SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

Worksheet for the Consolidated Statement of Financial Position of RUBY as at 31 December 2015:

	RUBY	SAPP				Consolidated
	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
Non-current assets	511,000	276,200	9,000	3	12,000	786,000
			1,800	4		
Investment in SAPP	190,000	-		1	190,000	-
Investment in DIAM	50,000	-		E1	1,002	**57,248**
			3,000	E2		
			5,250	E3		
Goodwill			50,700	1		50,700
Deferred tax assets			495	3,4	297	214.5
			16.5	5		
Inventory	115,500	34,500		5	100	149,900
Accounts Receivables	62,300	15,200				77,500
Cash	21,200	2,100				23,300
	950,000	*328,000*				*1,144,862.5*
Share capital	362,000	44,000	44,000	1		362,000
Retained earnings	146,000	114,000	85,000	1		172,763.1
			3,900	*2*		
			2,100	*3*	*346.5*	
			138.6	*4*	*840*	
			99	4	600	
			6,000	5	5,900	
				5	16.5	
			4,950.3	6		
			668	*E1*		
			334	E1		
				E2	*3,000*	
				E3	5,250	
Other comprehensive income	200,000	70,000	70,000	1		200,000
Non-controlling interests				1	59,700	**68,099.4**
				2	3,900	
			900	3	148.5	
			59.4	4	360	
				6	4,950.3	
Non-current liabilities	152,500	90,000				242,500
Current liabilities	89,500	10,000				99,500
	950,000	*328,000*				*1,144,862.5*

Reconciliation of NCI ***(not required by the question):***

		HK'$000
Book Value of net assets of SAPP (44 + 114 + 70) x 30%	=	68,400
Unrealised profit (HK$3m x (1-16.5%) x 2/5) = $1,002k x 30%	=	(300.6)
		68,099.4

Reconciliation of investment in associate

(not required by the question)		HK'$000
Book Value of net assets of DIAM (55+75+33) x 25%	=	40,750
Fair Value adjustment	=	668
(HK$8m x (1-16.5%) x 2/5) = $2,672k x 25%		
Implicit goodwill for investment in DIAM		*15,830*
		57,248

Calculation of goodwill for the acquisition of DIAM

		HK$'000
Book (Fair) value of net assets of DIAM	=	130,000
= HK$55m + HK$42m + HK$33m		
Fair value increment, after tax = HK$8m x (1-16.5%)	=	6,680
→ Fair value of identifiable net assets of DIAM	=	136,680
x 25%		34,170
Consideration transferred	=	50,000
Implicit goodwill for investment in DIAM		***15,830***

Answer 1

Consolidation journal entries (All figures in HK$'000) ***(not required by the question)***

J1	Elimination of investment in SAPP			
Dr	Share capital		44,000	
Dr	Retained earnings		85,000	
Dr	Other comprehensive income		70,000	
Dr	**Goodwill**		**50,700**	
	Cr	Investment in SAPP		190,000
	Cr	Non-controlling interests 30%		59,700

J2	NCI share of post-acquisition retained earnings of SAPP up to the beginning of the current year			
Dr	Retained earnings (30% x ($98m - $85m)		3,900	
	Cr	Non-controlling interests		3,900

J3	Eliminate gain on machine sold by SAPP to RUBY			
Dr	Machine (HK$13m → HK$22m)		9,000	
Dr	Retained earnings (HK$3m x 70%)		2,100	
Dr	Non-controlling interests (HK$3m x 30%)		900	
	Cr	Accumulated depreciation		12,000
Dr	Deferred tax asset (HK$3m x 16.5%)		495	
	Cr	Retained earnings		346.5
	Cr	Non-controlling interests		148.5

J4	Depreciation adjustment for the machine sold by SAPP to RUBY			
Dr	Accumulated depreciation (HK$3m x 3/5)		1,800	
	Cr	Depreciation of machine (COS) (HK$3m / 5)		600
	Cr	Retained earnings 70%		840
	Cr	Non-controlling interests 30%		360
Dr	Tax expense (HK$600k x 16.5%)		99	
Dr	Retained earnings 70% (HK$840k x 16.5%)		138.6	
Dr	Non-controlling interests 30% (HK$360k x 16.5%)		59.4	
	Cr	Deferred tax asset (HK$1,800k x 16.5%)		297

(if current year figures HK$(600 – 99) are shared to 30% NCI HK$(180 – 29.7): J4a: Dr NCI HK$150.3; Cr Profit attributable to NCI HK$150.3)

J5 Elimination of intragroup sales and unrealised profit for the inventory sold by RUBY to SAPP

Dr	Sales		6,000		
	Cr	Inventory ($6m - $5m) x 10%		100	
	Cr	Cost of Sales		5,900	
Dr	Deferred tax assets ($100 x 16.5%)		16.5		
	Cr	Tax expense		16.5	

J6 NCI share of post-acquisition profit of SAPP

Dr	Profit attributable to NCI of SAPP		4,950.3		
	Cr	Non-controlling interests		4,950.3	
				30% NCI	
		Reported profit of SAPP	16,000	4,800	J6a
	J6	Add: Depreciation adjustment on intragroup sales of machine, after tax (HK$600k – tax 99k)	501	150.3	J6a
			16,501		
			X 30%	**4,950.3**	

(if current year figures are shared in individual journal entry, J6a would share the unadjusted profit: J6a: Dr Profit attributable to NCI HK$4,800; Cr NCI HK$4,800)

Calculation of goodwill for the acquisition of SAPP

		HK$'000
Fair value (same as Book value) of net assets of SAPP = HK$44m + HK$85m + HK$70m	=	199,000
Consideration transferred	=	190,000
NCI (HK$199,000 x 30%)	=	59,700
	=	249,700
Goodwill on acquisition of SAPP		**50,700**

E1 Amortisation of fair value adjustment in DIAM

Dr	Retained earnings (HK$8m x 2/5 years) x (1-16.5%) x 25%		668	
Dr	Share of profits of associate		334	
	Cr	Investment in DIAM (HK$8m x 3/5 years) x (1-16.5%) x 25%		1,002

E2 Share of post-acquisition retained earnings of DIAM up to the beginning of the current year

Dr	Investment in DIAM (25% x (HK$54m - HK$42m)		3,000	
	Cr	Retained earnings		3,000

E3 Share of current year profits of DIAM

Dr	Investment in DIAM (25% x HK$21m)		5,250	
	Cr	Share of profits of associate		5,250

Answer 2(a)

To : Mr. Kenneth Lam, Director
From : Cindy Lee, Accounting Manager
Date : dd/mm/yyyy
Subject : Accounting treatment for the Game Product Revenue

I refer to your query regarding the accounting treatment for the Game Product Revenue.

Game Product Revenue

The general rule under *HKAS 18 Revenue* is that revenue is recognised when the significant risks and rewards of ownership have been transferred and there is no continuing managerial involvement or effective control.

Upon the sales of virtual items, BEGA typically has an implied obligation to provide the service which enables the virtual items to be displayed and used in the respective games. As a result, the proceeds from the sales of virtual items should be initially recorded in deferred revenue and should be recognised as revenue subsequently only when the services have been rendered.

Consumable virtual items represent items that will be extinguished shortly after consumption by a specific game player action. The Paying Players will not continue to benefit from the virtual items thereafter. Revenue is recognised (as a release from deferred revenue) when the items are consumed.

Durable virtual items represent items that are accessible and beneficial to Paying Players over an extended period of time. Revenue is recognised over the average playing period of Paying Players ("Player Relationship Period"), which represents the best estimate of the average life of durable virtual items for the applicable game.

BEGA should determine the Player Relationship Period on a game-by-game and platform-by-platform basis by tracking the player data, such as log-in data and purchase record.

If there is insufficient player data to determine the Player Relationship Period, such as in the case of a newly launched game, BEGA should estimate the Player Relationship Period based on other similar types of games of BEGA or third-party developers, taking into account the games profile, target audience and its appeal to Paying Players of different demographic groups, until the new game establishes its own history after launch.

BEGA should re-assess such periods regularly.

Answer 2(b)

Revenue Sharing Arrangement

HKAS 18 paragraph 8 states that in an agency relationship, the amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

Paragraph 21 of the Illustrative Example of HKAS 18 states that an entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services.

Although games developed by BEGA are published on third party Platforms, BEGA has the primary roles and responsibilities in the delivery of game experience to the Paying Players and BEGA takes the primary responsibilities in the rendering of service. Therefore BEGA is determined to be the primary obligor, i.e. principal, and BEGA can report gross revenue.

BEGA has to attempt to make a reasonable estimation for the gross revenue amount by tracking the marketing activities of Platform.

Because BEGA's mobile games are published through a limited number of mobile platforms and the marketing discounts offered by these platforms have not been significant, BEGA is able to track the marketing discounts reliably to make a reasonable estimation for the related gross revenues. Therefore, for mobile games, BEGA can recognise the gross amount as revenue.

The revenue shared with the mobile platforms should be recognised as the cost of revenue accordingly.

However, BEGA's webgames *are published through a large number of web-based platforms, while the marketing discounts vary from platform to platform. As such, BEGA is not able to make a reasonable estimation for the gross revenue derived from* webgames*.* Therefore BEGA should report Game Product Revenue for webgames only to the extent of the amounts received and receivable from third party Platforms, i.e. the net amount, under the Revenue Sharing Arrangements.

I hope the above explanation has answered your question. Please feel free to contact me if you have further queries.

Best Regards,
Cindy Lee

Answer 3

King’s Building

King’s Building should be reclassified from an owner-occupied property under HKAS 16 to an investment property under HKAS 40 upon the end of the owner-occupation on 30 April 2016.

As a reclassification from an owner-occupied property at depreciated cost to an investment property at fair value, HKAS 16 should be applied to account for the owner-occupied property up to the date of change in use (30 April 2016). On 30 April 2016, RUBY should treat any difference between the carrying amount of King’s Building in accordance with HKAS 16 and its fair value (HK$180 million) in the same way as a revaluation in accordance with HKAS 16.

As at 31 May 2016, King’s Building, as an investment property, should be stated at its fair value of HK$190 million.

For the 5 months ended 31 May 2016:

- Fair value gain on King’s Building as an investment property (1 May to 31 May 2016) = HK$190 million – (HK$180 million + HK$1 million) = HK$9 million.

- Depreciation of King’s Building as an owner-occupied property (1 January to 30 April 2016) = HK$108 million x 4 / 480 = HK$0.9 million

- Amount recognised in other comprehensive income as a revaluation gain on the reclassification of an owner-occupied property to an investment property on 30 April 2016 = HK$180 – (89.1 – 0.9) million = HK$91.8 million

Queen’s Tower

Queen’s Tower should be reclassified from an investment property under HKAS 40 to an owner-occupied property under HKAS 16 upon commencement of occupation for own use at 30 April 2016.

As a reclassification from an investment property at fair value to an owner-occupied property, Queen’s Tower’s deemed cost for subsequent accounting in accordance with HKAS 16 is its fair value at the date of change in use.
As at 31 May 2016, Queen’s Tower, as an owner-occupied property measured at cost model, should be measured at its depreciated deemed cost:

- Deemed cost at 30 April 2016 = fair value at 30 April 2016 = HK$254.8 million

- From 1 January 2009 to 30 April 2016, (7 x 12 + 4) months, i.e., 88 months has passed. Therefore, as at 30 April 2016, the remaining useful life of Queen’s Tower should be [(40 x 12) - 88 months = 392 months.

- Depreciation for 1 month from 1 May 2016 to 31 May 2016
  = HK$254.8 million / 392 = HK$0.65 million

- Therefore, cost less accumulated depreciation
  = HK$254.8 million – HK$0.65 million = HK$254.15 million

The amount to be recognised in the profit or loss for the 5 months ended 31 May 2016:

- Fair value gain on Queen's Tower as an investment property (1 January to 30 April 2016)
  = HK$254.8 million – HK$248 million = HK$6.8 million.

- Depreciation of Queen's Tower as an owner-occupied property (1 May to 31 May 2016)
  = HK$0.65 million

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer 4(a)

Journal entry for share options issued during the year ended 31 December 2014:

Share-based payment expense for senior management:
= 10,000 x 15 x HK$1 = HK$150,000

Share-based payment expense for staff:
= (1,000 x 200 x HK$1) x 75% x 1 year /4 years= HK$37,500

Dr	Staff costs		HK$187,500	
	Cr	Equity - share option reserve		HK$187,500

Answer 4(b)

	2014	Number of shares outstanding	Fraction of a year	weighted average number of shares outstanding
Number of shares brought forward	1 Jan to 30 Jun	3,000,000	6/12	1,500,000
Issue of shares on 1 July 2014		220,000		
	1 Jul to 31 Dec	3,220,000	6/12	1,610,000
Weighted average number of shares				3,110,000

Alternative:

	2014	Cumulative number of shares outstanding	fraction	weighted average number of shares outstanding
Number of shares brought forward	1 Jan to 31 Dec	3,000,000	12/12	3,000,000
Issue of shares on 1 July 2014	1 Jul to 31 Dec	220,000	6/12	110,000
Weighted average number of shares				3,110,000

Answer 4(c)

Earnings per share ("EPS")

The basic and diluted EPS of GCL for the year ended 31 December 2014 are calculated as follows:

Basic EPS = HK$18,120,000 / 3,110,000 = HK$5.8264

Considering the dilutive effects of the share options issued by GCL:

Outstanding share options granted to senior management:

The number of share options granted to senior management not yet exercised = 10,000 x 15 = 150,000

The proceeds raised on the exercise of the share options are 150,000 x exercise price of HK$9 = HK$1,350,000

To raise the same amount, the number of shares to be issued at market value of HK$9.9 would be HK$1,350,000 / HK$9.9 = 136,364 shares

Thus "free shares" = 150,000 shares – 136,364 shares = 13,636 shares

Outstanding share options granted to staff not yet vested:

Adjusted exercise price = exercise price of HK$9 + [HK$1 x (4-1)/4 years] = HK$9.75

The proceeds raised on the exercise of the share options are 200,000 x adjusted exercise price of HK$9.75 = HK$1,950,000

To raise the same amount, the number of shares to be issued at market value of HK$9.9 would be HK$1,950,000 / HK$9.9 = 196,970 shares

Thus "free shares" = 200,000 shares – 196,970 shares = 3,030 shares

Diluted EPS
= HK$18,120,000 / (3,110,000 + 13,636 + 3,030) shares
= HK$18,120,000 / 3,126,666 shares
= HK$5.7953.

Answer 4(d)

Pursuant to HKAS 33.47, options have a dilutive effect only when the average market price of ordinary shares during the period exceeds the exercise price of the options. As the exercise price is HK$9 per each share option which is the same as or above the average market price for the period the options were outstanding, all the share options will not have a dilutive effect on the earnings per share.

Answer 5(a)

(i) The lease of Machine A is considered as an operating lease to QML as:

There is no transfer of ownership of Machine A nor option to purchase the machine by QML throughout the lease period or at the end of the lease.

The lease term of 6 years is not for the major part of the economic life of Machine A, i.e. 15 years.

The total gross rental over the lease term is [(HK$18,000 x12) x 6] + HK$200,000 = HK$1,496,000. The present value of the above minimum lease payment amounts is not substantively all of the fair value of the leased asset, i.e. HK$3,500,000.

QML has no rights to continue the lease for a secondary period at a rent that is substantially lower than the market rent.

(ii) The lease of Machine B is considered as a finance lease to QML as:

QML has the option to purchase the asset at the end of the lease term at a price, i.e. HK$1,000 which is expected to be sufficiently lower than the fair value, i.e.HK$20,000 at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

The lease term of 4 years is for the major part of the economic life of the Machine B, i.e. 5 years.

The total gross rental over the lease term is [(HK$20,000 x12) x 4] = HK$960,000. The present value of the above minimum lease payment amounts is substantively all of the fair value of the leased asset, i.e. HK$920,000.

The lease is non-cancellable so that QML cannot reduce the minimum lease payment and cancellation is unlikely to occur.

Answer 5(b)(i)

The lease of Machine C is considered as an operating lease to QML as:

There is no transfer of ownership of Machine C nor option to purchase the machine by QML throughout the lease period or at the end of the lease.

The lease term of 5 years is not for the major part of the economic life of Machine C, i.e. 20 years.

The total gross rental over the lease term is [(HK$25,000 x12) x 5] = HK$1,500,000. The present value of the above minimum lease payment amounts is not substantively all of the fair value of the leased asset, i.e. HK$5,000,000.

The lease is cancellable with two months' notice and the penalty is only HK$50,000 which may increase the likelihood of cancellation if QML likes to terminate the lease early and reduce the minimum lease payment.

Answer 5(b)(ii)

QML has recognised all the rental payments under the lease of Machine C as an asset and a liability at the inception of the lease in prior years. However, given the lease is an operating lease, such overstatements of both asset and liability in prior years are considered as an error.

Under HKAS 8.42, QML shall correct the material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

(a) restating the comparative amounts for the prior period presented i.e. the statement of financial position as at 31 December 2013 and the statement of profit or loss and other comprehensive income for the year ended 31 December 2013 if the error has occurred during the year ended 31 December 2013; or

(b) for the errors occurred before the earliest prior period presented, i.e.1 January 2013, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

QML shall present a third statement of financial position as at the beginning of the preceding period when the retrospective restatement has a material effect on the information in the statement of financial position at the beginning of the preceding period.

Accordingly, the financial statements of QML for the year ended 31 December 2014 include three statements of financial position as at 1 January 2013, 31 December 2013 and 31 December 2014.

QML should also disclose the information required by HKAS 1.41 to HKAS 1.44 and HKAS 8. However, the related notes for the opening statement of financial position as at 1 January 2013 are not required.

Answer 6(a)

Under HKAS 32.33, if RGL reacquires its own shares, those shares ("treasury shares") shall be deducted from equity.

No gain or loss shall be recognised in profit or loss on such repurchase of its own shares.

This accounting treatment is the same no matter whether the treasury shares are acquired and held by RGL itself or by the Subsidiary.

Consideration paid or received in connection with these treasury shares shall be recognised directly in equity.

Answer 6(b)

Mr. Kong's advice is correct for the separate financial statements of the Subsidiary but not for the consolidated financial statements of RGL and its subsidiaries.

Even if the Subsidiary acquires the RGL's shares with a view to earn a trading gain, the RGL's shares are not recognised as a financial asset in the consolidated financial statements pursuant to HKAS 32.AG36.

However, in the separate financial statements of the Subsidiary, the RGL's shares are accounted for in accordance with HKFRS 9. If those shares are held for trading, they are recognised at fair value through profit or loss with subsequent fair value change through profit or loss.

Answer 6(c)

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. In acting in the public interest, a professional accountant shall observe and comply with the Code of Ethics for Professional Accountants (the "Code").

As a professional accountant, he has to comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as set out in s.100.5 of the Code of Ethics for Professional Accountants.

Integrity

A professional accountant should be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

(a) Contains a materially false or misleading statement;
(b) Contains statements or information furnished recklessly; or
(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

When a professional accountant becomes aware that the accountant has been associated with such information, the accountant shall take steps to be disassociated from that information.

Objectivity

A professional accountant should not compromise his professional or business judgment because of bias, conflict of interest or undue influence of others.

A professional accountant shall not perform a professional activity or service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that activity or service.

Professional Behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that the professional accountant knows or should know may discredit the profession.

Therefore, in this case, the intention of Mr Kong is not ethical. Ms Lee may consider obtaining legal advice on Mr Kong's request. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, Ms Lee should refuse to be or remain associated with information she determines is misleading and may conclude that it is appropriate to resign from the company (S.300.15 of the Code).

* * * END OF EXAMINATION PAPER * * *