SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

Peaceful Limited ("PL") is a company listed on the Stock Exchange of Hong Kong and is principally engaged in the sales of electronic products in Hong Kong. PL has grown over the past few years through the acquisition of companies.

Sorrow Limited

On 1 January 2013, PL acquired an 80% interest in Sorrow Limited ("SL") for HK$720 million when the equity of SL was:

	HK$'000
Share capital	150,000
Retained earnings	360,000
Other comprehensive income	240,000
	750,000

The carrying amounts of assets and liabilities of SL were the same as their fair values except for non-current assets for which the fair value was HK$60 million greater than the carrying amount. The non-current assets had a remaining economic life (same as useful life) of 15 years on 1 January 2013. The control premium for the controlling interest was considered to be minimal and thus ignored. The fair value of the non-controlling interests is HK$165 million at the date of acquisition.

Amicable Limited

On 1 January 2014, PL acquired a 30% interest (with a right to appoint two out of five directors) in Amicable Limited ("AL") for HK$180 million when the equity of AL was:

	HK$'000
Share capital	198,000
Retained earnings	150,000
Other comprehensive income	135,000
	483,000

The carrying amounts of assets and liabilities of AL were the same as their fair values.

Additional information

(a) PL and its SL (the "Group") have a financial year end date at 31 December.

(b) Tax impact is ignored. There is no impairment of goodwill since the date of acquisition of SL.

(c) It is the Group's policy to measure the non-controlling interests at fair value at the acquisition-date.

(d) Included in the non-current assets of PL, as at 31 December 2016, was a machine sold by SL on 1 January 2014 for HK$38 million. The carrying amount of the machine was HK$29 million on 1 January 2014. PL has depreciated the machine on a straight-line basis over a remaining useful life of 8 years since 1 January 2014, with no residual value.

(e) During 2016, SL sold goods to PL for HK$3,700,000. The inventory of PL, as at 31 December 2016, included goods acquired from SL on which SL recognised a profit of HK$120,000.

(f) Equipment with a carrying amount of HK$4,000,000 was sold by AL on 1 January 2016 to PL for HK$5,800,000. This equipment had an estimated remaining useful life of 10 years on 1 January 2016 with no residual value.

(g) The following is the financial information in relation to PL, SL and AL as at 31 December 2016:

	PL	SL	AL
	HK$'000	HK$'000	HK$'000
Non-current assets	1,652,500	807,600	450,300
Investment in SL	720,000	-	-
Investment in AL	180,000	-	-
Inventories	338,000	180,000	111,000
Accounts receivable	186,000	120,000	99,000
Cash	3,500	2,400	2,700
Total assets	3,080,000	1,110,000	663,000
Share capital	993,000	150,000	198,000
Retained earnings	441,000	390,000	180,000
Other comprehensive income	600,000	240,000	150,000
	2,034,000	780,000	528,000
Non-current liabilities	779,000	300,000	120,000
Current liabilities	267,000	30,000	15,000
Total equity and liabilities	3,080,000	1,110,000	663,000

Donation to Kowloon University

For the first time in its history, PL would like to donate HK$5 million in cash to Kowloon University ("KU"). A number of alternatives are available for the arrangement. PL's directors want to know whether the terms of these alternatives make any difference to the timing and measurement of the accounting treatment of the HK$5 million donation.

Alternative 1: PL enters into a private unenforceable agreement with KU to contribute HK$5 million to KU for general purposes. The benefits to PL are deemed only to relate to its reputation as a good corporate citizen. PL does not receive any consideration or significant benefit from KU in return for the donation.

Alternative 2: Same as alternative 1, except that instead of entering into a private unenforceable agreement, PL publishes a press release in relation to the donation announcing that payment is to be made in equal annual instalments of HK$1 million to KU over 5 years.

Alternative 3: PL enters into an agreement with KU to contribute HK$5 million to KU. The agreement is legally enforceable and the funds will be used by KU for research and development activities specified by PL. PL will retain proprietary rights over the results of the research and development activities.

Share options to Mr Lee and Ms Cheng

On 1 January 2014, PL granted Mr Lee, a director, share options on condition that the Hang Seng Index would reach 29,000 at the end of three years. The fair value of the share option at the date of grant, including the effect of this condition, is determined to be HK$1.5 million. As at 31 December 2016, the Hang Seng Index had not reached 29,000.

On 1 January 2014, PL granted Ms Cheng, the managing director, 100,000 share options; conditional upon Ms Cheng's remaining in PL's employment for three years. The exercise price was HK$60. However, the exercise price would drop to HK$45 if PL's earnings increased by at least an average of 8% per year over the three-year period. On the grant date, PL estimated that the fair value of the share options, with the exercise price of HK$45, is HK$24 per option. If the exercise price is HK$60, PL estimated that the share options have a fair value of HK$18 per option.

During the year ended 31 December 2014, PL's earnings increased by 10% and PL expected that earnings would continue to increase at this rate over the next two years. During the year ended 31 December 2015, PL's earnings increased by 9% and PL continued to expect that the earnings target would be achieved. During the year ended 31 December 2016, PL's earnings increased by only 2%. Ms Cheng completed the three years' service, and therefore satisfied the service condition.

Product and service revenue

Revenue of PL includes an amount of HK$28,350,000 for a sale made on 1 January 2016. The sale relates to a single product and includes ongoing servicing from PL for six years. The normal selling price of the product and the servicing would be HK$27 million and HK$750,000 per annum (i.e. HK$4.5 million in total), respectively.

Question 1 **(12 marks – approximately 22 minutes)**

Assume that you are Fatima Lam, the accounting manager of Peaceful Limited ("PL").

Required:

Prepare a memorandum to the directors to advise as to the principles in determining the timing in order that the donation should be recognised as an obligation. Apply these principles and advise what differences, if any, the alternative donation arrangements would make with respect to the timing and measurement of the accounting treatment of the HK$5 million donation to Kowloon University ("KU").

Note: Mark(s) will be awarded for proper memorandum format with logical presentation.

(12 marks)

Question 2 **(9 marks – approximately 16 minutes)**

Advise as to the appropriate accounting treatment for the share options granted to Mr Lee and Ms Cheng, and the accounting impacts for each of the three years up to 31 December 2016. Calculations are required.

(9 marks)

Question 3 **(7 marks – approximately 13 minutes)**

Advise as to the appropriate accounting treatment for the product and service revenue in the 2016 financial statements. Calculations are required.

(7 marks)

Question 4 **(19 marks – approximately 34 minutes)**

Assuming that the appropriate accounting treatments for the transactions and other information as set out in Questions 2 and 3 above have been incorporated, prepare the worksheets for the consolidated statement of financial position of PL as at 31 December 2016.

Note: Consolidation adjustments are to be shown in the form of a worksheet. For this question, you may wish to use the templates printed on the green paper provided to prepare your answers or continue your answer in the script booklet for Case Questions. You have to show the supporting calculation for each figure in the worksheet, but journal entries are not required.

(19 marks)

<u>Question 5</u>   (3 marks – approximately 5 minutes)

Prepare a reconciliation of the non-controlling interests as at 31 December 2016 showing the value of the net assets shared by the non-controlling interest and the goodwill component.

(3 marks)

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End of Section A

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

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

<u>Question 6</u> (19 marks – approximately 34 minutes)

Hydro Power Limited ("HPL") manufactures and assembles irrigation systems. As at 31 December 2016, HPL had a research and development ("R&D") project aimed at developing a hydro-powered irrigation pump by using kinetic energy to pump water to higher elevations without the need for active mechanical parts to provide a more sustainable irrigation system for sale to farmers in mainland China. HPL commenced the project on 1 March 2016.

The following R&D related activities had been carried out by the R&D team during the year.

- In order to obtain more information on current technology of kinetic energy and alternate materials for the pump to be more durable, HPL sent specific R&D members to attend local and regional exhibitions. Salaries and travelling costs incurred by these R&D members amounted to HK$650,000.

- HPL also recruited a well known technical expert on kinetic energy to design and test the prototype before full scale production of the products, since the board was convinced the products would have good markets and be profitable. Salary costs paid to the technical expert for his service amounted to HK$900,000.

- In order to promote the products, HPL developed and launched a new web-site solely for advertising the products. Total costs incurred for the web-site were HK$170,000, of which HK$100,000 was spent on developing the infrastructure for the site and HK$70,000 was spent on graphic design and content development.

- HPL also purchased an operating system for a machine to test the strength of the irrigation pump which amounted to HK$41,000. The machine could not operate the testing function without this operating system.

- In addition, HPL spent HK$200,000 to register a patent for the irrigation pump for a period of 2 years. The patent is renewable for another 2 years at minimum cost. The product is expected to have a competitive edge over the following 3 years after commercial production.

Faye Ho, a professional accountant, who joined HPL as a financial controller during the year had approved the accounting entries to book all the R&D costs as other assets on the Statements of Financial Position for the year ended 31 December 2016 without any questioning. Faye was fully aware that the incentive compensation scheme of HPL was linked to the financial performance of HPL.

<u>Required:</u>

(a) Advise HPL as to the accounting implications (both initial recognition and subsequent measurement) for the relevant costs of the R&D project incurred during the year ended 31 December 2016.

(15 marks)

(b) Identify and consider the ethical and professional issues faced by Faye Ho in the above situation in the context of a qualified certified public accountant.

(4 marks)

Question 7 **(19 marks – approximately 34 minutes)**

Nice Homes Limited ("NHL") runs 4 stores selling antique furniture and home accessories in various cities in mainland China. Each store makes all its retail purchases through NHL's purchasing centre and all stores are managed in the same way. Marketing, advertising and human resources functions are conducted and centralised in NHL's headquarters. Each store has its own customer base and generates daily sales information and monthly statements of profit or loss for management to make decisions about continuing to operate individual stores. NHL has a small research centre to analyse the purchasing behaviour of the customers for all stores.

At its recent management meeting, the Sales Director has expressed his concern about the decrease in sales performance of stores in some cities due to keen competition in that region and a change in the desire of customers for stylish modern furniture. The Sales Director is considering to re-allocate resources to enhance the profitability of the company and asked the Finance Director whether impairment assessment should be performed at entity level for NHL as a whole or at store level.

According to management's decision, the carrying amount of the headquarters' building can be allocated to the cash generating units under review, but the carrying amount of the research centre cannot be allocated. The allocation basis of the headquarters' building is based on the carrying amount of the stores weighted by the estimated remaining useful life of their assets.

As at 31 December 2016, the following financial data was obtained:

	Carrying amount of relevant assets HK$'000	Estimated remaining useful life of the assets (years)	Recoverable amount HK$'000
Store A	4,300	6	3,100
Store B	5,400	9	6,200
Store C	6,000	10	7,000
Store D	3,800	5	3,500
Total	19,500		19,800
Recoverable amount of NHL as a whole:			21,000
Carrying amount of headquarters' building:			1,800
Carrying amount of research centre:			1,000

Required:

(a) **Assume you are the Finance Director of NHL, based on the background information, advise the Sales Director at what level should NHL conduct its impairment assessment for the year ended 31 December 2016.**

(5 marks)

(b) **Determine the impairment of assets, with detailed calculation, if any, to be recognised by NHL at 31 December 2016.**

(14 marks)

Question 8 **(12 marks – approximately 22 minutes)**

Pro Golf Limited ("PGL") was a private company established by Adrian Poon and Bosco Lee in 2013 which sells golf equipment. Adrian holds a 70% shareholding interest in PGL, while Bosco holds 30%. All the shares carry equal voting rights. Throughout the years, Adrian has taken care of the accounting and finance function of PGL and his wife, Mimi Poon is responsible for the daily operations and marketing activities of the company. Bosco is a passive investor who is not involved in the management of PGL despite his 30% shareholding.

On 1 January 2016, both Adrian and Bosco agreed that PGL would enter into a financial guarantee contract in respect of a 3-year bank loan of HK$4.2 million obtained by Golf Clothing Limited ("GCL"). GCL was jointly owned by Adrian and Mimi. PGL committed to pay the principal amount of the loan if GCL defaulted on any payment of the bank loan. PGL had evaluated its risk of payment that there was no possibility that it has to honour the guarantee when it was first given. Accordingly, PGL had not recognised the financial guarantee contract at its inception. The bank loan was repayable over three years and repayment was due on 31 December each year.

During the year, due to a downturn in business and delay in settlements of the receivables by its debtors, GCL ran short of cash and was not able to repay the bank loan when the first instalment fell due. It was brought to the attention of Adrian that the guarantee would be called by the bank. The bank indicated the fair value of the guarantee was HK$120,000 and HK$140,000 on 1 January 2016 and 31 December 2016, respectively.

Required:

(a) **Explain the principles of accounting for a financial guarantee under HKFRS 9 and quantify with explanations the effect of the financial guarantee on the financial statements of PGL for the year ended 31 December 2016.**

(7 marks)

(b) **Identify the related parties with detailed explanations and identify the related parties transactions to be disclosed in preparing the financial statements of PGL for the year ended 31 December 2016.**

(5 marks)

* * * END OF EXAMINATION PAPER * * *