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. Ricky Cheung, the accounting manager of Pacific Limited ("PCF"). PCF is a conglomerate listed on the Stock Exchange of Hong Kong with many subsidiaries. PCF acquired the equity interest in Sanata Limited ("SNT") by two successive purchases with details as follows:

Date	Acquisition cost paid HK$	Fair value of SNT as an entity HK$	% acquired
1 April 2009	6,000,000	24,000,000	25%
31 March 2010	26,000,000	40,000,000	65%

The financial year of both PCF and SNT ends on 31 March. The fair value of non-controlling interests is measured as a proportionate interest in the fair value of the subsidiary as an entity. Information relating to SNT is as follows:

	1 April 2009 Book value HK$	1 April 2009 Fair value HK$	31 March 2010 Book value HK$	31 March 2010 Fair value HK$
Intangibles	--	3,600,000	--	3,200,000
Inventory	2,000,000	2,400,000	4,000,000	4,800,000
Other net assets	18,000,000	18,000,000*	24,000,000	24,000,000*
Net identifiable assets	20,000,000	24,000,000*	28,000,000	32,000,000*
Share capital	8,000,000		8,000,000	
Retained earnings	12,000,000		20,000,000	
	20,000,000		28,000,000	

* The fair value of other net assets and net identifiable assets are stated before considering the impact of deferred tax. Following the business combination, the tax bases of the assets and liabilities of SNT remain unchanged.

The net profit of SNT for the year ended 31 March 2010 was HK$8,000,000. The intangibles of SNT had a remaining useful life of 6 years from 1 April 2009 and all inventories were sold within 2 months from the year-end. Both PCF and SNT did not declare any dividends during the year ended 31 March 2010. The accounting policy of PCF is to account for the investment in associates at cost in its separate financial statements.

Customer loyalty programme

SNT is a regional chain of convenience stores. It operates a customer loyalty programme and it grants programme members loyalty points when they spend a specified amount on foodstuffs. Programme members can redeem the points for further foodstuffs. The points have no expiry date. Before 1 April 2008, the entity granted 200,000 points. Management expected 180,000 of these points to be redeemed. Management estimated the fair value of each loyalty point to be HK$1.

During the year ended 31 March 2009, 81,000 of the points were redeemed in exchange for foodstuffs. In the year ended 31 March 2010, management revised its expectations. It expected 190,000 points to be redeemed altogether. During the year, 90,000 points were redeemed.

You have prepared the draft consolidated financial statements of PCF for the year ended 31 March 2010. After you sent these draft consolidated financial statements to PCF's directors for review, one of the directors, who is not a certified public accountant, sent you an e-mail as follows:

To: Ricky Cheung, Accounting Manager, PCF
From: Emily Chen (Director)
c.c.: David Ip, Susan Tse, Richard Chung (Directors)
Date: 18 May 2010

Consolidated financial statements of PCF as at 31 March 2010

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

(A) I find that there is an item called "gain on step acquisition" in the consolidated financial statements. You told me that it is somewhat related to the remeasurement of the previously held equity interest in SNT at its acquisition-date fair value. What is it all about?

(B) I find that there are intangibles in the consolidated financial statements that I cannot find in the financial statements of PCF and SNT.

(C) It seems to me that goodwill is the difference between the amount that I paid and the value that I obtained from the investment. However, I cannot obtain the goodwill figure that you computed in the consolidated financial statements.

(D) I know that there will be tax-effect entries for fair value adjustments. However, why is this tax effect affecting the value of the goodwill?

(E) I find that portion of the revenue from the sales of foodstuffs by SNT has not been recognised in the same period as the sales are made. You told me that it is due to the customer loyalty programme. What is it all about?

I would appreciate your clarification for the upcoming board meeting.

Best regards,
Emily

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

Required:

Assume that you are the accounting manager, and you are required to draft a memorandum to Ms. Chen, a Director of PCF. In your memorandum, you should:

(a) **discuss and calculate the effect of the business combination, at 31 March 2010, on the 25% equity interests in SNT held by PCF in the separate financial statements of PCF and at consolidated level (ignore taxation);**

(14 marks)

(b) **discuss the rationale for the recognition of the intangibles in the consolidated financial statements that are not recognised in the financial statements of SNT;**

(10 marks)

(c) **calculate the amount of goodwill as at 31 March 2010 if deferred tax implications are ignored;**

(5 marks)

(d) **discuss the rationale and calculate the effect on goodwill if deferred tax implications follow from recognising the difference between the fair values and book values of the identifiable net assets is taken into consideration (assuming a tax rate of 16%); and**

(10 marks)

(e) **discuss and calculate the amount of revenue in relation to 200,000 loyalty points, granted before 1 April 2008, to be recognised for the year ended 31 March 2009 and 31 March 2010.**

(11 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 2</u> (10 marks – approximately 18 minutes)

(a) **Mr. K Chow is a member of the Hong Kong Institute of Certified Public Accountants ("HKICPA"). His brother, Mr. V Chow, is also a member of HKICPA and acts as an independent non-executive director and the chairman of the audit committee of a company listed on the Stock Exchange of Hong Kong Limited. For the audit committee meeting to be held next week, Mr. V Chow received a copy of draft audited annual financial statements for the year ended 30 June 2009 (the "Accounts") which reported a significant increase in profit. They discussed the company's financial performance and position with reference to the information shown in the Accounts. Mr. K Chow acquired shares in the company on the following day.**

<u>Required:</u>

Discuss the appropriateness of behaviours of both Mr. K Chow and his brother, Mr. V Chow in the context of Code of Ethics for Professional Accountants of HKICPA.

(5 marks)

(b) **"No goodwill is recognised in the financial statements prepared under merger accounting for business combination under common control. However, goodwill can still appear in the consolidated financial statements after applying merger accounting for business combination under common control." Discuss.**

(5 marks)

<u>Question 3</u> **(13 marks – approximately 23 minutes)**

Silver Coin Holdings Limited reported the following information in relation to the results and equity structure for each of the years ended 30 June 2008 and 2009:

Year ended 30 June	**2008**	**2009**
Profit for the year (before interest expense)	HK$32,800,000	HK$8,000,000
Equity structure:		
Ordinary shares, HK$1 par ("OS")	220,000,000	228,500,000
Redeemable, convertible preference shares, HK$10 par ("PS") issued on 1 July 2007	3,000,000	2,000,000
Cumulative annual dividend of HK$0.3 per share		
Convertible into eight ordinary shares per preference share		
Outstanding share options	1,000,000	1,000,000
Average market price of one ordinary share during the year	HK$1.8	HK$1.65

The PS were issued at par, which represented the then market price on the date of issue. 1,000,000 PS were converted into OS on 1 January 2009. 500,000 ordinary shares were issued to new investors at HK$1.4 per share on 1 October 2008. No dividend was declared by the company during the year ended 30 June 2008, HK$0.45 dividend was declared to PS holders on 31 December 2008.

All 1,000,000 share options, with exercise price for one ordinary share at HK$1.5 per option, were granted to employees on 1 July 2006. Each grant is conditional upon the employee working for the company over two years.

The company did not have other borrowings outstanding during both two years ended 30 June 2009.

<u>Required:</u>

(a) Calculate the basic earnings per share for each of the years ended 30 June 2008 and 2009.

(7 marks)

(b) Calculate the diluted earnings per share for the year ended 30 June 2009.

(6 marks)

(Note: Tax effect is ignored and a reasonable approximation of the weighted average number of shares by the number of months that the shares are outstanding as a proportion of the total months in a year is adequate.)

Question 4 **(15 marks – approximately 27 minutes)**

Howard Development Limited ("HDL") has financial difficulties and successfully renegotiated the contractual terms of a bank loan of principal HK$200 million on 30 June 2009, the date of the statement of financial position:

	Original	Modified
Term of interest	8 per cent payable yearly in arrears	6 per cent payable yearly in arrears since 1 July 2009
Date of repayment	30 June 2010	30 June 2013

The original effective interest rate is 8 per cent. No fees for renegotiating the finance are payable.

The holders of 100 units of HK$1 million, 4 per cent convertible bonds (the "Bonds") of HDL have agreed to convert the Bonds into 250 million ordinary shares of HK$0.1 par on 30 June 2009 and waive the payment of interest. Each unit of the Bonds was originally convertible into 2 million ordinary shares and with a maturity date of 30 June 2010. Interest is payable yearly in arrears.

The carrying amount of the Bonds as at 30 June 2009 is as followings:

	HK$
Current liabilities:	
The Bonds (effective interest rate: 8 per cent)	96,296,296
Bonds interest payable	4,000,000
Equity:	
Convertible bonds equity reserve	7,133,058

The market price of the ordinary shares of HDL on 30 June 2009 was HK$0.45.

Required:

(a) **Discuss the accounting treatment for HDL in relation to the modification of the terms of the bank loan.**

(8 marks)

(b) **Prepare the journal entries that HDL should make on 30 June 2009 in relation to the conversion of the Bonds.**

(7 marks)

<u>Question 5</u> (12 marks – approximately 22 minutes)

Super Shoes Limited ("SS") is the holding company of Rocket Running Limited ("RR") and Soft Walking Limited ("SW"). At the board meeting of SS on 30 June 2009, the management decided to dispose of all the assets of RR to an independent third party and close down the retailing operation of SW by the end of October 2009. The assets of RR and SW as at 30 June 2009 are measured at the consolidated financial statements before classification as held for sale and / or adjustment for impairment as a result of sales / closure of operation, if applicable, as follows:

	RR	SW
	HK$'000	HK$'000
Goodwill	2,400	2,700
Intangible assets	12,500	-
Property, plant and equipment	48,300	18,800
Inventories	16,600	6,400
Trade receivables	4,500	1,300
Held for trading equity investments	8,000	-
TOTAL	**92,300**	**29,200**

Taking into consideration the range of the price offered by the potential buyer, the management estimates that the fair value less costs to sell the group of assets of RR amounts to HK$85,000,000.

Almost all of the property, plant and equipment of SW are leasehold improvement of retailing shops located at premises rented under operating leases which would be abandoned upon the early termination of the lease terms. No proceeds are expected to be received even upon disposal. SW would continue to sell its inventories but at an estimate discount of 40% of the cost. The trade receivables are expected to be fully recovered.

<u>Required:</u>

Explain and calculate the impairment loss to be made to each of the assets of RR and SW.

(12 marks)

* * * END OF EXAMINATION PAPER * * *