<u>SECTION A – CASE QUESTIONS</u> (Total: 50 marks)

To : Ms. Tess Chow, Director of PHL
From : Karen Lam, Accounting Manager
Date : dd/mm/yyyy
Subject : Goodwill and net cash flows on acquisition of SPC, share based payment, leased machinery and consolidated statement of cash flows of PHL.

I refer to your queries regarding the note showing the calculation of goodwill and net cash flows on acquisition of SPC, the share based payment, the leased machinery and the consolidated statement of cash flows of PHL.

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

HKAS 7.39 requires that the aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses units shall be presented separately and classified as investing activities.

Therefore PHL should disclose, in aggregate, in respect of obtaining control of SPC as a subsidiary during the year each of the following:

(a) the total consideration paid;
(b) the portion of the consideration consisting of cash and cash equivalents;
(c) the amount of cash and cash equivalents in the subsidiaries over which control is obtained; and
(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries over which control is obtained, summarised by each major category (HKAS 7.40).

<u>Obtaining control of subsidiary</u>

During the year, the Group obtained control of subsidiary SPC. The fair values of assets acquired and liabilities assumed were as follows:

	$'000	$'000
<u>Fair value of identifiable net assets acquired</u>		
Machinery	7,920	
Inventory	1,536	
Accounts receivable	1,344	
Cash and cash equivalent	5,376	
Accounts payable	(3,264)	
Taxation payable	(816)	12,096
Add: Goodwill on acquisition		6,256
Less: Fair value of NCI		(2,880)
Total consideration		15,472
Non-cash consideration		(13,200)
Cash consideration		2,272
Cash and cash equivalent acquired		*(5,376)*
Net cash (inflow) on acquisition of a subsidiary		*(3,104)*

Answer 1(b)

Accounting for share based payment (SBP) transaction is governed by HKFRS 2.

SDL, being the entity receiving the services of its top executives, shall measure the services received as either an equity-settled or a cash settled SBP transaction by assessing:

(i) the nature of the awards granted, and
(ii) its own rights and obligations (para. 43A)

Since the awards are granted by its parent and there is no indication that SDL has an obligation to settle, SDL shall measure the services received as an equity-settled SBP transaction (para. 43B).

SDL shall subsequently re-measure such SBP transaction only for changes in non-market vesting conditions.

PHL, being the entity settling a SBP transaction when another entity (SDL) in the group receives the services, shall recognise the transaction as an equity-settled SBP transaction as it is settled in its own equity instruments (para. 43C).

From the consolidated group's perspective, the group receives services as consideration for its own equity instrument; therefore, it should be accounted for as an equity-settled SBP transaction.

In SDL's books

		$	$
Dr	Staff cost ($0.5 x 1,000,000 x 1/4)	125,000	
	Cr Equity / contribution from PHL		125,000

In PHL's books

		$	$
Dr	Investment in SDL ($0.5 x 1,000,000 x 1/4)	125,000	
	Cr Other reserves (equity) – ESOP		125,000

In consolidated financial statements of PHL

		$	$
Dr	Equity – contribution from PHL	125,000	
	Cr Investment in SDL		125,000

As a result, in the group's consolidated financial statements:

1. The staff cost will increase by $125,000
2. Other reserves (equity) – ESOP will increase by $125,000

The net effect is similar to the case where PHL issues its own equity instruments to its own employees under HKFRS 2.

Answer 1(c)(i)

Since the title to the machinery will pass to PHL (the lessee) and the present value of the minimum lease payments ($487,805 x 4.100 *approximates to $2,000,000)* amounts to substantially all of the fair value of the leased machinery, it is a finance lease to PHL (the lessee).

PHL should record both the asset and an obligation under finance lease at the present value of the leased machinery (i.e. $2,000,000).

Lease Amortisation Schedule (Lessee)

Date	(7%) Interest on Lease Liability	Annual Lease Payment	Lease Liability Recovery	Lease Liability
1 January 2011				$2,000,000
31 December 2011	$140,000	$487,805	$347,805	$1,652,195
31 December 2012	$115,654	$487,805	$372,151	$1,280,044

Answer 1(c)(ii)

The relevant journal entries for PHL (lessee) for the lease for the first two years (up to 31 December 2012) are as follows:

		$	$
1 January 2011			
Dr	Leased Machinery	2,000,000	
	Cr Obligation under finance lease		2,000,000
31 December 2011			
Dr	Interest expense	140,000	
Dr	Obligation under finance lease	347,805	
	Cr Cash		487,805
Dr	Depreciation	250,000	
	Cr Accumulated depreciation		250,000
31 December 2012			
Dr	Interest expense	115,654	
Dr	Obligation under finance lease	372,151	
	Cr Cash		487,805
Dr	Depreciation	250,000	
	Cr Accumulated depreciation		250,000

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

Best regards,
Karen Lam

Answer 1(d)

Consolidated statement of cash flows of PHL for the year ended 31 December 2012

Cash flows from operating activities	$'000	$'000
Profit before taxation		110,400
Adjustment for:		
Depreciation (W1)	19,320	
Gain on disposal of PPE	(6,000)	
Share of profit from associates	(21,000)	
Dividends from long-term investments	(9,300)	
Interest expense	9,000	
Increase in inventory (118,500 – 60,000 – 1,536)	(56,964)	
Increase in accounts receivable (111,000 – 76,500 – 1,344)	(33,156)	
Increase in accounts payable (44,002 – 28,428 – 3,264)	12,310	(85,790)
Cash generated from operations		*24,610*
Interest paid (opening 1,800 + P/L 9,000 – closing 2,400)		(8,400)
Tax paid (opening 13,800 + 29,700 – 29,520 + 816)		(14,796)
Net cash from operating activities		*1,414*
Cash flows from investing activities		
Proceeds from disposal of machinery	30,000	
Purchase of machinery (W1)	(116,080)	
Dividend received	9,300	
Dividend received from associates (opening 60,000 + P/L 21,000 – closing 66,000)	15,000	
Net cash inflow on acquisition of a subsidiary	3,104	
Net cash used in investing activities		*(58,676)*
Cash flows from financing activities		
Proceeds from issue of ordinary shares (W2)	150,480	
Proceeds from bank borrowings (129,318 – 38,920)	90,398	
Payments under finance lease (W3)	(372)	
Dividend paid to non-controlling interests (W4)	(1,980)	
Dividend paid (opening 150,000 + P/L 74,700 – 206,700)	(18,000)	
Net cash from financing activities		220,526
Net increase in cash and cash equivalents		163,264
Cash and cash equivalents at beginning of the year		109,200
Cash and cash equivalents at end of the year		272,464

All figures in $000

(W1) Depreciation of building and machinery and purchase of machinery

Building at NBV
Opening 132,000 → closing 122,680, thus depreciation for building = **9,320**

Machinery	Cost	Acc. depreciation
	$'000	$'000
b/f	84,000	66,000
Disposal	(28,000)	(4,000)
From new subsidiary	7,920	
Addition by cash	***116,080***	
Depreciation		***10,000***
c/f	180,000	72,000

Total Depreciation = 9,320 + 10,000 = 19,320

(W2) Proceeds from issue of ordinary shares

	Share capital
	$'000
b/f	185,700
For acquisition	13,200
Addition by cash	***150,480***
c/f	349,380

(W3) Payments under finance lease

	$'000	
b/f	1,652	(non-current 1,280 + current 372)
Capital repayment to lessor under finance lease	***(372)***	
c/f	1,280	(non-current 882 + current 398)

(W4) Dividend paid to non-controlling interests (NCI)

	$'000
b/f	20,000
Income to NCI	6,000
FV of NCI of new subsidiary	2,880
Dividend paid to NCI	***(1,980)***
c/f	26,900

* * * END OF SECTION A * * *

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

Answer 2(a)

Net realisable value of inventories is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Assessment of impairment of property, plant and equipment involves comparing the carrying amount of the asset with its recoverable amount, which is the higher of its fair value less costs of disposal and its value in use.

Fair value less costs of disposal is the amount obtainable from the sale of an asset or cash generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Answer 2(b)

The Final Order provides indicator that only 500,000 units would be sold at a price above the unit cost.

If there is no possible way to sell them to other customers, the net realisable value of the remaining 300,000 units will be nil, a write down of inventories up to $3,600,000 (300,000 x $12) would be recognised.

And the inventories of the finished goods, after write down the inventories, will be carried at $6,000,000 as at 31 October 2013.

For raw material purchased for the production of this model and work in progress under production, net realisable value is assessed with consideration of alternative use and their estimated selling price.

For the moulds used to produce the item concerned, a total of 10 months depreciation of $250,000 has been recognised and the carrying amount as at 31 October 2013 is $200,000.

The Final Order provides indicators that there would be no more new sales of the items and therefore the mould should be subject to impairment testing.

Value in use is considered nil and the recoverable amount should be determined based on fair value less costs to sell. Given the estimated selling price of scrap metal is $10,000, an impairment of $190,000 will be recognised.

Answer 3(a)

On 15 October 2013:

			$'000	$'000
Dr	Bank		1,200	
	Cr	Sales deposit *(12 trucks x $50,000 + 20 trucks x $30,000)*		1,200

On 30 November 2013:

			$'000	$'000
Dr	Bank *(12 trucks x $400,000 + 20 trucks x $6,000)*		4,920	
Dr	Sales deposit		1,200	
Dr	Trade receivable *(20 trucks x ($450,000 – $30,000))*		8,400	
	Cr	Sales *(12 trucks + 20 trucks) x $450,000*		14,400
	Cr	Other revenue (commission income) *($6,000 –$ 5,500) x 20 trucks*		10
	Cr	Bank - Paid to insurance company *($5,500 x 20 trucks)*		110

On 31 December 2013:

			$'000	$'000
Dr	Bank *(20 trucks x $20,000)*		400	
	Cr	Trade receivable		400
Dr	Trade receivable		91	
	Cr	Interest income ($8,400,000 x 13%/12)		91

Answer 3(b)

HKAS18 states that in an agency relationship, an entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services.

The features of the contractual arrangement between YCL and BT which would indicate that YCL is acting as a principal and BT is acting as an agent of YCL include:

- YCL has the primary responsibility for fulfilling the order and providing the trucks to the customer and YCL is the final decision maker as to whether to accept an order for the trucks by the customers solicited by BT;

- YCL has inventory risk before or after the customer order, during shipping or on return. For instance, trucks are just consigned to BT, or trucks are sold to BT subject to return, or all trucks will be delivered to BT upon confirmation of the order from the final customer or delivered to the customer by YCL directly;

- YCL has latitude in establishing the selling prices of the trucks, either directly or indirectly. For instance YCL can provide a standard price list or payment plans for BT to follow, any discount to be offered by BT to customers is subject to the approval of YCL or the pre-determined range agreed by YCL; and

- YCL bears the customer's credit risk for the amount receivable from the customer. For instance, BT can be responsible for the collection of payment and/or chasing the settlement from the customer but not for the uncollected amount.

In terms of the remuneration or share of profit for the services to be provided by BT, one feature indicating that BT is acting as an agent is that the amount BT earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

Answer 4(a)

Investment in the equity shares of LP and PMI shall be measured at fair value:

They are not a financial asset with contractual terms which give rise on specific dates to cash flows that are sole payments of principal amount and interest on the principal amount outstanding.

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

Being an unquoted equity investment, cost may be an appropriate estimate of fair value of investment in PMI, this may be the case if sufficient more recent information is not available to determine fair value, or if there is a wide range of possible fair value measurement and cost represents the best estimate of fair value within that range.

Investment in the equity instrument of MVC is considered as an investment in an associate as ZIL holds more than 20 per cent of the voting power of MVC and has representation on the board of directors of MVC and therefore is able to participate in policy-making processes.

Investment in MVC will be accounted for under equity method, i.e. initially recognised at cost and the carrying amount is increased or decreased to recognise ZIL's share of the profit or loss of MVC after the date of acquisition. ZIL's share of the profit or loss of MVC is recognised in ZIL's profit or loss. Distributions received from MVC reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in ZIL's proportionate interest in MVC arising from changes in MVC's other comprehensive income.

The loan to GE is on contractual terms that give rise on specified dates to cash flow is solely payment of principal and the interest on the principal amount outstanding.

Providing that the loan to GE held by ZIL within a business model whose objective is to hold the investment in order to collect contractual cash flows, the loan to GE shall be measured at amortised cost. Otherwise they are measured at fair value.

The equity investments in LP and PMI will be presented as a non-current asset unless it is expected to be realized within twelve months of the reporting period and it should be presented as a current asset.

The investments in associate, MVC, will be presented as a non-current asset.

The loan to GE with a repayment date after twelve months of the reporting period will be presented as a non-current asset.

Answer 4(b)

For the equity investment in LP, it is expected that the fair value is measured with level 1 input, i.e. quoted prices (unadjusted) in active markets for identical assets that ZIL can access at the measurement date.

For the equity investment in PMI, as it is unquoted, it is expected that the fair value is measured with unobservable input,

i.e. level 3, or even with observable input, it requires adjustment using an unobservable input and if that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would still be categorised within level 3 of the fair value.

* * * END OF EXAMINATION PAPER * * *