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

Assume that you are Mr. Raymond Wong, the accounting manager of Debussy Limited (DBL), which is principally engaged in the manufacture and sale of musical instruments. DBL is a company incorporated in Hong Kong and is listed on the Main Board of the Stock Exchange of Hong Kong. The financial year end date of DBL is 30 September. DBL acquired 70% of the ordinary shares of Stanford Limited (STF) for $768 million on 1 October 2008.

At the acquisition date, STF reported retained earnings of $350 million and a revaluation reserve of $10 million. The carrying amount of all assets and liabilities approximated the fair value except for intangible assets. The book and fair values of the intangible assets of STF (with a remaining useful life of eight years), excluding deferred tax liability on fair value adjustments, were $40 million and $120 million respectively at the date of acquisition.

Non-controlling interests are measured as the non-controlling interest's proportionate share in the recognised amounts of the acquiree's net identifiable assets as at the acquisition date. Investment in STF was carried at cost. Both companies had no reserves other than retained earnings and revaluation reserves.

On 1 October 2011, DBL held inventory purchased from STF at an invoiced price of $36 million which had been manufactured by STF at a cost of $24 million. During the six months ended 31 March 2012, STF sold musical instruments costing $96 million to DBL for $144 million. As at 31 March 2012, DBL had sold the entire beginning inventory, but continued to hold 35% of its current period purchases from STF.

DBL adopted the revaluation model for property, plant and equipment while intangible assets were carried at cost. Depreciation and amortisation is provided using the straight-line method. The tax rate for the years of assessment from 2008/09 to 2011/12 was 16.5%.

On 1 May 2012, DBL entered into a contract with Forever Young Limited (FYL). The contract requires DBL to make a ten-year variable rate $30 million loan to FYL while FYL at the same time makes a ten-year fixed rate loan for the same amount to DBL. There are no transfers of principal at inception of the two loans, since DBL and FYL have a netting agreement. During the ten years, DBL will pay a fixed rate of 3% per six months and receive a variable amount based on six-month HIBOR, reset on a semi-annual basis. The fixed and variable amounts are determined on the basis of a principal amount of $30 million.

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The draft financial data of the two companies for the six months ended 31 March 2012 are shown below:

	DBL	STF
	$'000	$'000
Sales	2,400,000	1,152,000
Cost of sales	(1,536,000)	(769,000)
Gross profit	864,000	383,000
Other income (including dividend income)	38,000	--
Distribution costs	(90,000)	(69,000)
Administrative expenses*	(150,000)	(75,000)
Finance costs	(172,000)	(34,000)
Profit before tax	490,000	205,000
Income tax expense	(106,000)	(61,000)
Profit for the period	384,000	144,000
Other comprehensive income: revaluation surplus	180,000	36,000
Total comprehensive income for the period	564,000	180,000

* Administrative expenses include the amortisation of intangible assets.

	Share capital	Retained earnings	Revaluation surplus	Total equity
	$'000	$'000	$'000	$'000
DBL				
Balance, 1 October 2011	960,000	1,092,000	120,000	2,172,000
Total comprehensive income	--	384,000	180,000	564,000
Dividends	--	(96,000)	--	(96,000)
Balance, 31 March 2012	960,000	1,380,000	300,000	2,640,000
STF				
Balance, 1 October 2011	480,000	654,000	30,000	1,164,000
Total comprehensive income	--	144,000	36,000	180,000
Dividends	--	(48,000)	--	(48,000)
Balance, 31 March 2012	480,000	750,000	66,000	1,296,000

	DBL	STF
	$'000	$'000
Property, plant and equipment, net	1,824,000	788,000
Investment in STF, at cost	768,000	--
Intangible assets, net	--	136,000
Inventory	1,536,000	648,000
Trade and other receivables	750,000	420,000
Cash and cash equivalents	690,000	312,000
	5,568,000	2,304,000

	DBL	STF
	$'000	$'000
Share capital	960,000	480,000
Retained earnings	1,380,000	750,000
Revaluation surplus	300,000	66,000
	2,640,000	1,296,000
Trade and other payables	1,428,000	408,000
Long term loan	1,500,000	600,000
	5,568,000	2,304,000

You have prepared the draft condensed consolidated financial statements of DBL for the six months ended 31 March 2012. After you sent these draft condensed consolidated financial statements to DBL's directors for review, one of the directors, Ms. Janice Lam, sent you an e-mail as follows:

To: Raymond Wong, Accounting Manager, DBL
From: Janice Lam (Director)
c.c.: Lucas Chong, Josiah Wong, Andrea Cheung (Directors)
Date: 7 May 2012

Condensed consolidated financial statements of DBL for the six months ended 31 March 2012

Could you please clarify the following points relating to DBL's draft condensed consolidated financial statements which I have just reviewed.

(A) I know that our interim financial report has complied with the requirements of HKAS 34, and thus we have complied with this HKFRS. Why don't you say that we have complied with HKFRSs in the notes to the financial statements? By the way, I understand that we have to disclose segment information in our annual financial statements. However, this is only the interim financial report; I don't think we need to disclose segment information!

(B) I am puzzled about the disclosure in relation to related parties. Who actually are the related parties of DBL? I understand that I am related to DBL because I am a director of DBL, but I don't think my private business, Beethoven Limited (BTV), is related. Although I have a 100% investment in BTV, which purchases musical instruments regularly from STF, it is not related to DBL in any sense!

(C) I know that we have just entered into a contract with FYL. How shall we account for this contract?

(D) I find that it is difficult to obtain the figures in the condensed consolidated financial statements. Can you tell me more about how you arrived at each figure?

I would appreciate your clarification for the upcoming board meeting.

Best regards,

Janice

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Question 1 **(50 marks – approximately 90 minutes)**

Assume that you are Raymond Wong, the accounting manager, and you are required to draft a memorandum to Janice Lam, a Director of DBL. In your memorandum, you should:

(a) **briefly discuss and advise whether DBL should describe its condensed interim financial report as complying with HKFRSs;**

(4 marks)

(b) **briefly discuss and advise whether the segment information should be disclosed in DBL's interim financial report;**

(4 marks)

(c) **discuss and identify the related party relationship among DBL, BTV and STF in their respective financial statements;**

(7 marks)

(d) **briefly discuss and advise the appropriate accounting treatment of the contract with FYL. Detail calculation is not required; and**

(5 marks)

(e) **prepare an annex to your memorandum showing worksheets for:**

(i) **the condensed consolidated statement of comprehensive income for the six months ended 31 March 2012, and**

(11 marks)

(ii) **the condensed consolidated statement of financial position as at 31 March 2012.**

(19 marks)

(Consolidation adjustments are to be shown in the form of a worksheet. For Question 1(e), you may use the template in green colour paper provided and/or the script booklet for Case Questions to prepare your answers. You are required to show the detailed calculations for each figure, journal entries are **not** required.)

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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 2 (19 marks – approximately 34 minutes)

Newtop Construction Company Limited is a construction company and has two contracts underway as at 30 September 2012:

	Contract A $'000	Contract B $'000
Total agreed contract sum	42,000	65,000
Estimated total costs (original budget)	36,000	63,000
Costs incurred to date	25,600	30,000
Contract sum certified and billed to date	28,000	26,000
Total billing received to date	22,800	23,500
Revenue recognised up to 30 September 2011	18,200	N/A
Costs recognised up to 30 September 2011	15,600	N/A

Management has reassessed the cost budget and considered that the original budget of contract A is reasonable while the budgeted total costs for contract B should be revised upward by 5%.

The stage of completion is determined based on the survey of work performed by external architects at each month end.

Required:

(a) Calculate the amounts to be recognised in profit or loss in the year ended 30 September 2012.

(10 marks)

(b) Show the amounts to be disclosed and presented under HKAS 11 *Construction Contracts for* Contacts In Progress as at 30 September 2012.

(9 marks)

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Question 3 **(17 marks – approximately 31 minutes)**

Winner Sports Limited (WSL) is a sports shoe manufacturer and it sells its products under two different brands, Run Pro and Jog Pro, which were acquired in 2008. Both units have been established for the research and development, design, manufacturing, and marketing the products of individual brands with their own production plant and sales teams. In the past two years, the sales performance for Run Pro has deteriorated significantly due to the keen competition in the market and the lack of new designs and models introduced, while Jog Pro has achieved a double digit growth of sales. The management is considering to re-allocate resources to enhance the profitability of the entity.

The statement of financial position showed the following assets at 30 June 2012:

	Run Pro	Jog Pro	Total
	$'000	$'000	$'000
Brand	25,000	5,000	30,000
Plant and equipment	40,000	25,000	65,000
Development cost capitalised	6,000	3,000	9,000
Inventories	12,000	8,000	20,000
	83,000	41,000	124,000

Both brands are determined to be of indefinite life. No impairment has been recognised since acquisition.

The above are the only assets that are directly attributable to the brands. Corporate assets are negligible.

For the purpose of preparation of the annual financial statements, the management has carried out the following estimation:

	Run Pro	Jog Pro	Total
	$'000	$'000	$'000
Value in use	64,000	60,000	124,000
Fair value less cost to sell			
– Unit as a whole	60,000	58,000	118,000
– Plant and equipment	36,000	22,000	58,000
– Development cost capitalised	nil	nil	nil

Inventories are excluded from the cash generating unit (CGU) carrying value and the impact has been properly incorporated in determining the value in use. Impact of other working capital is minimal.

The fair value less costs to sell of individual items under plant and equipment are indeterminable.

Inventories are with net realisable value / fair value less costs to sell higher than their carrying amount.

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Required:

(a) **Briefly discuss and advise whether WSL is required to conduct asset impairment review at 30 June 2012.**

(3 marks)

(b) **"The total of value in use of both brands is higher than their total net assets, there is no impairment issue." Comment on this statement with reasons.**

(5 marks)

(c) **Determine the impairment of assets with detail calculation, if any, to be recognised by WSL at 30 June 2012.**

(9 marks)

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Question 4 **(14 marks – approximately 25 minutes)**

Canyo Company Limited (CCL) has two bank loans at 31 December 2012 with the following terms:

	Bank loan A	Bank loan B
Principal	$10,000,000	$8,000,000
Interest rate in arrears	Fixed at 7 per cent per annum	Prime rate plus 1.5 per cent per annum
Borrowing date	1 July 2012	1 October 2012
Maturity date	30 June 2013	4 instalments of $2,000,000 repayable at 1 April and 1 October of 2013 and 2014
Repayment on demand clause	No	Yes
Penalty for early repayment	Nil	1 per cent of the early repayment balance

Effective interest rate for both loans approximated to the contractual rate. Prime rate at 1 October 2012 was 5.25%.

On 1 February 2013, CCL signed an agreement to extend the maturity date of bank loan A to 31 January 2015 with an increase in the interest rate to 8 per cent per annum payable at the end of the maturity date. A transaction fee of $500,000 is required to be paid to the bank for this arrangement.

On 1 April 2013, CCL obtained a new bank loan of $10,000,000 (bank loan C) from another bank, which carries a fixed interest rate of 7.5 per cent per annum and is repayable at 31 December 2014 without repayment on demand clause. The proceeds have been used to repay bank loan B early in full on the same day.

Required:

(a) **Explain how to present these two bank loans on the statement of financial position at 31 December 2012 with current / non-current presentation of financial liabilities.**

(3 marks)

(b) **Explain how to account for the extension of bank loan A on 1 February 2013.**

(6 marks)

(c) **Explain how to account for the early settlement of bank loan B on 1 April 2013 supported with detail calculation.** (Assuming the prime rate remains at 5.25%).

(5 marks)

* * * END OF EXAMINATION PAPER * * *

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