is limited by the amount of use the asset has had rather than its age in years. For example, a business may have a policy of trading in vehicles after travelling a certain distance. This is opposed to trading in the motor vehicle at the end of the third year of using that car.

Note: When answering a question on Depreciation – you can also any method used is used because '***it best reflects the loss of service potential of the asset'.***