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 Miss Karen Lam, the accounting manager of Proper Holdings Limited (PHL), which is a company incorporated in Hong Kong. PHL had a partially-owned subsidiary, Sunderland Limited (SDL), and an 25% associate, Assorted Limited (ASL), for many years.

On 1 January 2012, PHL acquired an 85% interest in Supercar Limited ("SPC") by issuing 10,560,000 ordinary shares (with a fair value of $13,200,000) and paying $2,272,000 in cash. The fair value of non-controlling interests at the date of acquisition was $2,880,000. There is no impairment of goodwill since the date of acquisition of SPC. PHL classifies cash received from investment income under the category of investing activities.

Fair value of the net identifiable assets of SPC as at the acquisition date is as follows:-

	$'000
Non-current asset	
Machinery	7,920
Current assets	
Inventory	1,536
Accounts receivable	1,344
Cash and cash equivalent	5,376
Current liabilities	
Accounts payable	3,264
Tax payable	816

The draft consolidated financial statements for PHL are as follows:

Draft consolidated statement of profit or loss and other comprehensive income of PHL for the year ended 31 December 2012

	$'000
Operating profit	89,100
Dividends from long-term investments	9,300
Interest expense	(9,000)
Share of profit from associates	21,000
Profit before taxation	*110,400*
Taxation	(29,700)
Profit for the year and total comprehensive income	80,700
Profit for the year and total comprehensive income attributable to:	
Owners of PHL	74,700
Non-controlling interests	6,000
	80,700

Draft consolidated statements of financial position of PHL as at 31 December

		2012		2011
		$'000		$'000
ASSETS				
Non-current assets				
Goodwill		6,256		
Investments in associates		66,000		60,000
Buildings at net book value		122,680		132,000
Machinery at cost	180,000		84,000	
Less: Accumulated depreciation	(72,000)	108,000	(66,000)	18,000
Financial assets measured at fair value through other comprehensive income		24,600		24,600
Current assets				
Inventory		118,500		60,000
Accounts receivable		111,000		76,500
Cash and cash equivalents		272,464		109,200
		829,500		480,300
EQUITY AND LIABILITIES				
Share capital		349,380		185,700
Other reserves		40,000		40,000
Retained earnings		206,700		150,000
		596,080		375,700
Non-controlling interests		26,900		20,000
		622,980		395,700
Non-current liabilities				
Obligation under finance lease		882		1,280
Bank borrowings		129,318		38,920
Current liabilities				
Accounts payable		44,002		28,428
Obligation under finance lease		398		372
Tax payable		29,520		13,800
Accrued interest		2,400		1,800
		829,500		480,300

Non-current assets

There have been no acquisitions or disposals of buildings during the year ended 31 December 2012. During the year, machinery with an original cost of $28 million was sold for $30 million resulting in a gain of $6 million. The gain on the disposal was included in the operating profit and there was a new machinery acquired in 2012.

Leased machinery

On 1 January, 2011, PHL leased a machinery under a five-year non-cancellable lease agreement. Equal annual payments of $487,805 that are due on 31 December each year provide the lessor with a 7% return on net investment. Titles to the machinery will pass to PHL at the end of the lease. The fair value of the machinery is $2,000,000 and the expected useful life is 8 years. The present value factor for an annuity for 5 periods discounted at 7% is 4.100.

Share - based payment

On 1 November 2011, PHL approved a plan that granted the top executive of its subsidiary, SDL, options to purchase a total of 1,000,000 shares of PHL's ordinary shares at $1.25 per share. The options were granted on 1 January 2012, vested on 31 December 2015, and may be exercised from 1 January 2016 to 31 December 2017. Using the Black-Scholes model, the fair value of each option was estimated at $0.50.

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

Assume that you are Karen Lam, the accounting manager, and you are required to draft a memorandum to Ms. Tess Chow, a Director of PHL. In your memorandum, you should:

(a) **Briefly describe the disclosure requirement under HKAS 7 relating to the acquisition of a subsidiary and prepare a disclosure note to the consolidated financial statements on the net cash flows in the acquisition of SPC as a subsidiary.**

(6 marks)

(b) **Advise the appropriate accounting treatment, with journal entries, for the share-based payment made by PHL in the individual financial statements of SDL and PHL, and in the consolidated financial statements of PHL for the year ended 31 December 2012.** *(The correct entries have already been made in the draft consolidated financial statements as presented).*

(10 marks)

(c) **In relation to the leased machinery of PHL, for the first two years (up to 31 December 2012) (Round to nearest dollar):**

(i) **advise PHL (lessee) as to the appropriate accounting treatment for the lease and calculate the outstanding lease liabilities; and**

(ii) **prepare the relevant journal entries for PHL (lessee) of the lease.**

(13 marks)

(d) **Prepare an annex to your memorandum showing the consolidated statement of cash flows of PHL for the year ended 31 December 2012, using the indirect method starting with profit before taxation.**

(21 marks)

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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 **(12 marks – approximately 22 minutes)**

Xelon Company Limited (XCL) is a tablet PC accessories manufacturing company which produces the finished goods in accordance with the indicated but not committed order quantities provided by customers on a quarterly basis. The selling price is pre-determined together with the quarterly order sheet.

At 31 October 2013, XCL had 800,000 units of finished goods of a particular model on hand at a weighted average cost per unit of $12. The customer advised XCL on the same date that a new series of tablet PC with a different size would be introduced by Q1 2014 and therefore, it would only take up another 500,000 units of the existing model at $14 per unit before discontinuance of the model (the Final Order).

The manufacture of the tablet PC accessories involves usage of specialised moulds developed internally and cannot be used for other models. For the model mentioned, XCL capitalised the mould production costs of $450,000 and depreciates the cost over the estimated useful life of 18 months commenced from January 2013. Estimated selling price of the moulds as scrap metal is $10,000.

Apart from the finished goods, XCL also has certain raw material purchased for the production of this model and work in progress under production in the warehouse.

Required:

(a) Discuss the differences between the measurement of net realizable value of inventories and impairment assessment of property, plant and equipment.
(4 marks)

(b) Advise XCL regarding the impact of the customer's Final Order on the carrying amount of (i) inventories; and (ii) moulds, as at 31 October 2013.
(8 marks)

Question 3 **(20 marks – approximately 36 minutes)**

Yammy Company Limited (YCL) is the sole distributor of Kammer trucks in Asia. The trucks are manufactured in Europe and shipment is made monthly to Hong Kong based on the purchase orders placed by YCL to Kammer. YCL offers its customers buying truck model 6.0 the following payment plans:

Plan I: an initial deposit of $50,000 upon signing the provisional sales order, and $400,000 upon delivery of the truck.

Plan II: an initial deposit of $30,000 upon signing the provisional sales order and 24 monthly instalments of $20,000 each in arrears commenced from the date of delivery of the truck.

A customer choosing Plan II is required to enter into an insurance contract for 2 years at a pre-paid premium of $6,000 per truck with Grant Insurance Inc. (GCC), an independent insurance company, which takes full obligation of the insurance arrangement. The customer pays the full insurance premium to YCL upon collection of the truck and YCL pays $5,500 to GCC on the same date.

Sales orders of 12 trucks under Plan I and 20 trucks under Plan II were signed on 15 October 2013. The trucks were delivered to customers on 30 November 2013.

Required:

(a) **Prepare the journal entries to be entered in October, November and December 2013 for these two sales transactions. The effective interest rate is estimated to be 13%.**

(12 marks)

(b) YCL is planning to expand its business to Guangzhou in co-operation with Best Trade Vehicle Limited (BT), a local car dealer. **Discuss the factors for consideration in the contractual arrangement with BT so that BT will only act as an agent of YCL in selling the trucks.**

(8 marks)

Question 4 **(18 marks – approximately 32 minutes)**

Zegard Investment Limited (ZIL) has a portfolio of investments at 30 June 2013 with costs as follows:

	$ million
3,000,000 ordinary shares of Long Pont Limited (LP), a company listed on London Stock Exchange, which represent less than 1% of the total number of issued shares of LP.	9.0
400 ordinary shares of Printon Medical Inc. (PMI), a privately owned entity, which accounted for 10% equity interest in PMI.	8.0
6 million shares of Micro Vision Company (MVC), a privately owned entity, with total number of issued shares of 14 million. ZIL can appoint three out of eight directors to the board of MVC.	12.0
A loan lent to Goldstan Enterprise (GE) on 1 January 2013, carried interest at HIBOR plus 4% payable in arrears at the anniversary date of the lending, repayable on 31 December 2016. The rate of HIBOR is determined at 1 January of each annual period.	15.0

Required:

(a) **Explain the appropriate accounting treatment (including classification between current and non-current presentation) for the above investments in the consolidated statement of financial position of ZIL as at 30 June 2013 in accordance with HKFRS 9 *Financial Instruments* and other applicable standards.**

(14 marks)

(b) **For those investments which will be subsequently measured at fair value after acquisition, identify the appropriate level of fair value hierarchy under HKFRS 13 *Fair Value Measurement.***

(4 marks)

* * * END OF EXAMINATION PAPER * * *