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

Highway Holdings Limited ("HHL") is a company incorporated in Hong Kong and is principally engaged in the distribution and marketing of electronic products. HHL has grown significantly over the last few years through mergers and acquisitions.

Alison Electronic Limited

On 1 January 2010, HHL acquired an 80% interest in Alison Electronic Limited ("AEL") for HK$500 million when the equity of AEL was:

	HK$'000
Share capital	150,000
Retained earnings	250,000
	400,000

The carrying amount of assets and liabilities of AEL were the same as their fair value.

Best Product Limited

On 30 November 2014, HHL acquired a 65% interest in Best Product Limited ("BPL") for HK$260 million when the equity of BPL was:

	HK$'000
Share capital	285,000
Retained earnings	50,000
	335,000

The carrying amount of assets and liabilities of BPL were the same as their fair value except for plant and equipment for which the fair value was HK$15 million greater than the carrying amount. The plant and equipment had a remaining economic life (same as useful life) of 10 years and depreciation of plant and equipment is charged to cost of sales account.

Additional information

(i) It is assumed that all the synergy arising from the business combinations rests with the acquirees (i.e. AEL and BPL) and thus allocation of goodwill upon acquisition is not required.

(ii) HHL and its subsidiaries (the "Group") have a financial reporting period ending at 31 March.

(iii) It is the Group's policy to measure the non-controlling interests as the proportionate share of the fair value of the identifiable net assets of the subsidiary at the acquisition-date.

(iv) Depreciation is recognised so as to write off the cost of assets over their useful lives, using a straight-line method. Depreciation is time apportioned from the date of acquisition.

(v) On 1 April 2014, AEL sold a freehold property to HHL for HK$100 million (land element HK$24 million). The property originally cost HK$110 million (land element HK$20 million) on 1 April 2006. The property's total useful life was 40 years on 1 April 2006 and there has been no change in the useful life. AEL has credited the gain on disposal to other income and gains account.

(vi) On 1 April 2014, BPL borrowed HK$120 million at 8% per annum (assume at the market interest rate) from HHL. Interest is payable twice yearly on 1 October and 1 April, HHL and BPL have accounted for the interest income / expense and interest receivable/ payable up to 31 March 2015.

(vii) HHL has accounted for its dividend received from AEL in other income and gains account.

(viii) Impairment tests conducted on 31 March 2015 revealed that, due to the unexpected economic downturn, the recoverable amount for AEL is HK$700 million and that for BPL is HK$330 million while the book values of the relevant assets of AEL and BPL for impairment review (excluding goodwill) are HK$450 million and HK$300 million respectively after adjusting for the effects of unrealised profits and fair value adjustments on consolidation. No impairment losses had previously been recognised.

(ix) Tax implication is ignored.

The following is the financial information in relation to HHL, AEL and BPL as at 31 March 2015:

	HHL	AEL	BPL For the year ended 31 Mar 2015	BPL 4 months from 1 Dec 2014 to 31 Mar 2015
	HK$'000	HK$'000	HK$'000	HK$'000
Sales	600,000	400,000	381,000	127,000
Cost of sales	(400,000)	(330,000)	(372,000)	(124,000)
Administrative expenses	(100,000)	(50,000)	(15,000)	(5,000)
Other income and gains	23,000	--	--	--
Finance costs	--	(5,000)	(21,000)	(7,000)
Profit / (loss) for the year / period	*123,000*	*15,000*	*(27,000)*	*(9,000)*
Opening retained earnings	137,000	277,000	68,000	50,000
Dividend paid	(20,000)	(5,000)	--	--
Closing retained earnings	*240,000*	*287,000*	*41,000*	*41,000*
Other non-current assets	492,000	372,200	400,100	
Investment in AEL	500,000	-	-	
Investment in BPL	260,000	-	-	
Current assets				
Inventory	116,000	85,000	27,000	
Trade and other receivables	62,000	65,000	33,000	
Cash	10,000	800	900	
Total assets	*1,440,000*	*523,000*	*461,000*	
Share capital	958,000	150,000	285,000	
Retained earnings	240,000	287,000	41,000	
	1,198,000	*437,000*	*326,000*	
Non-current liabilities	153,000	76,000	120,000	
Current liabilities	89,000	10,000	15,000	
Total equity and liabilities	*1,440,000*	*523,000*	*461,000*	

Review of financial statements of HHL

The directors of HHL have reviewed the separate financial statements of HHL for the year ended 31 March 2015. During the review, they noted the items below and they queried the appropriate accounting treatments of the following:

1. Useful life of a machine

   The directors of HHL determined that the total estimated useful life of a machine should be increased from five years to seven years. The machine was acquired on 1 April 2013 for HK$6 million and it was estimated that there would be no residual value. Depreciation has already been provided for up to 31 March 2015 based on the original estimated useful life of 5 years. The company uses the straight line method to depreciate assets.

2. Repair and maintenance

   Upon review of the repair and maintenance account of HHL and its transactions for the year ended 31 March 2014, it was discovered that an expenditure of HK$2 million on 1 April 2013 was recorded as a repair expense for the year ended 31 March 2014 while it should have been capitalised as a building. This building would have had an estimated useful life of 40 years and no estimated residual value.

3. Bankruptcy

   One of the customers of HHL, Metra Yoda Limited ("MYL"), went into bankruptcy on 10 May 2015. The directors of HHL expect that HHL can only collect 20% of the amount due from MYL on the completion of the bankruptcy process. As at 31 March 2015, MYL owed HHL HK$600,000. An additional sale of HK$140,000 was made to MYL subsequent to 31 March 2015. The total amount due from MYL was HK$740,000 on 10 May 2015. No provision had been provided for this bankruptcy before the review of the financial statements by the directors.

<u>Question 1</u> **(15 marks – approximately 27 minutes)**

Assume that you are Ivy Lee, the accounting manager, and you are required to draft a memorandum in response to the questions raised by Mr Kim Chong, a Director of HHL on behalf of all the directors of HHL.

<u>Required:</u>

Advise as to the appropriate accounting treatments in the financial statements of HHL and calculate the increase or decrease in the profit of HHL for the years ended 31 March 2014 and 31 March 2015 for each of the following:

(a) useful life of the machine, (6 marks)

(b) repair and maintenance, and (5 marks)

(c) bankruptcy of MYL. (4 marks)

<u>Question 2</u> **(9 marks – approximately 16 minutes)**

(a) Calculate the goodwill to be recognised in the consolidated financial statements of HHL at the date of acquisition of AEL and BPL.

(3 marks)

(b) Explain and calculate the impairment loss of the goodwill to be recognised in the consolidated financial statements of HHL for the year ended 31 March 2015.

(6 marks)

Question 3 **(26 marks – approximately 47 minutes)**

Assuming that the appropriate accounting entries for the three items revealed in the review of financial statements of HHL have been properly recorded in the financial statements of HHL, prepare the worksheets for:

(a) **the consolidated statement of profit or loss of HHL for the year ended 31 March 2015,**

(9 marks)

(b) **the reconciliation of opening and closing consolidated retained earnings of HHL for the year ended 31 March 2015, and**

(3 marks)

(c) **the consolidated statement of financial position of HHL as at 31 March 2015.**

(14 marks)

(Consolidation adjustments are to be shown in the form of a worksheet. For this question, you may use the template in the green papers provided and / or the script booklet for Case Questions to prepare your answers. You have to show the detailed calculation of each figure, but journal entries are not required).

* * * * * * * *

End of Section A

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

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

Question 4 **(16 marks – approximately 29 minutes)**

Popular Company Limited ("PCL") is developing an innovative system for making a new product for sale. During the first half of the year ended 31 December 2014, the project incurred costs of HK$2 million to carry out research for the evaluation of alternatives of the system to be used. During the second half of the year ended 31 December 2014, the project incurred technicians' salaries of HK$4 million to build up the system. PCL has completed its technical feasibility of the system in June 2014 and it is expected that the system will be ready for use by the end of 2015 and then will be obsolete after 8 years. Once PCL registers this innovative system, the patent granted by the authority will have a legal life of 5 years with a minimal cost to renew for a further 5 years. PCL plans to make the new product by constructing its own production facilities and sell it to the market. It is expected the future economic benefit generated from this innovative system, based on the discounted cash flows projection, will outweigh all the necessary costs and expenditures and there is no indicator of impairment.

Required:

(a) With reference to the phases of developing the innovative system, advise as to the accounting implication for each of the incurred costs above.

(6 marks)

(b) Advise PCL about the commencement of the amortisation period and the length of the amortisation period.

(4 marks)

(c) Based on the information given,

(i) advise as to whether PCL is required to conduct any impairment assessment as at 31 December 2014; and

(ii) list out the factors that should be considered in determining the recoverable amount as determined by the discounted cash flows projection if PCL should conduct an impairment assessment.

(6 marks)

Question 5 (14 marks – approximately 25 minutes)

Simple Company Limited ("SCL"), a company listed on the Hong Kong Stock Exchange, has issued a convertible bond ("CB") with a principal amount of HK$200 million on 1 April 2014. The coupon interest is 2% per annum and payable annually in arrears. The maturity of the CB is 31 March 2017. The holders are entitled to redeem at par together with any accrued interest upon maturity. The CB holders are entitled to convert the CB into ordinary shares of SCL at a variable conversion price on or before maturity. The conversion price would be 20% below the market price of each share at the date of conversion.

On 30 June 2014, certain holders exercised their options to convert into shares in SCL for a principal amount of HK$40 million. The conversion price at that date was HK$5 per share of SCL.

The prevailing market interest rate of a similar type of instrument without a conversion option was 6.1%. The functional currency and presentation currency of SCL is the Hong Kong dollar. SCL adopts 31 December as its financial year-end.

On 1 April 2014, the fair value of the conversion option was HK$40 million and the fair value of the liability component was HK$160 million. On 30 June 2014, the fair value of the conversion option was HK$50 million and the fair value of the liability component was HK$150 million. On 31 December 2014, the fair value of the conversion option was HK$65 million and the fair value of the liability component was HK$165 million.

For a compound instrument issued by SCL, SCL adopts an accounting policy to account for the debt component at amortised cost and the conversion option, being an equity component, is not remeasured.

For a hybrid instrument issued by SCL, SCL adopts an accounting policy to account for the debt component at amortised cost and the conversion / early redemptions option, being a derivative component, at fair value through profit or loss.

Required:

(a) (i) Explain how the CB will be accounted for under the above scenario.
(2 marks)

(ii) Prepare the journal entries with detailed calculations for the issue of the CB on 1 April 2014 and the partial conversion of the CB on 30 June 2014.
(6 marks)

(b) Assume there had not been any conversion in Question 5(a)(ii), prepare the journal entries with detailed calculations for the CB as at 31 December 2014.
(4 marks)

(c) Explain how the CB will be accounted for assuming the conversion price had been fixed at HK$4 per share upon issuance and other terms remained constant.
(2 marks)

<u>Question 6</u> (20 marks – approximately 36 minutes)

Forest Electricity Limited ("FEL") is a manufacturer of electricity appliances which owned two manufacturing plants in the PRC and one retail shop in Hong Kong. FEL has recurred losses in its operation of both manufacturing and retailing businesses. During its financial year ended 31 December 2014, the following transactions have taken place:

(a) Due to the poor performance of FEL, the management has decided to terminate the operation of one of the manufacturing plants on 1 December 2014 while they have not yet announced this to all the employees on 31 December 2014. In the year of 2015, it is expected to incur operational costs of HK$8 million, cost of relocation of staff of HK$1 million and dismantling cost of plant of HK$4 million.

(8 marks)

(b) FEL has a long-term supply contract with a customer to provide 100,000 Product X at HK$20 each every year for a term of three years from 1 April 2014 to 31 March 2017. Up to 31 December 2014, FEL has delivered 50,000 Product X to the customer. Because of the increased material costs, the manufacturing cost is expected to be HK$22 each from 1 January 2015 onwards. On 15 December 2014, the management also informed the landlord of the retail shop to terminate the lease of the retail shop as at 31 December 2014. FEL has entered into the non-cancellable leasing arrangement for a term of five years at a monthly rent of HK$80,000. The unexpired lease term is three years from the end of 31 December 2014 and FEL is not allowed to sub-let the retail shop to other parties.

(7 marks)

(c) FEL provides a warranty on Product Y when these products are sold to customers and FEL has also entered into an insurance contract with an insurance company for the reimbursement of these costs. For every defective Product Y, HK$10 per unit will be paid by FEL to the customer while the insurance company would reimburse the same to FEL. FEL sold 800,000 units of Product Y during the year and it is estimated that 10% of these units would have been defective based on the historical pattern. On 15 January 2015, 10,000 units of Product Y are claimed and certified as defective by customers for each of whom the insurance company also reimbursed FEL on the same day.

(5 marks)

<u>Required:</u>

Advise as to the accounting implications for each of the costs incurred in 2014 and 2015, and calculate the amounts to be recognised for each of the above events by FEL for the year ended 31 December 2014.