SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

To : Directors
From : Fatima Lam, Accounting Manager
Date : dd/mm/yyyy
Subject : Appropriate accounting treatment for the donation to Kowloon University

I refer to your query regarding the accounting treatment for the donation to Kowloon University ("KU").

Donation to Kowloon University

According to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision shall be recognised when: (a) an entity has a present obligation (legal or constructive) as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation.

The following principles are relevant in determining the timing that the donation to KU should be recognised as an obligation:

- to the extent that there is an enforceable agreement, PL should recognise an expense and a liability upon entry into that agreement;
- where the agreement is not enforceable, PL should recognise an expense and a liability when a constructive obligation arises; and
- if PL expects to receive benefits commensurate with the value of the donation, the arrangement should be treated as an exchange transaction. Such transactions may be executory contracts and may also give rise to the recognition of an asset rather than an expense.

Applying these principles to the alternatives:

Alternative 1

In alternative 1, the agreement is unenforceable. Since there is no legal obligation to make the payments, a liability is recognised when a constructive obligation arises.

It is a matter of judgement whether and when a constructive obligation exists. In many unenforceable agreements, a signed private unenforceable agreement would not, in itself, be sufficient to create a constructive obligation.

In this case, there is no announcement or conditions preceding payment and there is no exchange of benefits. In the absence of other facts and circumstances that would create a constructive obligation, an expense would be recognised only when PL transfers cash to KU.

Alternative 2

In alternative 2, it may be appropriate for PL to conclude that PL's announcement of the donation to be paid by instalments indicates that there is a constructive obligation because PL has created a valid expectation that it will make all of the payments promised.

Alternatively, it could determine that once the first instalment is paid, PL has created a valid expectation that it will make the remaining payments. This is a matter of judgement. In this case, PL would recognise an expense and a liability, measured at the net present value of the 5 instalments of HK$1 million, at the point when it is determined that a constructive obligation exists.

Alternative 3

In alternative 3, an enforceable agreement is involved which gives rise to a liability when the agreement is signed.

Since the donation is made under an enforceable agreement, a present obligation is created when PL enters into that agreement. When payment is required in cash, the signing of an enforceable agreement gives rise to a financial liability (HKAS 32.11) which is measured initially at fair value (HKFRS 9.5.1.1).

However, there is an exchange of benefits relating to the research and development activities performed by KU on behalf of PL.

An exchange transaction is a reciprocal transfer in which PL and KU receive and sacrifice approximately equal value. Assets and liabilities are not recognised until PL and KU perform their obligations under the arrangement.

For an exchange transaction, PL could regard the signing of the agreement as executory and could apply the criteria in HKAS 38 to determine whether an asset or expense would be recognised for the related research and development costs as incurred.

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

Best Regards,
Fatima Lam

Answer 2

Share options granted to Mr Lee

For the share options granted to Mr Lee, the condition that the Hang Seng Index will reach 29,000 at the end of three years is considered to be a non-vesting condition.

In the absence of evidence to the contrary, an award of share options that vests immediately is presumed to relate to services that have already been rendered, and is therefore expensed in full at grant date (HKFRS 2.14).

As this condition is the only condition to which the award is subject to, the award has no vesting conditions and therefore it vests immediately.

The fair value of the share option at the grant date (i.e. 1 January 2014), including the effect of the condition, is determined to be HK$1.5 million. Therefore, PL should immediately recognise a cost of HK$1.5 million on 1 January 2014 in profit or loss with accompanying credit to equity (e.g. stock option reserve).

The cost cannot be reversed in subsequent years, i.e. in 2015 and 2016, even though the Hang Seng Index cannot reach 29,000 as at 31 December 2016 and thus Mr Lee loses the award.

Since the Hang Seng Index cannot reach 29,000 as at 31 December 2016, the balance of the stock option reserve (HK$1.5 million) could be transferred to retained earnings.

<u>Share options granted to Ms Cheng</u>

Since the share options granted do not vest until Ms Cheng completes a specified period of service, PL should presume that the services to be rendered by Ms Cheng as consideration for those share options to be received during the vesting period (HKFRS 2.15). Therefore, PL should account for those services to be rendered by Ms Cheng during the vesting period with a corresponding increase in equity.

For the year ended 31 December 2014 and 31 December 2015, PL's earnings increased by 10% and 9% respectively and PL expected that the earnings target would be achieved. Thus the fair value of the share options with the exercise price of HK$45, i.e. HK$24 per option would be expected.

As at 31 December 2016, the earnings target was not achieved. Therefore, the 100,000 vested share options would have an exercise price of HK$60, with a fair value of HK$18 per option.

Year ended 31 December	Calculation of cumulative expense	Cumulative expense HK$	Expense for the period HK$
2014	100,000 options x HK$24 x 1/3	800,000	800,000
2015	100,000 options x HK$24 x 2/3	1,600,000	800,000
2016	100,000 options x HK$18	1,800,000	200,000
		Total cumulative	*1,800,000*

Answer 3

Product and service revenue

Under HKFRS 15 *Revenue from Contracts with Customers*, part of the sales made which include revenue for on-going servicing work should be deferred.

Any discount offered to stand-alone selling prices should be allocated to each component pro-rata based on the stand-alone selling prices.

The normal stand-alone selling price of the product and the servicing work would be HK$31.5 million (i.e. HK$27 million for the product and HK$4.5 million (HK$750,000 x 6 years) for the servicing work).

The actual combined selling price of HK$28.35 million represents a 10% discount on the stand-alone selling prices (28.35 / 31.5 = 90%).

Thus the sales revenue of HK$28.35 million would be allocated as HK$24.3 million (HK$27 million x 90%) for the product and HK$4.05 million (HK$4.5 million x 90%) for the servicing.

For the year ended 31 December 2016, total revenue recognised for this transaction is HK$24.975 million, consisting of HK$24.3 million for the product and HK$675,000 (HK$4.05 million / 6 years) for the servicing work.

At 31 December 2016, there are five more years of servicing work yet to complete, thus HK$3.375 million (HK$4.05 million x 5 years / 6 years) should be treated as deferred revenue, of which HK$675,000 as a current liability and HK$2.7 million as a non-current liability.

Answer 4

Worksheet for the consolidated statement of Financial Position of PL as at 31 December 2016:

	PL	SL				Consolidated
	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
Non-current assets	1,652,500	807,600	60,000	1,3	16,000	2,498,475
			3,375	5,4	9,000	
Investment in subsidiary	720,000	-		1	720,000	--
Investment in associate	180,000	-	54	E2,E1	540	**193,014**
			13,500	E3		
Goodwill			75,000	1		75,000
Inventories	338,000	180,000		6	120	517,880
Accounts Receivables	186,000	120,000				306,000
Cash	3,500	2,400				5,900
	3,080,000	*1,110,000*				*3,596,269*
Share capital	993,000	150,000	150,000	1		993,000
Retained earnings	441,000	390,000	360,000	1		456,118
			6,000	2		
			12,800	3		
			7,200	4,5	2,700	
			96	6		
			540	E1, E2	54	
				E3	9,000	
Other comprehensive income	600,000	240,000	240,000	1		604,500
				E3	4,500	
Non-controlling interests				1	165,000	**166,651**
				2	6,000	
			3,200	3		
			1,800	4,5	675	
			24	6		
Non-current liabilities	779,000	300,000				1,079,000
Current liabilities	267,000	30,000				297,000
	3,080,000	1,110,000				3,596,269

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Answer 4

Consolidation journal entries (All figures in HK$'000)

J1 Elimination of investment in SL

Dr	Share capital	150,000	
Dr	Retained earnings	360,000	
Dr	Other comprehensive income	240,000	
Dr	Non-current assets	60,000	
Dr	Goodwill	75,000	
	Cr Investment in SL		720,000
	Cr Non-controlling interests		165,000

J2 NCI share of post-acquisition retained earnings of SL up to 31 December 2016

Dr	Retained earnings [20% x (HK$390m – HK$360m)]	6,000	
	Cr Non-controlling interests		6,000

J3 Additional depreciation for fair value adj in SL

Dr	Retained earnings (HK$60m x 4 / 15) x 80%	12,800	
Dr	Non-controlling interests (20%)	3,200	
	Cr Non-current assets (Accumulated depreciation)		16,000

J4 Eliminate gain on machine sold by SL to PL

Dr	Retained earnings (HK$9m x 80%)	7,200	
Dr	Non-controlling interests (HK$9m x 20%)	1,800	
	Cr Non-current assets (HK$38m – HK$29m)		9,000

J5 Depreciation adjustment for the machine sold by SL to PL

Dr	Non-current assets (HK$9m x 3 / 8)	3,375	
	Cr Retained earnings (80%)		2,700
	Cr Non-controlling interests (20%)		675

J6 Elimination of intercompany sale of inventory

Dr	Retained earnings (HK$120k x 80%)	96	
Dr	Non-controlling interests (HK$120k x 20%)	24	
	Cr Inventory		120

E1 Elimination of intercompany unrealised gain

Dr	Retained earnings (HK$5.8m – HK$4m) x 30% associate	540	
	Cr Investment in AL		540

E2 Depreciation adjustment for intercompany unrealised gain

Dr	Investment in AL (HK$540k / 10 years)	54	
	Cr Retained earnings		54

E3 Share of post-acquisition retained earnings and comprehensive income of AL up to 31 December 2016

Dr	Investment in AL		13,500	
	Cr	Retained earnings [30% x (HK$180m – HK$150m)]		9,000
	Cr	Other comprehensive income [30% x (HK$150m – HK$135m)]		4,500

Reconciliation of investment in associate

		HK$'000
Book Value of net assets of AL (HK$198m + HK$180m + HK$150m) = HK$528m x 30%	=	158,400
Unrealised profit (HK$5.8m – HK$4m) x 9 / 10 = HK$1.62m x 30%		(486)
Implicit goodwill for investment in AL		*35,100*
		193,014

Calculation of goodwill for the acquisition of AL		HK$'000
Fair value of net assets of AL at acquisition	=	483,000
x 30%		144,900
Consideration transferred	=	180,000
Implicit goodwill for investment in AL		*35,100*

Answer 5

Reconciliation of NCI:

		HK$'000
Book Value of net assets of SL HK$780m x 20% NCI	=	156,000
Unrealised profit on machine (HK$9m x 5 / 8) = HK$5.625m x 20% NCI	=	(1,125)
Unrealised profit on inventory (HK$120k x 20% NCI)	=	(24)
Fair Value adj (HK$60m x 11 / 15) = HK$44m x 20% NCI	=	8,800
Goodwill for NCI [HK$165m – 20% x (HK$750m + HK$60m)]		3,000
		166,651

* * * END OF SECTION A * * *

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

Answer 6(a)

HKAS 38 *Intangible Assets* requires all internal expenditure that may result in an intangible asset be distinguished between two phases – the research phase and the development phase.

Costs incurred during the research phase are required to be expensed as it is uncertain that future economic benefit will flow to the company.

Costs incurred in the development phase should be recognised as intangible assets if and only if an entity can demonstrate that the six conditions for recognition are met: (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale; (b) its intention to complete the intangible asset and use or sell it; (c) its ability to use or sell the intangible asset; (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset; (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and (f) the ability to measure reliably the expenditure attributable to the intangible asset during its development.

The salary and travelling costs of HK$650,000 incurred by the selected R&D team members are costs incurred to search for new technology and possible suppliers of alternate materials, which should be treated as research costs. These costs should be expensed as incurred.

The hiring of the technical expert to design and test the prototype before full scale production demonstrates that HPL had the technical feasibility and intention to complete the intangible assets so that it would be available for sale.

The salary costs paid to the technical expert are considered to be incurred in the development phase because the technical expert was employed after / as soon as the board members were convinced that the products would have good markets and be profitable, i.e. ability to use or sell the intangible assets and probable future economic benefit.

Salary costs of HK$900,000 paid to the technical expert should be recognised as a development cost initially at cost.

An intangible asset should be recognised for website development costs if and only if it meets the general recognition requirements of HKAS 38 and the six conditions for recognition as development costs.

HPL is unable to demonstrate how the website will generate probable future economic benefits as it was developed solely or primarily for promoting and advertising its own products and services. Total costs of HK$170,000 spent on the developing and launching of the website should be expensed as incurred.

The operating system of HK$41,000 should be regarded as an integral part of the machine as the machine could not operate the testing function without this operating system and the cost should be recognised as part of the cost of the machine under HKAS 16 *Property, Plant and Equipment*.

The amount paid for the patent registration of HK$200,000 for an internally generated intangible asset should be recognised initially at cost.

The intangible asset should be amortised over the shorter of the period of the legal rights and period over which economic benefits are to be generated.

As the patent can be renewed with a minimal cost or without a significant cost, its useful life is determined by the legal right of 4 years.

However, as the intangible asset is expected to bring a competitive edge for HPL for the next 3 years from commercial production, the total of the salary for the R&D expert and the patent registration fee recognised as an intangible asset should be amortised over 3 years from commercial production.

For each subsequent period after recognition, the intangible asset should be reviewed for impairment indicators.

Should any impairment indicator be identified, a detailed impairment assessment on the related intangible assets should be carried out.

Answer 6(b)

Faye Ho has to comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour of the Code of Ethics ("COE") for Professional Accountants.

Faye Ho is holding a senior position as a financial controller of HPL. According to s.340.3 of the COE, a professional accountant in business shall not manipulate information for personal gain or for the financial gain of others.

The more senior the position that the professional accountant in business holds, the greater the ability and opportunity to influence financial reporting and decision-making and the greater the pressure there might be from superior and peers to manipulate information. In such situations, Faye Ho shall be particularly alert to the principle of integrity, which imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships.

Faye Ho 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.

Faye Ho should be alert to the principle of objectivity as she is fully aware that the incentive compensation scheme of HPL is linked to the financial performance of HPL.

Answer 7(a)

HKAS 36 *Impairment of Assets* is to ensure an entity's assets are carried at no more than their recoverable amount.

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs, unless either:

(a) the asset's fair value less costs of disposal is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be measured.

A cash generating unit ("CGU") is the smallest group of assets that generates largely independent cash inflows. This may be a single asset or group of assets.

Based on the information provided, each store generates its own cash flows that are largely independent of other stores by having a different customer base. Each individual store also produced daily sales information and monthly statements of profit or loss. Therefore although managed at the central level, individual stores generate cash inflows that are largely independent of other stores. Thus it is likely that each store represents a CGU.

Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units. Corporate assets do not generate cash inflows independently of other assets or groups of assets, and their carrying amount cannot be fully attributed to the CGU under review.

The corporate asset should be tested as part of a CGU because it does not generate independent cash flows, and so its stand-alone value in use cannot be estimated.

A fair value might be established for corporate assets, such as a brand or corporate headquarters. If the fair value less costs of disposal is higher than the carrying amount, the corporate asset is not impaired and a test at the CGU level will not be necessary.

NHL should perform assessment at the lowest level of its CGU, i.e. the store level.

Answer 7(b)

Despite the fact that the recoverable amount of NHL is higher than the carrying value of the NHL as a whole, NHL has to assess impairment at the lowest level CGU, i.e. the store level. The headquarters' building should be allocated to the stores.

Calculation of a weighted allocation of the carrying amount of the headquarters' building

	Carrying amount of relevant assets HK$'000	Estimated remaining useful life of the assets (years)	Carrying amount after weighting HK$'000	Allocation of carrying value of headquarters' building HK$'000
Store A	4,300	6	25,800	303
Store B	5,400	9	48,600	570
Store C	6,000	10	60,000	704
Store D	3,800	5	19,000	223
Total	19,500	30	153,400	1,800

Impairment testing of the CGU

	Carrying amount of relevant assets HK$'000	Carrying amount of allocated headquarters' building HK$'000	Carrying amount after allocation HK$'000	Recoverable amount HK$'000	Impairment loss HK$'000
Store A	4,300	303	4,603	3,100	1,503
Store B	5,400	570	5,970	6,200	0
Store C	6,000	704	6,704	7,000	0
Store D	3,800	223	4,023	3,500	523
Total	19,500	1,800	21,300		2,026

Allocation of impairment losses to the headquarters' building and to CGU

	Impairment loss HK$'000	To headquarters' building HK$'000	To assets in CGU HK$'000
Store A	1,503	99	1,404
Store D	523	29	494
Total	2,026	128	1,898

Impairment testing the smallest group of CGU to which the carrying amount of the research centre can b e allocated (i.e. NHL as a whole)

	Carrying Amount HK$'000	Impairment loss at NHL as a whole HK$'000	Carrying amount after impairment HK$'000	Recoverable amount HK$'000
Store A	4,300	1,404	2,896	
Store B	5,400	-	5,400	
Store C	6,000	-	6,000	
Store D	3,800	494	3,306	
Headquarters	1,800	128	1,672	
Research centre	1,000	-	1,000	
Total	22,300	2,026	20,274	21,000

Impairment loss to be recognised by NHL for the year ended 31 December 2016:

Dr. Impairment loss (Profit & Loss)	HK$2,026,000	
Cr. Assets in the store A		HK$1,404,000
Cr. Assets in the store D		HK$494,000
Cr. Headquarters' building		HK$128,000

As the recoverable amount of NHL as a whole is higher than its carrying value after impairment, no further impairment loss is required.

Answer 8(a)

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt.

The guarantee which PGL has given to the bank is a financial guarantee contract. It should be accounted for as a financial liability under HKFRS 9 and should initially be recognised at fair value. Therefore, PGL should debit equity on the basis that the shareholders agreed PGL entered into the financial guarantee contract and credit financial liability of HK$120,000 on 1 January 2016.

After initial recognition, an issuer of the financial guarantee contract shall subsequently measure it at the higher of:

(i) the amount of the loss allowance determined in accordance with the expected credit loss model in accordance with HKFRS 9; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation of income recognised in accordance with HKFRS 15.

According to HKFRS 9 B5.5.32, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed for a financial guarantee contract. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

As PGL had committed to pay the principal amount of the loan if GCL defaults on any payment of the bank loan, the loss allowance was determined to be HK$4,200,000, which was higher than HK$120,000 initially recognised.

PGL should debit equity and credit financial liability of HK$4,080,000 on 31 December 2016 to provide for the calling of the guarantee.

Answer 8(b)

HKAS 24 (Revised) defines a related party as a person or entity that is related to the entity that is preparing its financial statements. [HKAS24.9]

A person or a close member of that person's family is related to a reporting entity if that person: [HKAS 24.9]

(i) has control or joint control over the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity.

Adrian Poon is a related party of PGL, as he owns more than half of the voting power of PGL (70%). In the absence of evidence to the contrary, he controls PGL and is a member of the key management personnel. [HKAS 24.9(a)(i)]

Mimi Poon is also a related party of PGL as she is a close member (spouse) of Adrian Poon. [HKAS 24.9]

Bosco Lee is also a related party of PGL as he owns more than 20% of the voting power in PGL (30%) and has significant influence over PGL despite the fact the he has not been involved in the operational activities of PGL. [HKAS 24.9(a)(ii)]

An entity is related to a reporting entity if the entity is jointly controlled by a person identified as a related party. Therefore, GCL is a related party of PGL. GCL is jointly controlled by related parties, Adrian Poon and Mimi Poon. [HKAS 24.9(a)(i)]

In addition to the recognition of the fair value of the guarantee, PGL should disclose the guarantee given by PGL to the bank in respect of GCL's bank loan in the notes to the financial statements for the year ended 31 December 2016. [HKAS 24.18(b)(ii)]

* * * END OF EXAMINATION PAPER * * *