FREE SAMPLE: RESOURCE A AND QUESTION ONE, PARTS (a) TO (c)

RESOURCE BOOKLET · Resource A: Rimu Joinery Limited, draft income statement

A fictional practice scenario. Rimu Joinery Limited makes kitchens to order. Its owner has drafted the income statement below for a bank loan application and gave you these notes.

1. Other income of $90 000 is cash received on 14 June 2026 from customers who have signed contracts for kitchens that Rimu will build and install between August and October 2026. The customers can cancel and get their money back only if Rimu fails to deliver.

2. The provision for roof replacement of $18 000 is recorded as an expense because the workshop roof is 22 years old and the owner expects to replace it within three years. No quote has been requested, no contract has been signed and the owner has not decided when to replace it. The company owns the building.

The income tax rate is 28%.

Draft income statement, year ended 30 June	2026 $	2025 $
Sales	412 600	388 900
Other income	90 000	–
Cost of sales	(241 300)	(228 500)
Operating expenses	(95 700)	(90 400)
Provision for roof replacement	(18 000)	–
Net profit before tax	147 600	70 000

SAMPLE - NOT FOR RESALE OR REDISTRIBUTION

Question One (8 marks)

(a) Use information from Resource A and the 2018 NZ Conceptual Framework.

State the Framework's definitions of a liability and of income. Apply them to note 1 to decide how the cash received on 14 June 2026 should be classified at 30 June 2026.

[2 marks]

(b) Calculate the net profit before tax and the net profit after tax that Rimu would report if only note 1 were corrected, and explain the journal entry needed at 30 June 2026.

[2 marks]

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(c) Using the definition of a liability and the recognition criteria in the 2018 NZ Conceptual Framework, evaluate whether the provision for roof replacement should be in the 2026 income statement.

[2 marks]

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THE WORKED ANSWERS TO PARTS (a) TO (c)

Question 1 (8 marks) [Elements of the Conceptual Framework]

(a) Use information from Resource A and the 2018 NZ Conceptual Framework. State the Framework's definitions of a liability and of income. Apply them to note 1 to decide how the cash received on 14 June 2026 should be classified at 30 June 2026.

(a) Answer: A liability (a present obligation to transfer an economic resource arising from a past event), not income

- Entry step: worth marks in the 1-4 range of the 8-point question score.
- Income is an increase in assets, or decrease in liabilities, that results in an increase in equity (other than from owner contributions). A liability is a present obligation of the entity to transfer an economic resource as a result of past events. [1 mark]
- On 14 June Rimu received cash (an asset) but has promised to build kitchens that have not been built, and must refund the cash if it fails to deliver. It has a present obligation arising from a past event (signing the contracts and taking the cash), so the $90 000 is a liability (unearned revenue / contract liability). Equity has not increased, so it is not income. [1 mark]

> **KEY TAKEAWAY**
> A receipt of cash is income only when the entity has satisfied its obligation to the customer; until then the cash is matched by a liability.

(b) Calculate the net profit before tax and the net profit after tax that Rimu would report if only note 1 were corrected, and explain the journal entry needed at 30 June 2026.

(b) Answer: NPBT $57 600 (after tax $41 472); Dr Other income $90 000, Cr Unearned revenue $90 000

- Scholarship band (5-6): the part needs your own method and accurate reasoning.
- Remove the $90 000 from income: net profit before tax = 147 600 − 90 000 = $57 600. Tax at 28% = $16 128, so net profit after tax = $41 472. [1 mark]
- Correcting journal: Dr Other income $90 000, Cr Unearned revenue (a current liability) $90 000. The revenue is recognised in August to October 2026 as each kitchen is delivered, so the 2027 income statement gets the $90 000. [1 mark]

> **KEY TAKEAWAY**
> Correct a mis-classified receipt by moving it from income to a liability; profit falls by the whole amount and revenue is recognised later when the obligation is met.

(c) Using the definition of a liability and the recognition criteria in the 2018 NZ Conceptual Framework, evaluate whether the provision for roof replacement should be in the 2026 income statement.

(c) Answer: No: there is no present obligation from a past event, so no liability or expense; remove the $18 000

- Scholarship band (5-6): the part needs your own method and accurate reasoning.
- A liability needs a present obligation to transfer an economic resource arising from a past event. Rimu could avoid the replacement cost by selling the building, deferring the work or repairing the roof;

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no contract has been signed and no one outside the company can require payment. Wearing out of the roof is an event that reduces the asset (the building), which is reflected through depreciation, not a past event creating an obligation to a third party. [1 mark]

• Even if there were an obligation, recognition requires relevant information and a faithful representation; here the amount, timing and probability are unknown (no quote), so measurement uncertainty is high and the information would not be a faithful representation. The $18 000 should be reversed: Dr Provision for roof replacement $18 000, Cr Expense $18 000. [1 mark]

KEY TAKEAWAY

A future cost is a liability only if there is already an obligation to a third party; intending or expecting to spend money later is not a present obligation.

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