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

To: Ms. Chen, Director of PCF
From: Ricky Cheung, Accounting Manager, PCF
c.c.: David Ip, Susan Tse, Richard Chung (Directors)
Date: dd/mm/yyyy
Subject: Report on business combination

I refer to your e-mail dated 18 May 2010 regarding your queries about the draft consolidated financial statements for PCF as at 31 March 2010.

Answer 1(a)

Effect of business combination on the 25% equity interest in SNT

On 1 April 2009, PCF acquired the 25% equity interest in SNT at a cost of $6,000,000. Thus the investment in SNT would be stated initially at cost, i.e. $6,000,000.

On 31 March 2010, PCF obtained control of SNT in which it held an equity interest immediately before the acquisition date.

HKFRS 3 (Revised) *Business Combination* refers to such a transaction as a "business combination achieved in stages", sometimes also referred to as a "step acquisition".

In accordance with paragraph 42 of HKFRS 3 (Revised), in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit and loss.

On consolidation, PCF should then remeasure this 25% equity interest at its acquisition-date fair value and recognise the resulting gain or loss in profit and loss.

Business combination should not have any effect at the level of separate financial statements. The investment in SNT should simply be accounted for at cost in the separate financial statements of PCF, i.e. $6,000,000 + $26,000,000 = $32,000,000.

Gain on step acquisition at consolidation level

Since PCF had a 25% equity interest in SNT during the year ended 31 March 2010, PCF had significant influence over SNT and thus PCF had to account for SNT's profit for the year ended 31 March 2010 using the equity method at consolidation level (HKAS 28 *Investments in Associates*):

	$
Net profit of SNT for the year ended 31 March 2010	8,000,000
Less: amortisation of intangibles ($3.6m / 6 years)	(600,000)
Less: cost of sales from revalued inventory	(400,000)
Adjusted net profit for SNT	7,000,000

The carrying amount of the previously held equity interests at consolidated level would be equal to:

	$
The original acquisition cost for the 25% interest	6,000,000
Plus: share of profit after acquisition (**25%** x $7,000,000)	1,750,000
The carrying amount of previously held interests at consolidated level	7,750,000

Gain on step acquisition on previously held interest at consolidated level would be equal to:

	$
The remeasured acquisition-date fair value of the 25% equity interest (25% x $40,000,000)	10,000,000
Less: carrying amount of the 25% equity interest at consolidated level	(7,750,000)
Thus, gain on step acquisition at consolidated level would be	2,250,000

Answer 1(b)

Recognition of intangibles

The recognition principle under HKFRS 3 (Revised) states that "as of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree".

Accordingly, the acquirer should recognise an acquiree's intangible assets separately from goodwill, if the recognition criteria are met, i.e.:

- to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements* at the acquisition date.

- in addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions.

Paragraph 13 of HKFRS 3 (Revised) states that "the acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements".

For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion.

- An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

- The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability.

An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability.

Since goodwill is a payment for anticipated benefits that are not capable of being individually identified and separately recognised, it is inappropriate for an identifiable intangible asset to be subsumed in goodwill.

Thus an acquirer should recognise an intangible asset of the acquiree in the consolidated financial statements if it meets the definition of an intangible asset and its fair value is included in the exchange transaction relating to the business combination.

Answer 1(c)

Amount of goodwill as at 31 March 2010

	$
Fair value of consideration transferred	26,000,000
Amount of non-controlling interest (10% x $40,000,000)	4,000,000
Fair value of the previously held interest (25% x $40,000,000)	10,000,000
	40,000,000
Less: Fair value of SNT's recognised net identifiable assets	(32,000,000)
Goodwill	8,000,000

Answer 1(d)

Deferred tax

HKAS 12 requires the recognition of deferred tax liabilities or deferred tax assets on taxable or deductible temporary differences. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently (paragraph 19).

Paragraph 18 of HKAS 12 states that temporary differences arise when the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with HKFRS 3 Business Combinations, but no equivalent adjustment is made for tax purposes.

When the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability increases goodwill.

In Hong Kong, the Inland Revenue Department does not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. Therefore, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference.

However, HKAS 12 does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual.

In this case:
- the carrying amount of the inventory ($4,000,000) is increased to its fair value ($4,800,000) but the tax base will remain at cost,
- a taxable temporary difference ($800,000) arises,
- which results in a deferred tax liability of 16% x $800,000
- = $128,000 and this affects the amount of goodwill.

A temporary difference may also arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset is not deductible for tax purposes (paragraph 22).

In this case:
- intangibles are recognised at $3,200,000 which will not be deductible for tax purposes,
- a taxable temporary difference of $3,200,000 arises.
- Thus in accounting for the business combination, a deferred tax liability of 16% x $3,200,000
- = $512,000 should be recognised and this affects the amount of goodwill.

Thus the goodwill, after considering the deferred tax implication of the fair value differences will be:

	$
Original goodwill amount	8,000,000
+ deferred tax liability for inventory	128,000
+ deferred tax liability for intangibles	512,000
	8,640,000

*(Or *:*

- *In this case, the carrying amount of net identifiable assets ($28,000,000) is increased to its fair value ($32,000,000) but the tax base will remain at cost,*
- *a taxable temporary difference of $4,000,000 arises,*
- *which results in a deferred tax liability of 16% x $4,000,000*
- *= $640,000 and this affects the amount of goodwill.*

	$
Original goodwill amount	*8,000,000*
+ deferred tax liability for inventory and intangibles	*640,000*
	8,640,000

*or ***

	$
Total fair value	*40,000,000*
- Fair value of SNT's recognised net identifiable assets, after tax ($32,000,000 – $128,000 – $512,000)	*31,360,000*
	8,640,000)

Answer 1(e)

Customer loyalty programme

According to the HK(IFRIC)-Int 13, SNT should apply paragraph 13 of HKAS 18 and account for points of the loyalty programme as a separately identifiable component of the sales transactions in which they are granted (the "initial sales").

The fair value of the consideration received or receivable in respect of the initial sales shall be allocated between the award credits (the loyalty points) and the other component of the sale.

Since SNT supplies the awards itself, SNT shall recognise the consideration allocated to loyalty points as revenue only when loyalty points are redeemed and it fulfils its obligations to supply awards. In other words, a portion of the consideration shall be allocated to loyalty points and recognition of revenue thereof shall be deferred.

In this case, since SNT's management has estimated that the fair value of each loyalty point is $1, SNT shall recognise $200,000 ($1 x 200,000) as revenue only when the loyalty points are redeemed and thus the recognition of revenue of this portion of consideration amounting to $200,000 has been deferred to a period after 1 April 2008.

The amount of revenue recognised shall be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

Year ended 31 March 2009

As at 31 March 2009, 81,000 of the points have been redeemed in exchange for foodstuffs. Thus the amount of revenue to be recognised for the year ended 31 March 2009.
= (number of points redeemed / total number of points expected to be redeemed) × $200,000
= (81,000 points / 180,000 points) × $200,000
= $90,000

Year ended 31 March 2010

In the year ended 31 March 2010, the management of SNT revised its expectations. It expected 190,000 points to be redeemed altogether. This revised estimate of the total number of points expected to be redeemed shall be used.

During this year, 90,000 points are redeemed, bringing the total number redeemed to 81,000 + 90,000 = 171,000 points.

The cumulative revenue to date = (cumulative number of points redeemed / revised estimate of total number of points expected to be redeemed) × $200,000.

Thus, the cumulative revenue that SNT recognises is (171,000 points / 190,000 points) × $200,000 = $180,000.

SNT has recognised revenue of $90,000 in the year ended 31 March 2009, so the amount of revenue to be recognised in the year ended 31 March 2010
= cumulative revenue to date – cumulative revenue recognised to date
= $180,000 – $90,000
= $90,000

I hope the above explanation has answered your questions. Please feel free to contact me if you have further queries.

Best regards,
Ricky Cheung

* * * END OF SECTION A * * *

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

Answer 2(a)

In accordance with the Code of Ethics for Professional Accountants of HKICPA (the "Codes"):

Mr. V Chow, as the independent non-executive director of the listed company, should consider the need to maintain confidentiality of information within the listed company.

Mr. V Chow should not disclose the confidential information contained in the draft audited financial statements of the listed company to Mr. K Chow without proper and specific authority.

Both Mr. K Chow and Mr. V Chow should not use confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

Both Mr. K Chow and Mr. V Chow should comply with relevant laws and regulations and should avoid any action that discredits the profession.

The trading of shares by Mr. K Chow would constitute insider dealing under the Securities and Futures Ordinance.

Insider dealing in relation to the listed securities of a corporation takes place when, inter alia, a person who is "connected with the corporation" and who is knowingly in possession of "relevant information" deals in listed securities of the corporation or counsels or procures another person to do so knowing or having reasonable cause to believe that such person would deal in them. Relevant information is specific information about a corporation which is not generally known to persons accustomed or likely to deal in the listed securities of that corporation but which would materially affect the price of the securities if it were.

Answer 2(b)

Goodwill can still be recognised in the financial statements prepared under merger accounting for a business combination under common control.

The concept underlying the use of merger accounting to account for a common control combination is that no acquisition has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination.

The net assets of the combining entities or businesses are consolidated using the existing book value from the controlling parties' perspective.

The assets and liabilities of the acquired entity or business should be recorded at the book values as stated in the financial statements of the controlling party.

That is, it will require recording of:

- The fair value of the identifiable assets and liabilities of the acquired entity or business at the date of original acquisition from third parties by the controlling party.

- Any remaining goodwill arising on the previous acquisition and non-controlling interest recorded in the consolidated financial statements of the controlling party.

There is no recognition of any additional goodwill or excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of common control combination to the extent of the continuation of the controlling party or parties' interest.

Answer 3(a)

Year ended 30 June 2008:

Profit attributable to ordinary shares holders =
HK$32,800,000 – (3,000,000 x HK$0.3) = HK$31,900,000

Weighted average number of ordinary shares outstanding for the year = 220,000,000

Basic earnings per share = HK$31,900,000 / 220,000,000 = 14.5 HK cents

Year ended 30 June 2009:

Profit attributable to ordinary shares holders =
HK$8,000,000 – (3,000,000 x HK$0.15 + 2,000,000 x HK$0.15) = HK$7,250,000
*(Or**
Profit attributable to ordinary shares holders =
HK$8,000,000 – (1,000,000 x HK$0.15 + 2,000,000 x HK$0.3) = HK$7,250,000)

Weighted average number of ordinary shares outstanding for the year =
(220,000,000 x 3/12) + (220,500,000 x 3/12) + (228,500,000 x 6/12)
= 224,375,000
*(Or***
Weighted average number of ordinary shares outstanding for the year =
(220,000,000 x 12/12) + (500,000 x 9/12) + (8,000,000 x 6/12)
= 224,375,000)

Basic earnings per share = HK$7,250,000 / 224,375,000 = 3.231 HK cents

Answer 3(b)

Year ended 30 June 2009:

The potential impact of preference share conversion on earnings:
HK$750,000/ (1,000,000 x 8 x 6/12 + 2,000,000 x 8)
= HK$0.0375

No adjustment to the preference share dividend as the earnings per incremental share is higher than the basic earnings per share (3.231 HK cents) and therefore considered anti-dilutive.

Adjusted profit attributable to ordinary shares holders = HK$7,250,000

Adjusted weighted average number of ordinary shares:

No adjustment for the conversion of the preference shares

Weighted average number of shares under option = 1,000,000

Weighted average number of shares that would have been issued at average market price: (1,000,000 x HK$1.5) / HK$1.65 = 909,091

Weighted average number of shares assumed to be issued for nil consideration: (1,000,000 - 909,091) = 90,909

Weighted average number of ordinary shares used to calculate diluted earnings per share: 224,375,000 + 90,909 = 224,465,909

Diluted earnings per share = HK$7,250,000 / 224,465,909 = 3.230 HK cents

Answer 4(a)

HDL must determine whether the modification is considered to be an extinguishment of the original bank loan in accordance with HKAS 39.

HKAS 39.40 requires an exchange between an existing borrower and lender of debt instruments with substantially different terms to be accounted for as extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

AG62 of HKAS 39 states that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

The modified cash flow of the bank loan is as follows:

Year ended	Payments HK$ million
30 June 2010	12.00
30 June 2011	12.00
30 June 2012	12.00
30 June 2013	212.00

Present value at 30 June 2009 discounting at original effective interest rate of 8% is HK$186.75 million.

As the difference between the amortised cost of the bank loan at the date of modification, 30 June 2009 (HK$200 million) and the present value of the new bank loan, discounted by the original effective interest rate (HK$186.75 million), is less than 10 per cent ([HK$200 million – HK$186.75 million]/ HK$200 million x 100% = 6.625%), the modification is not considered as extinguishment of the original bank loan.

No gain or loss is recognised for the modification and the carrying amount of the bank load is still HK$200 million.

The bank loan was originally repayable on 30 June 2010 and classified as current liability. The modification of the maturity date of the bank loan results in such liability to be settled twelve months after the reporting period. Accordingly, it is classified as non-current liability in the statement of financial position as at 30 June 2010.

Answer 4(b)

In accordance with AG35 of HKAS 32, an entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specific date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

Journal entries that HDL should make on 30 June 2009:

		HK$	HK$
Dr	Expense	18,500,000	
Cr	Convertible bonds equity reserve		18,500,000

To record the amendment of the terms of conversion (100 x (2,500,000 – 2,000,000) x HK$0.45) – HK$4,000,000.

Dr	Convertible bonds	96,296,296	
Dr	Interest payable	4,000,000	
Dr	Convertible bonds equity reserve	25,633,058	
Cr	Share capital		25,000,000
Cr	Share premium		100,929,354

To record the conversion of the bonds under the amended terms of conversion and waive interest payable.

Answer 5

HKAS 36.18 defines the recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use.

<u>Rocket Running Limited ("RR") as a disposal group with an estimated fair value less costs to sell of HK$85,000,000</u>:

HKFRS 5.23 requires an impairment loss recognised for a disposal group to reduce the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of the HKFRS, in order of allocation set out in HKAS 36.104 and 122.

The allocation of the impairment loss is as follows:

	Carrying amount reported immediately before classification as held for sale	Allocation impairment loss	Carrying amount after allocation of impairment loss
	HK$'000	HK$'000	HK$'000
Goodwill	2,400	(2,400)	--
Intangible assets	12,500	(1,007)	11,493
Property, plant and equipment	48,300	(3,893)	44,407
Inventories	16,600		16,600
Trade receivables	4,500		4,500
Held for trading equity investments	8,000		8,000
TOTAL	92,300	(7,300)	85,000

An impairment loss of HK$7,300,000 (HK$92,300,000 less HK$85,000,000) should be recognised when the group is initially classified as held for sale.

The impairment loss reduces the amount of goodwill first. The residual loss is allocated to other non-current assets to which the measurement requirements of HKFRS 5 are applicable pro rata based on the carrying amounts of these assets (i.e. intangible assets and property, plant and equipment).

<u>Closure of the retailing operation of Soft Walking Limited ("SW") and abandonment of non-current assets</u>:

Super Shoes Limited should not classify the non-current assets of SW as held for sale that is to be abandoned as its carrying amount would be recovered principally through continuing use.

There is an indication that the assets of SW may be impaired and the recoverable amount should be estimated in accordance with HKAS 36.18 to 23.

Irrespective of whether there is any indication of impairment, goodwill should be tested for impairment annually in accordance with HKAS 36.80 to 99.

The recognition of impairment loss is as follows:

	Carrying amount reported immediately before impairment	Impairment loss recognised	Carrying amount after allocation of impairment loss
	HK$'000	HK$'000	HK$'000
Goodwill	2,700	(2,700)	--
Property, plant and equipment	18,800	(18,800)	--
Inventories	6,400	(2,560)	3,840
Trade receivables	1,300		1,300
TOTAL	29,200	(24,060)	5,140

Goodwill and property, plant and equipment are considered fully impaired as both the fair value less costs to sell and value in use are nil.

Inventories are stated at net realisable value of 60% of the cost in accordance with HKAS 2.9.

* * * END OF EXAMINATION PAPER * * *