Chapter 3: The New Zealand Framework

Activity 3.1

1 The NZ Framework sets out the concepts that underlie the preparation of general purpose financial statements for external users.

2 A special purpose financial statement is one that is prepared for a specific use or user, such as a tax return. A general purpose financial statement is intended to provide information to a wide range of external users who cannot require information specific to their needs.

Activity 3.2

1 The main functions of the NZ Framework are benchmarking, interpretation, audit and philosophical.

2 **1** To provide information that is useful to a wide range of users about:

- **a** the financial position,
- **b** the financial performance, and
- **c** the changes in financial position

of an entity so that economic decisions may be made.

2 To show the results of the stewardship (or accountability) of management for the resources entrusted to it so that users may make economic decisions about such matters as:

- **a** whether to hold or sell their investments in the entity, or
- **b** whether to reappoint or replace management.

3 Three assumptions that underlie the preparation of general purpose financial statements are going concern, accrual basis and period reporting.

Activity 3.3

1 Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. (NZ Framework, paragraph A4.4(c))

2 It must be probable that any future economic benefits associated with the asset will flow to the entity, and the asset has a cost or value that can be measured with reliability.

3 The criteria for recognising a liability are:

- it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation, and
- the amount at which the settlement will take place can be measured reliably.

(NZ Framework, paragraph A4.46)

4 Income is defined as:

… *increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.*

(NZ Framework, paragraph A4.25(a))

Thus, income includes both revenue and gains.

5 The matching principle is the direct association between items of income and the specific costs incurred in obtaining that income. Such an association is the association between sales and cost of sales. Paragraph A4.50 of the NZ Framework says:

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events …

Activity 3.4

1 The fundamental qualitative characteristics of financial statements are relevance (and the closely related concept of materiality) and faithful representation.

2 The enhancing qualitative characteristics of financial statements are comparability, verifiability, timeliness and understandability.

3 To be reliable, accounting information must be representationally faithful, show the economic substance of the activities being reported, and be neutral, conservative and complete.

4 To be relevant, accounting information must have feedback value, predictive value, and must be material.

5 The constraints are the balance of benefit against cost, timeliness, and balance between qualitative characteristics.

Activity 3.5

1 The four measurement methods are:

a Historical cost

Under the historical cost method, assets are recorded at the amount of cash or cash equivalents paid (or the fair value of the consideration given) for the assets at the time of their acquisition.

b Current cost

The current cost method records assets at the amount that would have to be paid at balance date to replace them with equivalent assets. Liabilities are recorded at the cash outlay needed to repay them at balance date.

c Realisable (settlement) value

Realisable value, sometimes referred to as settlement value, calculates the exit value of a business if its assets were sold in an orderly fashion.

d Present value

Under the present value method, assets are valued at a discounted amount representing the time-value of the future cash flows generated by the assets. Liabilities are valued at the present discounted value of the future net cash outflows that will be expended.

2 It enables mixed data to be expressed in a common form.

Review exercises

1 Income is defined as inflows of future economic benefits in the form of increases in assets or decreases in liabilities.

Assets are defined as future economic benefits controlled by the entity. Thus, they are expected to generate future economic benefits. As these benefits flow into the entity, they create income which either adds to asset values, or decreases liabilities owed. Consequently, the size of the economic benefit determines income and also the value of the asset.

2 Assets' values are measured according to their attributes. Since these attributes vary between different types of assets, it is unlikely that one measurement method will suit all occasions.

Choosing an appropriate method is crucial in achieving representational faithfulness in the accounting information.

3 Attributes are the properties of assets and liabilities that get measured. These properties may vary even with identical assets if they are used for different purposes, so it is the service potential that needs to be identified.

4 The user of a general purpose financial statement will be looking for feedback on the events being reported on, what happened, and whether it was above or below expectations. The reader also needs information useful for making predictions about the future success or otherwise.

The information must also be provided in a timely manner if the reader is going to find it useful.

5 General purpose financial statements are prepared in accordance with accounting standards based on the NZ Framework and with GAAP. For the information to be reliable, it must faithfully represent the economic substance of events being reported, and be neutral (that is, show no bias), prudent (not over- or under-estimating or over- or under-stating the results), and complete. Therefore, it must be verifiable, which is the normal purpose of the audit as part of the internal control strategy. However, falsification of, and error in, data can go undetected so there is always an element of risk attached to reliability.

6 Most accounting information is based on estimates – estimated values and future economic benefits, estimates of service potential, and estimates of when events will occur. Prudence affects accounting information, as it tends to present a conservative face rather than an optimistic one.

7 Financial statements are normally prepared by (or under the control of) the manager whose performance is being reported on. It is normal human behaviour to report our performance in the best light. Consequently, there is a tension around the issue of bias.

8 The limitation of historical cost is that it is not useful for predictive purposes, as historical cost looks back and not forwards. Thus, historical cost is not a measure of future service potential, as the latter is constantly under threat of change, competition, damage and obsolescence.

9 Historical cost is the measurement basis used by most New Zealand companies. However, because this records values that can quickly become out-of-date, many companies modify historical cost by applying one of the other remeasurement bases so that reported values better meet the objectives of general purpose financial statements. Appropriately qualified valuers, or knowledgeable staff where permitted, remeasure non-current assets at regular intervals to current market values. All assets within the same class must be revalued at the same time.

10 The monetary unit requires financial accounting data to all be stated in the same currency. If data cannot be stated in the monetary unit, then it is ignored in financial statements. Accordingly, financial statements need to be supplemented with narrative to explain financial figures.