SECTION A – CASE QUESTIONS **(Total: 50 marks)**

To	:	Mr. Yan, Director of CCN
From	:	Peter Wong, Accounting Manager, CCN
c.c.	:	Jacky Lam, Alex Cheng, Nelson Chan (Directors)
Date	:	dd/mm/yyyy
Subject	:	Consolidated financial statements of CCN as at 31 March 2010

I refer to your e-mail dated 8 May 2010 regarding your queries about the draft consolidated financial statements of CCN as at 31 March 2010.

Answer 1(a)

Indefinite useful life

HKAS 38 requires an entity to assess whether the useful life of an intangible asset is finite or indefinite. An intangible asset shall be regarded as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

It should be noted that the term “indefinite” does not mean “infinite”. The useful life reflects only that level of future maintenance expenditure required to maintain the brand at its standard of performance assessed at the time of estimating the brand's useful life, and CCN’s ability and intention to reach such a level.

In this case, Yeh-yeh is well-known internationally with a long history. The technology related to the product does not change rapidly. Besides, CCN has the history and experience to manage a brand as well as an intention and ability to manage Yeh-yeh. Thus the brand name was classified as having an indefinite useful life.

Value remain unchanged forever

The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not.

Although an intangible asset with an indefinite useful life shall not be amortised, its value may not be kept unchanged forever. In fact, the value of the brand name may change when there is:

(a) a change in the useful life assessment; or
(b) an indication of impairment.

In accordance with HKAS 36, CCN is required to test the brand name, being an intangible asset with an indefinite useful life, for impairment by comparing its recoverable amount with its carrying amount

(a) annually, and
(b) whenever there is an indication that the brand name may be impaired.

The useful life of this brand name, that is not being amortised, shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment.

If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with HKAS 8.

In accordance with HKAS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, CCN would have to test the asset for impairment if there is a change in the useful life assessment from indefinite to finite.

Also, the brand name shall be derecognised:

(a) on disposal; or
(b) when no future economic benefits are expected from its use or disposal.

Thus the value of the brand name may not be kept unchanged forever.

Answer 1(b)

Contingent consideration

HKFRS 3 (Revised) *Business Combinations* requires the consideration transferred in a business combination (including any contingent consideration) to be measured at fair value.

Para. 4 of HKFRS 4 *Insurance Contracts* states that an entity should not apply HKFRS 4 to contingent consideration payable or receivable in a business combination.

Para. 39 of HKFRS 3 (Revised) requires the consideration the acquirer transfers in exchange for the acquiree to include any asset or liability resulting from a contingent consideration arrangement. Thus, on 1 April 2009, CCN should recognise the acquisition-date fair value of contingent consideration (i.e. $400,000) as part of the consideration transferred in exchange for KKP.

According to para. 11 of HKAS 32 *Financial Instrument: Presentation*, CCN should classify this obligation to pay contingent consideration as a financial liability since it is a contractual obligation to deliver cash.

Para. 58 of HKFRS 3 (Revised) states that some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments.

During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

However, a change resulting from an event after the acquisition date, in this case, reaching a specified share price, is not a measurement period adjustment.

Being not a measurement period adjustment, this contingent consideration classified as a financial liability should be measured at fair value, with any resulting gain or loss recognised in profit or loss, i.e.

Dr	Loss on remeasurement of contingent consideration	$1,100,000	
	Cr Contingent consideration		$1,100,000

Being remeasurement of contingent consideration from $400,000 to $1,500,000

The additional $1,500,000 cash paid will clear and settle this remeasured value of contingent consideration and thus it will not result in an adjustment of acquisition cost, i.e.

Dr	Contingent consideration	$1,500,000	
	Cr Cash		$1,500,000

Being settlement by paying $1,500,000 in cash

<u>Answer 1(c)</u>

<u>Contingent liability</u>

HKAS 37 Provisions, Contingent Liabilities and Contingent Assets defines a contingent liability as:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

    (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

    (ii) the amount of the obligation cannot be measured with sufficient reliability.

However, para. 23 of HKFRS 3 specifies that the requirements in HKAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date.

Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably.

Therefore, contrary to HKAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

In this case, even though the lawyer has pointed out that the chance of loss is not probable, CCN has to recognise the contingent liability as it is present obligation that arises from a past event and its fair value can be measured reliably.

Calculation of goodwill

Consideration transferred:	$
2,000,000 shares at $10	*20,000,000*
Fair value of contingent consideration	*400,000*
Cash	*6,000,000*
	26,400,000
Fair value of NCI	*2,200,000*
	28,600,000
*Less: Fair value of identifiable net assets**	*20,406,400*
Goodwill	*8,193,600*

** Working*	*Book value*	*Fair value*	*Fair value difference*
	$	*$*	*$*
Plant and equipment	*12,000,000*	*16,800,000*	*4,800,000*
Intangible asset	-	*6,000,000*	*6,000,000*
Inventory	*500,000*	*750,000*	*250,000*
Accounts receivable	*200,000*	*200,000*	-
Cash	*10,000*	*10,000*	-
	12,710,000	*23,760,000*	*11,050,000*
Accounts payable	*(1,510,000)*	*(1,510,000)*	-
Contingent liabilities		*(90,000)*	*(90,000)*
Total identifiable net assets	*11,200,000*	*22,160,000*	*10,960,000*
Deferred tax of FV differences (16% tax)		*(1,753,600)*	*1,753,600*
*Fair value of identifiable net assets**		*20,406,400*	

I hope the above explanation has answered your questions. For the details, please refer to the annex. Please feel free to contact me if you have further queries.

Best regards,
Peter Wong

Answer 1(d)

	CCN	KKP	Eliminations			Consolidated
			Dr	working	Cr	
	$	$	$		$	$
Plant and equipt, net	89,200,000	11,000,000	4,800,000	(a)/(d)	480,000	104,520,000
Intangible asset	10,800,000	-	6,000,000	(a)		16,800,000
Investment in KKP, cost	26,400,000	-		(a)	26,400,000	-
Goodwill			8,193,600	(a)/(h)	819,360	7,374,240
Deferred tax asset			102,400	(g)		102,400
Inventory	31,200,000	1,600,000	250,000	(a)/(b)	225,000	32,185,000
				(f)	640,000	
Accounts receivable	2,000,000	600,000				2,600,000
Cash	8,000,000	100,000				8,100,000
	167,600,000	13,300,000				171,681,640
Share capital	32,000,000	10,000,000	10,000,000	(a)		32,000,000
Retained earnings	56,000,000	2,000,000	1,200,000	(a)		54,965,756
			225,000	(b)/(c)	36,000	
			480,000	(d)/(e)	76,800	
			640,000	(f)/(g)	102,400	
			819,360	(h)/(i)	114,916	
NCI			114,916	(i)/(a)	2,200,000	2,085,084
Loan	72,000,000					72,000,000
Accounts payables	7,600,000	1,300,000				8,900,000
Contingent liability				(a)	90,000	90,000
Deferred tax liability			36,000	(c)/(a)	1,753,600	1,640,800
			76,800	(e)		
	167,600,000	13,300,000				171,681,640
			32,938,076		32,938,076	

Journal entries are not required by the question

Consolidation adjustments for year ended 31 March 2010
(a) Elimination entry as at 1 April 2009

	$	$
Dr Share capital	*10,000,000*	
Dr Retained earnings	*1,200,000*	
Dr Plant and equipment	*4,800,000*	
Dr Intangible asset	*6,000,000*	
Dr Inventory	*250,000*	
Dr Goodwill	*8,193,600*	
Cr Contingent liabilities		*90,000*
Cr Deferred tax liability		*1,753,600*
Cr Investment in S		*26,400,000*
Cr Non-controlling interests		*2,200,000*

(b) Sale of revalued inventory ($250k x 90%)

Dr Cost of Sales	*225,000*	
Cr Inventory		*225,000*

(c) Tax effects of sale of revalued inventory ($225k x 16%)

Dr Deferred tax liability	*36,000*	
Cr Tax expense		*36,000*

(d) Additional depreciation for year ended 31 Mar 2010 ($4,800k ÷ 10)

Dr Depreciation	*480,000*	
Cr Accumulated depreciation		*480,000*

(e) Tax effects of depreciation ($480k x 16%)

Dr Deferred tax liability	*76,800*	
Cr Tax expense		*76,800*

(f) Elimination of intragroup sales and unrealised profit ($1,600k x 40%)

Dr Sales	*4,800,000*	
Cr Cost of sales		*4,160,000*
Cr Inventory		*640,000*

(g) Tax effects of intragroup sale ($640k x 16%)

Dr Deferred tax asset	*102,400*	
Cr Tax expense		*102,400*

(h) Goodwill impairment loss for 2010 ($8,193,600 x 10%)

Dr Goodwill impairment loss	*819,360*	
Cr Goodwill		*819,360*

No tax impact on goodwill impairment loss

(i) Share of profit/(loss) to NCI for 2010

Dr NCI	*114,916*	
Cr Retained earnings		*114,916*

Reconciliation of Non-controlling Interests <u>(not required by the question)</u>:

	$	$
Retained earnings at 31 March 2010		*2,000,000*
Retained earnings at acq date		*(1,200,000)*
		800,000
Sale of revalued inventory	*(225,000)*	
Tax	*36,000*	*(189,000)*
Additional depreciation	*(480,000)*	
Tax	*76,800*	*(403,200)*
Intragroup sales	*(640,000)*	
Tax	*102,400*	*(537,600)*
Goodwill impairment		*(819,360)*
		(1,149,160)
Share of profit / (loss) to NCI (10%)		*(114,916)*
Add: Original fair value of NCI		*2,200,000*
		2,085,084

<u>OR</u>

	$	$ 10% NCI
Retained earnings at 31 March 2010	*2,000,000*	
Retained earnings at acq date	*(1,200,000)*	
	800,000	*80,000*
Sale of revalued inventory	*(225,000)*	*(22,500)*
Tax on Sale of revalued inventory	*36,000*	*3,600*
Additional depreciation	*(480,000)*	*(48,000)*
Tax on Additional depreciation	*76,800*	*7,680*
Intragroup sales	*(640,000)*	*(64,000)*
Tax on Intragroup sales	*102,400*	*10,240*
Goodwill impairment	*(819,360)*	*(81,936)*
	(1,149,160)	*(114,916)*
Add: Original fair value of NCI		*2,200,000*
		2,085,084

OR

	$	$
Book value of net assets at 31 March 2010		*12,000,000*
Adjustments: (intragroup sales 537.6k)		*(537,600)*
		11,462,400
Unamortised Fair value adjustments:		
P&E (4,800k-480k) x (1-16%)	*3,628,800*	
Intangible (6,000k) x (1-16%)	*5,040,000*	
Inventory (250k-225k) x (1-16%)	*21,000*	
Less: Contingent liabilities (90k) x (1-16%)	*(75,600)*	*8,614,200*
		20,076,600
10% of net assets for NCI		*2,007,660*
Goodwill remains		
(159,360^ – 81,936)		*77,424*
		2,085,084

Goodwill for NCI (2,800k – 10% of net assets)	
Fair value of NCI	*2,200,000*
10% of FV of identifiable net assets	*2,040,640*
	*159,360^*

* * * END OF SECTION A * * *

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

Answer 2

(a) Company B: (Yes) Mrs. Kwok, a joint venturer of Company B, is:

a member of the key management personnel of Company A [HKAS24.9 (b) (vi)] OR a close member of the family of Mr. Kwok who controls Company A [HKAS24.9 (b) (vi)]

(b) Company C: (Yes) A wholly owned subsidiary of GIL. Company A is an associate of GIL [HKAS24.9(b)(ii)]

(c) Company D: (Yes) Being wholly owned by Mr. Ma, a member of the key management personnel of Company A [HKAS24.9 (b) (vi)]

(d) Company E: (Yes) Mr. Kwok, the controlling shareholder of Company A, is the husband of Mrs. Kwok, who is a key management personnel of Company E. [HKAS24.9 (b) (vii)]

(e) GIL: (Yes) Company A is an associate of GIL [HKAS24.9 (b) (ii)]

(f) Mr. Ma: (Yes) A member of the key management personnel of Company A [HKAS24.9 (a)(iii)]

(g) Ms. Chan: (No) Not a person or a close member of the family of a person as set out in HKAS24.9 (a)

(h) Mr. Wang: (No) Not a person or a close member of the family of a person as set out in HKAS24.9 (a)

Answer 3(a)

Both proportional consolidated method and equity method of accounting are acceptable accounting treatment for interest in jointly controlled entities under HKAS 31.

Under HKAS 8.14, an entity shall change an accounting policy only if the change is required by HKFRS or results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

HKAS 8.22 requires the ***change of an accounting policy voluntarily*** to be applied retrospectively, i.e. the entity shall adjust the opening balance of each affected component or equity for the earliest prior period presented and other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

Answer 3(b)

Both the cost method and revaluation method are acceptable measurement basis after recognition under HKAS 16.

HKAS 8.17 considers an initial application of a policy to revalue assets in accordance with HKAS 16 is a ***change in an accounting policy*** and requires this to be dealt with as a revaluation in accordance with HKAS 16, i.e. prospective application.

Answer 3(c)

HKAS 20.10A requires that the benefit of a government loan at a below-market rate of interest is treated as a government grant.

The loan shall be recognised and measured in accordance with HKAS 39. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with HKAS 39 and the proceeds received.

The benefit is accounted for in accordance with HKAS 20.

This accounting treatment was newly required for the accounting period beginning on or after 1 January 2009 and shall be applied prospectively in accordance with HKAS 20.43.

Under HKAS 8.19 (a), an entity shall account for a change in accounting policy resulting from the initial application of a HKFRS in accordance with the specific transitional provisions, if any, in that HKFRS.

Accordingly, no retrospective application of the new accounting requirement for Loan A is required.

Answer 3(d)

Change in the useful lives of depreciable assets is considered as a change in accounting estimate.

Under HKAS 8.36, the effect of a change in an accounting estimate shall be recognised prospectively by including it in profit or loss in the period of the change and future periods, if the change affects both.

Answer 3(e)

The understatement of the closing inventory balance as at 30 June 2009 is considered as an error.

Under HKAS 8.42, if the error is considered material, the entity shall correct the error retrospectively in the financial statements by restating the comparative amounts, i.e. the statement of financial position as at 30 June 2009 and the statement of comprehensive income for the year then ended.

Answer 4(a)

1. The RMB10 million debenture with the contractual terms gives rise on specified dates to cash flow that are solely, payments of principal (i.e. 30 September 2013) and interest on the principal amount outstanding (i.e. payable semi-annually), (HKFRS 9 para. 4.1.2(a)).

   Providing that the investment is held by Company J within a business model whose objective is to hold the investment in order to collect contractual cash flows (HKFRS 9 para. 4.1.2(b)), the debenture shall be measured at amortised costs under HKFRS 9 para. 4.1.2. Otherwise, the debenture is measured at fair value under HKFRS 9 para. 4.1.4.

   As the debenture is denominated in RMB, which is different to the functional currency of Company J, it is considered as a foreign currency monetary asset, which is reported at the end of each reporting period at closing rate. The exchange difference arising on such translation is recognised in profit or loss.

2. The semi-annual coupons of the equity linked deposit are indexed to the performance of a basket of listed securities, they are not a consideration for the time value of money and for credit risk associated with the principal amount outstanding.

   Accordingly, the contractual cash flows are not solely payment of principal and interest thereon, the RMB8 million equity linked deposit shall not be measured at amortised cost, but at fair value under HKFRS 9 para. 4.1.4.

   The gain or loss arising from the fair value change shall be recognised in profit or loss.

3. Ordinary shares of Company Y are not a financial asset with contractual terms which give rise on specific dates to cash flows that are solely payments of principal amount and interest on the principal amount outstanding.

   The investment shall be measured at fair value under HKFRS 9 para. 4.1.4.

   The gain or loss arising from the fair value change shall be recognised in profit or loss unless Company J has elected to present gains or losses on that investment in other comprehensive income providing that the investment in the equity instruments is not held for trading in accordance with HKFRS 9 para. 5.7.1(b).

Answer 4(b)

A refundable deposit to a supplier for steel purchase is considered as a financial asset as the holder has the contractual right to obtain a refund of cash under HKAS 32.11(c)(i).

A prepayment for steel supply with physical delivery is not considered as a financial asset as the holder does not have the contractual right to receive cash or other financial assets from the supplier or to exchange financial assets or financial liabilities with another entity under conditions that are potential favourable to the entity.

Answer 5

Mr. Kong's behaviour is unethical.

As a professional accountant, he shall comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior as set out in section 100.5 of the Code of Ethics for Professional Accountants (the "Code").

A professional accountant in business is expected to encourage an ethics-based culture in an employing organization that emphasizes the importance that senior management places on ethical behavior (300.5 of the Code).

A professional accountant in business shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles (300.6 of the Code).

A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organisation shall be satisfied that those financial statements are presented in accordance with the applicable financial reporting standards.

Ms. Yuen has been threatened to not comply with fundamental principles of the Code as she is pressured to become associated with fraudulent transactions and misleading information.

Safeguards shall be applied to eliminate the threats, such as consultation with superiors within the employing organisation, the audit committee or those charged with governance of the organisation or with a relevant professional body.

In circumstances where Ms. Yuen believes that unethical behaviour or actions by Mr. Kong will continue to occur within the company, she may consider obtaining legal advice.

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. Yuen shall refuse to be or remain associated with information she determines is misleading and may conclude that it is appropriate to resign from the company (300.15 of the Code).

* * * END OF EXAMINATION PAPER * * *